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Making the Case for a Post Bank

Report Prepared for the Communications Workers Union

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EXECUTIVE SUMMARY

This report sets out the case for a Post Bank in the UK.

The establishment of a Post Bank provides a solution which would enable the Post Office to ensure its long-term sustainability, by diversifying its portfolio of activities and increasing revenues. In addition, a state-owned Post Bank would also enable other important economic and social goals:

- better access to finance for Small and Medium Enterprises (SMEs)
- improved financial inclusion
- a rebalancing of the UK economy away from London and other major urban centres

The establishment of a Post Bank would also align the Post Office with the successful strategy of other postal operators around the world.

Post Office banking services are currently provided by the Bank of Ireland UK (Plc).

Background

Since 2010, the economic and financial landscape in the UK has changed substantially. Our analysis suggests that the Post Office's current partnership with the Bank of Ireland has not delivered the expected and potential results. The revenues the partnership has brought in for the Post Office remain significantly lower than post banks around the world and it has not delivered a full range of banking products for the Post Office's customers.

During a period where many new challenger banks have obtained a banking licence and some, such as Metro Bank, have managed to grow significantly, the Bank of Ireland has decreased its investments in the UK. The Irish lender was severely weakened by the financial crisis and needed state bailouts. To approve state aid, the European Commission imposed conditions which forced the Bank of Ireland to sell non-core activities, including its business banking and corporate banking activities in Great Britain, resulting in a significant gap in the partnership's provision of financial services which includes no business banking services. Another significant weakness is the failure to roll out current accounts on a national basis.

A proposal for the creation of a Post Bank was put forward in 2009 and rejected by the government in 2010, which concluded that the Post Office should continue to build on its existing relationship with the Bank of Ireland (UK) Plc. The arguments behind this rejection were:

1. It would be costly
2. It would require a new set of skills
3. It would introduce increased risk in the Post Office's balance sheet
4. It would be difficult to gain market share in a very competitive market.

Our proposal for a Post Bank addresses each of these concerns.

Recommendations

Our recommendation is that the partnership with the Bank of Ireland should be ended, for two key reasons:

1. Due to the persistent negative legacy from the financial crisis and further current challenges, the Bank of Ireland is unlikely to invest substantially in the partnership in the near future.
2. In more general terms, a partnership model with a large private bank for the provision of postal financial services leaves the Post Office's ambitions for growth dependent on the fortunes of the partner.

We advise that the Post Office acquires the Bank of Ireland UK portfolio (or part thereof), thereby retaining all the customers that have acquired products and services white-labelled via Post Office Money. This strategy would alleviate previous concerns that it would be difficult to gain market share in a very competitive market. This would also allow the Post Office to capitalise on existing skills and expertise.

We recommend that the Post Bank be set up as a subsidiary, with a separate management team. This would facilitate the newly established entity application for a banking licence to the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). It would also help ease the government concern that a Post Bank would introduce risk to the Post Office's balance sheet, as the new entity would be endowed with its own capital.

We estimate that the initial equity should be in the region of £2 billion. This amount of equity would be sufficient, for example, to allow the Post Bank to acquire the Bank of Ireland UK portfolio. While we discuss different alternatives to raise this initial capital, the amount equates to the investment the government has put into the Post Office in the past seven years. We estimate that the profits the Post Bank would generate would eliminate the need for an ongoing annual subsidy for the Post Office and put it on a sustainable footing for the future. Furthermore, the current macroeconomic conditions are ideal to raise the initial capital, due to the low interest rates environment.

Opportunities: building on existing strengths

A Post Bank is an opportunity to build on the Post Office's significant existing strengths.

The report identifies market opportunities for a Post Bank, particularly in SME lending. Several policy institutions in the UK have expressed concerns about a lack of competition in this market segment, which results in restricted access to finance for small and medium size firms.

This sector is characterised by barriers to entry such as a need for an extensive branch network and the offering of a broad range of financial products. Notably, while these represent barriers for traditional credit institutions, and even more so for newcomers, they would not be barriers for a Post Bank, as it could leverage on its large branch network very efficiently and on the current offer of a broad range of financial products through its partnerships and joint ventures.

Additionally, the Post Bank could join forces with those challenger banks that specialise in SME lending, in order to take full advantage of this opportunity, acquire new technology and make sure that lending and related risks are managed prudently and in a sustainable way. **We**

posit that there is room for a Post Bank as a new player aiming to gain market share in this sector—thus benefiting the whole economy.

In this strategy, the Post Bank will also capitalise on other existing strengths of the Post Office which include the **very positive public perception of the Post Office brand** compared to financial institutions. A strong brand and a solid reputation are key factors for a successful new player in any financial system, but these usually take years to build – the Post Office already has this significant advantage.

Finally, the capillary structure of the Post Office branch network puts the new Post Bank in a strong position to support financial inclusion by addressing the large pockets of people and small firms which are currently unbanked or face the consequences of the branch closure programmes operated by banks.

Introduction

This report sets out the case for a Post Bank in the UK. We will argue that a Post Bank is a viable business opportunity that will enable the government to achieve several objectives.

Firstly, it will contribute to the revenues of the Post Office, thereby ensuring its long-term sustainability and ending its reliance on government subsidies. Secondly, a Post Bank will also increase competition in the banking sector and offer a wider choice to consumers and a much-needed alternative source of funding to small businesses, thus contributing to the country's economic growth. Building upon the strong Post Office brand, a unique, capillary branch network, and free from the legacy of the financial crisis that still affects traditional banks, a Post Bank can be a modern, sophisticated and innovative player offering a range of banking services at a large scale.

The idea of a Post Bank is neither new nor exclusive to the UK. Declining revenues from postal services and mail business are a common experience for Post Offices around the world and the need to diversify revenue has become a necessity for them in most countries. A Post Bank is an established and successful player with a long history of collecting deposits and offering postal savings services to the public in many countries. They are often set up following major restructuring of the traditional Postal Service.

In Germany, the independent Deutsche Postbank was established in 1990, following the split of the Deutsche Bundespost into the three companies: Post, Telekom, and Postbank. Japan Post Bank (Yū-cho) was established in 2006, again following a restructuring of the sector. Along similar lines, the establishment of the BancoPosta in Italy in 1999 was part of the restructuring of Poste Italiane. Several examples from other countries show that a Post Bank can be a sophisticated, innovative and profitable player in the financial services industry, capitalising on core strengths (such as brand and branch network) and contributing to economic growth while delivering returns to shareholders.

The idea of a British Post Bank is also not new: In 2009, the Post Bank Coalition—a group comprised of the Federation of Small Businesses, Countryside Alliance, the New Economics Foundation, Unite, CWU and others—presented a case for a Post Bank in the UK. The group campaigned for a state-owned bank to be established in the Post Office. However, they were unsuccessful. In 2010, the Department of Business Innovation & Skills (BIS) recognised that a Post Bank was, in principle, a good idea, but they raised the following concerns:

1. Capitalising a new bank would be time consuming and expensive
2. It would require the development of a new set of skills
3. It would create a much more volatile and risky balance sheet
4. It would necessitate building a significant market share very quickly in a competitive market.

BIS (2010)[1] concluded that:

[1] https://www.gov.uk/government/publications/securing-the-post-office-network-in-the-digital-age.

> "*Post Office Ltd should build on its relationship with the Bank of Ireland. The Bank of Ireland is committed to making a success of its tie-up with the Post Office and has major plans to expand in Britain*."

As we set out below, this expansion has not happened. Furthermore, since then, market circumstances have changed significantly, and have resulted in a more favourable environment for the establishment of a Post Bank. In this report, we will argue that the establishment of a Post Bank is not only a viable business opportunity, but also a means by which to increase competition in parts of the banking sector that have high barriers to entry. We will point out and discuss the reasons why the partnership with the Bank of Ireland is not delivering the expected and potential results and we will propose and evaluate alternatives strategies. In doing so, we will provide counter-arguments to the concerns raised above.

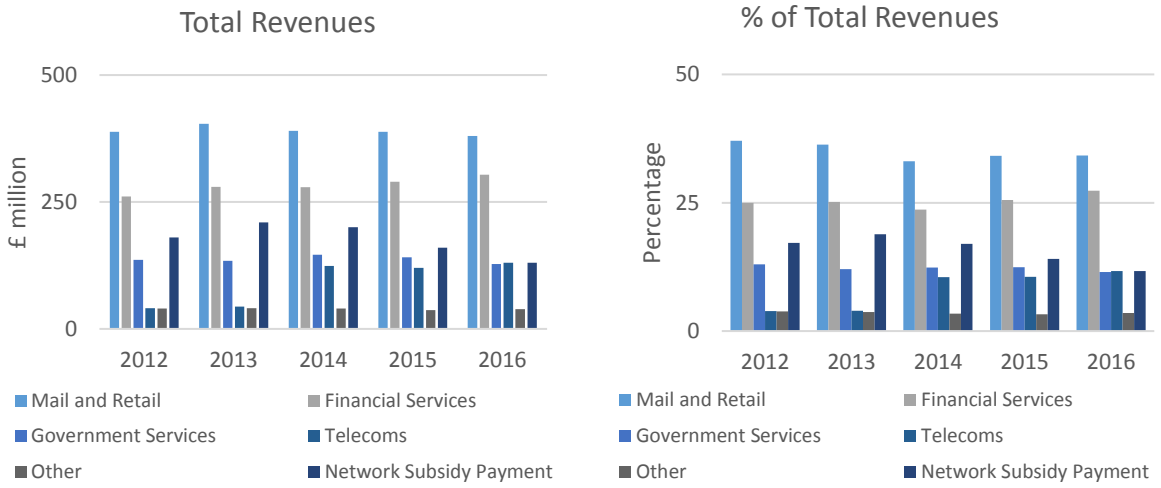
To present the case for the establishment of a Post Bank, **Part I** of this report evaluates the current performance of Post Office Ltd and of **Post Office Money** (the financial services brand operated by Post Office Ltd). **Part II** discusses the relevant changes in the financial services sector since the previous Post Bank proposal. The objective is to emphasise that most of the assumptions, which led to the government decision to prioritise the partnership model with the Bank of Ireland are no longer relevant. **Part III** of this report will provide a detailed proposal for the establishment a profitable Post Bank, by highlighting market opportunities and more importantly, by emphasising how the Post Office can leverage its current strengths.

Part I. Current situation of the Post Office

1. Current performance of Post Office Ltd

The current performance of the Post Office Ltd highlights the need for revenue diversification. In 2016, the Post Office revenues decreased by £43 million (-3.6%) to £1,136 million (Figure 1). This includes the decrease of £40 million in the Network Subsidy Payment from the government, which is expected to continue decreasing in the following years. Moreover, the operating loss in 2016 was £24 million, despite a series of cost-saving measures implemented since 2012, when the operating loss was £119 million.

Figure 1. Post Office Revenues from Financial Services



Source: Post Office Ltd Annual Reports, various years.

One part of the business where revenues increased is across Financial Services, in aggregate, operated via Post Office Money. This trend is in line with income diversification generated by Postal Operators (or Posts) around the world, as financial services revenues are increasingly used to diversify the sources of income and offset the decline in the traditional postal business. In industrialised countries, revenue from financial services (as share of total revenues) has increased from 10.8% in 2005 to 16.6% in 2015 (Box 1).

BOX 1: Current Trends in Postal Financial Services around the world

Despite their key role in a country's economy, postal operators around the world are currently facing financial difficulties. The main reasons why several postal operators have been operating at a loss—or have seen their profits decline dramatically—include **the strong decline in traditional mail revenues** (for both domestic and international services), which has not been fully compensated by the increase in parcel revenues. Another reason is that the **postal sector has been liberalised in many countries**, and hence those postal services that used to have a monopoly position now face domestic and international competition.

With increased competition and declining revenues, diversification into other services has become a necessity for the viability of Post Offices in many countries.

These trends have led Post Offices to diversify their business into financial services to generate profits or at least to compensate losses from traditional business. Across industrialised countries, the share of income from postal financial services increased from

10.8% in 2005 to 16.6% in 2015. This share of income is even higher for European countries, reaching 22.8% in 2015.

INDUSTRIALISED COUNTRIES

- Share of income from postal financial services in 2005: 10.8%
- Share of income from postal financial services in 2015: 16.6%

EUROPE

- Share of income from postal financial services in 2005: 19.2%
- Share of income from postal financial services in 2015: 22.8%

ITALY

In 2015, **Poste Italiane** operating profit was €880m, of which:

- Operating loss of €568m in the core postal business
- Operating profit of €930m in the financial services unit
- Operating profit of €487m in the insurance unit

NEW ZEALAND

In 2015, **New Zealand Post Office** operating profit was NZD143mn – of which:

- Operating loss of NZD3m for mail and logistics services
- Operating profits of NZD132m from financial services

SWITZERLAND

PostFinance represents 56% of the Group's operating profits

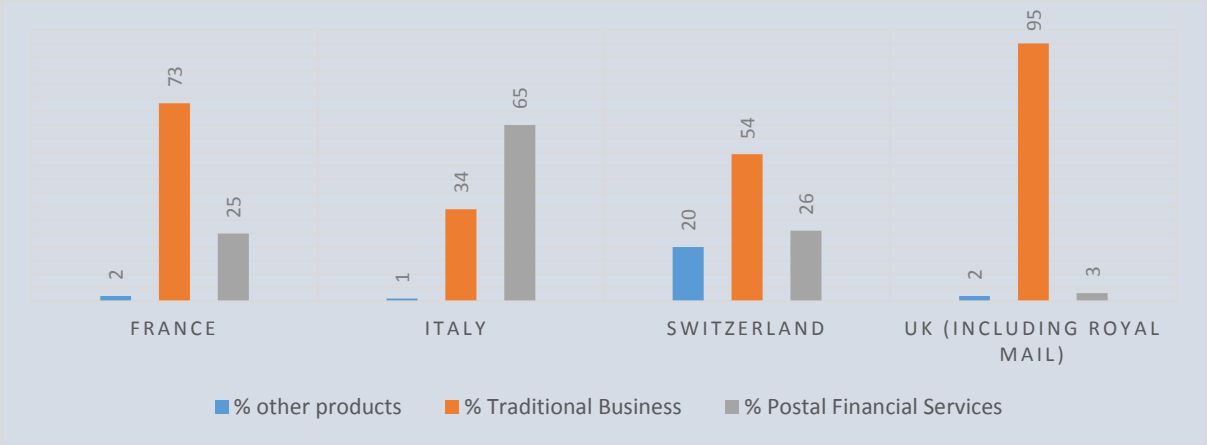
FRANCE

La Banque Postale represents about 25% of Poste Group's overall operating profit, roughly the same the parcels business.

Figure 1.1 presents a comparison in terms of income composition for France, Italy and Switzerland, where the national Post has expanded strongly in the financial services provisions via the establishment of a Post Bank. UK data are sourced from the Post Office and Royal Mail annual reports; this allows us to compare the financial revenues with the revenues from the whole postal business as it is the case for the other countries.

Adding the 2015 revenues for Royal Mail UKPIL — Royal Mail's core UK business (£7,757m) — to the Post Office revenues would see the percentage of income from postal services in the UK to account for just above 3%.

Figure 1.1. Percentage of income from postal financial services (selected countries) in 2015



Source: Data from Universal Postal Union (UPU) Database, Post Office Annual Report 2015, and Royal Mail Annual Report 2014-15.

Post Office Money is a financial services brand operated by Post Office Ltd, which provides credit cards, insurance products, mortgages and personal loans to customers in the United Kingdom through **Post Office** branches, the internet and telephone.

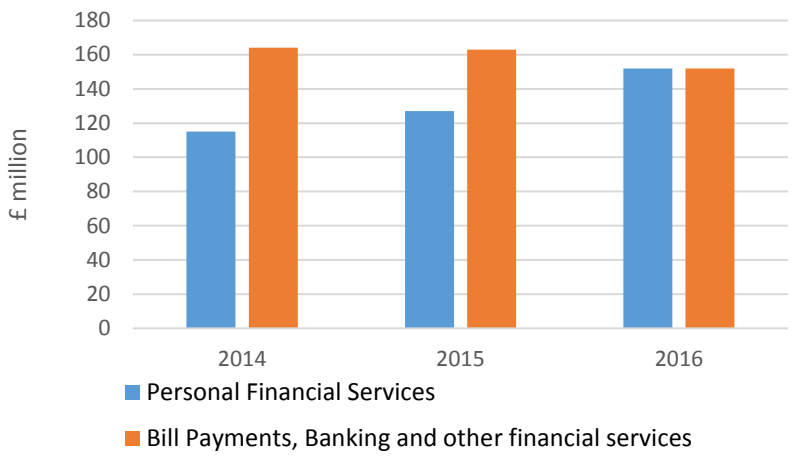
For the Post Office Ltd, Financial Services revenues are allocated between *Personal Financial Services* and *Traditional Financial Services* products:

1. *Personal Financial Services* include savings commissions (ISAs and online savings), insurance and new mortgage products.

2. *Traditional Financial Services* include bill payment services, business banking services and Postal Orders.

Revenues from *Personal Financial Services* have increased recently, driven by a strong growth in savings commissions (particularly ISAs and online savings), insurance and new mortgage products. However, revenues from *Traditional Financial Services* products have declined. Much of this decline is commonly attributed to the increased use of online banking services and decrease in bill payment services and Postal Order. However, it is also driven by the fact that business-banking services are no longer offered by the Bank of Ireland UK (the current partner of the Post Office for the provision of banking services). In fact, taking into account the lack of revenues from business banking, traditional financial services have remained remarkably profitable.

Figure 2. Post Office Revenues from Financial Services



Source: Post Office Ltd Annual Reports, various years

Table 1 shows the Post Office's current business model for the provision of financial services, under the umbrella of Post Office Money, for each of the three types of financial services offered: i) banking services; ii) insurance services; iii) currency services.

i) For the provision of banking services, the Post Office launched a joint venture with the Bank of Ireland (Midasgrange Ltd) in 2004. In 2012, the Bank of Ireland bought out the Post Office's share of this joint venture for £3m and moved to a contractual relationship between the two organisations that runs until 2023. Under the new agreement, which is referred to as an *exclusive partnership*, the Bank of Ireland is responsible for product development and delivery while the Post Office has the primary responsibility for product sales and marketing and ensuring all customer interactions meet the Post Office's brand values. In addition, the Post Office also offers a Post Office card account, designed especially for receiving pensions, benefits and tax credit and aimed at people without a bank account. The Post Office card account is offered by J.P. Morgan Europe Ltd.

ii) In the insurance business, the Post Office has recently completed its first acquisition, buying the joint insurance business from the Bank of Ireland (UK) plc and incorporating it into its subsidiary Post Office Management Services Limited, which operates the business alongside its existing travel insurance activities. From the date of acquisition (September 2015) the insurance business has contributed £15m of financial services revenue and £6m of profit before tax.

iii) For currency services, the Post Office has a joint venture with the Bank of Ireland, called First Rate Exchange Services Holdings Limited, whose principal activity is the supply of foreign exchange in the UK. The Post Office owns 50% of First Rate Exchange Services Holdings Limited, which generated £35m in dividends in 2015-2016.

For banking services, the reliance on the partnership with the Bank of Ireland is very strong (it is the only partner for almost all banking services), whereas for other financial services Post Office Money acts as a platform for different providers. In the provision of insurance services, the Post Office both offers own products (travel insurance) and sells policies of specialist

providers. Overall, the profits from the foreign currency Joint Venture increased significantly in absolute terms since 2012, but decreased by £1m in 2015/16.

Table 1. Post Office Money – the current business model

Banking services	Provider	Insurance services	Provider	Currency services	Provider
Current Accounts	Bank of Ireland	Travel Insurance	Post Office Limited and Post Office Management Services Limited (bought out Bank of Ireland in 2015)	Travel Money	First rate Exchange Services Ltd (Post Office and Bank of Ireland joint venture 50-50)
Credit cards Personal Loans	Bank of Ireland	Home Insurance Motor Insurance	BISL Limited Devitt Insurance Services Limited		
Mortgages Money ISAs	Bank of Ireland One Family	Life Insurance Business Insurance	Royal London Arthur J. Gallagher Insurance Brokers Limited		
Savings	Bank of Ireland	Pet Insurance	Pinnacle Insurance Plc		
Post Office Card Account	J.P. Morgan Europe Ltd.				

In general terms, Post Office Money's business model follows the *Partnership Model* (*BM3 – Partnership with a financial services provider*); see Box 2 for a description of business models. This model has both advantages and disadvantages, as shown in Table 2. One of the main drawbacks of the partnership model in terms of revenue generation is the strong dependence on the partner's willingness or ability to expand the business. This dependence is even more critical when the partner is a traditional bank facing financial distress, following the legacy of the financial crisis, as is the case with the Post Office's partnership with the Bank of Ireland. Instead, a Post Bank (*BM4* and *BM5*) has no such dependence.

Table 2. Partnership model: Advantages and disadvantages

Advantages	Disadvantages
Easier implementation in terms of changes to the organisation	Products offered may not come with the Post's brand. No say on the quality of products and on the sales strategy.
No significant initial investment required	Limited revenue if only certain functions are performed.
Possibility of partnership with multiple providers	Reliance on the partner for the provision of services (i.e. if the partner is a bank, exposure to the banking industry) and reputational risks.
Easier in terms of regulatory burden	Possible coordination issues with the partner(s)
Lower exposure to financial risks	Limited impact on financial inclusion
Brand capitalisation	Limited training/learning process for staff who fail to acquire the necessary skills

BOX 2: Different arrangements for the provision of financial services

By choosing the types of postal financial services to offer and the business strategies to adopt, Postal operators define their business model. These models are constantly evolving because of economic and political changes, making it difficult to identify winning models and strategies. In general terms, Post Offices have adopted one or a combination of five business models (BMs) described below, presented in order of increasing commitment and potential impact on revenues and financial inclusion.

Figure 4: Business models for Post operators offering Postal Financial Services.

Source: Authors' elaboration based on Universal Postal Union (UPU), 2016.

BM 0: Real estate provider (no provision of financial services)

Under this strategic model, the Post Office enters into an arrangement with an external financial services provider whereby the partner uses the space rented in a postal branch to install an office or a window, and provides its own services with its own staff. In this case, the Post Office plays no role in the provision of the services.

BM 1: Cash merchant

The Post Office acts as a cash-in/cash-out agent for one or various partners (Money Transfer Operators (MTO); Mobile Money Operators (MMO); government entities; utility companies; financial institutions, etc.). The services facilitated by the Post Office are transactional financial services, such as remittances, bill payments, mobile payments, account withdrawals/deposits. This is the easiest model to deploy for Post Offices that are starting to offer financial services as it does not require much know-how and is relatively inexpensive to organise.

BM 2: Proprietary domestic and cross-border payments

The Post Office operates its own domestic payments and international remittance services (for the latter, also in partnership with other Post Offices).

BM 3: Partnership with a financial services provider

The Post Office partners with a financial services provider, such as a bank, an insurance company, an MTO (Money Transfer Operator), or a microfinance institution (MFI) to offer the financial services of that partner. The main difference from the previous model is that the Post Office is not merely providing cash-in/cash-out services, but is much more involved in the provision of the services. Products can be developed jointly with the partner and adapted to the postal clientele. In many of such partnerships, the postal brand is used to sell financial products. In the BM 3 model, the Post Office is involved fully in all front-office aspects and postal staff has an important role to play in promoting financial services.

BM 4: Postal savings bank

Under this model, the Post Office offers its own insurance and/or account-based services (savings or current accounts), under a regulatory framework that is specific to the Post. This is the traditional postal savings model. Usually in BM 4, the Post is not allowed to offer lending services or any other sophisticated financial products, which is often one of the main reasons why Post Offices are willing to transition to BM 5.

BM 5: Fully-fledged postal bank

Under this model, the Post Office offers its own insurance and/or account-based services as well as loans, but under the supervision of the central bank or financial services regulatory authority. In some cases, postal banks still have some limitations either on the type of product they can offer (not all types of loans for example) or the clientele they can target. The products have the postal brand and are defined in accordance with the role of the Post Office.

Key Points

- *The Post Office is currently suffering from weak financial performance, and lacks a clear plan to ensure its long-term sustainability.*
- *Revenues from financial services via Post Office Money are increasing but still limited, both in terms of the range of products generating revenues and in terms of plans to grow the banking business.*
- *The revenues currently generated via Post Office Money are substantially below those achieved by Posts offering financial services via a Post Bank in other countries.*

2. The Partnership with the Bank of Ireland UK

As mentioned above, the provision of banking services of the Post Office relies almost entirely on the partnership with the Bank of Ireland (UK) plc, which is a separately incorporated subsidiary of Bank of Ireland Group, employing 505 staff (full-time equivalent) in the UK at the end of 2016. The partnership was first established in 2003 as a joint venture and in 2007 it was renewed to 2020. In 2012, the Bank of Ireland bought out the Post Office's share of the joint venture and moved to a contractual relationship, defined as an *exclusive partnership,* which runs until 2023. The Bank of Ireland (UK) plc has no branches and relies on Post Office branches to distribute financial products and raise deposits. Table 3 outlines the bank's recent history. The Bank of Ireland was severely affected by the financial crisis and needed two state bailouts. The European Commission (EC) approved two restructuring plans in 2010 and 2011, which entailed deleveraging and selling non-core activities, including the exit from its business banking and corporate banking activities in Great Britain.

Table 3. Key events for the Bank of Ireland (BOI) after the financial crisis

2009	**The Irish government provides €3.5bn for recapitalisation of the BOI and other state aid assistance.**
2010	Bank of Ireland UK plc is incorporated and established as a separate legal entity. The partnership with the Post Office (created in 2003) in terms of **a Joint Venture** is **extended to 2020.** A first restructuring plan was approved by the European Commission (EC), on 15 July 2010. The plan anticipates that the BOI will pay a considerable proportion of its own restructuring costs, to limit competitive distortions deriving from state aid. The BOI is forced to reduce its presence in certain market segments through the transfer or winding down of assets and through divestitures. **The plan requests that the BOI significantly reduces its presence in the UK corporate lending market.**
2011	The EC confirms the second restructuring plan for the BOI in December 2011. The plan is meant to restore the bank's viability by exiting risky portfolios and by implementing more prudent risk management practices. The BOI will have to substantially deleverage its balance sheet to reduce its dependency on wholesale funding, and will need to refocus its business model on balanced-risk lending in Ireland and the United Kingdom. The plan also ensures a fair burden sharing of past losses and that the bank and its capital providers contribute significantly to the financing of the restructuring costs by selling several businesses and portfolios.
2012	The BOI records a loss of €1.8bn (£1.6bn) for 2012. The value of customer deposits rises from €16bn to €19bn during the year, exceeding expectations. **The BOI buys out the Post Office from their 50% share in the joint venture (Midasgrange Ltd). The new partnership agreement is extended to 2023.**
2013	The EC authorises changes to BOI's second restructuring plan, approved in December 2011. The BOI is no longer required to divest New Ireland Assurance Company (NIAC), but **confirms the exit from the Great Britain Business Banking and Great Britain Corporate Banking businesses.** Additionally, the Irish authorities commit to ensure that the BOI will extend limitations on the distribution of

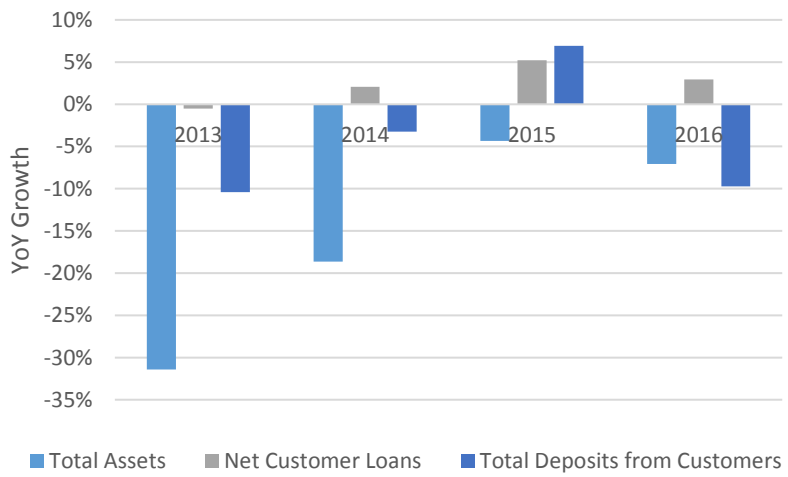
	dividends beyond December 2015 or until it has reimbursed the Irish State for the preference shares.
2014	Regulation of the bank transferred to the European Central Bank (ECB).
2015	The Bank of Ireland sells the joint insurance business to the Post Office Ltd, which incorporates it into its subsidiary Post Office Management Services Limited.
2017	The Group intends to implement a corporate reorganisation, which would result in the Bank of Ireland Group plc (BOIG plc) being introduced as the listed holding company of the Group. The reorganisation will be implemented by a scheme of arrangement under the Companies Act 2014 (the "Scheme"). The corporate reorganisation was required by the EU's Single Resolution Board and the Bank of England to provide a framework for the bail-in of bondholders in the event of another financial crisis.

Source: EU Commission, Bank of Ireland and Post Office press release.

After several years of severe losses following the financial crisis, the Irish lender returned to profitability in 2014. Despite posting a pre-tax profit of about €1bn in 2016, the overall performance of the Bank of Ireland is still uncertain as the latest profit figure is 16% lower than in 2015.

Since its establishment, the overall performance of the UK subsidiary of the Bank of Ireland has been similarly lacklustre, as illustrated in Figure 3, with a noticeable decrease in 2016 in terms of total assets and total deposits from customers.

Figure 3: Bank of Ireland expansion into the UK banking system



Source: Data from Bank of Ireland (UK) annual reports.

Commenting upon the performance of the Bank of Ireland UK, analysts suggest that the lender still faces several challenges, both legacy issues and several new ones.[2] Among the new potential threats to the Bank of Ireland's operations are the risks deriving from currency fluctuations following the Brexit referendum, the potential litigation costs and reputational

[2] The legacy problems derive mainly from the Irish bank financial operations and do not relate to the UK portfolio.

losses related to the tracker mortgage review case and the need for restructuring its IT system.[3] We review these challenges below.

Brexit. Currency fluctuations strongly impacted the 2016 results. The Bank of Ireland has a substantial exposure to the UK market, the highest among Irish institutions. Due to the weakness of the pound, **profits in its UK retail business declined by 24 per cent to £106m** for the parent bank. The Bank of Ireland UK has 3 million UK customers, which is more than the adult population of Ireland. But the bank is a small player in a highly competitive market and therefore Brexit poses unique challenges for the Irish lender. With increasing risks and decreasing revenues from the UK market, the viability of the partnership with the Post Office is at risk.

Reputation. In terms of reputational risk, the Bank of Ireland is facing a review over potential mis-selling of a tracker mortgage. Against potential litigation costs, the bank has already set aside €25m. A large fine could also call into question the viability of the partnership with the Post Office.

Rising modernisation costs. For Bank of Ireland to remain competitive in the future, a major modernisation of its technology and infrastructure is overdue, thus raising IT costs substantially. The bank has earmarked capital expense of €225m annually over the next four years for this purpose. This represent a major investment for the lender, which will result in an increase in an already higher than average cost-to-income ratio.

Key Points:

- *The partnership with the Bank of Ireland has not delivered the expected and potential results.*
    - *Since the renewal of the partnership in 2010, the Irish partner had no plans for further expansion in the UK market.*
    - *In 2012, it exited from the Great Britain Business Banking and Great Britain Corporate Banking businesses.*
- *Because of the persistent negative legacy from the financial crisis, the partner is not expected to deliver significant growth in the near future.*
- *A partnership model with a large private bank for the provision of postal financial services leaves the Post Office's ambitions for growth dependent on the fortunes and willingness of the partner.*

[3] https://www.irishtimes.com/business/financial-services/bank-of-ireland-s-results-something-of-a-curate-s-egg-1.2987751

PART II. The new UK competitive landscape

One of the reasons for the rejection of the proposal for a Post Bank in 2010 was the consideration that it would be difficult for it to become profitable in a highly competitive sector such as the banking sector. This statement was in line with the political view at that time: the UK public authorities opted for consolidation in the banking sector in the immediate aftermath of the financial crisis. Accordingly, in 2010 the UK banking sector was deemed as highly competitive. Nevertheless, this view has changed radically since then: the authorities have repeatedly expressed concerns about the lack of competition in the banking sector in more recent years.

In 2010, the Office of Fair Trading (OFT) published a report focused on competition in retail banking.[4] They concluded that "*new entrants face significant challenges in attracting personal and SME customers through a combination of low levels of switching, high levels of brand loyalty and consumers' preference for providers with a branch network*."

In 2011, the Independent Commission on Banking presented its final report[5] and highlighted that: "*There are long-standing competition issues in UK retail banking. On the supply side, core markets are concentrated—the largest four banks account for 77% of personal current accounts and 85% of SME current accounts. On the demand side, competition between banks on current accounts is muted by difficulties of switching between providers and by lack of transparency about banking services on offer*."

Partly as a response to these concerns, during the creation of the new institutional banking regulatory landscape, both the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) were given explicit objectives to promote competition. In particular, it is one of the three FCA objectives to promote effective competition, and a secondary objective for the PRA to act in a way that facilitates effective competition.

As part of this push towards increasing competition in the banking sector, the Financial Services Authority first, and the Bank of England later, simplified the process for obtaining a banking license. Additionally, to facilitate the process the New Bank Start-up Unit was set up at the Bank of England.

Based on these considerations, this section reviews the key changes that have impacted the UK financial sector in recent years, to foster an understanding of the industry a newly formed Post Bank would be operating in. Our analysis highlights the challenges as well as the opportunities in a fast-changing sector.

Market competition

The UK banking market is dominated by the presence of five large banking groups: Lloyds, HSBC, RBS, Barclays and Santander UK. Together, these large banking groups control over 50% of the mortgage market, 77% of the personal current account market and 85% of small business banking. These banks operate throughout the UK and provide the full range of retail banking services. In addition, there are a number of smaller banks and over 40 building societies. The largest six banks and building societies (the five above plus Nationwide) now

[4] http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/personal-current-accounts/oft1282.
[5] http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf

account for 80% of the outstanding household and corporate lending, up from 65% at the start of 2008.[6] Other providers also offer elements of retail banking services such as credit unions, alternative finance providers (for example, crowd-funding and peer-to-peer lending), as well as new payment providers offering digital wallets and other services (for example PayPal, Amazon, Google and Apple).

As mentioned before, there have been numerous investigations into the competitive nature of UK banking, most recently highlighted by the findings of the Competition and Markets Authority report on retail banking.[7] This highlights the authorities' desire to increase competition in the system, especially in the light of the high degree of market concentration[8] in certain sectors of the banking business—personal and SME areas. Concentration levels have increased since the financial crisis following Santander's acquisitions of Bradford & Bingley and Alliance & Leicester building societies and Lloyds Banking Group's acquisition of HBOS. Despite the divestment of TSB and the entry of challenger banks, the large banks have lost only 5% of their market share since 2005, thereby justifying the renewed focus on increasing competition.

i) Challenger banks

Partly because of the authorities' efforts highlighted above, we have seen new entrants to the banking sector in recent years: in 2010 Metro Bank was the first new high-street bank to obtain a full banking licence in over a century (see Box 3 for a brief overview of Metro Bank) and since then several new banks have been authorised by regulators. The changes in the regulatory requirements and authorisation process, designed to reduce entry barriers in the sector and increase competition, have contributed to this new trend.

These new entrants are referred to as challenger banks because they compete in a market dominated by long-established operators. Technological and regulatory change have enabled the emergence of these new competitors. They have some advantages compared to traditional players: their size enables them to be nimbler, easier to manage and they are not hampered by old technology. Moreover, they have no legacy from the financial crisis. While many of these entities are unlikely to survive as stand-alone companies, triggering a likely wave of M&As with more established players—although not necessarily from the financial sector—will enable them to increase their competitive and disruptive potential.

Box 3. Case Study: Metro Bank

When it launched in 2010, Metro Bank was the UK's first new high-street bank in over 100 years. It offers a range of retail banking services to personal and business customers (including SMEs) in and around London. Its aims are to differentiate itself from other banks. Metro's strategy is based on building a strong and recognisable brand and offering a good customer experience, with a customer-focused culture borrowed from retailer-type operations. It is also defined a **branch-based challenger**, as it focuses on an innovative use of "stores" to attract customers. Today, Metro Bank has about 41 stores (opened in the last six years),

[6] http://www.bis.org/review/r140515b.htm.
[7] Competition and Markets Authority. 2016. Retail banking market investigation. https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf.
[8] See Haldane, A. 2011. Control rights (and wrongs). http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2011/speech525.pdf.

with a further 59 expected by 2020. This strategy also differentiates Metro Bank for traditional banks, which are cutting costs precisely via branch closures.

The Set-up of a Challenger Bank

2009 - Banking Authorisation process begins.
2010 - £75m of private capital raised (February).
2010 - Banking license granted (March).
2010 - Launch; first branch opened (July).

Financial Highlights

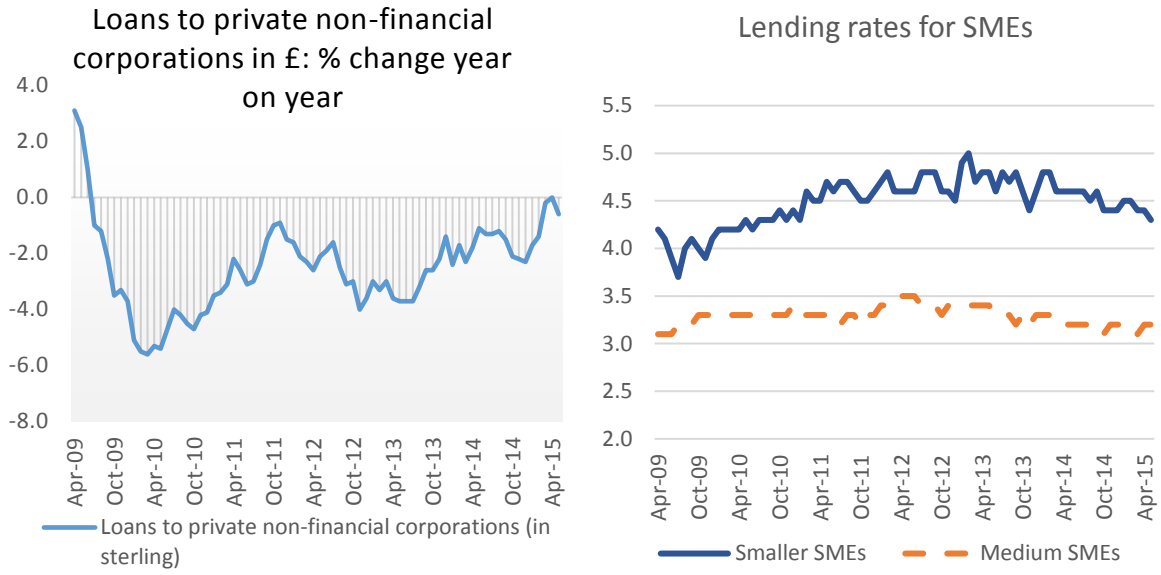
Six years later, Metro Bank is a fast-growing player in the UK retail service market. The results for 2016 confirm this trend:

- Asset growth up 64% year-on-year to £10,057m
- Revenue up 62% year-on-year to £195m
- Strong Common Equity Tier 1 capital ratio at 18.1%
- Record 260,000 increase in customer accounts to a total of 915,000

ii) SME Lending

Despite its paramount importance for the recovery of the economy, one type of business has found it difficult to recover: **Business and SME lending**. Business lending was severely affected by the crisis and decreased steadily between 2008 and 2015. As it can be seen in Figure 4, the annual growth rate of the outstanding lending to non-financial corporations in the UK remained negative until 2015. SME lending became expensive (especially for smaller SMEs) and mostly unresponsive to the unconventional monetary interventions during the post-crisis period.

Figure 4. Business lending since the crisis



Source: Bank of England – Credit Conditions Survey 2015Q2

A recent report by the Competition and Markets Authority and the Financial Conduct Authority[9] found that the provision of business current accounts (BCAs) and business loans is highly concentrated among the four top banks: they make up for 85% of BCAs and 90% of all business loans. These levels of concentration imply a Herfindahl-Hirschman Index (HHI) score of slightly below 2,500, the level that the U.S Department of Justice considers to be "highly concentrated".[10] This feature has barely changed since 1999.

These two facts—**business lending has been decreasing for several years after the crisis, and it remains highly concentrated**—remain true even though there has been a significant political appetite to increase both SME lending and banking competition. An example is the Funding for Lending Scheme (FLS), an initiative launched in July 2012 by the Bank of England and HMT. [11] The policy provides cheaper funding for banks and building societies that invest in the real economy. It was further amended to incentivise lending to SMEs. The policy has provided more than £60bn funding.[12]

At the same time, more and more challenger banks have taken an interest in this type of lending; for instance, Virgin Money and TSB. However, they face the costs related to the high entry barrier—the need for a physical presence to encourage and support SMEs via branches. We will expand the discussion on this issue in Part III of this report.

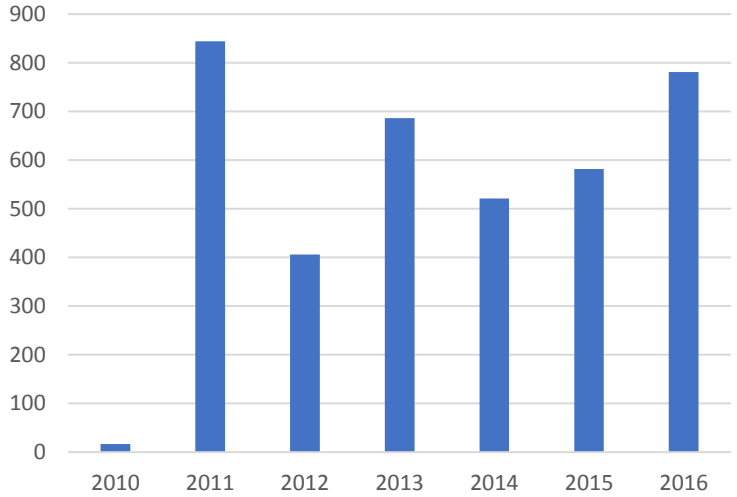
iii) *Branch closures*

Another reason why SME lending business has been suffering is the vast rate of bank branch closure—especially in more remote and rural areas. About 3,000 branches have closed over

[9] CMA & FCA. 2014. Banking services to small and medium-sized enterprises. https://assets.publishing.service.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf.
[10] https://www.justice.gov/atr/herfindahl-hirschman-index.
[11] http://www.bankofengland.co.uk/markets/pages/fls/default.aspx.
[12] https://www.ft.com/content/a8b1d864-976c-11e5-95c7-d47aa298f769.

the last decade, according to the Campaign for Community Banking Services, leaving around 8,000 in 2016. Data from SNL Financial indicate, as shown in Figure 5, that almost 4,000 branches have closed since 2010. In many areas, basic banking services are only available through the Post Office branches.

Figure 5: Bank branch closures over the period 2010-2016



Source: SNL Financial

Data from the big five banks derived from BBC research[13] and reported by the House of Commons[14] show that about 650 branches closed in 2015 and 2016 and Which? reported estimated closures in 2016 to be 1,046,[15] equal to 11% of the network of the seven largest banks. Some challenger banks, such as Metro Bank, are following an opposite strategy, expanding their network through branches in order to take advantage of the retreat of big banks. However, most of these branches are in major urban centres, while rural areas and communities are the most affected by bank branch closures and many of them are left with only certain basic services of the Post Office.

Key Points:

- *Regulators and policy makers have put in place initiatives to increase competition in the UK financial system, in particular in the provision of retail banking services.*
- *To this end, they have licensed new entrants, which are now fast-growing participants in the UK banking system, while traditional banks are still recovering from the financial crisis and dealing with post-crisis regulation.*
- *Among retail banking businesses, SME lending is suffering the most from high concentration and branch closures.*
- *While non-traditional competitors (challenger banks) find this business potentially attractive, they lack the required physical infrastructure to offer local business banking and SMEs services in a profitable manner.*

[13] http://www.bbc.co.uk/news/business-36268324
[14] Edmonds, T. (2016) Bank Branch Closure, Briefing Paper, House of Commons Library, Number 385, 15 December.
[15] http://www.which.co.uk/news/2016/12/revealed-1000-bank-branches-shut-in-two-years-458451/.

PART III. A Post Bank model for UK

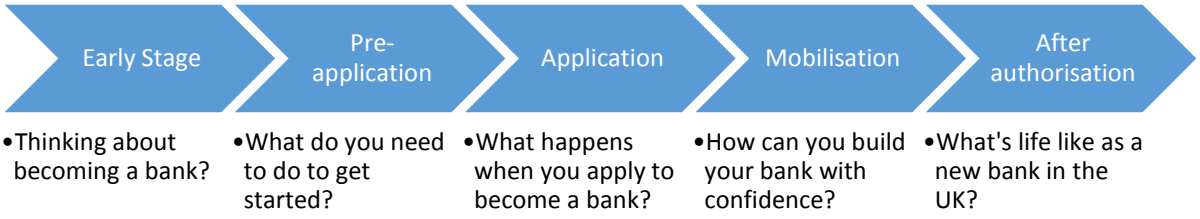
In this section, we outline the case for a Post Bank and present an analysis that illustrates the opportunities for the Post Office if it were to choose this strategy. We look at the change in regulatory requirements for the process of obtaining a banking licence and argue that to take full advantage of the new process the Post Bank should be set up as a separate subsidiary. We then look at the possible ownership structure and how to raise the initial capital. We discuss the growth opportunities for a Post Bank within the current market developments. Finally, we will show how a Post Bank can also help achieve broader objectives, both in terms of increased credit available to the economy and increased financial inclusion.

As a first step of this analysis, we note that there is an appetite for increased competition in the banking sector. This is evident in the number of new licences granted in recent years and by the fact that the supervisory authorities have reviewed and simplified the authorisation process.

In March 2013, the Financial Services Authority (FSA) simplified the process of obtaining permission to offer banking products. Now the permission is granted by the PRA (Prudential Regulation Authority, Bank of England), with the Financial Conduct Authority (FCA)'s consent.

The process is managed on a case-by-case basis. The managers of the firm seeking authorisation typically have a preliminary meeting ("pre-application stage") with the PRA at the Bank of England to present their proposal. This meeting's goal is to help the firm to prepare the application as well as possible. After this meeting, the regulators would explain the documentation that the firm needs to prepare, as well as the initial requirements. The whole process might take up to 6-12 months. Figure 6 illustrates the process.[16] The application is to obtain permission to undertake regulated financial activities. Deposit-taking, mortgages, and SME lending, for instance, all fall in this category.

Figure 6: Banking licence application process



Source: Authors' elaboration based on Bank of England's guidelines

[16] http://www.bankofengland.co.uk/pra/nbsu/Pages/default.aspx

We now turn to how a Post Bank could work in practice (see Box 4 for brief case studies of the Post Banks in Italy and France). Our proposal for a Post Bank considers the following aspects:

i) A separate subsidiary entity for financial services

ii) Raising equity capital and ownership structure

iii) Size and portfolio composition

iv) Market analysis

v) Capitalising on existing strengths

BOX 4: Successful Post Banks

POSTE ITALIANE AND BANCOPOSTA

An example of a Post Office that has successfully expanded into different business areas is **Poste Italiane**, which started to focus on financial services when the European Union began liberalising postal markets in 1997. Italy's national postal service, Poste Italiane, became a public limited company in 1999 and relinquished their monopolies on many postal services. Today, Poste Italiane is partially state-owned (around 60% percent) after it completed an IPO in 2015. Poste Italiane has a network of 13,000 branches.

Early set-up of the Italian PostBank

1998 Poste Italiane becomes a public limited company
1999 BancoPosta is created as a business unit of Poste Italiane and Poste Vita, the Group's life insurance company, is established
2002 First profit for the Poste Italiane reported after fifty years in the red
2003 Postepay, the most widely used prepaid card in Europe, is created
2006 Poste Italiane pays its first ever dividend to shareholders.
2015 IPO on Italian Stock Exchange (40%)

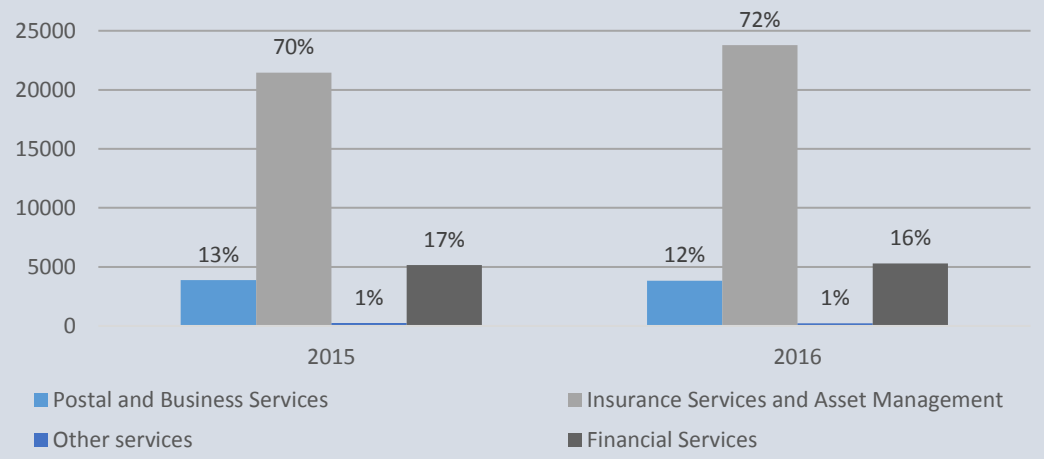
Business diversification strategy and revenues

Poste Italiane has earned a reputation for diversification and innovation. Along with postal services, the company offers integrated products in communications, logistics, finance, insurance, and mobile telephone services. Currently, Poste Italiane has plans to adopt mobile technology to improve and modernise all services and products.

Poste Italiane's revenues are generated by financial services, insurance services and asset management for more than 80% and only 13% from core postal services. In 2016, revenues increased by 7.7%. The improvement primarily reflects the positive performance of insurance services and asset management, where total revenue amounts to €23.8bn.

Poste Italiane saw a large increase in deposits in 2016 and 2017, as savings were transferred from traditional banks to the Italian Post Office due to the emerging evidence of Italian banks' bad loans.

Figure 4.1: Poste Italiane's revenue by business units (in €m and as percentage)



Institutional setting and capital regulation (ring-fencing)

Banking services are offered via BancoPosta. Poste Italiane SpA manages BancoPosta's operations through an entity with ring-fenced capital, called BancoPosta RFC, established in 2011. At December 2016, the ring-fenced capital was equal to €3,386m.

LA POSTE AND LA BANQUE POSTALE

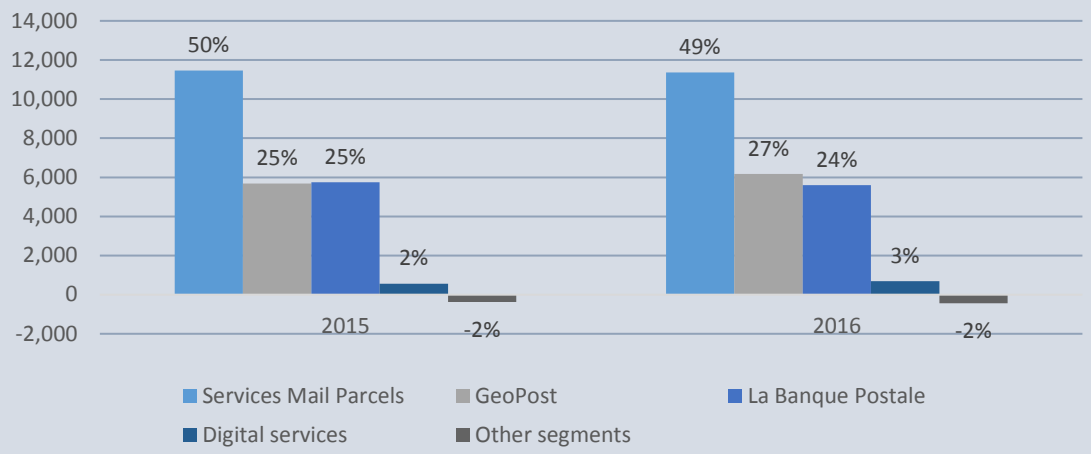
La Poste became an independent, public sector company in 1991, following the split of the French PTT, a government department responsible for mail, telegraph and telephone services. By the mid-1990s, the Group expanded into financial services, which soon generated about one-fourth of its revenues. In 1997, the French Government forced La Poste to separate its financial services products from its mail services, to reduce its competitive advantage. Meanwhile, La Poste was facing increasing competition in its mail and parcel delivery services. As a response, La Poste began diversifying its operations, including financial services offerings. To comply with French law and EU directives, banking activities had to be provided through a separate subsidiary. La Banque Postale was established in 2006 and it is currently one of the major public banks providing retail financial services in France, based on a network of about 17,000 outlets.

Multi-business model and revenues

La Poste has a multi-business model which, next to more traditional postal services, includes logistics and corporate mail and parcels services, and digital services for corporations. In addition, La Banque Postale—a separate subsidiary—offers retail banking, insurance and asset management products and services.

The Group consolidated operating profit totalled €975m in 2016, up 11.5% from 2015. There are four main business units as shown in Figure 4.2 below. About 25% of the revenues come from the financial services offered by the Banque Postale.

Figure 4.2: La Poste's revenue by business units (in €m and as percentage)



La Banque Postale

La Banque Postale Net Banking Income (NBI) was €5.60bn in 2016. Of these, NBI from the Retail banking division amounted to €5.24bn. At the end of 2016, La Banque Postale capital position was very strong, with a CET1 ratio of 13.7 %. The bank successfully expanded both deposits and loans: retail demand deposit reached €52bn (+6.4 % / 2015) while corporate credit outstanding saw the highest growth to €15.3bn (+25.9 % / 2015).[17]

i) A separate subsidiary entity for financial services

One of the goals of the Post Bank is to provide a steady stream of income for the Post Office to ensure its long-term viability and reduce its reliance on government subsidies. It is therefore crucial that the Post Office receives the profits of the Post Bank. Setting up the Post Bank as a subsidiary, fully or majority-owned by the Post Office, would achieve this objective.

There are different ways to set up a Post Bank in the Post Office. However, a fully-fledged subsidiary seems to be the right structure for several reasons: (1) regulatory purposes; (2) isolating risks related to financial services provision, and (3) management.

In this context, a separate subsidiary would simplify the process of obtaining a banking licence. In addition, as the new entity would be subject to the supervision of the PRA and FCA, a separate subsidiary would increase transparency and would allow for the separation of risk between the bank and the Post Office. This structure would also appease some of the concerns previously voiced by the government, that is, a Post Bank would create a much more volatile and risky balance sheet for the Post Office.

A separate subsidiary would also allow the Post Bank to have a separate management team, with financial markets experience and the ability to make independent decisions within the Group. This would also ensure that the management's decisions are not politically driven.

[17] https://www.ipc.be/en/reports-library/publications/member-publications/le_groupe_la_poste_2016_ar

There are numerous examples of government-owned financial institutions (for example, the Cajas in Spain) that have undertaken financial investments for political reasons rather than economic ones, with disastrous consequences for the sector in many countries.

To account for the fact that the Post Bank will be part of a government-owned group (The Post Office Ltd) and therefore subject to the Group's overall management, a possible model is that of *functional independence*. Under this model, while the overall goals are set by the Group management (and, in this case, the government), the way how these goals are pursued is a matter for the bank's management. An example of this is the Bank of England model. The Bank of England is not independent: its objectives are set by Parliament. However, the Bank of England is independent in the way it chooses to achieve these objectives—under their regulatory powers. The Post Office could do something similar: it would set the objectives—in terms of financial inclusion and portfolio composition—but the actual day-to-day operations would be performed by the management of the Post Bank.

ii) Raising equity capital and the ownership structure

Another concern raised in the previous discussion on setting up a Post Bank back in 2010 was that capitalising a new bank would be time consuming and expensive. As mentioned before, the licence process can take less than a year. In this section, we discuss in detail the financial implications of raising equity to finance the Post Bank.

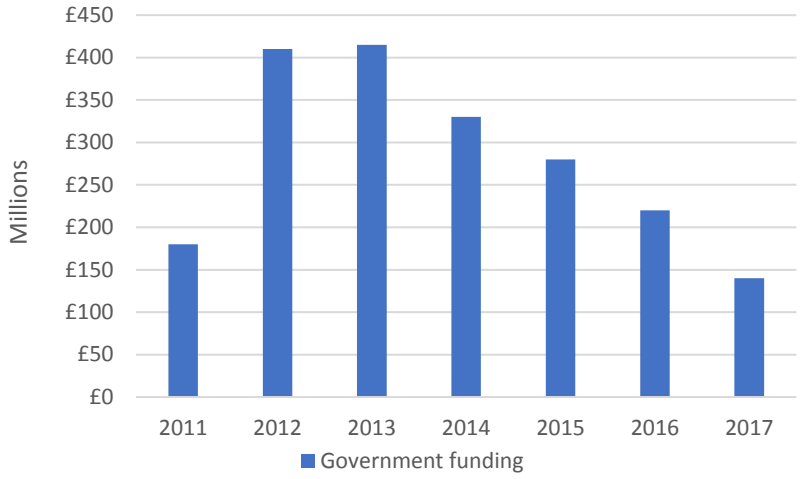
We note that raising the initial equity would be relatively cheap as current market conditions are favourable for this. There are various possible options available, each with different implications in terms of ownership structure, whereby the resulting firm would be either entirely or partially government owned.

- ***Initial capital injection from the government***

The initial capitalisation could come directly from HMT. Under current arrangements, the Government is subsidising the Post Office annually; in the last seven years, it has provided funding in the region of £2bn, as it can be seen in Figure 7.[18]

[18] We consider the last seven years to reflect the new funding structure set out by the coalition government in 2010, as highlighted in the document "Securing the Post Office Network in the Digital Age". https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31809/10-1260-securing-the-post-office-network.pdf.

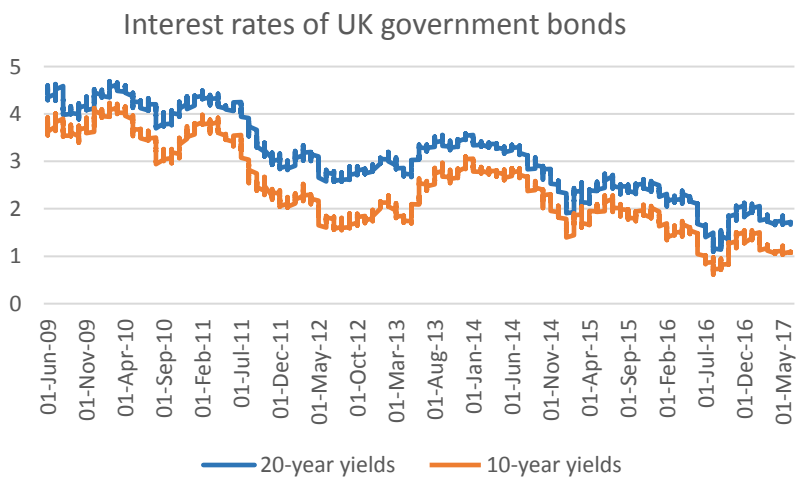
Figure 7: Government funding to the Post Office over the period 2011-2017.



Source: Post Office Annual Reports.

Given the current low interest rate environment, it would be cheaper to capitalise the Post Bank than continue subsidising the Post Office. The Government could issue long-term debt (20 – 30 years) to finance this equity. The UK Government is currently able to issue debt at a very low interest rate. As Figure 8 shows, the interest rates paid by the UK government on long-term debt are a fraction of what they were in the last stages of the financial crisis. The current yield for 10-year-bond securities from the British Government is very close to 1%. This means that issuing debt to finance the set-up of a Post Bank would not be expensive.

Figure 8. Cost of issuing debt for UK government



Source: Bank of England IUDLNPY and IUDMNPY series.

The low rates faced by the UK Government reflect their strong credit rating, which is set at AA despite some turmoil generated by the Brexit referendum. The Credit Rating Agencies have not changed their assessment since the referendum, and hence we expect that these ratings will continue in the medium term. Furthermore, the public debt levels are now under control,

and they are on the lower end when compared to other OECD countries—at around £1.7tr or 89% of GDP.

Therefore, an initial capitalisation of circa £2bn—we explain below how we arrive at this number—would have a minor impact on public finances. Indeed, the government has already spent a similar amount over the last seven years, just to ensure the on-going business of the Post Office. A key difference is that this investment would ensure its long-term sustainability.

- ***Post Office to issue long-term debt to finance initial equity***

There are alternatives to the Government raising the full initial equity of the Post Bank. For instance, the Post Office, rather than the Government, could issue long-term debt (20 – 30 years) to finance it. Ideally, this debt would be backed by HMT, making it very cheap—similar in terms of costs to the case where the Government would issue it directly. To the extent that the Post Bank is profitable—and we will see it should be—then this would not assume any burden for the Post Office operations.

- ***Government/Post Office issuing external equity***

There is also the possibility of issuing external equity. The Post Office does not need to retain 100% of its Post Bank participation in order to retain control of the entity: a 51% stake would suffice. Poste Italiane is an example of a Post Bank only partially government-owned. This option implies that the share of profits would be lower, but it also means that risks are shared and that the Post Bank's operations can potentially grow faster. Given the nature of the business of the Post Bank, with a strong component of financial inclusion, as we explain below, several firms could be interested in taking part of it, to boost their Corporate Social Responsibility (CSR) profile.

- ***Mutual ownership model***

The options we just described refer to the case where the Post Office sets up a Post Bank. There are, however, different ownership structures that characterise other types of financial institutions, such as mutual banks. Mutuals are owned by their customers, cannot readily raise external capital and rely almost exclusively on accumulated reserves of retained profits. These features can constrain their growth opportunities.

In the financial services industry, a mutual ownership model is followed by Building Societies, with some success. Building societies are mutual organisations, owned by their customers or members. Although technically they are not "banks" and do not offer the full range of banking services, as mutuals they are a subset of stakeholder-based financial institutions. In recent years, building societies have enjoyed political support as the importance of mutuals within a more diverse financial sector has been highlighted by policymakers and regulators. This support is also recognised by customers, as indicated by the high levels of satisfaction and trust.[19]

The government has promoted mutual ownership in various sectors, citing evidence that this ownership structure can help to ensure that decisions are focused on the long-term sustainability of the business.[20] The Government believes that Post Office Ltd could be ideally

[19] Casu, B. and Gall, A. (2016). *Building Societies in the Financial Services Industry.* Palgrave Macmillan UK.
[20] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31678/11-1401-guide-mutual-ownership-models.pdf

suited to a mutual model; they do however recognise that a move to a mutual would not be possible until the business is on a more financially sustainable footing.[21]

iii) **Size and portfolio composition**

Having discussed possible ways to raise the initial equity capital, the key question is *how much* initial capital would a Post Bank need. The answer to this question depends both on the size and the riskiness of the initial portfolio.

Equity capital is only a small part of a bank funding; the large majority of funds relates to retail deposits. More specifically, equity capital would only form around 5 – 10% of the total funding of the Post Bank. Most of the funding would come from different types of deposits, from personal current accounts (PCAs), business current accounts (BCAs), and savings products with different terms. As a retail-oriented bank, deposits could make around 70% of the total funding.

The rest of the funding would come from long-term debt to be placed to institutional investors. This long-term debt would have the implicit guarantee of the government, which again would make it cheap. Part of this long-term debt could also be offered to retail investors looking for a secure long-term investment.

- ***The size of the bank portfolio***

A crucial part of the process to set up the Post Bank, and something that needs to be decided before applying for a banking license, concerns its initial portfolio. We highlight several options, which are not mutually exclusive. This is, however, a simplified exercise, and a much deeper market analysis would be needed to inform appropriate decisions.

OPTION 1: Acquiring the Bank of Ireland UK portfolio[22]

A first option to explore is acquiring the portfolio of the current partner of the Post Office, the Bank of Ireland UK plc. Table 4 shows the balance sheet of this institution in 2016. Most of the asset portfolio is made up of loans to customers and mortgages. The liquidity is managed with cash and central bank balances, as well as some Available-for-Sale (AFS) financial assets.

Table 4. Bank of Ireland UK plc – balance sheet in 2016

Assets: £25,960m	**Liabilities: £25,960m**
Cash and CB balances: £1,172m	Deposits from banks: £2,691m
Loans to banks: £3,369m	Customer accounts: £19,475m
Loans to customers: £19,821m	Subordinated liabilities: £335m
AFS financial assets: £1,140m	Other liabilities: £1,409m
Other assets: £458m	**Equity: £2,050m**

Source: BoI UK Annual Report 2016

[21] http://webarchive.nationalarchives.gov.uk/20121030091159/http://www.bis.gov.uk/assets/biscore/business-sectors/docs/b/12-939-building-a-mutual-post-office-government-response
[22] https://www.bankofirelanduk.com/fs/doc/wysiwyg/boi-uk-annual-report-2016-web.pdf.

In terms of funding, most of it comes from customer accounts (75%). Among these accounts, £15,500m are already Post Office-branded deposits. Equity capital is around £2bn.

We believe that acquiring this portfolio—or a similar one—would constitute a solid *first stage* for the Post Bank. This is because most of its products have been offered through the Post Office branch network, and hence there is already expertise in the institution. As mentioned before, many of the Bank of Ireland UK products are already branded as Post Office. Moreover, the Bank of Ireland UK's current profits are well above the 2017-18 planned government subsidy to the Post Office; in other words, with such portfolio, the need for this subsidy would be eliminated. Finally, the Post Office undertook a similar operation when it acquired the Bank of Ireland share of their joint insurance business, which has become a profitable stream of revenues.

For comparison, if the Post Bank were to acquire the Bank of Ireland UK portfolio, it would be one order of magnitude bigger than many of the new challengers, and approximately *twice* as big as Metro Bank.

A key question relates to the price for such acquisition. If we estimate the UK subsidiary of the Bank of Ireland' market value to be equal to its book equity, the price would be around £2bn. This amount, as discussed above, could be raised in different forms.[23] Nevertheless, banks, especially the biggest ones, currently have price-to-book ratios below 1.[24] In other words, the market value of these institutions is below their book value. The Bank of Ireland UK could be a similar case, therefore reducing the price of the initial investment to below the £2bn price tag. An important remark on these lines is that, given the difficulties discussed in Part I, the Bank of Ireland might be forced to divest from the UK market, making the acquisition terms advantageous for the Post Office.

OPTION 2: A new partnership or merger with a challenger bank

Another option to consider is to partner or merge with one or more challenger banks. There are two main reasons why this option would be beneficial: expertise acquisition in some banking products and technology.

The Post Office has already expertise in offering some banking products, such as mortgages and savings accounts. Other types of products, such as business accounts and SME lending, have not been provided in Post Office branches and hence the institution lacks expertise. Therefore, especially if one of the objectives is to expand in a type of product without prior experience, using the expertise of challenger banks—via partnership or acquisition—would ensure that the products meet the customer demand.

The other reason is the technology. Challenger banks are new, and hence most of their technological infrastructure has been built very recently. Older institutions tend to have lower flexibility to improve their IT, which is associated with higher operating expenses. For this reason, acquiring a challenger's technology would put the Post Bank in a good position to contain costs and be profitable enough to sustain other parts of the Post Office.

Table 5 below provides a summary of some challenger banks that focus on the SME sector, which is a target market segment but also one where the Post Office lacks strong expertise.

[23] This would amount to approximately 0.12% of the Government debt in the UK.
[24] https://www.bloomberg.com/news/articles/2016-06-16/europe-s-biggest-banks-are-worth-more-on-paper-these-days-chart.

This sector would offer strong growth opportunities for a Post Bank. Most challenger banks have relatively small portfolios, but as already mentioned, this would not be the main reason to join forces with them. Importantly, none of these challenger banks have a branch network: they could be very interested in having access to the Post Office's extensive one.[25] The last column of Table 5 shows the equity of these banks when available, which serves as an approximation of the cost of acquiring these institutions.

There are several players which are of potential interest. First, the ***British Business Bank***, a government-owned business development bank dedicated to making finance markets work better for smaller businesses. We understand from the Communication Workers Union that this is an option the government is aware of and may consider for the Post Office. A closer relation or partnership with the British Business Bank would help the Post Bank gain market share in the SME lending market, as well as capitalising on the state-owned development bank's expertise. In numbers, the British Business Bank currently supports over 48,000 small business, for over £3.1bn, through its partnership with other lenders.

Another note-worthy example is the ***Cambridge & Counties Bank***, a unique partnership between two established and respected institutions—Trinity Hall, Cambridge & Cambridgeshire Local Government Pension Fund. This bank is of interest in this context, as it is a partnership with a Local Authority.

Finally, the ***Community Savings Bank Association (CSBA)***, a new association which markets itself as "customer owned local banking for Britain" and aims to create a UK-wide network of customer-owned, regional banks to serve the every-day financial needs of ordinary people, local community groups and small and medium sized companies.

[25] Some of these banks are more digitally-focused, but this is partly by necessity, since the initial investment required to set up a branch network is too high for them.

Table 5. Challenger banks specialising in SME lending

Bank	Banking License	Business Model	Equity
Aldermore Bank	Established in 2009, Aldermore is essentially the reincarnation of private bank Ruffler after it was sold off to private equity group Anacap Financial Partners.	Serving customers and intermediary partners online, by phone and face to face through our network of twelve regional offices	£626m
British Business Bank	A government-backed bank	A development bank (start up; scale up and stay ahead)	£791m
Cambridge & Counties Bank	Granted a licence in 2012; it is fully in operation	It is owned by Trinity Hall Cambridge and Cambridgeshire Local Government Pension Fund	£29m
Community Savings Bank Association (CSBA)	Originally working with Airdrie Bank, which failed in 2017. The banks' model and legal form has been agreed with the FCA and registered. Individual banks will apply for banking licences	Mutual business model. CSBA intends to set up a network of independent, customer-owned, regional banks to support local communities and businesses. Once set up, these banks will own and run the CSBA	NA
Hampshire Trust Bank	Granted. Formed in 1977, relaunched in 2014.	Specialist lender.	NA
OakNorth	Granted in 2015	A start-up bank, focusing on business lending	£81m
Redwood Bank	Granted in 2017 (subject to restrictions). In post-authorisation mobilisation phase	SME Business Bank. It will provide secured lending products and deposit accounts to SME businesses	NA
Shawbrook Bank	Formed in 2011, owned by RBS Equity Finance	Specialist lender	£370m
Tide	Tide is a current account, not a bank.	Tide is a business current account aimed at sole traders and SMEs.	NA

Sources: annual reports and websites of the different institutions.

iv) Market analysis

Another concern raised by the government to the previous Post Bank proposal was that it would be extremely difficult to build a significant market share quickly in a competitive market. We argue that there is room for growth in the UK banking sector, as demonstrated by Metro Bank. We build the case by considering the current revenues of the Bank of Ireland UK and comparing it with the growth rate of Metro Bank.

Revenues of Bank of Ireland UK

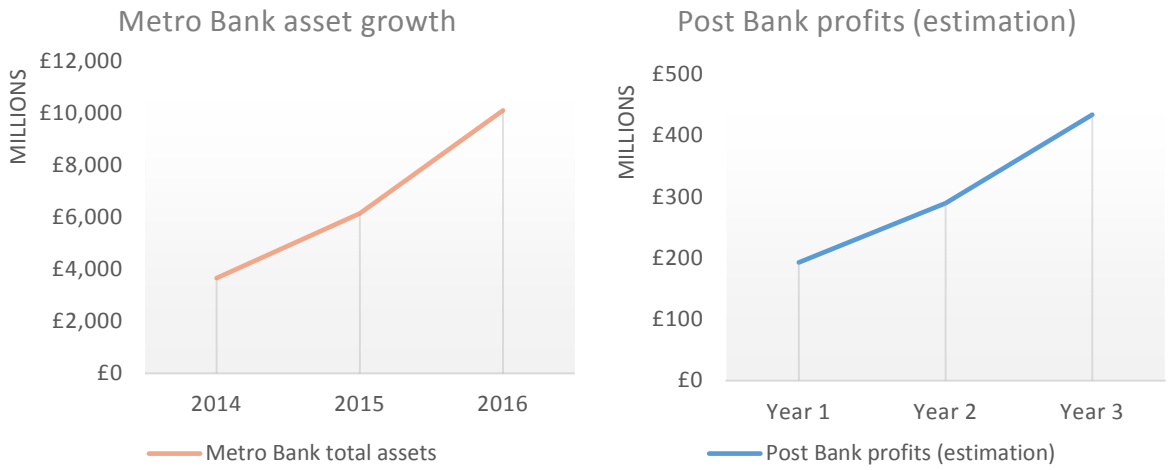
The Bank of Ireland UK had £193m in profits in 2016. We take this number as a close estimate of the initial profits that the Post Bank would be able to obtain if it acquired the Bank of Ireland UK portfolio. While it is true that the transition from the Bank of Ireland UK to the Post Bank could carry some costs, the Bank of Ireland UK has been underinvesting in recent years and hence the potential profits of its current portfolio are probably higher.

The current profits are higher than the average Network Subsidy Payments from the UK Government in recent years, which means that such operation would allow these payments to stop. This is one of the main objectives of the Post Bank: to make the Post Office financially viable without depending on regular government subsidies.

Moreover, the initial portfolio has a strong potential to grow substantially. Metro Bank, for instance, was growing its assets at a 64% growth rate in 2016.[26] Metro Bank's initial portfolio was smaller, but even in absolute terms, this growth amounts to £4bn, and this is without the availability of an extensive branch network to distribute the products. Figure 9 shows that Metro Bank has been able to maintain a growth rate above 60% the last two years.

[26] https://www.metrobankonline.co.uk/about-us/press-releases/news/metro-bank-reports-record-annual-growth-in-deposits-and-strengthening-profitability/.

Figure 9: Metro Bank asset growth vs Post Bank estimated profits



Source: Metro Bank and Bank of Ireland UK annual reports and authors' estimations

A working assumption would be, then, that the Post Bank would be able to grow at similar rates initially. For instance, assuming a growth rate of 50% (slightly below Metro Bank's growth rate in 2016) during the first two years, this would imply that the profits by Year 3 would be above £400m. Profits and assets would grow at a similar rate in a Post Bank given that a large initial investment in a branch network is not needed.

These profits would be added to the current ones that the Post Office already receives for financial products; these products, such as currency services, should continue to be offered by the Post Bank. Furthermore, as we highlight below, we think that there is also an opportunity for the Post Bank in SME financing that would increase profits even further.

Branches

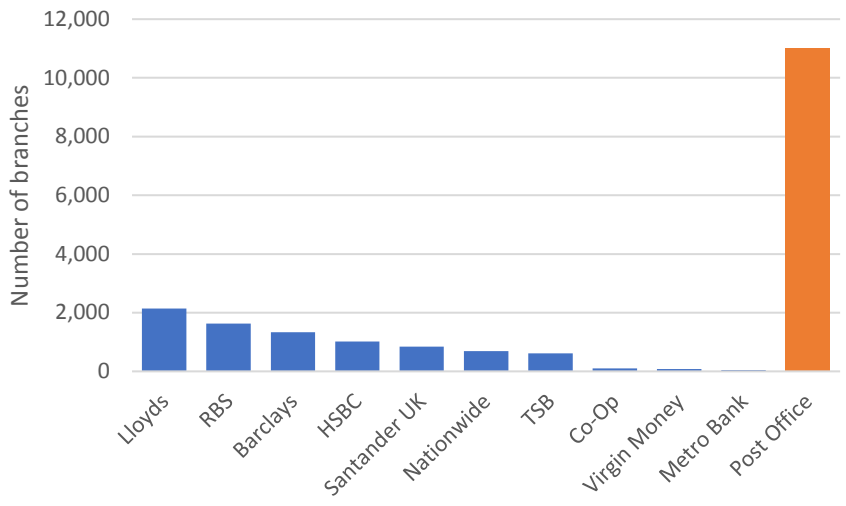
The assumption that the Post Bank would be able to grow significantly during the first years capitalises on the strongest asset that the Post Bank would have: its branch network. As we have mentioned before, the UK banking sector has experienced many branch closures in recent years, an on-going trend which accelerated after the financial crisis. There are pockets of customers that have had their banking options severely reduced, and here is where the Post Bank would have room to grow.

The branches of the Post Office are present in many areas where banks have no longer a presence. In fact, some banks have argued that the presence of the Post Office allows them to withdraw from some areas. When asked about why they dropped the pledge to stay open when RBS was the last bank in town by the Treasury Committee, Moray McDonald, Managing Director of Products, Personal and Business Banking Division, mentioned that "*We have an alliance with the Post Office, which has 11,000 locations—more than we ever could have*".[27]

As Figure 10 shows, the Post Office has more branches than the rest of the banks in the UK combined. Not only that, but its distribution is not as centered around urban areas as it is the case for commercial banks.

[27] Briefing paper 385, "Bank branch closures".

Figure 10: A comparison of branch network of the Post Office vs major UK banks



Source: SNL Financial and Post Office

At the moment, the Post Office has agreements with several banks so that the customers can access their bank accounts and perform some basic operations. Nevertheless, the branch network could be much more profitable if it was used directly by the Post Bank.

The reduction of bank branches has been a trend for at least 30 years. In fact, nowadays there are less than half the number of bank branches as compared to 1988.[28] One of the reasons for this trend is related to technological advances and the diminished need of continued interaction between the bank and its customers. The recent digitalisation push is also contributing to the lower use of branches. According to a report by the British Bankers Association ("Digital Disruption"),[29] "*the number of people going into branches to do their banking is falling dramatically (by around 30% in the last three years)*". However, this decline is not homogenous across gender, age and income (as we show in the next section on financial inclusion).

While some banks are pursuing this strategy, a few others, such as Metro Bank, have developed a different business model where branches—stores, as they call them—are at the centre of it. In the words of Craig Donaldson, its CEO, "*I see the store as central to what we do*". Part of the reason why customers are using branches less and less is because, in an effort to cut costs, the services offered in branches have been progressively cut down and customers encouraged to use online services. While some challengers are countering this trend and expanding their branch network, this is far from enough to compensate the branch closures of the main banks. Not only that, challenger banks will typically open their branches in places where they can be more profitable, and this means that they will expand around urban areas whereas more rural areas are barely serviced by either traditional or challenger banks.

For a Post Bank, the marginal cost of keeping a large branch network is very small as it would be capitalising on the existing real estate of the Post Office Ltd rather than having to acquire or lease new buildings. This would allow the Post Bank to achieve an immediate national

[28] Ibid.
[29] https://www.bba.org.uk/news/reports/digital-disruption-uk-banking-report/.

presence and therefore become a competitive player much faster than challenger banks could achieve.

As we shall see in the next sections, some customers, especially SMEs, do still use bank branches frequently and hence would benefit from a Post Bank operating through Post Office branches.

Opportunity in SME finance

As explained in Part II, the banking sector is particularly concentrated for SME products, both lending and business current accounts (BCAs). There are several reasons for this situation, but two of them stand out: small businesses value the presence of a branch network much more than other banking consumers, and they need their main lender to provide different products. This makes it very difficult for new competitors to enter this market: some of them lack the branch network infrastructure, and some of them specialise in specific products.

The Post Bank would be in an ideal position to reverse the low competition trend in this sector. Small businesses typically obtain finance via their main personal bank, as highlighted by a recent CMA and FCA report.[30] Moreover, small businesses use the Post Office branches on a regular basis, be it to send their products or to make payments. Therefore, the Post Bank would be able to use its extensive branch network, its existing retail products, and its current stock of business customers to build up a portfolio of SME lending and BCAs rapidly.

The revenues and volume of these businesses are substantial. According to the CMA and FCA report, BCAs generate in excess of £2bn in revenue a year. In terms of SME business loans, the total outstanding amount is around £90bn.

There are other reasons why the Post Bank would be better equipped than the large banks to undertake this type of business. Commercial banks have been reducing the supply of credit to SMEs because of a combination of debt overhang problems from the financial crisis and the new regulatory framework of Basel III: their objective has been to reduce risk-weighted assets, a measure of bank asset riskiness that is used to calculate the capital requirements, as well as costs associated with branches.

The Post Bank, on the other hand, would not need to deleverage as commercial banks have done. Moreover, the branch network already exists as it is needed for postal services, so the marginal cost associated to branches is much smaller than for commercial banks. Furthermore, the main line of business would be domestic retail and SME, which would isolate the Post Bank from global shocks and make their activities less pro-cyclical; this is in line with the empirical evidence that government-owned banks' lending is substantially less pro-cyclical that private banks' lending.[31] As seen during the financial crisis, this is very important since it means that the Post Bank would counteract, rather than exacerbate, future recessions.

Targeting SMEs lending and BCA, therefore, would increase competition in the sector and allow the Post Bank to obtain substantial revenues from these activities. But there are other social benefits. The increased availability of products for SMEs would be more important in

[30] CMA / FCA (2014) "Banking services to small and medium-sized enterprises" (https://assets.publishing.service.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf).

[31] Bank ownership and credit over the business cycle: Is lending by state banks less procyclical? By Ata Can Bertay, Asli Demirgüç-Kunt, and Harry Huizinga. Journal of Banking & Finance 50, 2015. http://www.sciencedirect.com/science/article/pii/S0378426614000958.

areas where commercial banks have recently been retreating from, typically more rural and poorer areas. Therefore, these areas would benefit more from the existence of the Post Bank: banking products availability would improve their SMEs' performance, which would have positive economic consequences for these areas.

Given the privileged position that the Post Bank would have, it could acquire a substantial market share in the SME segment in a relatively short period of time, especially if it partners with an institution with some expertise. Several surveys suggest that there is strong demand from SMEs for better banking services.[32] We suggest, as an initial target, a goal of 5% of the market share. Acquiring a 5% market share in small business loans would give rise to a portfolio of circa £5bn, and it would amount to £100m in terms of profits from BCAs.

This SME lending portfolio would need additional equity capital to maintain healthy solvency ratios. For the mentioned portfolio of £5bn, this would imply additional equity of around £500m. However, this would be a gradual process, and the Post Bank's own profits could be used to build up this additional equity to enter into the SME market segment, without the need of an additional equity injection by the government.

v) Capitalising on existing strengths

Brand

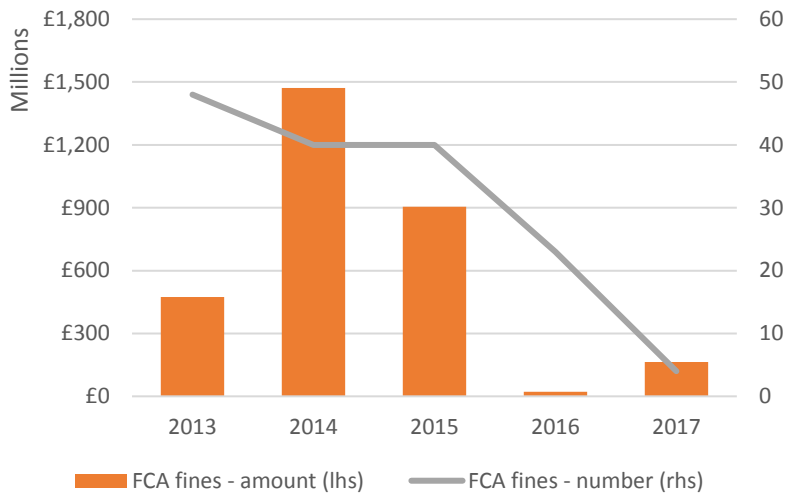
The perception of banks by the public in the UK is generally negative. The financial crisis, together with the excesses of the sector and its conduct scandals, has increased the mistrust towards banks. A report by YouGov[33] published in 2013 highlights that 73% of the people surveyed described the reputation of banking as bad, the highest number among the industries they tested.

The industry itself recognises this issue. Antonio Simoes, the CEO of HSBC, believes that "*the public trust in us might take a generation to re-establish itself*".[34] Mark Carney, the Governor of the Bank of England, has expressed similar thoughts: "*A series of scandals ranging from mis-selling to manipulation have undermined trust in banking, the financial system and, to some degree, markets themselves.*"[35]

The Libor and the PPI scandals are probably the two best known recent misconduct behaviours, but they are not the only ones. As Figure 11 shows, the FCA has imposed 155 fines since 2013, with the total amounting to over £3bn. Even in the first months of 2017, fines of a total of £163m have been imposed.

[32] https://yougov.co.uk/news/2017/05/22/smes-want-banks-do-more-support-business/.
[33] http://cdn.yougov.com/cumulus_uploads/document/ylf7gpof19/Public_Trust_in_Banking_Final.pdf.
[34] http://www.telegraph.co.uk/business/2016/03/08/hsbc-boss-customers-wont-trust-banks-for-a-generation/.
[35] http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech970.pdf.

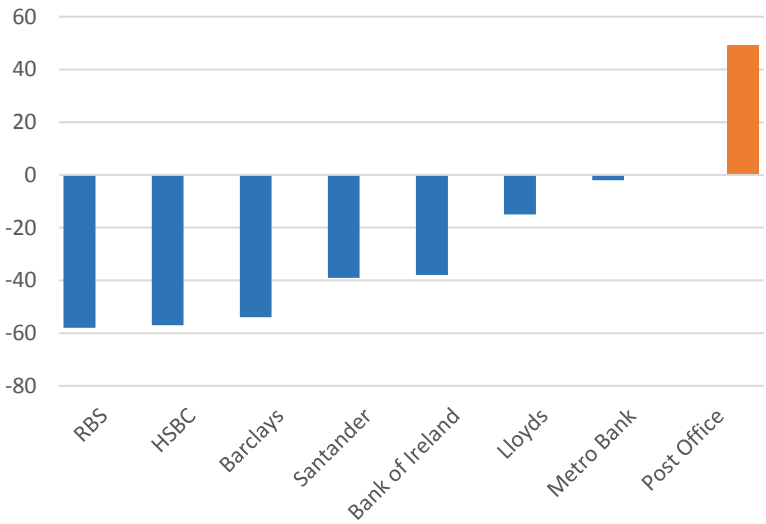
Figure 11: Fines on banks for misconduct cases in the period 2013-2017



Source: FCA website.

In contrast, the public opinion of the Post Office is very positive. A recent survey showed that the Post Office is the second most trusted brand by the British people.[36] The website YouGov, where users can rate different brands, shows the difference in perception between banks and the Post Office. Figure 12 shows that the ratings for the top banks are significantly negative; the current partner of the Post Office, the Bank of Ireland, is no exception. Even Metro Bank, which is a new lender with a strong focus on customer service, has a slightly negative rating. The Post Office, on the other hand, shows a highly positive rating.

Figure 12. Brand perception for the Post Office vs other banks.



Source: YouGov (June 2017)

[36] http://www.thedrum.com/news/2014/04/11/britons-trust-aa-post-office-boots-and-google-more-any-other-brand.

This positive perception would allow the Post Bank to attract customers more easily and faster than new challengers could achieve, since it would capitalise on an already known and valued brand.

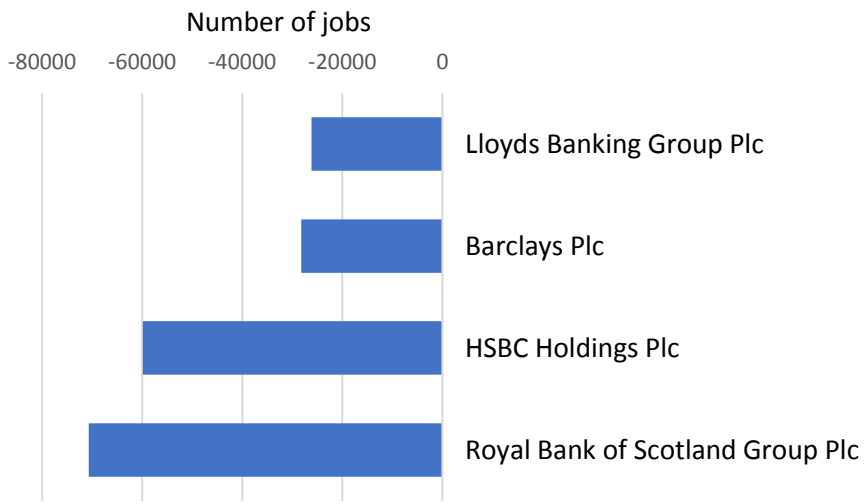
Skill availability

The Post Office has already a number of staff with the relevant skills. For example, there are mortgage advisors in approximately 100 larger branches. While the Post Office will be able to retain and retrain some of the current workforce, it is also true that a Post Bank will require a recruitment drive for personnel with the right skill set. This can be also seen as an opportunity to create highly skilled jobs, particularly in areas where there is a paucity of opportunities.

A key impact of the financial crisis on the banking industry has been a severe cut in jobs in order to reduce costs. As for the bank branch closure, this is an on-going process. The cumulative sum of the job losses over the period 2011- 2017 is presented in Figure 13 for the Big-4 UK banks. In absolute term, full time equivalent workers (excluding temporary workers) that have been dismissed by the Royal Bank of Scotland numbers to above 60,000. On similar level are the jobs cuts by HSBC. Slightly behind, we find Lloyds and Barclays. Even assuming that some of these workers have been absorbed by the fast-growing challenger banks, many have been left behind.

A Post Bank will need their expertise to adequately offer banking products and more in general the management skills to run the banking business—for instance in terms of marketing strategy, risk management and accounting. Part of this expertise could come from bank staff that were laid off but have the relevant skills and experience in the different banking business areas in which the Post Bank will plan to expand. The upside will also be to alleviate the negative implication of banks' decisions on the economy in terms of employment.

Figure 13. Job losses in Full-Time Equivalent terms since the financial crisis



Source: SNL Financial

Financial inclusion

UK banking was traditionally centred on physical branches and personal interaction with bank staff; for this reason, branch closures are worsening the ability to access financial services particularly in remote and less densely populated areas. As noted by the FCA,[37] "*bank branch closures are commercial decisions by banks that may disproportionately affect certain consumer segments such as older people, those in low-income communities… and small business.*"

The government has acted upon these concerns by negotiating with banks to maintain an adequate coverage of the most remote areas, and in most of the cases suggesting the use of Post Office branches. However, only basic banking services are offered in this case. Given that physical branches are still crucial for accessing to banking services, particularly for those customers who are less likely to have internet access, the set-up of a Post Bank would allow the offering of retail services via an extensive network and thus alleviate the additional financial exclusion created by bank branch closure and their reliance on online banking services.

This issue is very relevant for a considerable part of the population: around 1.5 million UK adults remain unbanked;[38] 3.8 million UK households do not have internet at home, and 12 million people live in rural or remote areas of the UK where poor internet access can make it difficult for them to manage their money online.[39] Moreover, 1 in 5 consumers in UK lacks digital skills.[40]

Access to financial services is globally recognised as important to financial stability and the integrity of markets. Consumers excluded from mainstream financial services are more likely to use the cash economy and alternative providers. In the process, they are more vulnerable to being exploited or scammed by criminals. More in general, research has indicated that financial inclusion facilitates greater participation in the economy and cost savings. Indeed, formal financial services, such as savings or insurance, can help planning and provide protection against potential income losses deriving from illnesses, accidents and natural disasters. Access to credit for micro, small and medium-sized enterprises is an indispensable tool for economic growth. For people on low income, ready access to formal financial services can make the difference between poverty and the ability to stay above the poverty line.

Table 6 discusses the role that a Post Bank plays in terms of: i) easier and "wider" access to financial products for customers; ii) financial products offered to a larger set of customers, including traditionally "unbanked" customers; and iii) financial products offered at a lower cost, thereby contributing to socio-economic development [41].

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[37] https://www.fca.org.uk/publication/occasional-papers/occasional-paper-17.pdf.

[38] Rowlingson, K., and McKay, S. 2015. Financial inclusion annual monitoring report 2015. http://www.friendsprovidentfoundation.org/wp-content/uploads/2015/10/University-of-Birmingham-Financial-inclusion-report-2015-final.pdf.

[39] Office for National Statistics, 2015. Statistical bulletin: Internet Access - Households and Individuals: 2015 https://www.ons.gov.uk/peoplepopulationandcommunity/householdcharacteristics/homeinternetandsocialmediausage/bulletins/internetaccesshouseholdsandindividuals/2015-08-06

[40] House of Lords, 2015. Make or break. The UK digital future. https://publications.parliament.uk/pa/ld201415/ldselect/lddigital/111/111.pdf

[41] Cull, R., Ehrbeck, T., and Holle, N. 2014. "Financial Inclusion and Development: Recent Impact Evidence", Focus Note No. 92, CGAP.

Table 6. Post Bank and Financial Inclusion

	Main challenges	***Post Bank's role***
Access	• **Physical barriers** This relates both to the ability to access financial services in the local community as well as the accessibility of these services.	The Post Bank would own one of the largest and most 'capillary' retail networks in the world which aims to connect all parts of a country - unlike banks which tend to concentrate in profit centres such as larger and wealthier cities.
Eligibility	• **Income** Banks tend to focus on higher-income customers.	Based on its unique public-oriented mission and universal service obligation, a Post Bank would be more willing to accept all types of customers (in terms of income, employee status, race, gender).
Affordability	• **Cost** The cost of accessing financial services, including both direct and indirect costs, is a main barrier to financial inclusion.	Post Banks can provide financial services at a large scale, which should enable them to exploit economies of scale, thereby minimising production costs and increasing their likelihood to be profitable

Source: UPU (2016)

Final remarks

In the above we have set out a case for the establishment of a Post Bank as a separate subsidiary of the Post Office. We envisage the Post Bank to be a modern, sophisticated and innovative player offering a range of banking services at a large scale. We argue that a Post Bank is a viable business opportunity that will contribute to the revenues of the Post Office, thereby ensuring its long-term sustainability and ending its reliance on government subsidies.

We make the following recommendations.

1. We recommend that the partnership with the Bank of Ireland should be ended, as it has failed to deliver the expected outcomes.
2. We recommend the establishment of a Post Bank that is (at least partially) owned by the Government and operates through the Post Office branch network.
3. We advise that the Post Office acquires the Bank of Ireland UK portfolio as the initial portfolio of the Post Bank, retaining all the customers that have acquired products and services white-labelled via Post Office Money.
4. We recommend the Post Bank to be set up as a separate subsidiary, with a separate management team and separate accounting, and endowed with its own capital.
5. We advise the Post Bank to make use of the capillary branch network to expand in SME lending and BCA segments.
6. We identify possible mergers or partnership with challenger banks that specialise in SME lending in order to acquire modern technology and skills.
7. We encourage the Post Office capitalise on its existing strengths, its strong brand and reputation, to fully benefit from the establishment of a Post Bank

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