UK Retail Banking – will the Challenger Banks really challenge?

UK Retail Banking has not come out of the financial crisis in good shape. Two rehabilitated banks are largely in public ownership, and there have been continued issues over payment protection insurance plus more recent crises over Libor and foreign exchange price fixing. It's no wonder public confidence is at an all-time low.

As part of a wide initiative to encourage innovation and competition and to improve the lot of the customer, the regulator has speeded up the licencing process for UK banks, so that now there is a score of new entrants just launched or about to launch.

The hope is that these new Challenger Banks will stimulate competition in the retail banking sector, and could even introduce a disruptive element that will challenge the long established hegemony of the large incumbents.

But is it likely that these Challenger Banks will significantly impact or even disrupt the retail banking sector and if not what would they need to do to make a material impact?

In this paper, we set out the view that the Challenger Banks will in fact make little impact on the retail banking sector, certainly not disrupt it. They appear to offer a wide array of 'me too' strategies which the incumbents have experience of dealing with. More likely to make an impact are a range non-bank competitors with different business models that attack pockets of value in adjacent markets, needed by the incumbents to support free current accounts. Instead of tackling the incumbents head on, some of the Challengers would do better to adopt the tactics of disruption, not just to make more impact, but to have a viable long-term future.

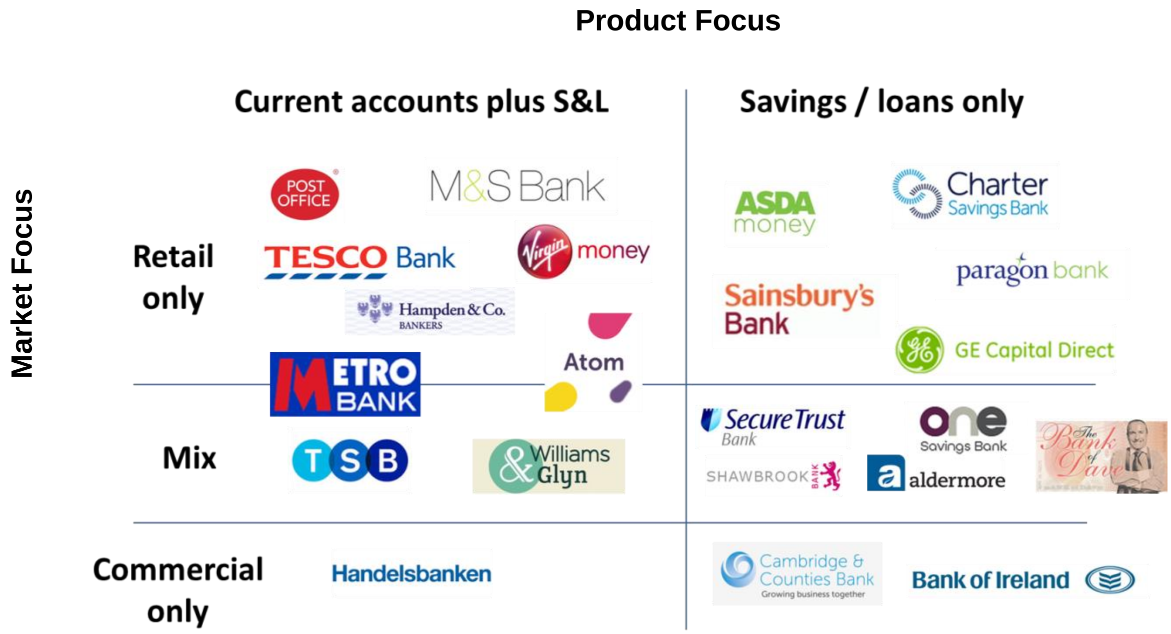
I The Challenger Banks offer a wide range of strategies to target traditional markets but do not offer the seeds of disruption

The Challengers appear to be a very heterogeneous group, and do not represent a concerted approach or a commitment to any particular strategy.

They can be thought of as including the supermarket banks and the Post Office as well as Metrobank and other firms, both launched and in the pipeline. Some of the new licence applicants are pure start-ups, but most are rebadged businesses and there are two foreign entrants, some specialist lenders and a private bank.

A review of the range of offers in the pipeline, shown in the chart overleaf, reveals a spread of strategies. In terms of market focus, there is a spread across retail and SME. In terms of product some offer current accounts and savings and loans, others concentrate just on savings and loans.

Product Market Focus of 'Challenger Banks' and other Recent Entrants



Source: Lawrence Somerset

As to channel, there is a spread of well-used models: bank branches with online, online only and "affinity" businesses levering wider, non-banking customer bases.

Channel Focus of 'Challenger Banks' and other Recent Entrants

Source: Lawrence Somerset

Most of the Challenger Banks appear to be variations on a theme of banking as it now is with some added ingredient – for example: more trustworthy; more moral; more personal; more accessible; more fun; more committed to service; less expensive, etc. etc., but with a strong claim of: “we are not them”.

There are very few with business models that appear to be suited to competing in a materially different way. Some do stand out:

- **Atom Bank**: An online only bank whose claim is to offer a sub-30% cost to income ratio. That is very different, so long as their proposition is compelling, but since current accounts are free at present and interest rates on savings and loans are very low, Atom may not be able to offer sufficient margin to draw in customers except for limited balances.

- **The supermarkets**: Affinity businesses which have an ongoing and non-banking relationship with their customers and who could compete on a very different basis in banking markets. However, they are likely to be defending their core businesses against discounters for some while and may not be pursuing banking as vigorously as in the past.

- **The Post Office**: Another affinity business, currently sponsored by the Government and so is in a similar position to NS&I with arguably some element of unfair advantage. They have an enormous branch network and market reach. However, their cost to income ratio is likely to be high and so they may not have a sustainable model without continued support.

- **TSB and Williams and Glynn**: Worth highlighting since they are not really start ups but have the advantage of largish branch networks and the use of legacy brands from Lloyds and RBS. TSB aims to offer a different proposition but sustaining this on similar economics to the incumbents with a shareholder structure may prove difficult. Williams and Glynn is likely to be similar but more moral – due to launch in 2016.

Despite these exceptions, it remains the case that these strategies do not appear to offer the seeds for a disruptive or even a major influence on the retail banking market. Indeed, we suspect that many of the Challengers are predicating their strategies on the return of higher interest rates since this would give them more leverage in their chosen markets.

One of the major accountancy firms essentially confirms this perspective: their view is that the effect of the Challengers and all the other new entrants to financial services may reduce the market share of the large incumbents by only 10%. Since this forecast is based on an expansion of the market definition that appears to be a relatively small impact.

The likelihood of any major disturbance from the Challengers seems even more remote when one considers the incumbents themselves.

II The incumbents are capricious competitors because they see the world differently to others

The incumbents are difficult competitors, especially for small new entrants, taking the incumbents head-on with traditional strategies, because, apart from their enormous resources and ability to wait out less resourced competitors, their own strategies are not based on the same concept of customer value. Basically, certain retail customers are potentially worth more to an incumbent that to a new entrant with a traditional business model.

This is because the retail banking business is distorted by the existence of free banking. Introduced by Midland in 1984 and rapidly adopted by everyone else, free-banking has left the banks facing a “Prisoner’s Dilemma”. They could all benefit if the practice were revoked, but the first incumbent to make the move without regulator support would fear losing many accounts.

Free current account banking distorts the incumbents’ strategy because their response in any given market will affected by selling non-banking services to customers, using current account contact to “cherry pick” additional revenue opportunities.

Since 1984, the large banks have spent huge energy seeking other sources of revenues to compensate for the lack of a fair market price for their core service.

The tactics employed have ranged from finding indirect ways to charge - leading to many claims of unfair treatment of customers - to selling additional services such as insurance and wealth management – leading to regulator attention, fines and withdrawals, and to lack of real competition in the SME market, always the poor relation between Retail and Corporate divisions.

Incumbents’ Strategies for Incremental Revenues

Within core services:

- High charges for unauthorised overdrafts
- Perpetuation of 3-day clearing
- Packaged accounts – payment for bundled services – travel insurance etc.
- High charges on international services

In adjacent retail markets:

- Direct selling of life and pensions products
- Broking insurance, such as PPI
- Mortgages and the subsequent syndication of loan books

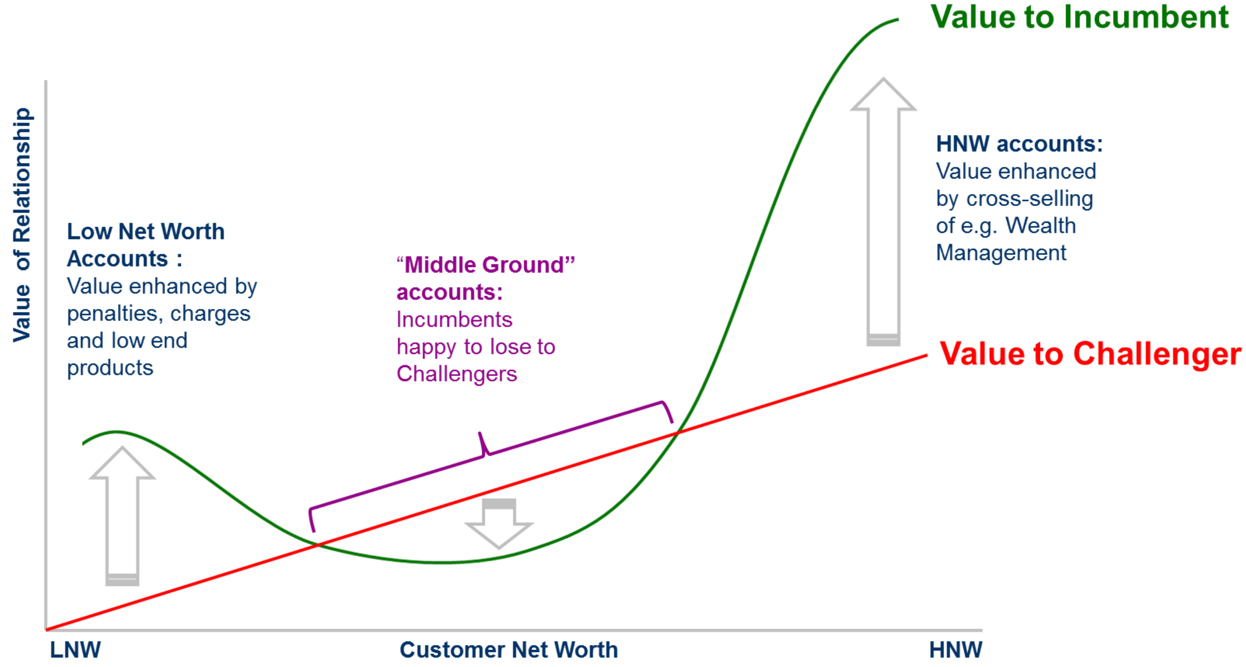
In adjacent banking markets:

- Lack of real competition in SME banking

Source: Lawrence Somerset

In most cases, the current account has provided the conduit to these incremental revenues and led to the “lifetime value” concept of customer value. The incumbents place more value, curious as it may seem, on two dissimilar groups: those with poorly performing accounts they can charge or to whom they can sell insurances; and the better off who can provide opportunities to sell wealth management and pensions.

Differing Perspectives on Customer Value



Source: Lawrence Somerset

So when new competitors offer core banking products the response from the incumbents will be determined by the role of the relationship in this wider product context. The point is: the incumbents are very prepared to lose relationships in the "Middle Ground" if the impact on the wider financial contribution is low even though it creates the impression that competitors may be growing in the short term.

The downside for the challenger is that the newly acquired customer is not likely to be profitable for the new entrant unless they have a very different business model to deliver traditional banking or they intend to cross-sell valued added services.

The incumbents are also prepared to lose loan opportunities, largely because they have limited capital and so will apply this to the customers they want to keep. In retail markets they did not take up an obvious opportunity in payday lending, ie their own customers needing funds to survive until the end of the month, and in the SME market they have been content to see other entrants, especially in the mortgage, invoice finance and asset backed markets.

Despite the incumbents' chequered history of entering adjacent markets, new technology has rekindled the old dream of selling adjacent market services and incumbents are once again focussed on the accounts of customers with more to offer beyond current account banking. Omni-channel systems, nudge marketing and behavioural finance are providing fresh impetus for banks to engage in the wealth management and retirement preparation and decumulation markets with renewed vigour. (See our previous article: Challenges in the Mass-Affluent Decumulation Market)

In another regard, the incumbents are unusual competitors because of their approach to innovation. They are not disruptive innovators themselves, and tend, with hindsight, to innovate as a group. This is not to say retail banking is not innovative – it has been very active in incremental innovation. Most of the great innovations in banking have involved the sector as a whole - credit cards, debit cards, ATMs, online banking. The brave step of First Direct perhaps 'proves' the rule. The first telephone bank, built to purpose with a fresh brand, it has built a committed customer base. It did not disrupt the sector – its main proposition was rapidly copied by the incumbents by grafting on telephone banking, and took decades to make any money.

This incremental style of innovation is such as to protect existing revenue streams until an innovation becomes unavoidable or until all the banks are prepared to introduce the innovation more or less in concert.

Incumbents are also disposed to acquire either a good idea or capacity when it suits them.

It is useful to observe the effect of building society demutualisation during the 90s. A number of new banking entities were launched with branches, customer bases and good local brands.

The Demutualised Building Societies and What Happened to Them

Cheltenham & Gloucester	1995: Bought by Lloyds Bank
National & Provincial	1996: Bought by Abbey National
Bristol & West	1997: Taken over by Bank of Ireland, 2005: transferred to Britannia Building Society
Birmingham Midshires	1999: Taken over by Halifax.
Woolwich	2000: Taken over by Barclays Bank.
Halifax	2001: Merged with Bank of Scotland to form HBOS
Abbey National	2004: Bought by Santander
Alliance & Leicester	2008: Bought by Santander
Bradford & Bingley	2008: Mortgage book nationalised and retail savings transferred to Abbey
Northern Rock	2008: Placed in temporary public ownership, 2011sold to Virgin Money

Source: Building Societies Association

None of the ex-Building Society banks remain as independents - most of them (the previous challengers?) were bought by or ended up within the incumbents. Will the fate of Challenger Banks be any different?

So it does not look as if the Challengers are thought likely to make much impact on the incumbents and are unlikely to make them change their behaviours. That is unless they can introduce other elements into their strategies.

III The Challengers would do well to exploit some of the insights of disruptors in other sectors if they want to build large businesses

The Challengers' longer term strategies may of course be to become a thorn in the side of an incumbent and be bought. That would certainly make sense as a shareholder strategy.

Acquisition most likely remains in the thinking of the incumbents and in fact is reflected in at least two of the Challengers. Aldermore and Secure Trust, following planned flotations, and perhaps TSB, are already poised to act as acquisition agents themselves, rather than seeking to offer an innovative proposition per se. This is despite the recent news of continued downsizing of branch networks by the incumbents.

But if the objective is to build significant market share and to be successful as an independent business, there are some insights from a study of disruption from other markets that might be useful to take on board, some of which do not need a banking licence.

Clayton Christensen from Harvard has developed a set of theories of innovation and disruptive competition. His idea is that new technologies allow a disruptive new entrant to build a scalable business in a way the incumbents cannot or will not copy until such time as it has built scale, has improved its proposition and is ready to take the incumbents head on, but with lower costs.

He has set out some preconditions for disruption:

1. A large potential customer base – either "over served" by incumbents with a high priced, sophisticated proposition they don't need, or a large "non-customer" base not served by the incumbents.
2. A compelling proposition to the potential customers, albeit not necessarily with all the features of the incumbents' proposition ("low end") and not necessarily attractive to existing customers.
3. A business model based on some fresh insight and/or technology that is cheaper than the incumbents' models, scalable and difficult for them to replicate, at least initially.

The first point to note is that traditional retail banking in the UK does not exhibit many of these characteristics. Current account banking is hardly over-serving its customers with a high priced sophisticated product – the core product is free!

However, many of the adjacent markets do exhibit these characteristics: they have complex products; providers are seen as not very honest; often obscure; often with high and/or ad valorem pricing. They also have increasing numbers of 'non-customers' with an increasing trend to DIY. In fact the insurance and now the wealth management sectors are talking about the "protection gap", the "pension gap", the "advice gap" – as if the potential customers they are referring to are somehow being incredibly stubborn for not wanting the products on offer!

In addition, there are many innovators in the financial services markets that are targeting new types of customer, new buying processes and situations, new price-setting processes with new propositions and, crucially, with very different types of business model.

Some of the more prominent are shown in the following chart:

Selected Examples of New Business Models in Financial Services

Potentially Disruptive Entrants	Major Examples
Pay day lenders	Wonga, Payday Express, Quick Quid, Payday UK, Reddies Direct, Sunny
Overseas money transfers	Transferwise, Kantox, Peertransfer, CurrencyFair
Online payment providers	PayPal, Google Wallet, Apple Pay, GoCardless, eWay, Stripe, Amazon
POS payment providers/ contactless payments	Oyster, Bionym, Coin, Bitpay, Worldpay
Sub-prime lenders	Provident Mutual, Magellan Homeloans, FX Mortgages
Currencies	Bitcoin
Price Aggregators	Compare the Market, Moneysupermarket, GoCompare, uSwitch, Petrolprices, mysupermarket
Passive management:	iShares, Vanguard
Online wealth management:	Nutmeg, FundsNetwork, Hargreaves Lansdown
Peer to peer lenders (lending to individuals)	Zopa, RateSetter
Debt crowdsourcing (lending to business / against assets)	Funding Circle, FundingKnight, Wellesley & Co, Assetz Capital, Lendinvest, Landbay
Equity crowdsourcers:	SyndicateRoom, Crowdcube, Seedrs

Source: Lawrence Somerset

There are many current and potential new entrants that are systematically stripping the financial services markets of value or, at least, denying that value to the incumbents by inserting in the value chain and/or providing value for customers. Of course, many of the innovations still use the banking system, and so the incumbents do still participate in some small way. However, being reduced to a utility provider does not meet the aspirations of many incumbents' shareholders.

Using the Christensen thinking and some of the role models that are emerging as having disrupted or begun disrupting adjacent financial services markets, the Challenger Banks might explore some of the following strategies:

- **New customer groups**. Focus on customer groups not especially targeted by the incumbents or ones that are clearly over-served and would benefit from a simpler offer, so long as the business model is adapted. This could be an approach for the Post Office and supermarkets who are in frequent direct contact with millions of customers on a regular basis, including many of the unbanked. Pay day lending is another example, lending to waged people short of money. A less exploitative approach may have been more sustainable.

- **New circumstances**. Focus on circumstances not directly covered by traditional banking that lend themselves to a new service proposition in order to build a business that does not compete head on with the incumbents. This strategy has been followed with outstanding success by Paypal which grew as the payment mechanism for EBay and which now has 162 million active accounts, processes more than 11 million payments per day, and is expanding to reach into merchant services.

- **Low-end propositions.** Create new propositions that are just good enough to do the task in hand and charged appropriately. For example, exchange traded funds, available in Europe since 1999, have grown popular in recent years and offer the promise of a fresh approach to passive management. So far, the incumbent wealth managers have resisted their introduction because of the paucity of fees, and have sought to position them as a small part of a portfolio, but that is changing. ETFs are increasingly able to mimic aspects of active strategies and deliver portfolios for basis points.

- **Lower cost business models**. Target parts of the incumbents' own strategies for adjacent markets that take advantage of high pricing with a different business model that can withstand price competition. This is the strategy of the FX suppliers whose business model is to swap currency in country rather than incur the costs of conversion.

  The new wave of FX suppliers such as Transferwise and Kantox are doing this in conjunction with a new business model and are concentrating on the huge numbers of young professionals arriving in the UK seeking employment who wish to send money internationally. The recent $1bn funding for Transferwise is an excellent endorsement of this approach. In the short-term the incumbents will be reluctant to respond by cutting margins on their existing business.

- **Aggregating buying power**. Find ways of changing the buying power in areas where buying leverage is low. This was the approach adopted by the fund-supermarkets such as Fidelity and Cofunds which started with a great customer proposition for investors who were frustrated by all the paperwork associated with mutual funds. When they gained sufficient volume, they were able to use their aggregate buying power to strip margin from fund managers through lower delivered fund charges. This process continues.

- **Shopping and Price Setting**. Explore new shopping processes facilitated by the internet to set prices in different ways. Price aggregation is used to great effect in motor insurance and illustrates the lack of disruptive innovation from incumbents. Price aggregation, introduced in the UK in 2002 by confused.com, quickly followed by Moneysupermarket, Compare the Market etc, was driven by insurance brokers before the insurers found they could not avoid it. This model is being explored in other rate-driven products.

- **Capacity Sourcing**. Find new ways of disintermediating markets and tapping capacity directly. Peer-to-peer, crowd-sourcing and auction processes are powerful capacity aggregation mechanisms as well as novel price-setting processes. They are also taking off in savings, loans, equity accumulation and SME debt, and could be applied to other markets such as consumer loans and even insurance. One measure of the growth in this area is the substantial increase in the size of the overall alternative finance industry from £267m to £1.74bn between 2012 and 2014 (although these figures include online invoice financing).

These strategies have the advantage that they are seeking to do things differently and more cheaply – and in ways that have distinct customer appeal. They will, in some cases, take time to have the full impact that they might have in some sectors because of the natural inertia of customers and the stock vs flow issue. For example, the flow of assets in play in a given year is a small proportion of the stock currently invested and prising stock from an incumbent is harder than diverting a flow. They may also not meet the regulator's need to increase competition by having more look-alikes to choose from, but they are likely to make more of an impact on the banking market in the long run and increase pressure to move on from free current accounts.

* * *

IV Conclusions

In conclusion, most of the Challenger Banks appear to be offering a version of traditional banking in a core banking market that does show the preconditions for disruption. They are going head-to-head with entrenched incumbent competitors who place different value on the retail and SME customers in contention. The Challengers are likely to be ignored, allowed to take customers who are low value to the incumbents and then rebuffed or taken over.

More seriously for the incumbents, there is a host of new business models being launched that at the very least will reduce the incumbents' ability to earn additional revenues from their current account relationships, and could even begin to threaten their core businesses. On this basis, loss of only 10% market share seems conservative, especially on the basis of an expanded market definition. This indirect competition could put pressure on the regulator to support the end of free current account banking. This single move could do more to reintroduce active competition into retail banking but it might not please the consumer lobby if retail banking were to charge all low end customers for the cost of their service.

Challenger Banks who wish to build large independent businesses should examine the strategic principles of these other new entrants. There are some powerful ideas being deployed that could enhance their traditional approaches to good effect.

* * *

Lawrence Somerset Ltd. Is a specialist consultancy offering strategy, customer insight and innovation services to the financial services markets. We have 25 years' experience of working with wealth managers, insurers and banks. If you would like to know more about any of the research or the issues mentioned in this paper, or if you are facing specific challenges in these markets, please call us to discuss.