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# *Who are you calling a ‘challenger’?*

How competition is  
improving customer choice  
and driving innovation  
in the UK banking market



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**PwC wishes to thank the BBA for its collaboration in producing this report.**

The BBA is the leading trade association for the UK banking sector with 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide.

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# Foreword

In recent years, policymakers have been encouraging greater competition in the UK banking market, both to benefit customers and to reduce systemic risk. The result has been an increase in the number of new banking licences issued, including 15 in the last three years, and the emergence of new players with a range of propositions and business models.

These ‘challenger banks’<sup>1</sup> are not only providing customers with more choice, but are helping to drive innovation and meet the needs of customers who may not be targeted by the main high street banks. This has translated into steadily growing market share in retail and commercial lending, and an increasing social and economic impact; the top 10 largest ‘challenger banks’, which include the main mid-sized high street banks, employ more than 35,000 people and serve more than 20m customers.<sup>2</sup>

However, while the emergence of these new players is exciting, they are too often viewed as a single, homogenous group with identical challenges and opportunities. This report sets out to challenge such assumptions, to better understand the distinctive propositions these banks offer, and to identify the obstacles that stand in their way.

To achieve those goals, PwC and the British Bankers’ Association (BBA) have interviewed CEOs and senior executives from many of these organisations, while working with YouGov to establish consumers’ views and preferences as the banking industry evolves.

Our research reveals that addressing a series of issues – including disparate capital requirements, regulatory proportionality, access to payments systems and product transparency – could substantially improve the competitive landscape for new entrants. But it is also clear that new entrants must take responsibility for themselves, executing their strategic priorities and addressing potential weaknesses in their business model.

Our report documents the findings of our research in detail: the depth and breadth of the ‘challenger bank’ segment, the regulatory impediments to new entrants’ progress, the promise of technology and the priorities for each category of new player. It is aimed at all stakeholders with an interest or possible role in transforming the UK’s banking industry for the better. We look forward to hearing your views.



**John Lyons**

PwC Partner

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<sup>1</sup> The term, as used in this document, describes any bank which is not one of the main high-street banking groups (Barclays, HSBC, Lloyds, Nationwide, RBS, and Santander)

<sup>2</sup> Annual reports

# *Executive Summary*



A new group of banking businesses is emerging in the UK, typically described as ‘challenger banks’. These banks tend to have distinctive unique selling points (USP) which they believe set them up for success in their chosen markets. These USPs are often built around client franchise or need, geographic location or product specialism.

The use of the term ‘challenger bank’ to describe any bank that is not a recognised main high street bank has become commonplace. However, our research and interviews with the CEOs of these banks have highlighted four key findings about this part of the UK banking market.

## **The term ‘challenger bank’ does not reflect the breadth of these banks’ offerings and varied strategies**

These banks actually consist of four broad groups with different models, aspirations and challenges. Many do not define success in terms of their ability to challenge or rival the main high street banks. Rather, their goal is to serve their specific target markets profitably. As a result, many don’t anchor their propositions around current accounts as they recognise that customers are willing to multi-bank.

This was substantiated by our survey of British consumers, carried out in conjunction with YouGov, that showed over half of the respondents preferring to use a range of banks for different products and services, according to which is best placed to serve them. Some of the new digital players are offering current accounts, and are focused on developing exciting propositions that help customers control their finances and access the best value banking and non-banking products available from third parties.

## **While regulatory policy has begun to make it easier for new banks to enter the market, a more level playing field will improve customer choice and outcomes**

The banks we spoke to recognised and appreciated regulatory efforts to open the market to new entrants and foster further competition, for instance through the recent investigation by the Competition and Markets Authority (CMA) into the retail banking market.



However, they highlighted a number of areas that could accelerate progress, specifically:

1. reducing the disparity in capital treatment;
2. improving regulatory proportionality;
3. increasing access to payment systems;
4. increasing transparency of products to improve customer understanding of product value.

### **Open Banking is set to drive a fundamental change in the banking landscape**

As the regulators take action to further develop competition, the future market will be increasingly varied and modular, resulting in a very different banking experience for customers. Open Banking will give rise to new business models, with some providers choosing to specialise in narrow areas rather than offer a traditional suite of products or attempt to manage the customer's end-to-end experience. Others will compete by making it possible to integrate niche offerings from a number of different companies in a seamless way. Banks take the threat of larger tech organisations such as Google, Amazon, Apple and Facebook very seriously. By facilitating financial services like payments directly on their websites and inserting themselves between the customer and the underlying bank, these players could relegate banks to the role of invisible 'plumbing'. While not every new player will prosper, we believe there will be room in the market for many different banks and non-banks to succeed.

### **To be successful, each bank needs to overcome specific challenges**

Our consumer survey highlighted significant customer perception issues for most of the groups. Each group also has specific strategic challenges. For example, many mid-sized high street banks face pressure to transform their operating models and differentiate their propositions, while digital-only players seek to build awareness with customers and attract them with distinctive service offerings.

To succeed, all banks must embrace new digital models whilst ensuring they make coherent strategic choices – for example, around which customer segments to target, and how to tailor their products and services to be differentiated in those segments.

If the players in this sector understand and address the key challenges outlined in this report, we expect the industry to transform and move towards a diverse market that offers customers the choice to assemble the banking experience they desire. This will depend partly on new entrants' ability to differentiate themselves and grow their customer base, but also on the extent to which innovation drives new products and services.

Due to new banking market players' lower fixed costs, building scale is no longer an imperative and consolidation is not inevitable. Moreover, UK banks will be supported by positive growth trends in both retail and corporate lending.<sup>3</sup>

As a result, we believe that customers will have increasing choice of the products and providers they wish to use. They may opt to engage directly with financial services providers (traditional banks, product specialists, or peer-to-peer (P2P) services); they might start at an intermediary (perhaps a comparison service, a broker or an aggregator); and sometimes the financial service will be in the background or even invisible as the consumer interacts with other companies (for instance, retailers, travel providers or social networks).

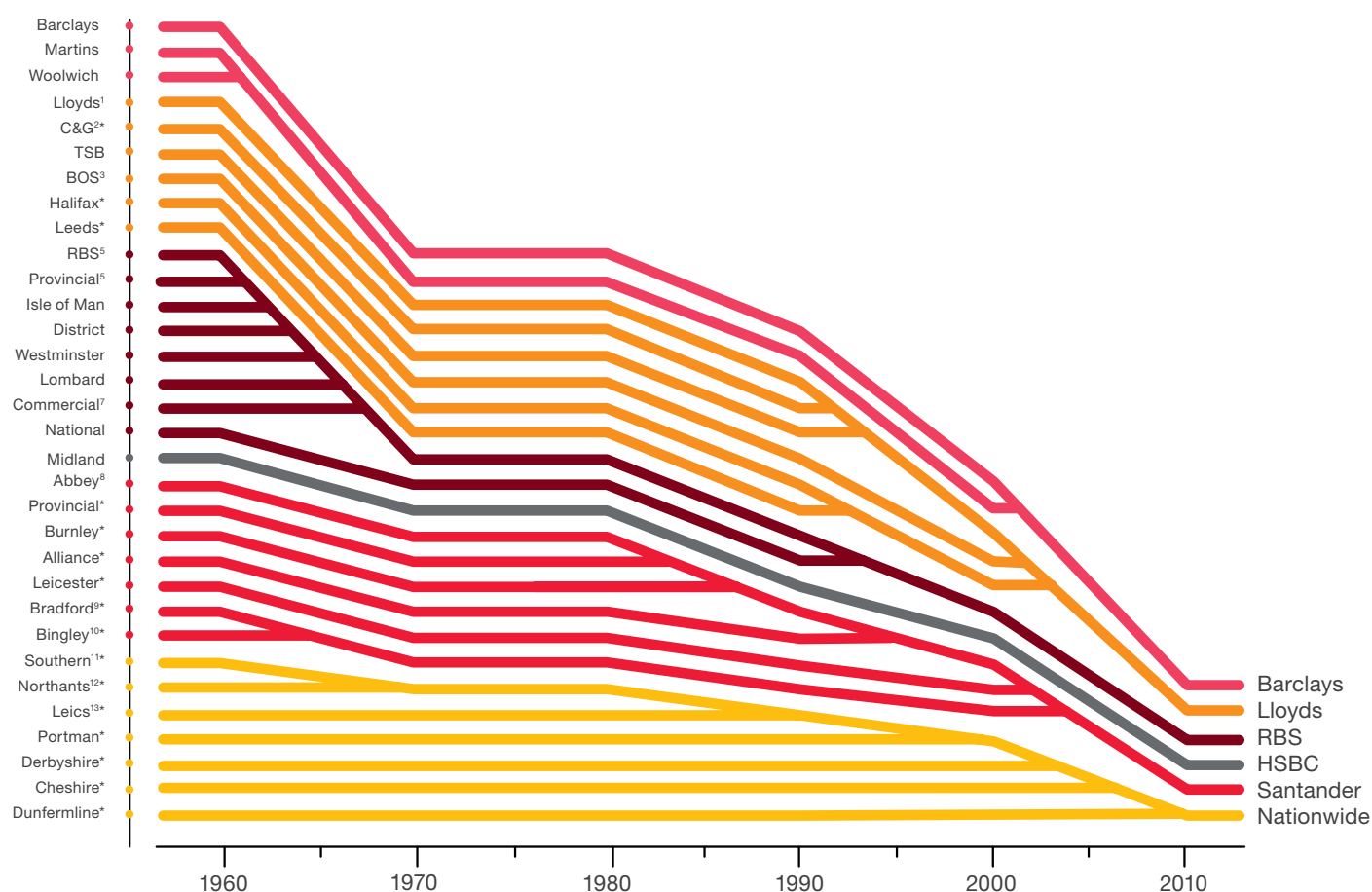
In these types of scenarios the traditional banks will likely only carry out part of the end-to-end activity, with a complex web of interactions between multiple companies' systems. Customers will be able to combine these banking modules for a customised and personal experience. New competitors from other industries will seek to command consumers' attention and strive to be the preferred interface. Unexpected alliances and partnerships will be created to provide more seamless and attractive propositions. All these factors will accelerate the trend towards a more modularised, diverse and innovative UK banking market.

# Introduction – A wave of new entrants as the banking market has opened up

Over the 50 years from 1960-2010, the UK banking market saw significant consolidation. By 2010, 26 of the 32 banks and building societies which existed in 1960 were absorbed into just six major groups: Barclays, HSBC, Lloyds, Nationwide, RBS, and Santander. The concentration of the market became particularly acute in the aftermath of the 2008 financial crisis, when a number of failing banks

were either merged or acquired. In its 2011 report, the Independent Commission on Banking (ICB) highlighted that following the 2008 crisis, the largest four banks accounted for 77% of UK personal current accounts and 85% of small and medium-sized enterprise (SME) current accounts.<sup>4</sup>

**Figure 1 – Consolidation of major UK banks<sup>5</sup> and building societies: 1960-2016**



Note: \* = Building society † = Acquisitions not listed

Sources: Bankers Magazine, Collins (1988), published accounts and RBS Archives; adapted from 'Evolution of the UK Banking System', Quarterly Bulletin, Q4, Bank of England, 2010  
<sup>1</sup>Lloyds Banking Group, <sup>2</sup>Cheltenham and Gloucester, <sup>3</sup>Bank of Scotland, <sup>4</sup>Leeds Permanent, <sup>5</sup>Royal Bank of Scotland, <sup>6</sup>National Provincial, <sup>7</sup>National Commercial, <sup>8</sup>Abbey National, <sup>9</sup>Equitable, <sup>10</sup>Permanent, <sup>11</sup>Southern Co-operative Permanent, <sup>12</sup>Northampton Town & County Freehold, <sup>13</sup>Leicestershire, <sup>14</sup>National Provincial and Westminster merged to form National Westminster (NatWest) in 1970, <sup>15</sup>Bradford and Bingley merged to form Bradford & Bingley in 1964, <sup>16</sup>Southern Co-operative Permanent changed its name to Nationwide in 1970, <sup>17</sup>Northampton Town & County Freehold and Leicestershire merged to form Anglia in 1966, <sup>18</sup>Provincial and Burnley merged to form National & Provincial in 1984, <sup>19</sup>Alliance and Leicester merged to form Alliance & Leicester plc in 1985, <sup>20</sup>HSBC acquired Midland Bank in 1992, <sup>21</sup>The Santander Group acquired Abbey National in 2004.

<sup>4</sup> ICB, Final Report Recommendations, 2011

<sup>5</sup> The Northern Ireland banking market has a different competitive landscape to the broader UK banking market

By 2010, the market concentration reached new heights across retail banking products. The six large banking groups held an 89% market share of the current account market which reached a peak market concentration score of 1830 on the Herfindahl-Hirschman Index<sup>6</sup> (where anything over 1000 is considered concentrated).<sup>7</sup> SME banking market was the most concentrated, as it reached a score of 1910.<sup>8</sup>

In parallel with increased concentration, the banking market experienced relatively low customer satisfaction, as highlighted in a 2013 survey in which retail banking customers rated the main high street banks negatively for satisfaction.<sup>9</sup> A study by the Financial Conduct Authority (FCA) and CMA also found that whilst many SMEs were generally satisfied with the service they receive from their bank, the satisfaction was often passive and low in relative terms. It also revealed that only 13% of SMEs believed that their bank acted in their best interest.<sup>10</sup> Both studies included high levels of market concentration amongst the main high street banks as one of the key drivers for dissatisfaction.

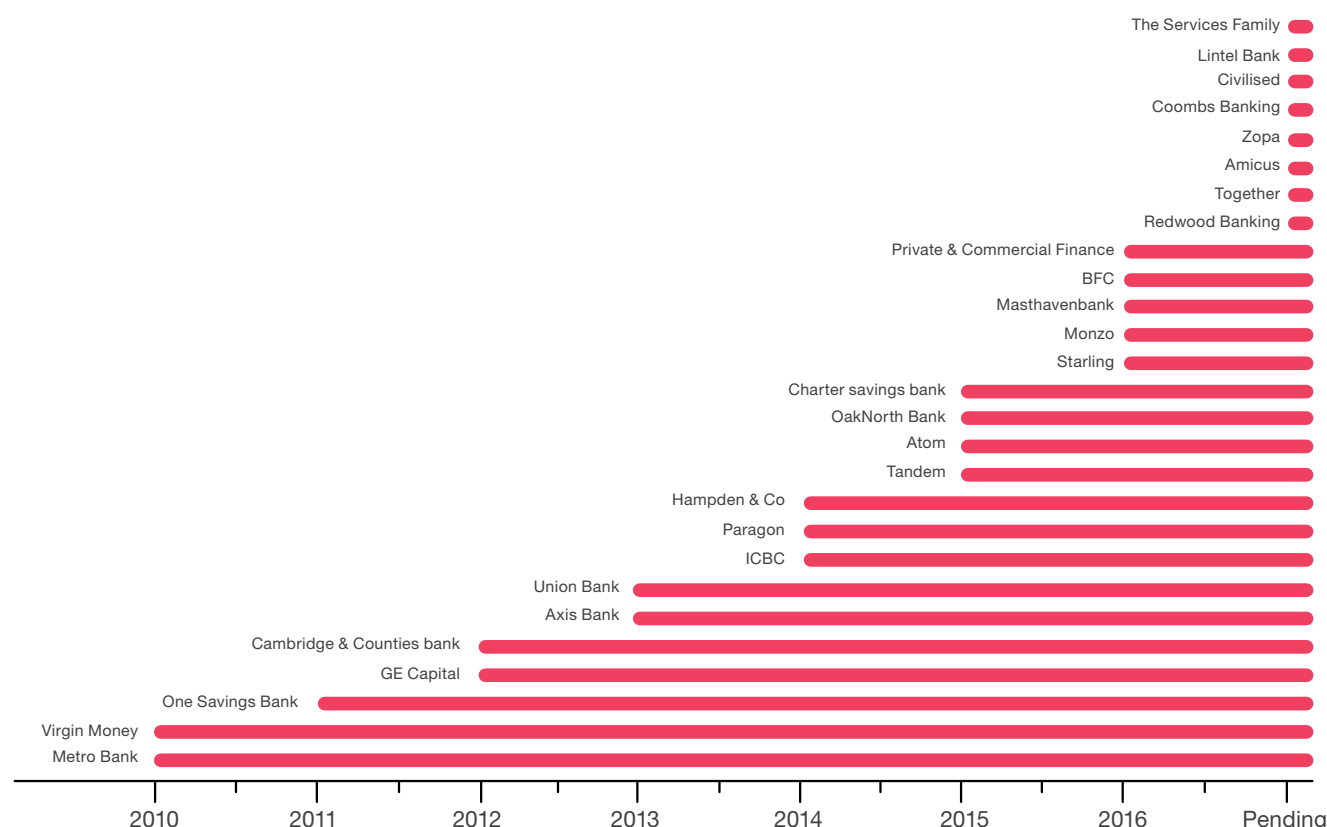
As the UK banking market concentration approached its highest levels, banks trying to enter the market were finding the journey incredibly difficult. The Bank of England responded by simplifying the process for acquiring a banking licence and lowering the capital requirements for new bank entrants in 2013.

As a result, there has been an increase in the number of banks entering the market – with a wide range of propositions and business models.

Since 2010, 19 new retail and commercial banking licenses have been issued, with at least eight more pending as at January 2017. These new entrants join a number of more established mid-sized full service banks, such as CYBG (the owner of Clydesdale Bank and Yorkshire Bank brands) as well as other smaller, specialist players such as Aldermore (founded in 2009) and Secure Trust (operating since 1954).

**Figure 2 – New banking licences and changes in authorisations, 2010-present**

Retail and commercial banks only (non-exhaustive)



<sup>6</sup> The Herfindahl-Hirschman Index measures market concentration by squaring the market share of each competitor and summing the resulting numbers (ranging from close to zero to 10,000)

<sup>7</sup> Competition Commission and OFT, 2010, Merger Assessment Guidelines.

<sup>8</sup> Independent Commission on Banking, Final Report Recommendations, 2011

<sup>9</sup> YouGov, 2013

<sup>10</sup> FCA and CMA market study – Banking services to small and medium sized enterprises



There are now hundreds of local and international banks operating in the UK<sup>11</sup> in addition to the main high street banks, not all of which are mentioned in this report. These banks are not only providing customers with more choice, but are helping to drive innovation and meet the needs of customers who may not be targeted by the main high street banks. As a result these banks are steadily growing market share across a number of retail and commercial lending

products. In 2015, they increased gross mortgage lending by 56% to over £30bn<sup>12</sup> (14% market share), providing around 200,000 British consumers with mortgages, and increased their share of gross SME lending to 20%, providing new loans and overdrafts to around 50,000 SMEs.<sup>13</sup> The top 10 largest 'challenger banks' employ over 35,000 people and serve c.20m customers.<sup>14</sup>

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<sup>11</sup> Bank of England 2017

<sup>12</sup> Council of Mortgage Lenders

<sup>13</sup> Challenger Bank Letter to Parliament (2016), BBA and PwC analysis

<sup>14</sup> Annual reports, PwC analysis



# There is no such thing as a challenger bank

## Success need not be defined by becoming another main high street bank

While these banks may share some common characteristics, the ‘challenger bank’ label is not helpful. Many of these banks’ distinctive offerings mean they do not need to compete directly with the main high street banks to succeed. Moreover, the ‘plucky underdog’ label is inappropriate for what are in some cases long-established and significant businesses.

Most of the CEOs we spoke to do not aspire to replace the main high street banks or in many cases even to challenge them directly; rather they aim to meet customer needs not currently being well-served. These banks tend to have a strong unique selling point (USP) which sets them up for success in their chosen markets. These USPs are often around client franchise or need, geographic location or product specialism. Specialist lenders in particular aspire to operate in the gaps left by other banks, typically

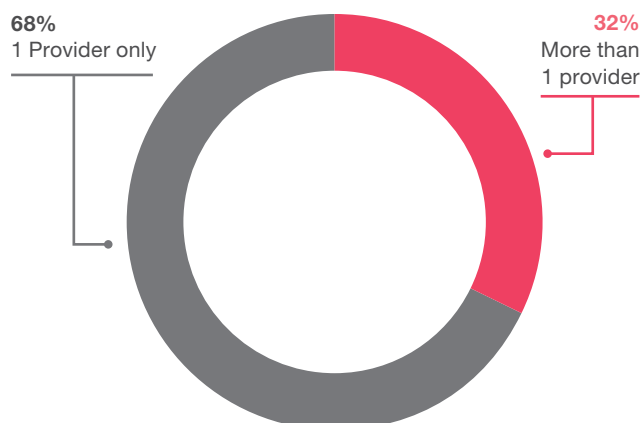
addressing customers with more complex needs rather than the ‘vanilla prime’ segments.

Many banks are content not to be their customers’ primary bank. They recognise that customers are increasingly willing to multi-bank, which is substantiated by the proportion of customers who are already multi-banked for their financial product needs (see Fig.3). Although it has been the focus of the CMA in recent years, many of the banks do not view current accounts as being critical to their success.

***“We’re happy being customers’ second bank. We don’t want to be their primary bank and we don’t offer current accounts for this reason; current accounts are a dated product.”***

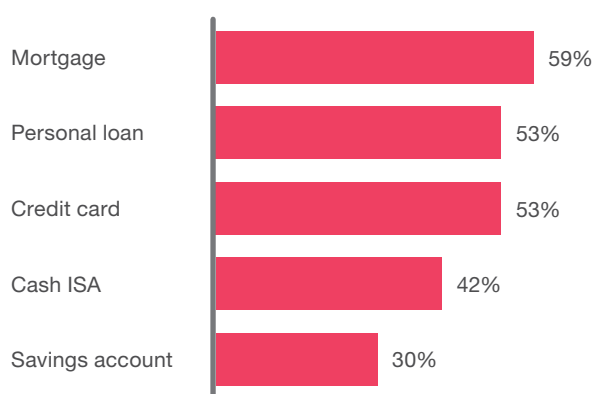
**Figure 3 – A large proportion of customers are multi-banked for their current account...**

Number of current account providers used by customers  
– % of respondents (2015 – 1,948 respondents)



**...and even more customers use multiple providers for the other product needs**

Proportion of customers that use an alternative bank to their current account provider – % of respondents (2015 – 1,872 respondents)



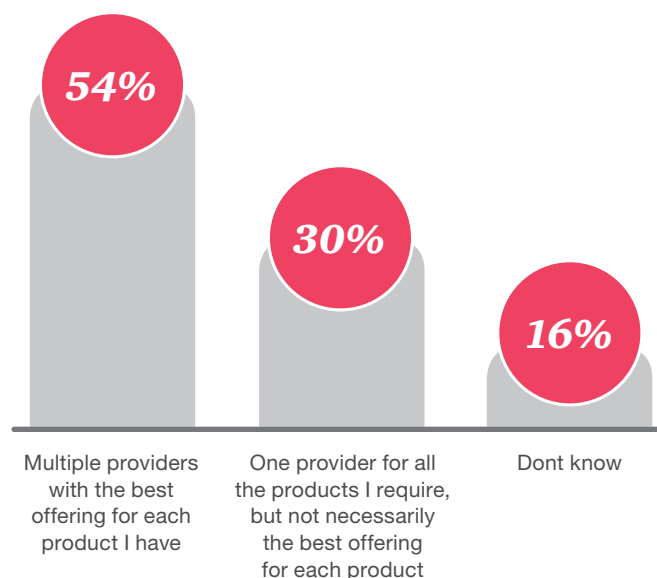
Our research also demonstrates that retail customers are not seeking more full-service banks, but rather, providers that specialise in specific products or segment needs.

In January 2017, in conjunction with YouGov, we polled more than 2000 British consumers on their awareness of and preference for different types of banks, banking products and services. Asked to choose between two ideal banking scenarios, the majority of respondents (54%) said they would prefer to bank with multiple providers with the best offer for the products they have, compared to only 30% of customers who would bank with just one provider even if it meant they might not always get the best deal (see Fig. 4).

However, not all banks see current accounts the same way, as some anchor their proposition around them – for these banks to grow, improving switching rates will be fundamental. For many mortgage players as well, current account volumes are helpful to provide a lower cost source of funds. The six large banking groups still account for 89% of UK current account market<sup>15</sup> as use of the Current Account Switch Service remain low at 3%<sup>16</sup> and declined by 3% from 2015 to 2016.<sup>17</sup> Of the small percentage of customers that have switched, 85% of them have moved to one of the main high street banking groups.<sup>18</sup> This highlights the significant challenge facing banks which are seeking to convince customers to switch current accounts.

**Figure 4 – Customer willingness to multi-bank for the best offer**

Customer preference for banking scenarios  
– % of customers (2017)



Source: YouGov, PwC Strategy& analysis

<sup>15</sup> Mintel, Consumer and Retail Banking, 2015

<sup>16</sup> CMA, Retail Banking Market Investigation, 2016

<sup>17</sup> Bacs, Current Account Switch Service Dashboard, 2017

<sup>18</sup> GfK, PCA banking survey report, 2015



## Four broad groupings

The catch-all idea of a challenger bank also masks the very significant differences between many of the banks it purports to describe. We see these banks split between four broad groupings with varying target markets and service models.

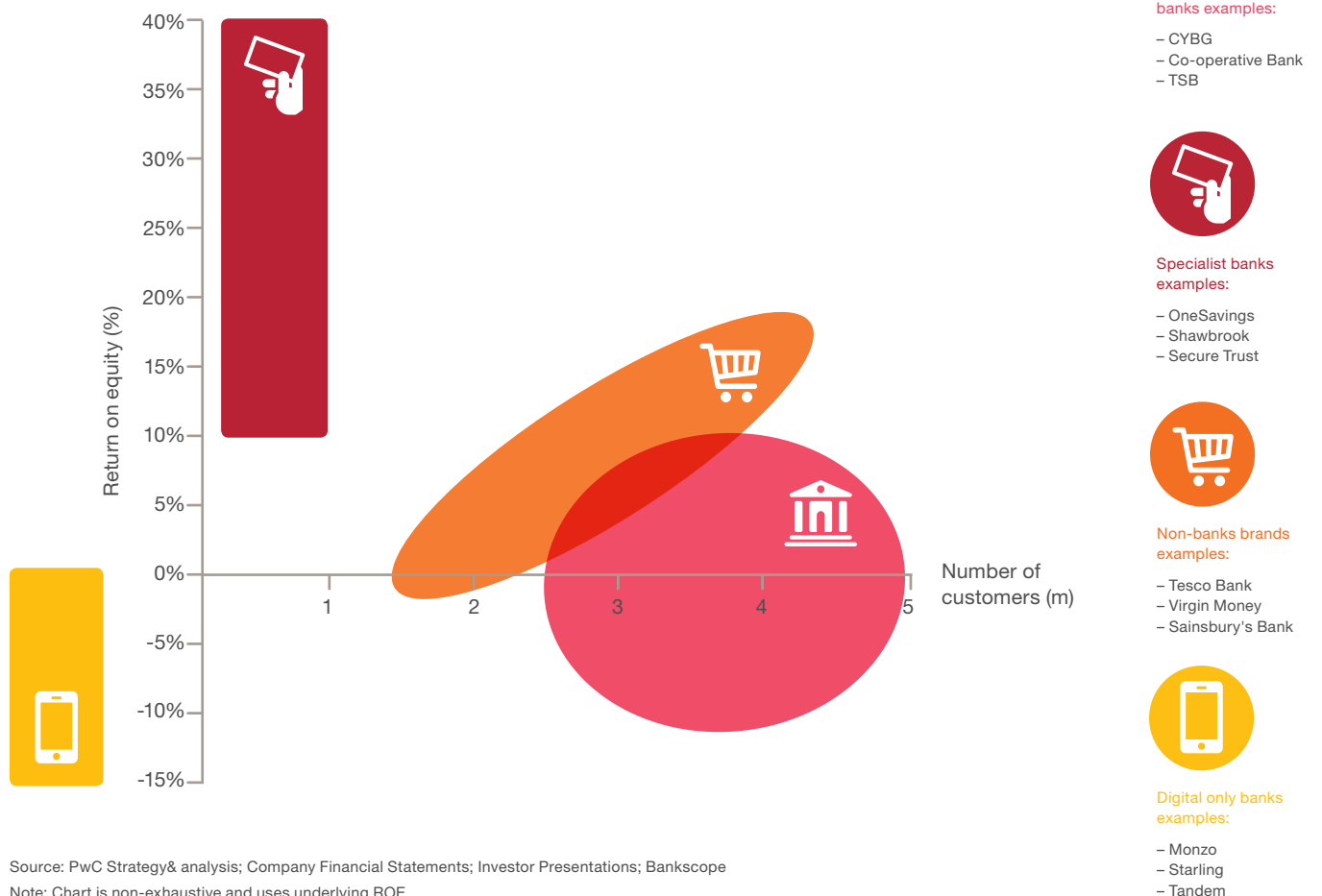
Inevitably, there are hybrid and/or newer banks that do not fit neatly into one of these groups. For example, whilst Metro shares some characteristics with the mid-sized full-service banks in terms of their full product offering

and commitment to a physical presence (one of the only banks actively growing their footprint), their higher rate of growth and modern technology platforms sets them apart. Despite these outliers, this segmentation helps to identify the positioning of different types of banks and their key focus areas.

The chart below shows how they compare based on their number of customers and return on equity.

Figure 5 – Relative positioning of selected UK banks

(Indicative)





### Mid-sized full service banks

Mid-sized full service banks tend to be banks with well-known brands, with single-digit millions of customers and between 2,000 and 9,000 employees. They typically have a full (and relatively conventional) product and service offering. They have been moving to digital channels, but believe that physical presence remains important and serve customers with a physical network of up to 600 branches.

They generally have a regional focus where they energetically seek growth opportunities to gain market share. Most are focussed on the need to transform their operations and replace legacy IT systems, and are investing in scalable platforms to do so. At present, many of these banks face profitability pressures, and are aiming to improve returns on equity that are currently negative or under 10%, and cost-to-income ratios that are between 70% and 350%.



### Specialist banks

Specialist banks have propositions typically anchored around specialist lending and saving for customers who they believe are underserved by others in the market, such as certain types of small and medium-sized enterprises and the buy-to-let market. They generally have very limited physical presence, placing more emphasis on call centres, third-party distribution channels, some regional offices and increasingly digital channels.

They often work with intermediaries to source new business. Generally these banks are relatively small, with between 500 and 1,000 employees and a few hundred thousand customers, but tend to be profitable, with cost-to-income ratios of between 20% and 40% and returns on equity in the range of 10% to 40%. They still see potential for growth in their target markets, but are nimble and confident in their ability to adapt when the time comes to broaden their areas of focus.



### Non-bank brands

Non-bank brands have parent companies that are strong players in other industries, such as major supermarket chains. They have strong and trusted brands, and generally seek to serve the needs of customers loyal to the parent group as a whole. Partly as a result of their established banking lineage (for example, Tesco Bank started as a joint venture with Royal Bank of Scotland) these banks have a significant number of customers (between 1 million and 8 million) and 1,000-3,000 employees.

They generally focus on digital channels with a limited physical presence (for example, Tesco has travel money desks in some retail outlets, whereas Virgin Money has over 75 stores and lounges). They don't offer a full range of banking products and services, but are progressively expanding where they believe they can add value for customers.

These banks are typically profitable, enjoying returns on equity of between 2% and 15%, very similar cost-to-income ratios of between 65% and 70%. They have a unique opportunity to build on data-rich loyalty schemes to offer value-adding propositions.



### Digital-only banks

Digital-only banks recognise the megatrend of customers shifting to digital channels and are building their business to serve both digital natives and converts. They pride themselves on innovative technology platforms that promise exceptional customer experience and engagement, primarily through mobile apps. The majority have been founded very recently, and are launching in different ways: Starling intends to offer a current account; Monzo has launched with a pre-paid card; Atom is starting with a fixed-term savings account.

These banks are still very small with a low cost-to-serve, typically having fewer than 150 employees and, for those that are active, fewer than 100,000 users. They are positioning themselves to lead in the forthcoming era of Open Banking, which will require specific banks to share specific data securely through open APIs, the technological tools that will deliver this change.





	Mid-sized full service banks	Specialist banks	Non-bank brands	Digital-only banks
<b>Example banks</b>	<ul style="list-style-type: none"> <li>Co-op</li> <li>CYBG</li> <li>TSB</li> </ul>	<ul style="list-style-type: none"> <li>Aldermore</li> <li>Secure Trust</li> <li>Shawbrook</li> </ul>	<ul style="list-style-type: none"> <li>Tesco</li> <li>Sainsbury's</li> <li>Virgin</li> </ul>	<ul style="list-style-type: none"> <li>Monzo</li> <li>Starling</li> <li>Tandem</li> </ul>
<b>Scale</b>	Larger scale 1m-5m customers, 2k-9k employees	Smaller scale 80k-600k customers, 500-1K employees	Larger scale 1m-8m customers, 1k-3k employees	Start-ups with small, but growing scale 5-150 employees, <100K users
<b>Proposition</b>	Full-service, traditional product offering	Focussed proposition (specialist personal & SME lending to niche markets)	Focussed, but growing propositions targeted at parents' customers	Initially limited retail product offering, focussed on digitally savvy customers
<b>Physical presence</b>	Committed to a physical presence as part of blended model	Limited or no physical presence	Limited, but flexible physical presence	No physical presence
<b>Profitability</b>	Less profitable -15%-5% ROE	Highly profitable 10%-40% ROE	Relatively profitable 0%-15% ROE	Growing, but not yet profitable
<b>Strengths</b>	<ul style="list-style-type: none"> <li>Well-established</li> <li>Strong brand</li> <li>Physical presence</li> </ul>	<ul style="list-style-type: none"> <li>Customer understanding</li> <li>Low cost-to-serve</li> <li>Modern systems</li> </ul>	<ul style="list-style-type: none"> <li>Well-known, trusted brands</li> <li>Access to parents' large customer base, data, and physical footprint</li> <li>Mostly modern systems</li> </ul>	<ul style="list-style-type: none"> <li>Modern platforms and apps</li> <li>Scalable models</li> <li>Strong online communities</li> </ul>
<b>Strategies for success</b>	<ul style="list-style-type: none"> <li>Transform operating model to cut costs</li> <li>Build scale</li> <li>Sharpen focus of proposition to differentiate</li> </ul>	<ul style="list-style-type: none"> <li>Identify where and how to grow</li> <li>Deal with growing pains</li> <li>Defend against risk of legacy creeping in</li> <li>Develop digital capabilities</li> </ul>	<ul style="list-style-type: none"> <li>Seize the data opportunity</li> <li>Optimise the distribution model</li> <li>Manage the impact on parent groups</li> <li>Differentiate from other high-street players</li> </ul>	<ul style="list-style-type: none"> <li>Attract customers and build trust</li> <li>Differentiate from other digital players</li> <li>Take advantage of Open Banking and innovate</li> <li>Expand profitably</li> </ul>

# Continued regulatory drive can enhance competition in banking

Many of the CEOs we spoke to cited a number of challenges, including: regulatory capital requirements that they believe put them at a disadvantage; a perceived lack of proportionality in regulation; a model for accessing payments systems that is expensive and constraining; and lack of comparability between products which is potentially to the detriment of consumer outcomes.

These factors may inhibit competition if banks feel unable to compete in certain markets and choose not to enter, or to leave.

Other CEOs we spoke with thought that the impact of these structural impediments on competition was overstated, or were more optimistic about progress in addressing the challenges. However, all bank executives agree that the impact of structural challenges must be seen in the context of specific products.

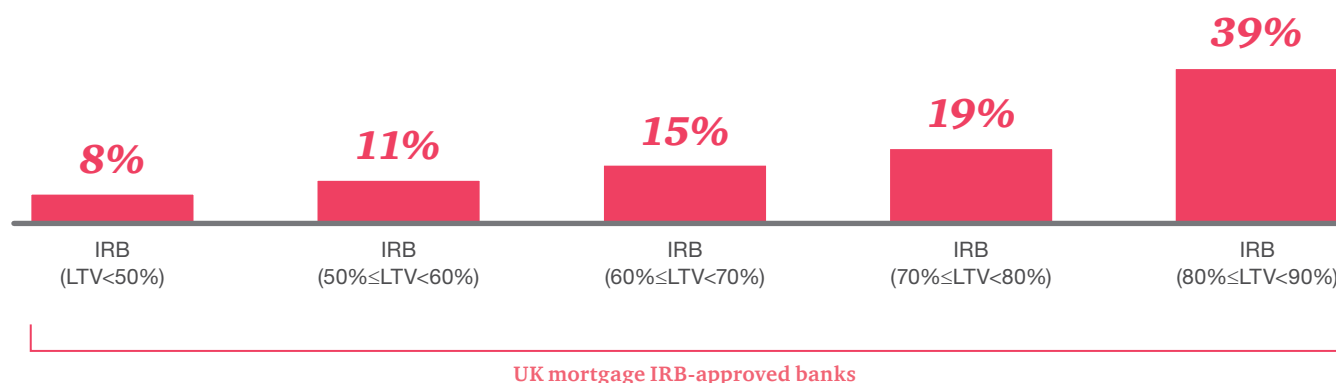
## Capital requirements – hampering competition in the mortgage market?

By far the most commonly cited structural challenge in our CEO interviews was the regulatory approach to capital requirements. Many banks believe these requirements place them at a structural disadvantage.

For capital requirements purposes, UK banks are split into Internal-Ratings Based (IRB) and Standardised Approach (SA) banks under the Capital Requirements Regulation (575/2013) (CRR). Under these designations, the capital requirements are higher for SA banks relative to IRB banks. All the six main high street banking groups are IRB approved, but it is currently difficult for many other banks to follow suit because of the data requirements and significant costs of obtaining and maintaining approval.

Figure 6 – Regulatory capital requirements for a £100k buy-to-let mortgage

Current/proposed risk weight percentage



Source: PwC Strategy& analysis; CMA; BoE; PRA Consultation Paper - Refining the PRA's Pillar 2A capital framework, February 2017

Note: Analysis based on Basel Committee's published second Consultative Paper on SA; the risk weights are still being debated by the Committee

Many banks believe the disparity in capital requirements drives an uneven playing field, particularly in the mortgage market. For example, on a less than 50% loan-to-value buy-to-let mortgage, average IRB weights are 7.8% and current standardised weights are 35%. Some banks using the standardised approach therefore argue that they must hold almost five times as much capital for the same loan. It should be noted that there are also LTV bands where the standardised approach has more competitive risk weightings than IRB, which are exploited by many of the SA banks. More concerning for the SA banks is that the Basel Committee on Banking Supervision proposed to increase the SA capital requirements for certain asset classes – for example, buy-to-let would rise from 35% to 70-120%. However, although this is the published position, these proposals are the subject of ongoing discussions by the Basel Committee.

***“Capital (standardised vs. IRB model) is the single biggest issue and dwarfs everything else.”***

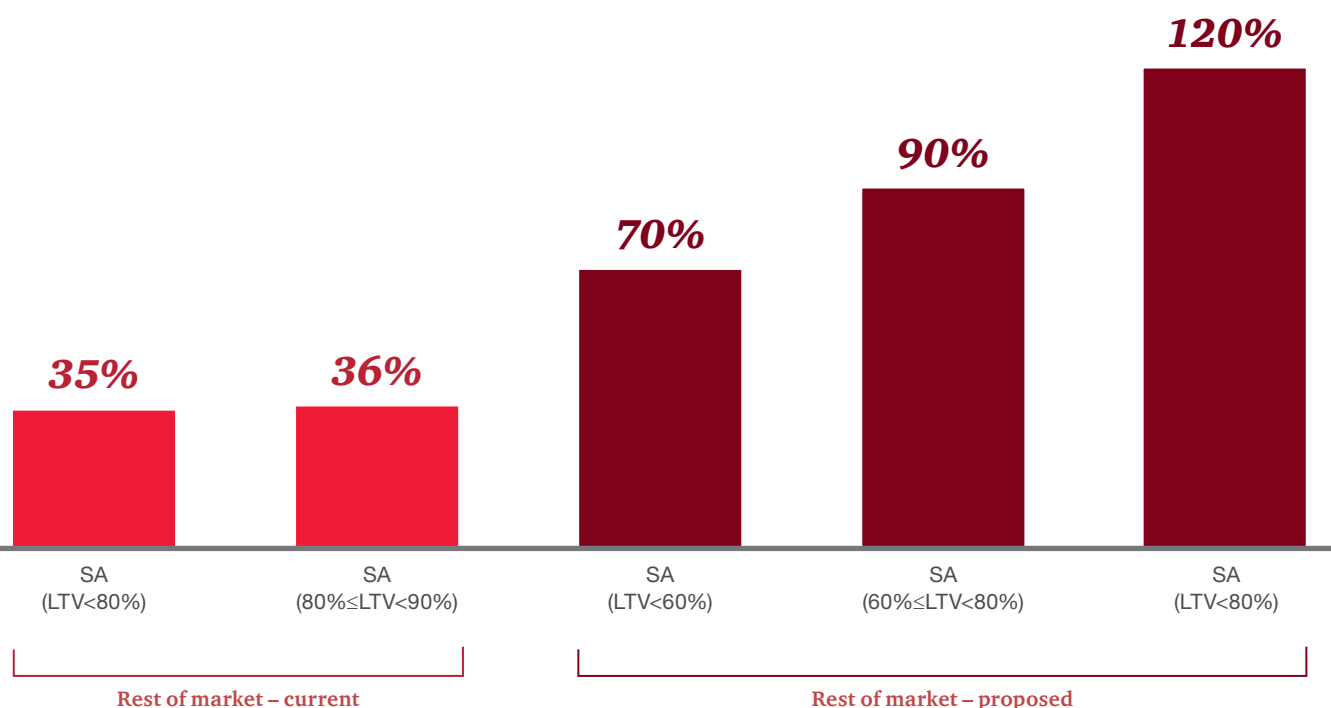
Some argue that the Basel regulations were never intended to apply to them – rather, that they were aimed only at banks that pose a systemic risk or operate internationally. Additionally, some of the banks view European Union regulations for products such as mortgages as less suited to the UK market, given the varying levels of market maturity and risk profile in EU countries.

They also believe that the leverage ratios affect some of the main high street banks to a lesser degree, as they have diverse balance sheets which allow them to optimise their mix to adapt.

Additionally, due to the Minimum Requirement for own funds and Eligible Liabilities rules (MREL), regulatory capital requirements rise sharply once a bank provides or services between 40,000 and 80,000 transactional current accounts,<sup>19</sup> which may run contrary to creating a competitive market if it deters banks from scaling their current account products. This is likely to be a particularly acute issue for smaller banks which anchor their proposition around a current account, such as some of the new digital-only banks.

A number of CEOs point to the example of the US, which they believe is more competitive because the equivalent regulation does not apply to the majority of banks. However, others argue that the US market is less affected by this since US banks do not have mortgages on their balance sheets and package these off to federal agencies (Fannie Mae and Freddie Mac). Still, other banks point to European counterparts that have received IRB approval in their jurisdictions, many of which are the size of the UK banks on SA.

One could argue that other regulators in Europe have been more successful in promoting a risk-based capital regime compared to the Prudential Regulation Authority (PRA). Hence the importance of the PRA encouraging this sector and looking at IRB through a proportional lens.



<sup>19</sup> Bank of England, ‘Approach to setting a minimum requirement for own funds and eligible liabilities (MREL)’, November 2016; Note: transactional accounts are defined as those which have at least nine withdrawals over the past three months.

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***“The most important structural issue the bank faces is the disproportionate application of capital requirements. The current capital regime has significantly influenced decisions on banks’ business model, such as the decision not to launch mortgage products due to the prohibitive capital requirements.”***

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As the PRA highlighted in its 2016 report on competition, the key obstacle for some banks is the “difficulty in building up adequate default and loss data points to facilitate IRB modelling consistent with the CRR standards. Specifically, given that loss data can only emerge post-default, the time taken to adequately model loss given default becomes the greatest constraint, particularly for retail mortgage portfolios”.<sup>20</sup> Some of the CEOs acknowledge that the PRA has understood their concerns, but many are keen to see the regulator implement solutions at a faster pace.

### **How market players are addressing these challenges**

It’s important to note that there are CEOs who believe that “the impact of capital requirements on competition is overstated.” In their view, improving structural impediments, such as risk weighting requirements for smaller banks, will not necessarily drive better customer outcomes in markets that are already competitive, such as in mortgages where the market leader only has 17.5% market share.<sup>21</sup>

Other banks are working with the PRA to propose a more proportional approach to IRB, whereby banks with nearly enough data and the required modelling capability would be allowed to calculate their own capital requirements. A ‘conservative overlay’ of capital could be applied to mitigate the risk posed by any uncertainty in the calculations. Introducing capital floors or introducing risk-adjusted approaches to risk weights could be alternative approaches.

Some bank CEOs believe the Bank of England (BoE) has data that could be leveraged to give them IRB status. Theoretically, the Bank could anonymise the data and provide it to banks to use in quasi-IRB models.

It could then be used as a proxy for proprietary data. However, there are challenges involved in this approach as the BoE would likely be required to take responsibility for the quality and accuracy of the data. The PRA, for its part, has committed to providing further information on its expectations regarding data requirements, including the use of external data to supplement a firm’s own data. A number of banks are working on innovative data-augmenting solutions with third-party data providers to address the limited internal data challenge.

In addition to addressing the data challenges involved with transitioning to IRB, the PRA has also committed to enhancing the transition process for SA banks moving to IRB. It has promised to increase engagement with the

banks and make the process more transparent, with module based assessment and indicative timescales for responses, and regular feedback to applicants. Furthermore, the PRA recently launched a consultation on the Pillar 2A capital framework. The work delivers a commitment made in the PRA’s Annual Competition Report 2016 to address the disparity in risk weights between firms using the standardised approach and firms that use their own models. The changes are expected to help ensure capital standards are not overly prudent for smaller firms, facilitating effective competition.<sup>22</sup>

### **The likely path forward in an uncertain world**

Many banks see Brexit as an opportunity for the PRA to level the playing field further. Following Brexit, the UK Government should have greater discretion to determine which aspects of legislation derived from the EU it wishes to maintain in the UK – and which it will reform. Some of the CEOs hope that the PRA will take the opportunity to tailor regulation to the needs of the UK banking system – which they argue would include lower capital requirements for those on the standardised approach.

The new Trump administration in the US could also have an impact on global banking standards. Trump’s publicly stated aversion to foreign entanglements is unlikely to sit comfortably with global, coordinated regulation such as that from the Basel Committee on Banking Supervision. Moreover, his plans to dismantle the Dodd-Frank financial regulation and transform the way the US oversees its banks could also signal a departure from global banking standards.

Whilst the impact of Trump’s presidency on global banking standards is not yet clear, the UK regulator’s behaviour is easier to predict. The PRA’s first responsibility is to ensure the safety of the UK banking system, with a secondary objective of promoting competition. The regulator is rightly concerned that deviating from Basel standards could be perceived as a weakening of regulation – something which the government may want to avoid following the recent financial crisis. In addition, it is conscious of the obvious benefits of maintaining the UK’s position as a global financial centre, which make it desirable to maintain global standards as much as possible.

We believe the most likely outcome is that the UK will continue to collaborate with regulators at the Basel level to progressively lessen the capital disparity between the biggest banks and the smallest.<sup>23</sup> Brexit is unlikely to

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<sup>20</sup> PRA, Annual Competition Report, 2016

<sup>21</sup> Council of Mortgage Lenders, 2016

<sup>22</sup> PRA, News Release: PRA launches consultation on Pillar 2A capital framework, 2017

<sup>23</sup> EuroMoney, ‘Western Europe Banking: Challengers at the Gate’, October 3, 2016



trigger significant changes as UK regulators will fear departing from the global banking standards so soon after a global crisis. Still, the UK may follow suit if those in the European Commission that are pushing for applying CRR rules in a more proportionate manner prevail, though this remains an open discussion.

### ***Lack of regulatory proportionality – diverting smaller banks’ focus and resources?***

One of the most frequently mentioned challenges in our interviews with bank CEOs concerns the lack of proportionality in the application of regulation. Many smaller banks employ only several dozen, or hundreds of staff. Such banks do not have the infrastructure to respond to the same level of regulation as is applied to banks which have substantial resources to draw upon for compliance purposes.

The consequence is a heavy burden of administration forced upon these banks’ small leadership teams. The CEOs believe that the volume of onerous regulatory requirements, such as participating in thematic reviews, distract the business from focusing on improving customer outcomes, and would prefer that the expectations of smaller banks more overtly take their size into account.

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***“We agree with the principle driving these exercises, but the CMA is going to drive more barriers into the market by imposing costly and time-consuming regulations on small banks.”***

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Some CEOs argued that the cost of compliance in the sector is increasing to such an extent that it forces them to build scale to offset their rising fixed costs. They believe these compliance structures are disproportionate to their mission, scale of their operations and revenue base. This is inherently reducing many small banks’ profitability and ability to meet their customers’ needs.

Other examples that the CEOs gave around proportionality issues concerned Know Your Customer (KYC) and Anti-Money Laundering (AML) regulation. Currently, the same rules apply whether customers open an account with £200 or £20,000. Smaller banks in particular believe they have

performed more KYC/AML checks than they feel are productive. Others argue that the pace of regulation has not kept up with the way in which new banks operate.

For example, the FCA expects computer code that is developed within the bank to be internally assured by a different party that was not involved in creating the code.

Many new banks have small coding teams and all members have been involved in developing all code, so there is no independent internal party. A new approach to IT controls could be developed by the FCA (for example, peer code review), but it’s important the approach doesn’t slow down the pace of the bank’s code development by creating an ‘agility constraint’.

Some of the mid-sized full service bank CEOs we spoke to also called out that other industry initiatives, such as those performed by the government around Open Banking and access to banking protocols, can be as onerous as the regulatory initiatives. Whilst the smaller banks are usually not required to participate, mid-sized banks are often included. Given their relatively smaller management and compliance teams compared to the larger high street players, they viewed these as initiatives as “burning a lot of time and resources, for very little return.”

Other CEOs see the additional bank surcharge tax as an unfair hindrance. They argue that if the additional tax is intended to ensure banks “make a fair contribution in respect of the potential risks they pose to the UK financial system and wider economy”<sup>24</sup>, then it should be less relevant to smaller banks, which pose less of a risk.

Overall, the banks we spoke to think the regulator should focus on enabling smaller players to take risks that will have a smaller impact – and even if they fail, such exercises provide learning opportunities for the industry.

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***“The additional tax is intended to ensure banks make a full and fair contribution in respect of the potential risks they pose on the wider economy. Given our smaller scale, we don’t pose as significant a risk to the economy, so it doesn’t seem fair.”***

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Additionally, some banks believe non-bank financial institutions, such as peer-to-peer lenders, receive less regulatory scrutiny than banks.

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<sup>24</sup> HMRC, ‘Bank Corporation Tax Surcharge Policy Paper’, July 8, 2015

To some extent this is reasonable, since they pose less risk to customers and the economy, but less regulation may lead to bad customer outcomes and unfair competitive advantage within the industry. For example, peer-to-peer lenders are not subject to capital and liquidity regulations, but nonetheless some imply to customers that they have adequate buffers to ensure customers' money is always available in times of economic stress. The capital and liquidity buffers they have in place are often other customers' money, so in times of stress these funds may not actually be available.

Finally, some of the new entrants also thought the bank authorisation process should be simplified further so it is more proportionate to the size of the bank. These CEOs felt industry bodies were taking a 'one-size-fits-all' approach that imposes a large burden on small banks. For example, start-up banks often have only one member of staff that is able to complete the lengthy assurance forms. There was a view among several applicants currently going through the process that more dedicated resources at the regulator may also help to speed up the feedback and processing of applications through to completion. Despite these views, there is an acknowledgement from several banks that have recently gone through the authorisation process that the Regulator has become more supportive and clear about the process and its requirements, and applicants are now more aware of where they are in the process and next steps they need to take. Some CEOs thought the regulators could reduce duplication between forms for the Faster Payments Scheme, FCA, and Current Account Switch Service to simplify the process.

Despite the recent simplifications to the process (the introduction of restricted authorisation), many new entrants would like to see the process further simplified in order to increase the level of competition in the sector, for example, by allowing banks to become authorised rapidly with limited capital up to certain thresholds.

### ***How market players are addressing these challenges***

From the UK regulators' perspective, they are constrained as Europe currently has only 'one rule book' which all banks must comply with, regardless of size. Additionally, some of the CEOs we interviewed recognised how participating in a proportion of regulatory reviews could help them build trust in the market.

These CEOs want to play by the same rules as the main high street banks, and viewed this as a badge which they could use to attract customers. They also thought that although the bank surcharge will remove a structural advantage from smaller banks, the issue is 'peripheral'.

Although they welcome competition, some of the banks are concerned that relaxing the authorisation process has driven a number of new banks to enter the market to deliver very similar services, particularly under the current capital rules. This forces some new entrants to adopt aggressive credit risk approaches to enable them to scale. More licences may therefore be at odds with some regulatory objectives under the current capital rules.



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***“It is fair that we comply with the same rules as established banks if they want to be taken seriously by investors and inspire confidence.”***

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## **Access to payment systems – limiting new entrants?**

Today, a small number of main high street banks with direct access to payment systems provide indirect access to the other banks and building societies. This arrangement imposes cost constraints on the other banks as they have a narrow choice of providers which limits their ability to negotiate on price. There are also barriers to switching as information about services and fees can be complex and opaque.

Additionally, some of the banks we interviewed said they have experienced quality issues, such as service outages, or found it difficult to get information around operational issues. Some clearers require the challengers to hold specific accounts with them, which impinges on their preferred operating model. Notice periods which the direct access banks give to banks before terminating indirect access agreements can also be relatively short, which makes it tougher for users to migrate effectively to another provider.

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***“There were frequent outages, providers prioritised fixing issues for their own customers over those of challenger banks. This is one of the reasons we discontinued our personal current account offering.”***

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Some CEOs were more positive about the service levels they receive from the payments systems providers. However, such banks are more likely to operate customer propositions that are less reliant on fast or frequent payments. Other satisfied CEOs of larger players thought that the better quality of service they received was driven by their “higher volumes, which gave them more bargaining power”.

Many banks felt that the alternative to the prevalent model, of becoming a direct bank themselves, was still inaccessible – “direct banking is a myth”. The cost and governance

overhead of joining multiple payment schemes is enormous for a small bank. Some CEOs point to the lack of Bank of England settlement accounts as the fundamental problem, while others believe that services such as Faster Payments were not set up with the intention of accommodating new joiners and consequently have unclear joining processes.

Most believe that if it was made easier for non-banks to gain direct access to payments systems, this would “be a huge step forward” for the industry. Others have suggested the creation of an industry utility for non-clearing banks as another potential solution.

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***“It’s very difficult to become a direct member of payment schemes due to lack of knowledge in the market – they haven’t had many new joiners and therefore there are no processes.”***

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## **How market players are addressing these challenges**

Several market players have undertaken initiatives to address payments issues. For example, since mid-2016, several new banks such as Metro and Starling have started to connect directly to Faster Payments (the UK’s 24/7 real-time payment service, launched in 2008). Some of these banks plan to act as a sponsor for other payment service providers to access payments through its connection. Faster Payments thinks as many as 50 of the firms currently gaining access through the main high street banks could switch to the new providers.<sup>25</sup>

The UK government and regulators are also working to identify new functionality and technology to improve clearing, processing and settlement in payments. Initiatives include the Bank of England’s review of its Real Time Gross Settlement (RTGS) system, the Competition and Markets Authority’s remedy on Open Banking and HM Treasury’s work on the transposition of the revised Payment Services Directive (PSD2) which introduces new services and players into scope of the legislation.

The regulators have also made it possible for new entrants to apply for a BoE settlement account when they apply for a license, effectively shortening the process before banks can launch their products. Many of the CEOs we interviewed expect PSD2 and Open Banking rules to help them acquire customers by enabling them to act as product ‘marketplaces’, anchored around a current account.

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<sup>25</sup> Faster Payments, 2016

Industry bodies such as the Payments Strategy Forum (PSF) have been established to drive collaborative innovation in payment systems. In November 2016, the PSF set out its strategy to enable simpler access, greater innovation, increased adaptability and better security.

The CEOs also recognised the work done by the Payments Systems Regulator (PSR), describing it as “very supportive and understanding”. The PSR report on the supply of indirect access to payment systems raised concerns around “the ability of current technical solutions for real-time payments to meet the required quality of service”.

This may limit the ability of some banks and other large payment providers to compete in related markets, such as retail banking.

The report also supported the CEOs’ views that “banks, building societies and other payment providers face barriers to switching indirect access providers, which reduces competitive pressure and prevents them from securing the best possible price and quality of service.”

However, the PSR has also noted progress, such as the expansion of the market as organisations are planning to start offering indirect access, and the emergence of alternative access models for interbank payment systems, including the development of aggregator arrangements for the Faster Payments Scheme (FPS). The PSR concluded that it will support these developments rather than taking regulatory action.<sup>26</sup>

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26 FCA, Payment Systems Regulator, Market review into the supply of indirect access to payment systems





## **Lack of product transparency – limiting consumer choice?**

Some of the CEOs we spoke with were disappointed that the remedies suggested by the CMA did not include sufficient measures to increase the transparency and comparability for key products such as current accounts, which they believed would significantly improve customer outcomes. Rather than a simple 'best buy' table, these banks would like a more sophisticated solution which shows customers what the total cost of ownership might be based on their behaviour (for example, overdraft costs for customers which are typically in debt). Some CEOs argued that customers needed to be provided with the tools required to make informed decisions about the best products and services for their needs.

One of the banks has conducted research into a simple visual comparison system that helps consumers understand differences in the features and value of products offered by different banks.

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***“The research found that the difficulties customers experience in understanding the value of their account and the differences between accounts were critical barriers to increased switching levels and healthy competition – with 55% of customers finding it impossible to determine the value of their account and only 14% believing there are large differences between accounts.”<sup>27</sup>***

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Overall, the bank believes that the lack of a comparison system is limiting the impact of introducing the CASS (Current Account Switch Service) because customers do not see meaningful differences between provider offerings. PwC's own research<sup>28</sup> suggests many consumers are simply fed up of being urged to 'shop around', complaining that this attitude is condescending and that they should not be made to feel foolish for not switching. These customers will need more compelling reasons to persuade them to move.

Some bank CEOs also argued that there is insufficient transparency of pricing in the SME banking market. These findings were echoed by the recent CMA report which found comparing prices to be too difficult for small businesses.

As a result of this lack of transparency, the CMA identified a misperception among SMEs that the potential gains from switching are not high and that there is limited differentiation between banks.

Their analysis demonstrated significant differences between the highest and lowest monthly costs of a business current account for almost all customer profiles.<sup>29</sup>

The banks we interviewed thought it was important to recognise that this lever in isolation will likely not introduce more competition, without the other structural issues being addressed.

### ***How market players are addressing these challenges***

Various banks have tried to create transparency in the SME deposits market by embedding a rate-checker on their website that allows customers to compare the interest rates offered by other providers. However, some banks which operate legacy systems are often unable to support rate-checkers. Others have opposed comparison sites which are purely price based, as they do not necessarily compete or differentiate purely based on price. These banks argue that if the underlying capital requirement issues are not addressed, price comparison tools may put them at a disadvantage.

The government has also backed the development of a 'Business Banking Insight' website, which allows small and medium sized businesses to rate, review and compare banks' performance. The site is designed to create greater transparency by sharing the experiences of small businesses.

In addition to its findings on the personal current account market, to improve competition in the SME banking market, the CMA recommended in its recent report that the FCA should support the development of comparison tools to improve transparency, although there are still limitations on what metrics need to be captured and displayed depending on the type of bank. The CMA also mandated the standardisation of business current account opening processes, and introduced soft searches to enable SMEs to shop around without adversely affecting their credit rating. Furthermore, the CMA has recently backed the Nesta SME Banking Challenge Prize to deliver market-led comparison tools for SME finance.

Finally, the FCA has also launched a market study to find out if competition in the mortgage market can be improved to help consumers. The FCA wants “to understand whether consumers are empowered to choose on an informed basis between products and services and are in a position to understand whether these represent good value for money”.<sup>30</sup>

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<sup>27</sup> Tesco Bank, News Release, 2015

<sup>28</sup> PwC, 'Citizen Jury for Financial Services', 2016

<sup>29</sup> CMA, 'Retail banking market investigation', 2016

<sup>30</sup> FCA, 'Mortgages Market Study Terms of Reference', 2016



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# Technology will shape the future market landscape

## **Technology can fundamentally change banking**

Technological change will have a significant impact on how consumers access and use their financial services as well as on how banks deliver them.

Smart mobile devices are pervasive, and consumers of all generations are increasingly eager to use these devices in almost all aspects of their lives. This expectation extends into banking where common activities such as being able to access accounts, view balances, make and receive payments, and manage personal finances are taken for granted; and where the advent of distributed ledger technologies, voice controlled devices and robotics raises the bar on what consumers expect to be able to do – both in terms of speed, complexity of products offered, usability and control.

Banks are also benefiting from technological advances which change the way in which they work and deliver their services.

There is a progressive automation of manual processes, which should reduce risk, increase accuracy and speed through straight-through-processing, while being able to streamline the headcount required. Artificial Intelligence and robotics will increasingly support decision making, as well as standardising and enriching customer interactions.

The migration to more modern banking platforms also gives banks the ability to reduce the complexity of their IT architectures and introduce more sophisticated functionality. Crucially this should make it easier for banks to outsource processes and to exploit cloud technologies. These offer the opportunity to scale rapidly, and shift from a high fixed cost base to a much more variable situation – where the cost of IT systems (typically a very significant cost item) remains manageable and in proportion to the number of users and customers.

## **Open banking will bring more competition and new opportunities**

The advent of Open Banking, enabled by technology and regulatory developments, will be particularly influential on competitive dynamics. Supported by a new regulatory regime, this initiative means that banks will be able (and required) to share more customer information than ever before. This will be achieved via technologies such as Application Programming Interfaces (APIs) which enable systems to be connected in a far more modular and component based way across organisational boundaries. Making infrastructure available through standardised interfaces will be a major trigger for new competition, from many different sources.

Open Banking will give rise to new business models, with some providers choosing to specialise in narrow areas rather than offer a traditional suite of products or attempt to manage the customer's end-to-end experience.

Others will compete by making it possible to integrate niche offerings from a number of different companies in a seamless way. They might select which partners to work with, or they might give customers the choice to assemble a totally personalised suite of banking products and services from a financial 'app store'.

Already, a large number of FinTech start-ups are working hard to establish themselves as digital providers of services such as payments, investment, and lending. These 'digital value chain players' are focused on providing excellent experience and functionality at lower cost, for specific traditional banking services. Whilst many bank CEOs we spoke with believed the threat of FinTechs was overplayed by the media, others thought they presented an opportunity to enhance their offering through partnerships. Fidor's use of Currency Cloud's payment engine and Metro's partnership with peer-to-peer lending platform Zopa provide examples.<sup>31</sup>

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<sup>31</sup> Sophie Guibaud, 'How to develop a profitable, customer-focused digital banking strategy', Journal of Digital Banking, Dec 2015



Banks take the threat of larger tech organisations such as Google, Amazon, Apple and Facebook very seriously. One CEO claimed these companies pose an “existential risk” to banks, by facilitating financial services like payments directly on their websites and disintermediating banks that are subsequently “left out of the data loop”. The CEOs believe it will be these players which drive the real change and disruption in the banking industry. By inserting themselves between the customer and the underlying bank they could take value from the bank, relegating them to the role of invisible ‘pipes’. Apple has already started to do this with Apple Pay.

The Second Payment Services Directive (PSD2), is an example of legislation that is accelerating this shift towards Open Banking and subsequent use of APIs, enabling banks, FinTechs and companies from other industries to transform the payments industry. Many of the CEOs viewed PSD2 as a significant opportunity to implement new digital strategies, as they will now have access to other banks’ customer data and can become an Account Information Service Provider (AISP). In this scenario, banks could consolidate or aggregate data from a variety of banks and create new propositions, such as a dashboard presenting all customer account information in one place.

Although there are important security and data security issues to be addressed, the potential for this future scenario is underlined by our consumer research – 39% of bank customers would share their financial data with other banks and third parties (such as Amazon, Apple, Tesco and so on) if in return they received benefits such as an overall view of their accounts in a single app, or being able to compare tailored product offers from third parties. However, banks and third-party providers will need to reassure consumers that they have the appropriate security measures in place to safeguard their data and respect confidentiality. According to our consumer survey, 58% of respondents would not open a current account with any financial provider, new or established, if it shared their financial data with third providers.<sup>32</sup>

## **The future UK banking market – diverse and modularised**

Like many new entrants to the industry, we think the banking landscape will change fundamentally in the future, with two key trends accelerating the transformation:

### **Modularisation**

Providers of financial services are increasingly able to focus on very specific modules, or components, of banking services or products. This is largely being driven by new digital technology and Open Banking provisions within PSD2 and the CMA OB Remedy that enables direct access to consumers as well as integration of systems, within and across companies.

Customers will have significantly more choice of products and providers they wish to use. Sometimes they may opt to engage directly with financial services providers (traditional banks, product specialists, or peer-to-peer (P2P) services); sometimes they may start at an intermediary (perhaps a comparison service, a broker or an aggregator); and sometimes the financial service will be in the background or even invisible as the consumer interacts with other companies (for instance, retailers, travel providers or social networks). In all of these scenarios the traditional banks will likely only carry out part of the end-to-end activity, with a complex web of interactions between multiple companies’ systems. Customers will be able to combine these banking modules for a customised and personal experience.

New competitors from other industries will join the competition to command consumers’ attention and strive to be the preferred interface. Unexpected alliances and partnerships will be created to provide more seamless and attractive propositions. All these factors will accelerate the trend of specialisation and modularisation.

### **Fragmentation**

The recent influx of new entrants into banking has broken a half-century long trend of consolidation. Whether this continues will depend partly on new entrants’ ability to differentiate themselves and win market share from incumbents, but also on whether the market grows, as innovation drives new products and services. Due to the lower fixed costs of the new banking market players, building scale is no longer an imperative and consolidation is not inevitable.

We believe that although not every new bank will survive, and while success will vary by product, there is room in the market for many to prosper. Market conditions should support the growth of the banks outside the six main high street banking groups, some of which are actively limiting their market share targets in mortgages and SME lending due to regulation-driven deleveraging targets and historic conduct issues.

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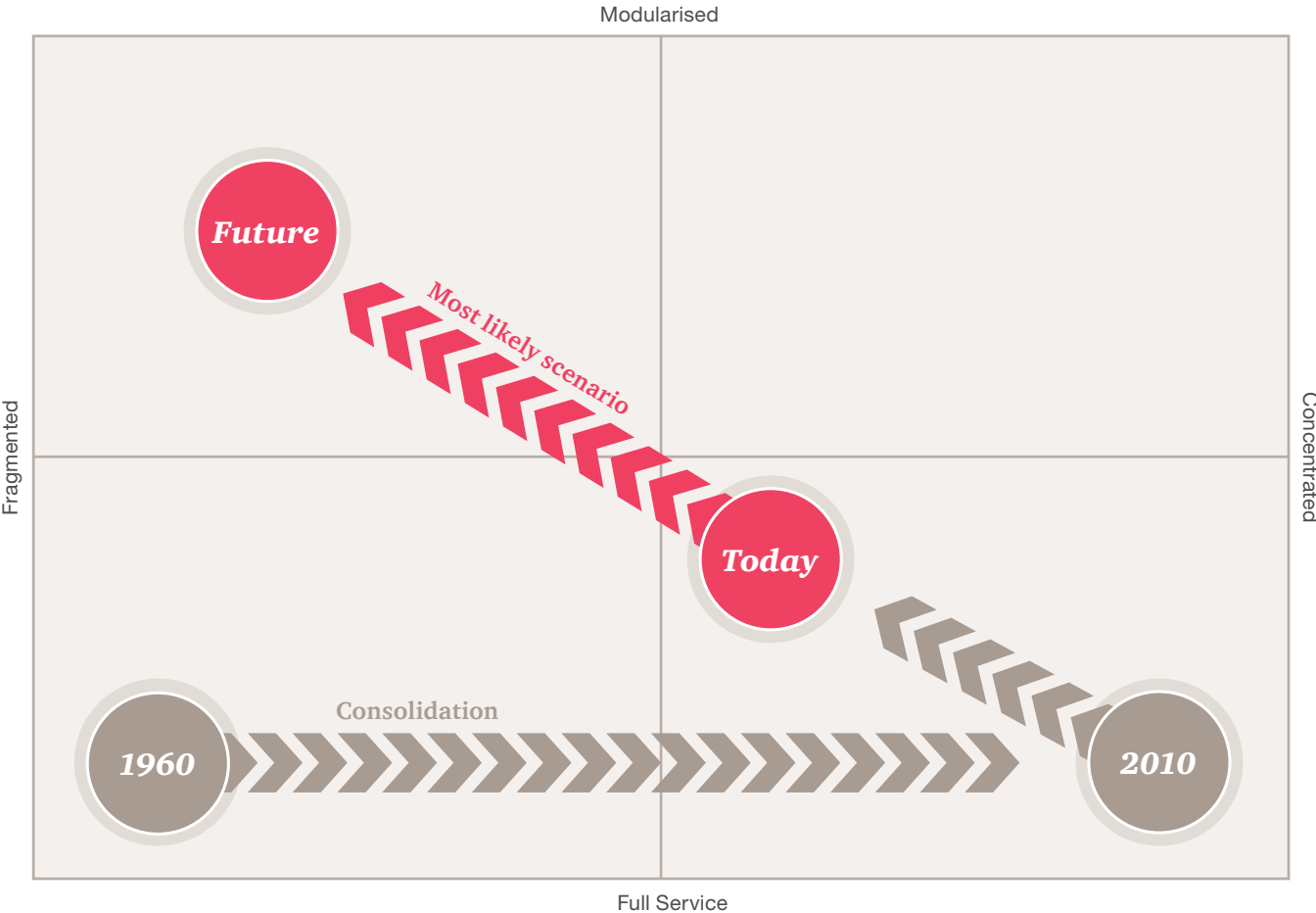
<sup>32</sup> YouGov, PwC Strategy& analysis



Moreover, UK banks will be supported by positive growth trends in both retail and corporate lending. According to the Bank of England, retail loan growth is now running at +3.5%, mortgages at +2.8%, consumer credit at +9.1%, and corporate loans at +2.0% year on year.

Going forward, retail loan growth is expected to continue to grow at the current pace, whilst corporate loan growth is forecast to accelerate to c.3% per annum by 2017, and to stay in line with nominal GDP growth over the long term.

Figure 7 – Future of the UK banking market



# To be successful, each bank needs to overcome specific challenges

Regulatory change and broader initiatives to address structural barriers will help banks in this part of the market to be more competitive, but this isn't going to be the only determinant of success. The CEOs we interviewed speak proudly of the compelling propositions they are building and which will attract and delight customers, rather than assuming that customers dissatisfied with the main high street banks will naturally gravitate towards them.

However, in order to succeed they will need to address their own challenges, which vary by the group in which they operate.

Smaller banks cannot rely on customers to be driven to them by poor experiences with the main high street banks. Our research demonstrates that only a small minority (11%) of British consumers switched banking providers because they were dissatisfied with the level of customer service provided.

57% of consumers who changed their bank in the last three years, did so due to one of the listed financial incentives (i.e.. better rates, cash back, discounts), but the majority of CEOs we spoke to did not feel able or willing to match the incentives offered by main high street banks (see Fig. 8).

## Mid-sized full service banks – well placed to compete or trapped in the middle?

### Key strengths

The mid-sized full service banks are perceived as well established banks that, like the large traditional banks, are trusted as part of a safe and stable banking infrastructure. They have a significant physical presence, established controls, ways of working and experienced employees, as well as a significant customer base. These banks have strong brand recognition, and reputations relatively untarnished by the financial crisis.

Some of these banks' regional focus means they can credibly position themselves as local banks that understand specific needs and can serve their customers in a more personal way. They are able to offer their customers an appropriate blend of physical and digital interaction, but foresee operating with a focussed branch network that facilitates customer interaction and promotes the brand.

The importance of the branch network was supported by our consumer research, which found that more than half

of respondents still think a branch is essential for them to consider opening a current account, savings account, personal loan or mortgage (see Fig. 9).

As these banks have a smaller scale than the larger high street banks, they should be more nimble and able to pursue innovative and differentiating ideas. Some have already implemented modern technology platforms, which offer good functionality, enable straight-through processing and enable them to scale without a disproportionate increase in cost.

### Strategic priorities

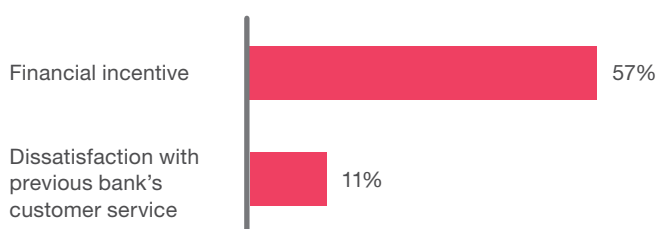
The mid-sized banks have a number of strategic options to consider:

#### Continue transforming their operating models to cut costs:

- Many of the banks are simplifying their business and reducing exposure to more complex and manually intensive activities.
- In an effort to reduce costs, many are right-sizing physical presence and increasing the use of digital channels.
- Other strategies for reducing cost include re-engineering processes to automate and streamline the way in which the bank works.
- Older banks in this group also recognise the need to replace legacy technology and streamline large unwieldy change portfolios.

Figure 8 – Reasons for British consumers changing banking provider

% of customers (2017)



Source: YouGov, PwC Strategy& analysis

Note: Financial incentive includes better rates, cash incentives, discounts

### Build scale:

- The mid-sized full service banks can grow organically by leveraging strong local brands, tailored to regional needs and emphasising customer centricity.
- Many are also considering expanding into less saturated markets such as SME and business banking.
- Others may pursue consolidation through M&A if an organic growth path proves too slow or difficult, a number of players in this group are also pursuing portfolio acquisition of struggling smaller banks.

### Sharpen focus of proposition to differentiate brand and attract customers:

- These banks are continuing to focus on providing an enhanced consumer experience – service, convenience, personal interaction creating long lasting loyalty.
- It is critical these banks highlight how they are different to the main high street banks, enabling them to extend their footprint to have a greater national presence – particularly considering only 14% of British consumers thought they had a more attractive offering than the larger high street banks (see Fig. 11). Such banks' regional focus means they can credibly position themselves as local banks that understand local needs and can serve their customers in a more personal way. They are also able to offer their customers an appropriate blend of physical and digital interaction.

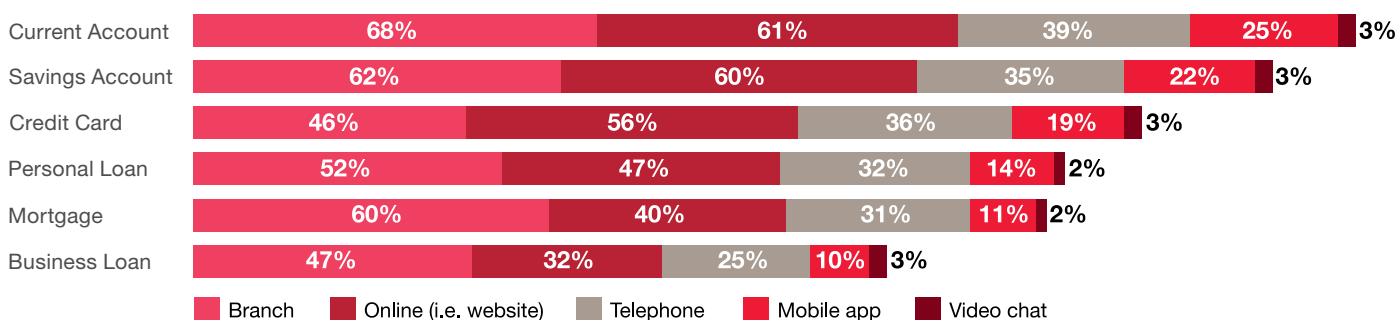
- Many of these banks will also consider exiting businesses which are not profitable or do not leverage core capabilities.

### Develop an Open Banking strategy:

- Mid-tier banks run the risk of losing the customer interface as FinTechs, other banks, or other industry players offer better functionality or usability in the front end, which simply plugs in existing accounts.
- There is also a risk that increasing demands for API-based modular architectures will create significant drain on change resources due to legacy architecture.
- Banks able to move fast to develop a modular business and technical architecture can leverage their brands to dominate parts of the value chain – whether front, middle or back, while dynamically integrating offerings and data from other players.
- The role of IT will likely need to shift from being viewed as a cost centre to a capability that supports business development by enabling innovation through third-party partnerships. This is a new concept for the bank that will involve building new systems, functions, roles (e.g. API platforms, and new roles for people including API managers, partner-developer relationship managers, cloud service managers).

**Figure 9 – Proportion of British consumers that require specific channels to open new banking products**

% of customers (2017)

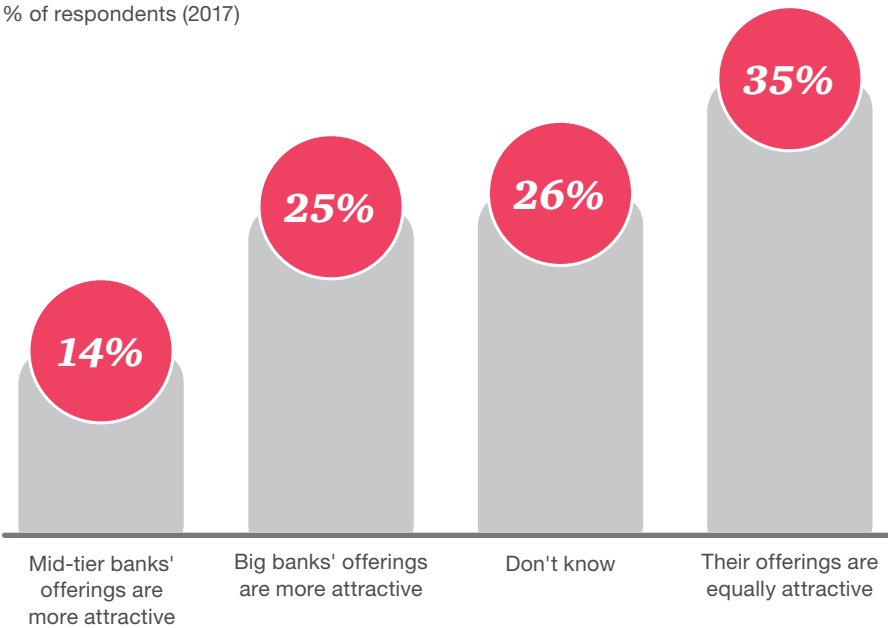


Source: YouGov, PwC Strategy& analysis

Note: Customers were asked "Which, if any, of the following channels would you consider essential for a bank to offer, for you to open each of the following types of product with them?"

**Figure 10 – Proportion of British consumers that think mid-tier banks have a more attractive offering than big banks**

% of respondents (2017)



Source: YouGov, PwC Strategy& analysis



## **Specialist banks – small and successful, but approaching an inflection point?**

### **Key strengths**

As specialists, these banks have a deep understanding of the segments they serve. The areas these banks focus on tend to require depth of expertise, which creates a barrier to entry for potential competitors. They are able to price risk on an individual basis in a way that is more difficult for larger, more automated providers. Many have experienced management teams, who have operated across the full spectrum of UK banking. Their relatively small size also means they are better able to manage certain types of risk. These factors mean they are able to provide differentiated services and competitive offers to their customers.

Without an extensive (or any) branch network, the specialist banks operate with a lower cost-to-serve than larger competitors, albeit offset by a higher cost of funds for some of these banks.

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***“Specialist lenders have existed for years and will continue to enjoy a good return on equity at low volumes”.***

***“Branches are an industrial-age solution to distribution”.***

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They typically have modern systems that are flexible and scalable, usually sourced from third-party providers and outsourced. As a result, IT doesn't require the level of maintenance as that of some of the older players. Systems often offer market leading functionality and can be adapted to respond to changing needs.

The platform can be scaled rapidly to support growth. As smaller players, specialist banks can be more agile and nimble than larger banks, rapidly reorienting to customer needs and new opportunities.

### **Strategic priorities**

In the short term, the specialist banks feel confident about their ability to keep growing steadily and profitably by focusing on their areas of focus and maintaining a relatively simple business model. The pace of growth will depend on the economic environment, with low economic growth posing an impediment to increased lending. In the longer term, however, there is plenty to consider:

### **Develop a strategy to grow and reduce concentration risk:**

- Once they have fully penetrated their niche segments, some specialist bank CEOs expect to face an inflection point where they must either continue to grow at lower profitability as they increasingly compete on price, or accept more risk as they take on business they would not have previously considered.
- These banks must leverage their deep understanding of customers to develop attractive propositions in adjacent markets.
- As relatively small and profitable organisations, some specialist banks are considering M&A or portfolio acquisition as a means to build scale, usually involving a combination with similar banks focused on adjacent areas.

### **Deal with growing pains:**

- As the specialist banks may choose to look elsewhere for growth, they may need to extend their product range into new areas.
- While some capabilities might be reused – in the case of an expansion from invoice finance to broader business finance, for example – these banks will likely have to invest in new skills even before they know whether or not their forays will be successful.
- As they grow they also need to ensure their operating model is scalable and continues to be efficient.

### **Defend against the risk of legacy system issues creeping in whilst harnessing digital:**

- Critical to maintaining a low cost-to-serve will be ensuring their technology remains legacy-free and as simple as possible.
- As customers accelerate their adoption of digital channels, and the industry progressively shifts towards Open Banking, the specialist banks will need to establish their positioning in a new eco-system. Those that are able to adapt their technology platforms rapidly and partner wisely, will benefit in a more transparent, less broker-dependent environment.

### **Develop an Open Banking strategy:**

- Specialist banks will seek to maintain their position as differentiated specialist 'spokes' within a 'hub and spoke' model, and may benefit from having their offerings presented to consumers by aggregators.
- However, there is a risk greater comparison of offerings will result in commoditisation and margin pressure. The impact (positive and negative) would be most significant for those who move fast to comply and participate in an open ecosystem.
- Partnerships are likely to prove valuable to increase presence and the possibility of integrated offerings.



## Digital-only banks – building for the future, but are there customers?

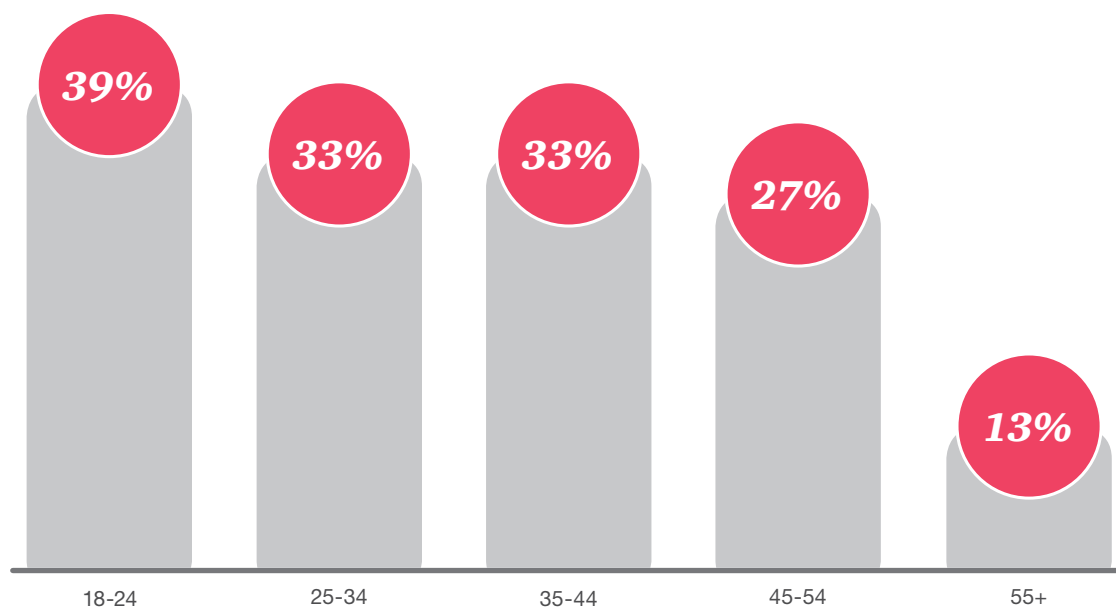
### Key strengths

These banks are clear on who they are targeting: a growing segment of digitally literate customers who want simplicity, transparency and useful services. These customers tend to be younger, as our consumer research revealed with 39% of

British 18-24 year olds viewing a bank's mobile app as essential when opening a current account, compared to only 13% of those aged over 55 (see Fig. 11).

Figure 11 – Proportion of British consumers that require mobile channels to open a current account by age group

% of customers (2017)



Source: YouGov, PwC Strategy& analysis

They recognise that to serve this constituency well, they need to be totally customer-centric. Their online communities are therefore crucially important as they seek to gather new ideas, collect feedback on what customers want and to share their plans. The use of crowdsourcing to raise funds, which encourages customers to be owners and vice versa, can have a similar effect.

These banks understand the trend towards Open Banking and are actively designing the role they will play in this future environment. They are also conscious of the need for their segment to establish credibility – a single failure would damage confidence in them all.

The digital-only banks are all fresh, technology-driven start-ups. Like other exciting new digital ventures they have been able to attract highly skilled and motivated talent. They are visionary and ambitious, actively re-imagining how banking could be radically transformed. They are nimble with their relatively small size and willingness to change ensuring they have the ability to keep innovating and adapting.

***“If one pillar falls, the others are at risk.”***

These banks have modern, state of the art technology platforms, either developed in-house or using the latest software from well-established and credible banking system vendors. Such platforms offer differentiating functionality in a user-friendly way, deployed for use on modern devices, and particularly through mobile channels. They are designed to be scalable, so that the banks can grow volumes rapidly without an adverse impact on performance, and ensuring that the cost of service provision remains reasonable for the size of the business.

They are also typically built in a modular way, positioning the banks to take advantage of the Open Banking trend by readily integrating functionality and data from other sources.

### Strategic priorities

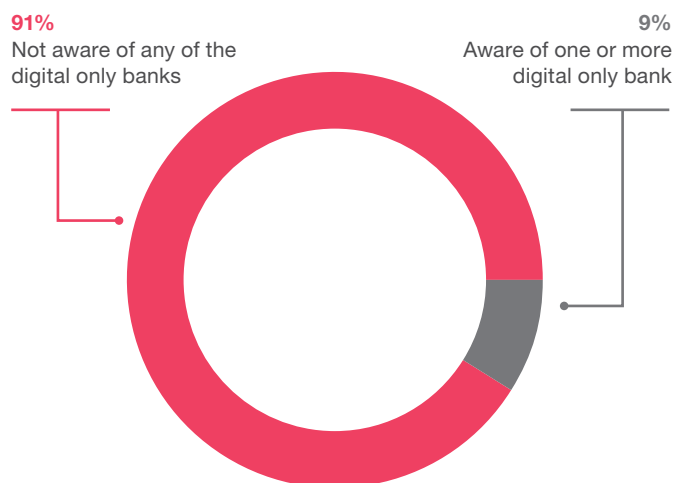
The digital-only banks are all expanding their capabilities in anticipation of the (potentially significant) organic growth which could flow from customers recognising, appreciating and trusting their digital offering. Their main priority right now is to finish establishing their new businesses and to prove they are sufficiently credible and attractive to engage and satisfy a critical mass of customers. To do this they must deliver against a number of strategic priorities:

#### Attract customers:

- As these banks are still in their infancy, they face very low levels of consumer awareness. Only 9% of our survey respondents were aware of any of the digital players (Fig. 12). Moreover, only 9% of consumers said they would consider opening a financial product with the digital players in the next three years, in addition to the 9% of respondents which already bank with them.
- These banks recognise the importance of building functionally rich propositions. Given that the main high street banks have their own digital capabilities, the digital-only banks must prove their offer is sophisticated enough for customers to start using their products. Critically, the proposition must be more than a better app, as our survey revealed that only 4% of customers who changed banking arrangements in the last three years did so because their previous provider's mobile app didn't meet their needs.<sup>33</sup>
- Leveraging community will also be critical for these banks as they aim to capitalise on the compelling benefits of the network effect of satisfying users in the social media age.

**Figure 12 – Currently, very few consumers are aware of the digital only banks...**

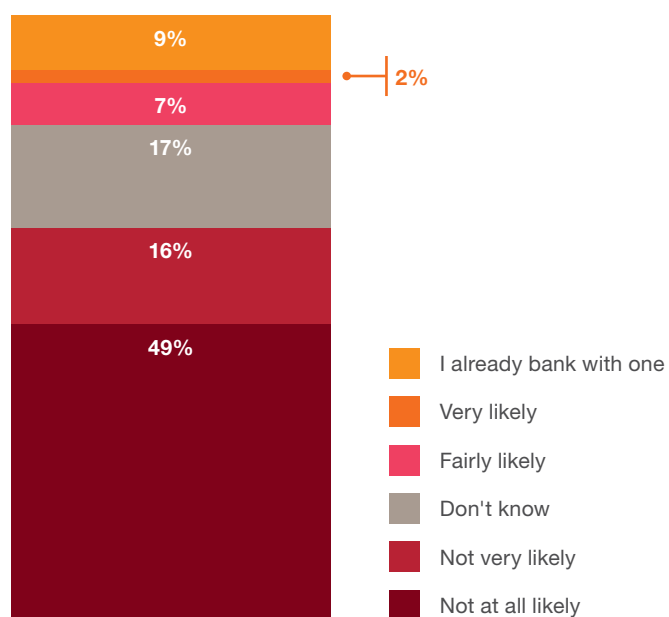
Proportion of consumers which are aware of any of the digital only banks – % of respondents (2017)



Source: YouGov, PwC Strategy& analysis

**...and the majority would not consider banking with them in the next three years**

Proportion of customers that would consider banking with a digital only bank in the next 3 years – % of respondents (2017)



Source: YouGov, PwC Strategy & analysis

<sup>33</sup> YouGov, PwC Strategy& analysis, 2017

### **Differentiate from the other digital players and the high street banks who are digitising fast:**

- A steady stream of new digital-only banks are entering the market, most of which are perceived as offering similar, if not identical services.
- Without clear differentiation, it will be difficult for any single bank to corner enough of the (still limited) market of customers seeking digital-only propositions.

### **Expand profitably:**

- While the digital-only banks have low cost bases, profitability is tough given small customer numbers; all the more so, since their customers tend to be younger, multi-banked and, for the time being, less financially mature.
- Investors in digital-only banks understand that these ventures won't turn a profit overnight, but pressure will mount.
- However, the flexibility and location independence of their business models mean these banks are able to consider expansion into other geographies – provided customer needs are sufficiently similar and they can obtain local regulatory approvals.

### **Seize the Open Banking opportunity and innovate:**

- Given their corporate agility, these companies will be well-placed to adopt new business models such as becoming an Open Banking aggregator and innovator, potentially giving them a first-mover advantage over slower banks or newer entrants.

- They should be able to select which parts of the value chain they wish to focus on (likely including the customer interface) and successfully scale in these areas.
- They may be able to leverage their technical skills and modern architectures to practically implement the use of emerging technologies in innovative ways – distributed ledgers, artificial intelligence, algorithm-based advice and robotics will all provide opportunities.
- As licenced banks that are small and ambitious, these players could be attractive partners, investment opportunities or acquisition targets – either for large players in other industries such as telecoms, technology or retail which have an interest in financial services, or for international banking groups hoping to compete in the UK.

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***“Many challenger banks will get bought within the next five years; I find it difficult to see a future where all the current challenger banks will be successful in the long term and many will find it difficult to balance growth with profitability, particularly with the capital constraints. This will make it challenging for them to receive more funding.”***

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## ***Non-bank brands – about to unleash the power of personalisation?***

### ***Key strengths***

The non-bank brands all benefit from having well known, trusted brands that they have inherited from their parent companies. This is particularly valuable in an environment where banking brands have been impacted by the financial crisis and conduct issues, and large numbers of consumers have mixed views about the banking industry.<sup>34</sup> By non-bank brands building their identities around their parent groups' brand values, they are able to position themselves in a differentiated way.

The parent group also provides access to a large customer base, with large numbers of potential customers who have a proven affinity with the brand, including, in some cases, membership of loyalty schemes. In addition to being able to market their services to a receptive audience,

the non-bank brands also have access to rich data about customers – this goes significantly beyond the traditional banking data set that competitors expect to work with.

The non-bank brands have all invested significantly in IT platforms, which they regard as essential for providing the digital experience their customers demand and the flexibility to grow and adapt the proposition.

While these banks tend to be digitally focused, they should have the potential to change their physical footprint dynamically in response to customer needs, leveraging the extensive network of stores held by the wider group.

This may help them to determine which services should be offered in person and to select locations in a very fluid way.

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<sup>34</sup> PwC, 'Citizen Jury for Financial Services', 2016

### Strategic priorities

The non-bank brands may have well-differentiated brands, but they have a number of obstacles to overcome and opportunities to seize to deliver long-term success:

#### Seize the data opportunity:

- With access to rich data sources, including people's preferences and behaviour patterns as well as their financial needs, the non-bank brands can develop new services and produce highly personalised offers to drive differentiation.
- This will require different capabilities, including agile product development, flexible user engagement and industry-leading data analytics. The non-bank brands may continue building these skills internally or to partner with third parties to accelerate their initiatives.
- With an overall shift in banking towards API-enabled relationships – and specifically towards Open Banking – other players will also find ways to merge banking and non-banking data intelligently. These banks therefore need to move quickly to capitalise on their competitive advantage while they retain it.

#### Optimise the distribution model:

- Many of the non-bank brands' parents have massive national distribution networks, offering an opportunity to experiment with in-store branch formats.
- This needs to be balanced with maintaining a profitable cost-to-serve and meeting the digital channel preferences of customers.

#### Manage the impact on their parent groups:

- As non-bank brands grow (particularly inorganically) they must manage the impact on their parent's risk profile and products.
- Banks must ensure their brand maintains congruence with that of the parent.

#### Differentiate from high street banks:

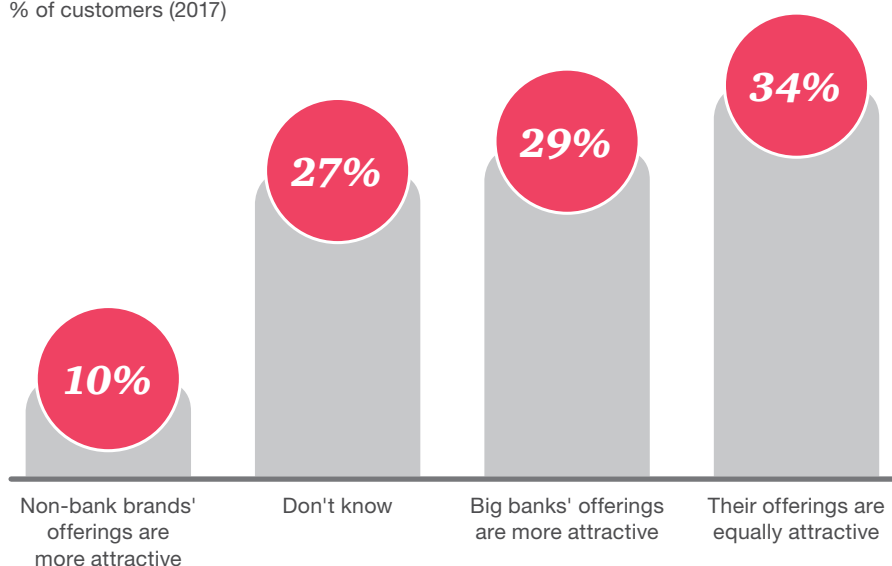
- As yet these banks' products and services are not regarded as being very different to what is already available from the main high street banks, as only 10% of customers think they have a more attractive offering than the main high street banks (see Fig. 13). They therefore face challenges convincing customers to opt for their products.
- Historically, spikes in growth have often followed changes in competitors' rates, rather than being driven by a strong positive pull based on the proposition.
- Although the non-bank brands are not small or new, their positioning means there may still be questions about the robustness of their banking processes and controls.

#### Develop an Open Banking strategy:

- Non-bank brands that embrace Open Banking and react quickly could supplement their banking offerings, by partnering/integrating APIs to offer consumers a full service experience.
- The ability to innovate, along with leadership in data analytics and proposition development, would make it possible to truly differentiate and to offer value to target customers.
- Alternatively, not reacting rapidly could result in another party (bank/FinTech/other) innovating and eroding these players' natural trust, proximity and data advantages.

**Figure 13 – Proportion of British consumers that think non-bank brands have a more attractive offering than big banks**

% of customers (2017)



Source: YouGov, PwC  
Strategy& analysis



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# Conclusion

As the so-called ‘challenger banks’ continue to grow, they are becoming more relevant to the banking industry and to the UK economy as a whole, and are offering customers greater choice. It is therefore increasingly important that these banks are understood by customers and by those with an interest in transforming the UK’s banking industry for the better.

In an effort to contribute to this understanding, our research and CEO interviews uncovered four important realities about the sector:

- First, the sector is better characterised by sub-sectors defined by banks’ business models, strategies and attributes, rather than an unhelpful ‘challenger bank’ label.
- Second, while regulation has not acted as a deterrent to new players entering the market, further levelling of the playing field will improve customer choice and outcomes. This can be achieved through four levers: less disparity in capital treatment, more proportionality of regulation, greater levels of independent access to payment systems, and increased transparency of products.
- Third, Open Banking is set to drive a fundamental change in the banking landscape, with an increasingly diverse and modularised market on the horizon.
- Fourth, the success of each player will depend on the business model focus and service excellence, as well as providing customers with compelling and differentiated propositions.

For this part of the banking market to continue to grow, drive competition, and improve customer outcomes and choice, action is required by both the banks and policy makers. The banks must execute their strategic priorities and the regulators must take further action, particularly to address the structural issues around capital requirements.

If this occurs, we expect the industry to transform, moving towards a diverse and modularised market that offers customers a greater choice to assemble the banking experience that they desire. Customers will have significantly more choice of products and providers they wish to use. Traditional banks will likely only carry out part of the end-to-end activity, with a complex web of interactions between multiple companies’ systems.

New competitors from other industries will join the competition to command consumers’ attention and strive to be the preferred interface. Unexpected alliances and partnerships will be created to provide more seamless and attractive propositions. All these factors will accelerate the trend towards a modularised, diverse and innovative UK banking market.

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# Our team

We hope that you have found our report to be interesting and useful. If you would like to discuss any of the issues raised, please feel free to contact one of the authors listed below.

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