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A squeezed middle?

Tracking the state of the sector's finances

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Creatures great and small: An end to the Big Four monopoly?

As the government seeks to streamline the large banks and encourage the development of smaller challenger banks, Diane Sim *surveys the options open to charities.*

IT'S BEEN almost 10 years since the banking crisis but restructuring moves continue apace as the government tries to strengthen the sector and prevent a recurrence of the failures of 2008/9.

The six largest UK banks by deposits – namely Barclays, Co-operative Bank, HSBC, Lloyds Banking Group, RBS Group and Santander UK – are currently working towards compliance with new ringfencing requirements introduced by the Financial Services (Banking Reform) Act of 2013. From 1 January 2019, banks with at least £25bn of deposits must separate core retail banking services from investment banking. The move is intended to aid financial stability by insulating the former from the riskier activities of the latter and by making large banking groups easier to resolve in case of failure.

As well as streamlining the larger players, the government is also trying to develop the smaller ones – the so-called challenger banks – in order to increase competition and choice. Measures introduced in 2013 for simplifying the process for acquiring a banking license and lowering the capital requirements for new banks continue to bear fruit.

As a result there has been a steady stream of new entrants. They include: Virgin Money and OneSavings Bank, which floated in 2014; Aldermore Bank and Shawbrook Bank, which floated in 2015; Clydesdale Bank and Yorkshire Bank, which were demerged from National Australia Bank and listed on the London and Australian stockmarkets as holding company CYBG in 2016; and Metro Bank, which made its stock market debut the same year.

Other new entrants include privately-financed digital banks Atom, Monzo, Starling and Tandem, which were awarded banking licenses in 2015/16.

Tandem lost its banking license in early 2017 following its failure to secure funding from a Chinese conglomerate. However, it obtained another license earlier this year with its acquisition of Harrods Bank, which also brought it 10,000 new customers and a new capital injection of £80m.

And just last month CYBG made a takeover approach for Virgin Money, valuing the lender at £1.6bn. A combination of CYBG and Virgin Money would create the UK's largest challenger bank with six million personal and business customers and a balance sheet of over £60bn. The proposal is currently being considered and does not at present constitute a formal offer.

Acquisitions and partnering strategies – such as Starling's link up with digital wealth manager Moneybox, and peer-to-peer lender Zopa's distribution

FIGURE 1: BANKS USED AS PRIMARY PROVIDER BY CHARITIES[1]

	Charity income				
Number of clients	< £1m	£1m - 5m	£5m - 20m	> £20m	**Total**
Barclays	5	8	4	96	113
NatWest[2]	3	9	3	71	86
Lloyds Bank[3]	5	9	5	61	80
HSBC	5	4	4	39	52
Co-operative Bank	26	11	3	7	47
RBS[2]	3	5	0	38	46
CAF Bank	17	8	0	0	25
Coutts[2]	1	1	1	14	17
Unity Trust Bank	10	5	2	0	17
Bank of Scotland[3]	3	2	1	5	11
Allied Irish Bank[4]	0	0	0	8	8
Clydesdale Bank/ Yorkshire Bank[5]	2	1	0	3	6
Santander	1	1	2	1	5
Triodos	4	1	0	0	5
C. Hoare & Co.	1	0	0	2	3
Handelsbanken	0	0	0	2	2
Metro Bank	2	0	0	0	2
Other	1	1	1	2	5
Total	**89**	**66**	**26**	**349**	**530**

(1) Based on data provided by 350 members of the Charity 100 and Charity 250 Indexes, plus 195 survey respondents (minus the overlap)
(2) Part of RBS Group
(3) Part of Lloyds Banking Group
(4) Part of AIB Group
(5) Both parts of holding company CYBG, spun off from National Australia Bank in February 2016

agreement with Saffron Building Society – look set to boost progress in an already fast-growing segment of the UK banking sector.

Divestments on the part of Lloyds Banking Group and RBS Group, mandated by the European Commission in order to meet requirements for entitlement to state aid, have also served to slim down the larger banks and beef up the smaller ones.

Lloyds Banking Group fulfilled its obligations by demerging Lloyds TSB in 2013 and selling is stake in TSB Bank in two 50 per cent tranches in 2014 and 2015.

RBS Group's abortive plan to divest over 300 branches under the Williams and Glyn brand by the end of 2017 was superseded by "an alternative remedies package" agreed last year by HM Treasury and the European Commissioner responsible for competition policy. Under the new scheme, RBS will be spending £835m to pay business customers to switch their accounts to competitors and to fund rivals' growth ambitions. The deal includes a £350m "Incentivised Switching Scheme", aimed at encouraging SME customers to transfer their business to competitors, and a £425m "Capability and Innovation Fund", which will award grants to challenger banks and other financial services providers to increase their business banking capabilities.

Another recent restructuring involving the larger UK banks is last year's recapitalisation of the Co-operative Bank, which has finally cut the bank's historic ties with its former owner, the Co-operative Group. The Co-operative Group's stake in the bank had been cut to 20 per cent in 2013, when the bank had to be bailed out by private investors – mainly hedge funds – following the discovery of a £1.5bn capital shortfall. Last September five hedge funds, including four of the original 2013 investors, completed a £700m rescue deal. This reduced the Co-operative Group's stake to just 1 per cent, which it has since sold.

HIGH STREET BANKS VS CHALLENGER BANKS

Structural changes to the supply of banking services, which have been a recurrent feature of the last 10 years, do, however, take time to impact on customer behaviour.

As figure 1 shows, primary banking relationships with charities are dominated by the main four High Street banking groups, with the only real challenges coming from the Co-operative Bank and the specialist banks focused on the not-for-profit sector.

Another common use is for deposits, as charities seek to maximise their cover from deposit protection insurance for balances up to £85,000. According to The Charity Best Buy Table, recently launched by Savings Champion and Back of the Sofa, challenger banks tend to offer better interest rates than the high street banks on deposit accounts. It is reasonable,

> "Primary banking relationships with charities are dominated by the main four High Street banking groups"

That said, challenger banks have a reasonably strong showing in the list of banks that charities use in addition to their main banking provider (see figure 2). Additional banks may be used for a wide variety of functions such as loans, card payments foreign exchange transactions or trading subsidiaries.

therefore, to expect secondary banking relationships between charities and challenger banks to increase.

RESPONSE LEVELS

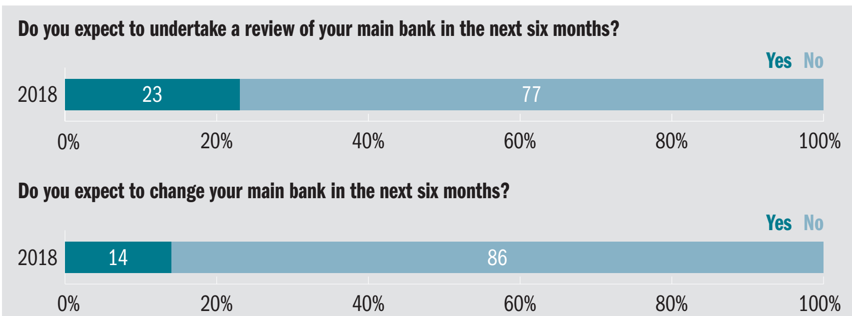
Almost 200 charities participated in *Charity Finance's* annual banking survey. Small charities with annual income of under £1m are well

FIGURE 2: SECONDARY BANKS USED BY CHARITIES

Co-operative Bank	10%	RBS	3%
Lloyds Bank	9%	Scottish Widows Bank	3%
Santander	7%	Cambridge & Counties Bank	2%
Virgin Money	6%	CCLA	2%
NatWest	5%	Triodos	2%
HSBC	5%	United Trust Bank	2%
Nationwide Building Society	5%	Charity Bank	2%
Unity Trust Bank	5%	Aldermore	1%
Barclays	4%	Close Brothers	1%
Shawbrook Bank	4%	Julian Hodge Bank	1%
Bank of Scotland	3%	Metro Bank	1%
CAF Bank	3%	Other	13%

FIGURE 3: CHANGING BANKS

■ One in seven charities expects to switch their main bank in the next six months ■



represented and make up 45 per cent of the survey sample. The remainder is split between charities in the £1m-£5m income bracket (34 per cent); those in the £5m-£20m income bracket (12 per cent), and large charities with income of over £20m (9 per cent).

The survey data has been supplemented with data sourced from the UK's top 350 charities, which are routinely tracked for the purposes of compiling the haysmacintyre / *Charity Finance* Indexes.

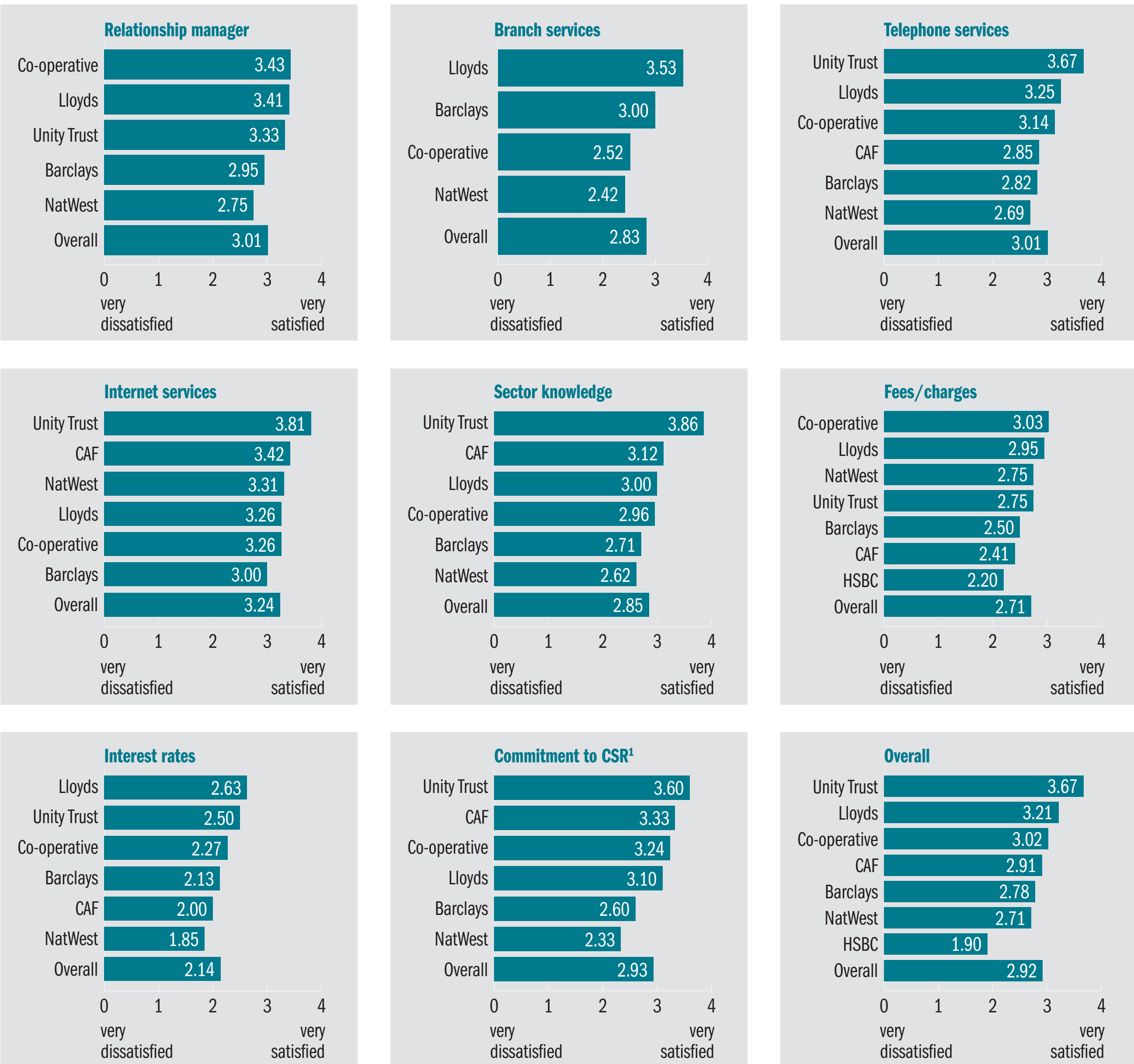
Figure 1 shows the primary bank used by charities in this sample. Whilst it does not purport to represent the charity banking market as a whole, it provides fairly comprehensive coverage of large charities with annual income of over £20m and more selective coverage of small and medium-sized charities.

The large charity segment is dominated by the big-four high street banks, namely Barclays, HSBC, Lloyds Banking Group (comprising Lloyds Bank and Bank of Scotland) and RBS Group (comprising NatWest, RBS and Coutts). Together these four act as main bank to 93 per cent of charities with annual income of over £20m.

Barclays is the main single provider to charities in this income bracket with a 28 per cent share of main banking relationships. RBS Group has a 35 per cent share split between NatWest (20 per cent), RBS (11 per cent) and Coutts (4 per cent). Lloyds Banking Group has a 19 per cent share of main banking relationships with charities in this segment, split between Lloyds Bank (18 per cent) and Bank of Scotland (1 per cent), while HSBC has an 11 per cent share.

The large high street banks have different relationship strategies for different segments of the charities sector, and ring-fencing requirements are likely to reinforce this separation.

FIGURE 4: CUSTOMER SATISFACTION RATINGS



(1) Commitment to corporate social responsibility

Note: Banks with fewer than ten charities rating their services have been excluded. Satisfaction ratings have been calculated by assigning responses with values and then calculating an average: "very satisfied" = 4, "fairly satisfied" = 3, "slightly dissatisfied" = 2, "very dissatisfied" = 1

According to David McHattie, head of charities, corporate banking at Barclays: "We have completed our structural reform programme ahead of schedule: charities with income greater than £6.5m are served by Barclays Bank plc, while charities below this threshold are served by Barclays UK."

The Co-operative Bank has just a two per cent share of main banking relationships with charities with annual income of over £20m. This has gradually fallen over the last five years from six per cent, probably reflecting uncertainties about the Co-operative Bank's financial future and the gradual transfer of ownership from the Co-operative Group to private investors.

Now that the recapitalisation has taken place and its financial future is looking more assured, the bank is keen to communicate that whilst its ownership has changed, its ethical banking credentials haven't. The bank's ethical policy, introduced in 1992 and incorporated into its constitution in 2013, means that it will turn down business from companies whose values are not aligned with its own. "Values and ethics are really important to our customers: 40 per cent of 500 new joiners in an unprompted survey cited our values and ethics as the main reason for joining us," says Ryan Etchells, head of SME at the Co-operative Bank.

Banks with a specialist focus on the not-for-profit sector enjoy a strong position in the charities market, albeit not in the large charities segment, and have done a good job of communicating the ethical nature of their business models.

CAF Bank, for example, purports to deliver both social and economic benefit

FIGURE 5: BIGGEST COMPLAINTS

Fees	18%
Withdrawal of services/facilities	12%
Low interest rates	12%
Lack of dedicated contact	8%
Call centre / back-office support	8%
Internet / online services	7%
Understanding needs of charities	5%
Poor customer service	3%
Change in relationship manager	2%
Lack of ethical policy	1%
Other	2%
No complaints	22%

FIGURE 6: IMPORTANT FACTORS WHEN CHOOSING A BANK

Good reputation in charity sector	45%
Ease of access	32%
Ethical / socially-responsible approach	31%
Internet/online banking	31%
Historic relationship	30%
Competitive fees	29%
Range of services	16%
Availability of specialist charity services	15%
Recommendation	14%
Attractive interest rates on cash deposits	10%
National representation	6%
Credit rating	3%
Sponsorship/support	3%
Other	3%

Note: Respondents could choose more than one category

FIGURE 7: ETHICAL BANKING

■ There has been a decline in the importance that charities place on ethical banking ■

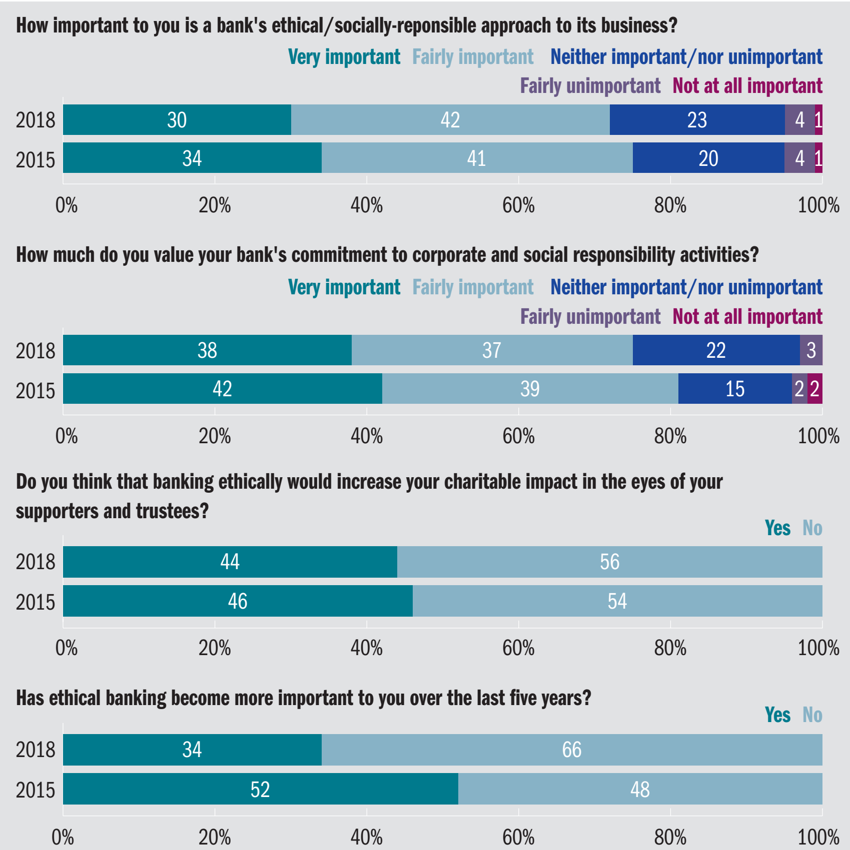
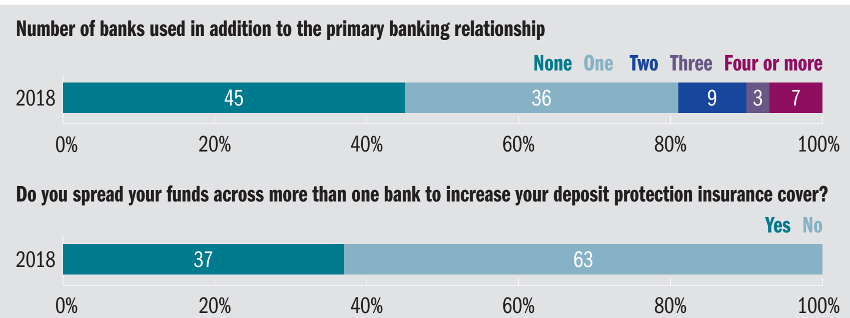


FIGURE 8: USE OF ADDITIONAL BANKS

■ Most charities use more than one bank, but not necessarily for deposits ■



to its customers by gifting any profits back to its owner, the Charities Aid Foundation (CAF). Unity Trust Bank focuses the use of customers' deposits to fund lending where there are "clear social impacts", while Triodos will only "lend to and invest in organisations that benefit people and environment".

DIGITAL BANKING

The number of UK bank branches has declined steadily over the last 30 years from over 20,000 in 1988 to less than 10,000 at the end of 2017, according to the British Bankers' Association. Diminishing numbers of bank branches is a particular concern for charities, which frequently need to deposit cash and cheques collected via their shops and fundraising activities. The development of digital banking facilities, both collectively by the sector as a whole and by individual banks, is therefore of paramount importance.

Last year's launch of image-based cheque clearing, which enables cheques to be deposited digitally, has been described by the Charity Finance Group as a "significant boon" for charities, making payments "quicker and simpler." The new system, which is designed to reduce cheque processing times from six working days to one, will be universally adopted for all cheque clearing later this year.

Also later this year, Barclaycard, the cards and payments services division of Barclays, plans to roll out the contactless donation boxes that it has been piloting with 11 national charities including Oxfam, Barnardo's and RNLI. The bank estimates that charities may be missing out on more than £80m in donations each year by only accepting cash donations.

At the end of last year, Lloyds Banking Group's payment services division Cardnet partnered with the Royal British Legion to pilot a contactless donations scheme utilising 200 mobile terminals for the 2017 Poppy Appeal. Area director for the education, charity and social enterprise sector Nathan Whitaker says: "Lloyds is investing significantly in improving the digital skills of its customers. We are on track with the recruitment of 4,000 digital champions by the end of 2017 to help over 700,000 charities and businesses acquire digital skills."

According to research undertaken by the bank, highly digital charities are ten times more likely to save costs.

FIGURE 9: BANK LOANS (% RESPONDENTS ANSWERING YES)

■ Charities' appetite for borrowing is in decline ■

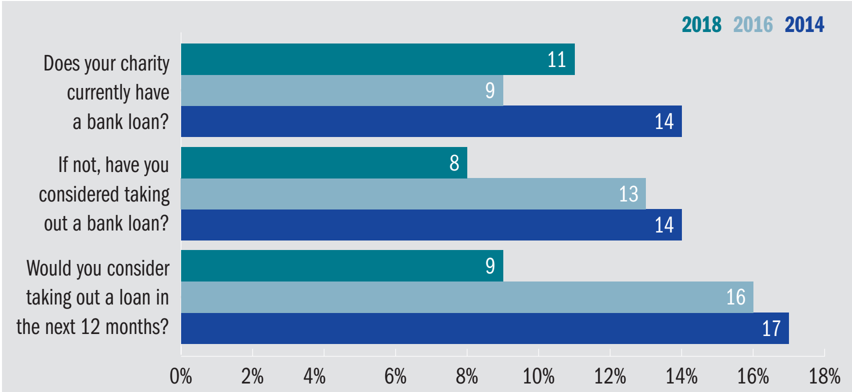
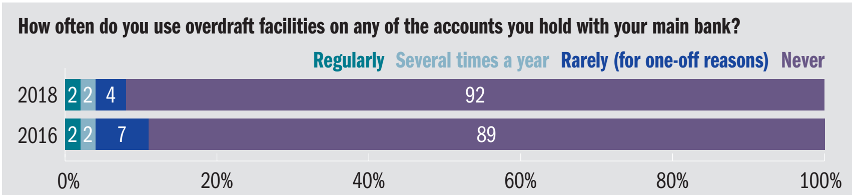


FIGURE 10: OVERDRAFT FACILITIES

■ Use of overdraft facilities is fairly minimal ■



> "Charities' appetite for borrowing seems to have subsided based on the charities surveyed this year"

"Lloyds Bank's relationship managers are now routinely equipped with a number of digital tools, including a Working Capital tool and a Cash Optimiser tool. This basic treasury functionality is particularly important for charities which often carry significant liquidity in advance of future commitments," says Whitaker.

NatWest has also recently launched a number of new digital services such as the Receipts app, which allows business customers to capture and manage receipts via mobile banking. "Charities can digitise paper receipts by taking a photo with the app, which then extracts the information and reconciles it with transactions on their business account," says Hugh Biddell, head of charities and not for profit at NatWest and Royal Bank of Scotland, both parts of RBS Group.

According to Neil Poynton, head of charity client services at CAF Bank, one of the biggest industry challenges for charities is fraud mitigation. "CAF Bank has introduced text alerting to further enhance our online banking security features and the CAF Bank Online Security Centre where we provide advice on fraud prevention and best practice."

LOAN DEMAND

Charities' appetite for borrowing seems to have subsided based on the responses of the charities surveyed this year (see figure 9). Poynton at CAF Bank says: "Loan demand remains but there does seem to be an air of uncertainty given the political and economic environment. Brexit has been a key factor. Since the turn of the year there has been a slowdown in enquiries."

However, others observe an increase in loan demand. Unity Trust

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relationship manager Sonya Powe reports "a 41 per cent increase in loan approvals to charities in 2017".

Whitaker at Lloyds also notes an increase in demand for borrowing from charities over the last year. "Whilst the vast majority of these requests are to support clients acquiring or developing physical assets, we are seeing some organisations request working capital facilities or growth finance to assist them in moving to new operating models," he says.

And Biddell at RBS comments: "Charities that are growing shop networks, changing their delivery models, updating CRM systems or installing LED lighting or other green products are increasingly looking to match more closely the cash outflow to the receipt of cost savings or income."

Social finance as an alternative option to a bank loan has had a fairly lukewarm reception from the charities surveyed this year, with many questioning its relevance and desirability (see figure 11). This is mirrored by comments made by the banks surveyed on the appetite of charities for social finance products. "Some of our charity clients are looking at social finance, but the speed and simplicity of banking loan documentation and, in some cases, pricing mean that loan finance continues to be an attractive option," says McHattie at Barclays.

Whitaker at Lloyds observes: "Our relationship managers are often asked to discuss social finance with charities, but the majority of our clients tend to find commercial borrowing arrangements from the bank more simple and cost effective for straightforward borrowing requests."

A groundbreaking initiative in this area comes from Triodos Bank, which earlier this year became the first UK bank to launch its own crowdfunding platform. This enables customers to invest directly in equity or bonds issued by established charities or businesses that have been screened by Triodos for social and environmental impact. Customers can invest as little as £500, and sometimes less, and their investments are eligible to be held in an ISA, so that they can receive the interest earnt tax free.

> "Less than 20 per cent of charities commenting on Open Banking give it a positive reception"

In its first three months, the platform has raised over £7m for five organisations. These include the Thera Trust, which aims to raise £5m to invest in new homes for people with learning disabilities, and Rendesco, which aims to raise £5.5m to develop green energy from ground source heat pumps which will provide low-carbon heating for around 100 sites including retirement homes.

The move follows last year's launch by Triodos of a personal current account, which has resulted in thousands of new customers. According to social and cultural team manager Paul Nicoll: "Our crowdfunding platform and personal account are both intended to raise the profile of impact investment with retail investors and depositors, thereby increasing the funds available to organisations that create social and environmental benefit."

OPEN BANKING

Another government initiative intended to increase competition and choice in the UK banking market is Open Banking, which came into force in January as part of the EU's second Payments Services Directive (PSD2). Under the terms of PSD2, the nine largest UK banks and building societies are legally required to allow customer account information to be shared securely online with other regulated companies, subject to the accountholder's consent.

Though not legally required to do so, other banks and building societies can elect to provide Open Banking voluntarily. For example, Unity Trust Bank is currently working towards PSD2 compliance with a target date of September 2019.

The initiative is intended to help accountholders to access other financial products and services (such as current accounts, cash management, savings and loans) which may be more suitable for their needs based on their account history. The information sharing is facilitated by Application Programming Interfaces (APIs), which enable different software applications to communicate with each other.

Banks interviewed in the course of this year's survey are uniformly positive about the benefits that Open Banking will provide charities. "Open Banking has, first and foremost, been developed with the consumer in mind," says Biddell at RBS.

"Increased competition leads to originality and creativity, with organisations incentivised to launch offers and services that set them apart from the competition. This means that the consumer benefits from personalised deals that match their needs," he adds.

For their part, the charities surveyed this year are less sure. Less than 20 per cent of charities commenting on Open Banking give it a positive reception, with the remainder expressing uncertainty or concerns over security and privacy. Lack of awareness, however, is the main problem, reflecting the fact that this is still a very new development. ●

FIGURE 11: SOCIAL FINANCE

■ There is only limited interest in social finance ■