



Guide to Challenger Banks

For more information call 0800 321 3581



Executive Summary

The term challenger bank is generic and for the purposes of this guide refers to a bank with a UK banking licence, that is challenging the high street banks (Barclays, Royal Bank of Scotland, HSBC, Lloyds and Santander) for a greater proportion of market share.

Within the definition of ‘challenger bank’ are new start up banks, such as Charter Savings Bank, as well as long established private banks, such as Weatherbys, whose heritage extends as far back as 1770.

Challenger banks feature significantly within Savings Champion’s Best Buy tables. For example they formed 74% of the easy access, notice and fixed rate bond best buy tables, during April 2015. Unlike most best buy tables Savings Champions tables are based on whole of market research and are free of any commercial influence, which makes them unique and highlights why challenger banks are playing such an important role for savers.

Challenger banks have come to prominence for three reasons;

1. Legislative reform within the banking sector to improve competition,
2. Radical reform of high street banks business models, following the financial crisis in 2008.
3. Banking being discredited – a host of scandals, many of which have been to the detriment of the banks’ customers.

Traditionally individuals have remained loyal to the high street banks and took the view that the bigger the institution, the safer they were. The catastrophic failure of large and established banks, such as Lehman Brothers, identified a significant flaw in this approach, which was that large complex corporate structures contain risks that are not easily identifiable. It was these previously undetected risks that resulted in the need for radical reform by the high street banks.

In contrast, many of the challenger banks do not carry the same degree of complexity and offer greater transparency. This, in conjunction with the benefit afforded by the introduction of the Financial Services Compensation Scheme (FSCS), has resulted in more savers using challenger banks.

If you would like further information about challenger banks or help managing your savings (subject to a minimum of £100,000), please call our advisers on **0800 321 3581**.

- The term ‘challenger bank’ is very broad.
- Challenger banks tend to be focused on specific parts of the banking market and each has a very different business model.
- It is expected that more names will appear as competition increases.



Introduction

In July 2010, the retail banking industry experienced something not seen in over 100 years – the launch of a new high street bank. The bank in question was Metro Bank, one of many banks commonly referred to as ‘challenger’ banks.

Traditionally, banks were like jobs - people tended to stick with the same one for life. However, many consumers found that their banking experience amounted to prolonged periods of poor value and customer service, and in many cases being mis-sold inappropriate products. Unsurprisingly, this has resulted in dwindling loyalty.

This experience has coincided with an unprecedented period of low interest rates, which means that those who wish to maximise interest on savings accounts have had to become more proactive.

It is these changes within the banking sector, which have highlighted the need for the advice which Savings Champion provides to our clients and has contributed to our success.

Background to UK Banking Market

The UK has one of the most concentrated banking systems in the world. In 2011 a government report identified that the 'Big 5' UK Banks had 85% of the Personal Current Account (PCA) Market and the top four banks held 80% of the small business liquidity market, which resulted in the banking sector being referred to as "too big to fail, too big to compete against"⁽¹⁾.

The dominance of the high street banks created a need for implicit government guarantees that acted as a barrier to entry to the banking sector. The consequence of this was that it prevented uncompetitive banks and potentially failed ones, from exiting the market, which meant that there was no space or opportunity for innovation and competition for new banks.

The significance of this concentrated market was illustrated by the banking crash in 2008, which resulted in the need for the UK government to prop up the banking system to the tune of £1trillion.

The inefficiency that the high barriers to entry created was illustrated after the credit crunch, when it was found to be extremely difficult to kick start lending to small businesses and consumers, which was considered critical to economic recovery.

This was despite the introduction of a number of government initiatives, including;

- Project Merlin,
- Quantitative Easing,
- National Loan Guarantee Scheme,
- Business Finance Partnership and
- Funding for Lending

The inability to get banks to lend further exacerbated government frustrations with the banking industry.

- The high street banks are focused on the acquisition of new clients rather than the retention of existing clients.
- Loyalty towards the high street banks is declining.
- Low interest rates have led to savers being more active.
- There is now more competition in the banking sector, which is good for savers.



Government Policy and Regulation

Following the publication of the Cruikshank Report in 2000(2) which highlighted the poor competitive environment in the UK Banking sector, there has been an increasing government emphasis on reform.

Most banking markets experienced little change in concentration between 2000 and 2008. The Office of Fair Trading's (OFT) market study of PCAs in 2008 found that overall the relative market shares of the four established banks (Lloyds, RBS, Barclays and HSBC) and the then challenger banks (HBOS, Abbey, Nationwide and others) were almost unchanged between 1999 and 2007.

More recently and during the financial crisis however, concentration in the sector rose, with the merger between Lloyds TSB and HBOS in 2008 removing a challenger bank which had been a driver of competition in the market and increasing the size of the existing market leader. Simply put, this has had the effect of increased concentration in an already concentrated market.

The OFT's review of barriers to entry, expansion and exit in retail banking found that the greatest barrier to entry and expansion was the inability of new and expanding providers to persuade personal and small business customers to switch their accounts. The reason people don't switch is because of the burden of administration. The difficulty of expanding market share, combined with the significant IT investment required deterred firms from entering these markets.

Switching rates are low in the PCA market and are only slightly higher for small business banking and savings accounts.

Changes in Government policy and regulatory structures are now well underway and are having a profound impact on the structure of the banking industry in the UK, resulting in the growing ability of the challenger banks to compete.

Consequently, the UK fiscal and regulatory environment has undergone a sea change. Politicians, the Treasury and the Bank of England were united in a common goal to ensure that the UK's finances were never threatened again by a 'too big to fail' regime.

Change began with the formation of the Financial Conduct Authority (FCA) on the 1st April 2013. The FCA was created to provide a new regulatory framework for financial services and replaced the Financial Services Authority. Specifically, it gave the Bank of England responsibility for financial stability, bringing together macro and micro prudential regulation, creating a new regulatory structure consisting of the Bank of England's Financial Policy Committee, the Prudential Regulation Authority and the Financial Conduct Authority.

It is into this banking environment that challenger banks are now emerging as stronger competitors, the opportunities for meaningful market share growth are more favourable than for generations.

- Savers can no longer rely on a 'too big to fail' approach to managing risk.
- The FSCS is designed to give savers confidence in utilising smaller banks.

Banking in Crisis

As well as legislative reform, there have also been a number of consumer driven events that have impacted the banking industry, and this has resulted in a need for change in how banks operate.

Some examples of these events are:

- Office of Fair Trading Reports on Bank overdraft mischarging and the Personal Current Account market.
- Various financial scandals such as mis-selling.
- The financial crash, followed by a government funded rescue.
- The inability of the government to implement fiscal and monetary policy through the banking system following the credit crunch.

The examples keep coming. It has recently been reported that Barclays have set aside £1.25 billion as provision for fines that they expect to receive following an investigation into currency market manipulation.

We do not want to be alarmist but we have witnessed, across many different industries, well established brands fall from grace. The high street banks may have been 'too big to fail' in the past, but that may not last forever.



Changes to the banking landscape

The combination of these economic events, the need for industry reform to promote competition and reduced reliance on government support has resulted in considerable change within the banking industry.

Some of the developments to have taken place so far include;

- Division of regulatory responsibility into three constituent parts:
 1. Bank of England,
 2. Financial Conduct Authority (FCA) and
 3. Prudential Regulation Authority (PRA).
- Independent Commission on Banking
- Financial Services (Banking Reform) Act 2013
- PRA and FCA review of barriers to entry for new banks
- Competition and Markets Authority investigation of PCAs and services to SME's
- Basel III capital requirements.
- Current Account Switch Service (which cut the time it takes to move accounts from one bank or building society to another from typically 18 to 30 days to 7 days)

An example of how these developments have changed the banking landscape is the fact that the Current Account Switch Service has resulted in over a million people taking advantage of the service and moving to a new provider.

Being proactive on account management is core to what we do at Savings Champion and is the reason for the creation of the Savings Champion Concierge service. This service advises clients on the best savings accounts, helps to set them up and tells clients when it is time to change accounts. The service has been proven to increase the level of interest clients receive, as well saving our clients' time.

For more information or a free review of your current savings accounts please call us on our Freephone number **0800 321 3581** or email **concierge@savingschampion.co.uk**.

<https://www.savingschampion.co.uk/concierge/>

- The savings market is predicated on banks attracting new customers with headline rates and then lowering rates and relying on their inertia.
- Savers need to be active with account management.
- Savings Champion's Concierge service makes life easier and saves clients time and money.

The Market Opportunity

The impact of changes to legislation, poor levels of customer service, brand erosion of existing banks and forced disposals by bailed out institutions has resulted in greater competition in UK banking.

Existing banking companies see an opportunity to achieve scale through developing a branch network, whilst private equity houses have identified industry weaknesses and are looking to capture market share. Also, retailers, such as Tesco, see opportunities arising from making use of their existing consumer base with the provision of banking products.



Challenger Banks

Challenger Banks fall into two groups:

- Independent Challenger Banks backed by individuals, investors, or listed on stock markets, which are focused on providing innovation, focused product portfolios and higher levels of customer service.
- Backed Challenger Banks created out of existing large commercial organisations or institutions, such as Tesco, which will focus on a similar approach to Independent banks, but utilising an existing brand and branch network.

Challenger banks all have a full banking licence, as is the case with high street banks. Since the establishment of the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), banks are dual-regulated; by the FCA for the way they conduct their business and by the PRA for prudential requirements (such as capital and liquidity). As with high street banks, challenger banks are involved with the taking of deposits, provision of loans and a range of financial services and are covered by the government backed deposit insurance, known as the Financial Services Compensation Scheme (FSCS).

Challenger banks are generally focused on a defined market segment and products. This might be a focus on geographical location or expertise in a specific sector. For example Silicon Valley Bank's core focus is within the technology sector in London.

The ability of challenger banks to lend makes them very attractive to new clients, in particular the small business market. The big banks are currently hamstrung because they need to reduce their balance sheets (i.e. reduce the amount of money they lend), due to new regulations demanding greater capital adequacy (i.e. the amount of money banks must hold to offset risk). The only way for them to achieve this is by scaling back some of their historic lending activity – much of which is deemed to be of a higher risk under the new banking legislation.

It is the ability to lend that is the driving force behind challenger banks featuring in Savings Champion's Best Buy tables. The reason for this is that banks make their money from taking deposits and lending this money at a higher rate of interest. Therefore for the challenger banks to expand, they need to grow their lending book, which results in the need to attract deposits, which they do by offering higher rates of interest on savings accounts.

A list of some of the challenger banks that have established themselves include;

- Secure Trust Bank
- Vanquis Bank
- Weatherbys Bank
- Metro Bank
- Aldermore
- Shawbrook Bank
- United Trust Bank
- United Bank UK

- There are reported to be over 20 applications for new banking licences outstanding.
- Most challenger banks will not provide Current Accounts as this requires very expensive infrastructure.
- The business models of many challenger banks are likely to focus on the internet rather than a branch network.

- Many challenger banks are well established but their names may be less well known to savers.
- New challenger banks have to complete a comprehensive application process and adhere to strict requirements.

The most recent challenger bank to launch was Charter Savings Bank.

Charter Savings Bank is part of Charter Court Financial Services (CCFS) with its headquarters in Wolverhampton. Founded in 2008, they originally provided credit and collections expertise to help lenders analyse and service mortgage portfolios. In 2010 they added residential and buy to let mortgage lending and launched an intermediary only lender. Most recently in 2015 they launched the Charter Savings Bank brand to offer a retail banking proposition that would enable diversification of their business model.

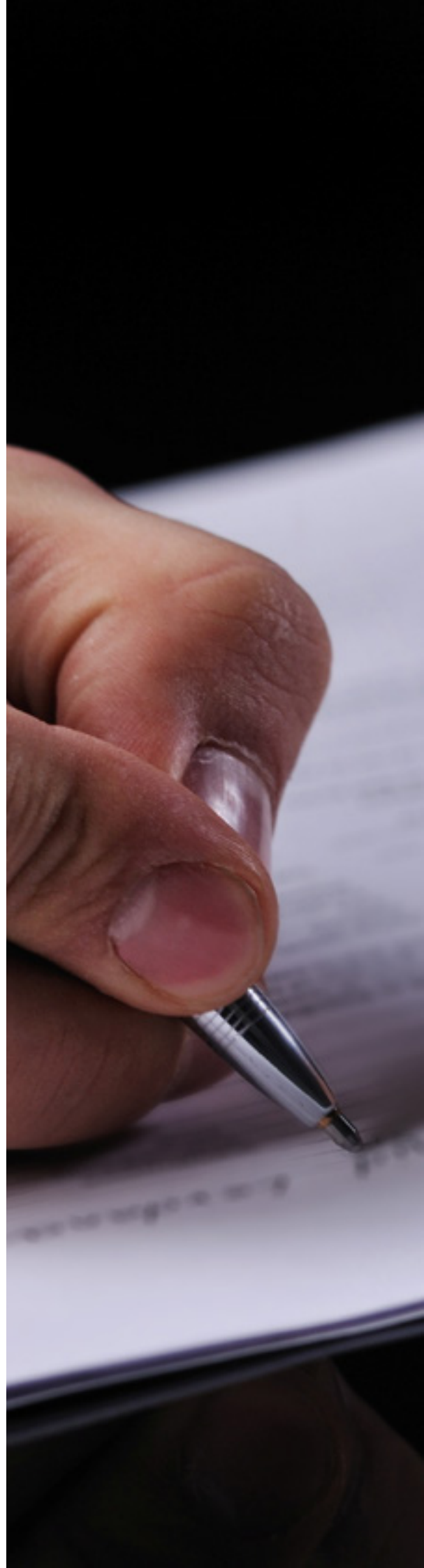
Like many of the challenger banks, Charter Savings Bank has been created from an existing business, that has applied for and been granted a UK banking licence.

To obtain a banking licence, an application must be made to the PRA, the lead regulator for banks, which is assessed through a collaborative process; from a prudential perspective by the PRA and from a conduct perspective by the FCA, against the Threshold Conditions of the respective regulators. To authorise the firm, the PRA must have received the FCA's consent.

The application process requires a significant investment of resource and clearly those that are approved must have met stringent criteria and must continue to display strict corporate governance. This means that whilst you may not have heard of a particular challenger bank, comfort can be taken by the fact that they cannot simply be established without the prerequisite skill, experience and capital adequacy.

Challenger banks generally offer a more traditional method of banking that is focused on relationships. For example Metro Bank has long opening hours, 7 days a week. In contrast the high street banks have reduced the number of branches in favour of less personal call centres.

Handelsbanken (a Swedish bank) has developed an extensive branch network in the UK, with over 136 offices and has developed a reputation for retaining key employees that are remunerated differently from other banks – for example employees involved in lending money are rewarded when loans are repaid, which encourages a different approach to lending behaviour and avoids the somewhat reckless lending undertaken by the Big 4 – which was a major contributory factor to the credit crunch. In contrast many of the larger banks have a greater dependency on credit scoring systems for credit decisions, which leads to a 'one size fits all' approach, and can result in customer dissatisfaction.



Challenger Banks

A competitive environment is good and the regulatory framework, as we have witnessed, has resulted in greater competition.

The challenger banks are still David to the traditional banks' Goliath. For example Metro Bank has approximately 360,000 customers compared to the 16.7 million people who currently bank with Barclays. The 'Big Four' still control some 85% of the nation's personal current account market.

Traditionally, financial institutions have been viewed by many as offering more security the bigger they were. For banks, this was underpinned by implicit government guarantees. However, there is no doubt that times have changed. We have witnessed the fall of several banks and the fall out of continued scandal within the banking sector.

The introduction of the Financial Services Compensation Scheme (FSCS), the compensation fund of last resort for customers of authorised financial services firms, means that consumers can have the confidence in being proactive with their banking services by utilising a wider range of banks, including relatively young and small players. It is authorisation by the PRA and FCA that ensures this - not the size of the bank.

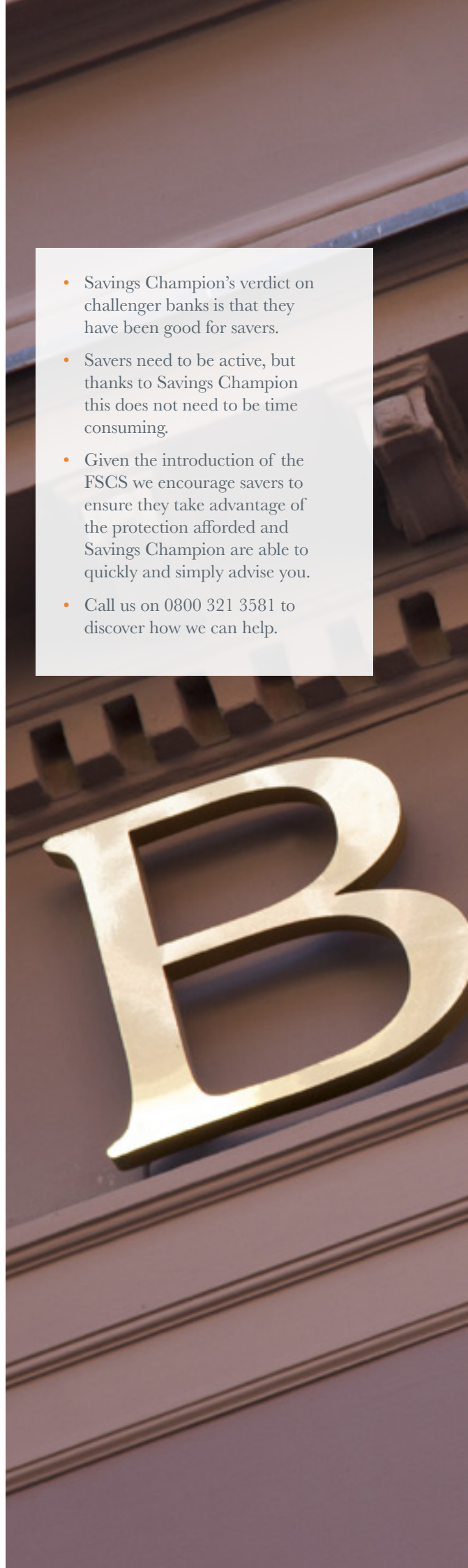
The savings market, as we have seen, is predicated on inertia, however, as we have witnessed in the utilities sector, consumers are now becoming more confident in switching and are more aware of the benefits of doing so.

Savings Champion offers a cash management service, known as the Concierge Service, through which we advise clients on the accounts most suitable for them. This was created to maximise the interest earned on cash savings and to ensure all, or as much as is practical, of their capital is protected by the FSCS; to achieve this, active management is key. One of the reasons for inertia is the administrative requirements of switching and the Concierge Service helps with that – ensuring that we help you save time, as well as money.

A typical Savings Champion Concierge Service client has received an additional £4,198 of gross interest in the first year of using the service based on a savings portfolio of £345,452.

We believe that the benefit of the competitive interest rates offered by the challenger banks should be welcomed by savers and Savings Champion encourages a proactive approach to account management, making use of the protection offered by the FSCS, where appropriate.

- Savings Champion's verdict on challenger banks is that they have been good for savers.
- Savers need to be active, but thanks to Savings Champion this does not need to be time consuming.
- Given the introduction of the FSCS we encourage savers to ensure they take advantage of the protection afforded and Savings Champion are able to quickly and simply advise you.
- Call us on 0800 321 3581 to discover how we can help.





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