



A new landscape

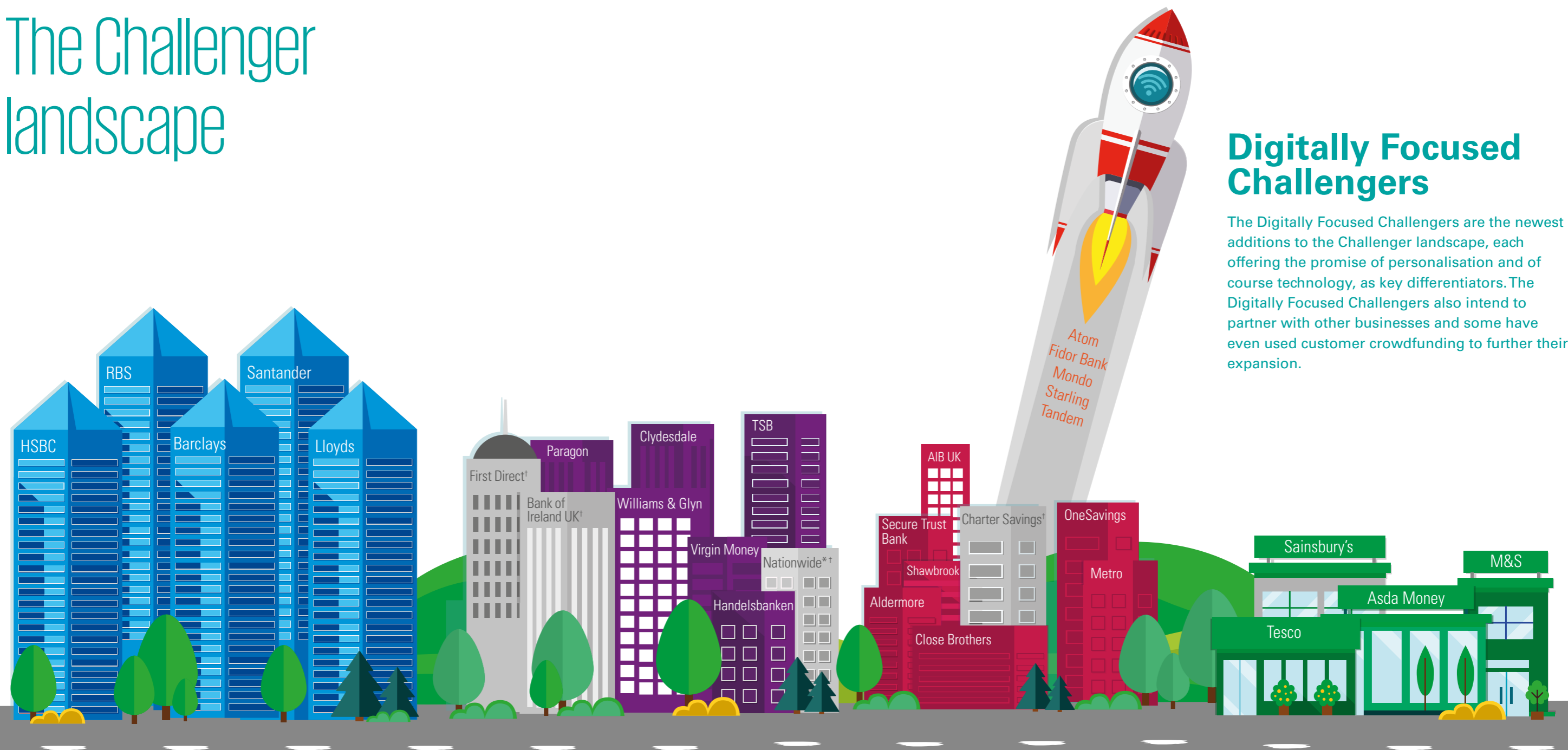
Challenger banking annual results

May 2016

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The Challenger landscape



Digitally Focused Challengers

The Digitally Focused Challengers are the newest additions to the Challenger landscape, each offering the promise of personalisation and of course technology, as key differentiators. The Digitally Focused Challengers also intend to partner with other businesses and some have even used customer crowdfunding to further their expansion.

The Big Five

The high street is led by a small group of retail banks along with mutuals, where Nationwide is the dominant player. Throughout the report, the 'Big Five' banks referred to are HSBC, Barclays Bank, Lloyds Bank, The Royal Bank of Scotland and the UK subsidiary of Santander.

Larger Challengers

The Larger Challengers are typically longer established. Two of them are relatively new in terms of branding, but have inherited relatively large portfolios of loans and advances to customers.

*Nationwide is one of the largest providers of mortgages in the UK, but considers itself a Challenger in terms of current accounts.

† Data for Nationwide, First Direct, Bank of Ireland UK and Charter Savings are not included in our analysis.

Smaller Challengers

The Smaller Challengers have typically been incorporated in the past five to ten years and were backed by private equity through their initial growth phase. Five of them are listed banks.

Large Retailers

The large existing retailers have entered the financial services market offering unsecured products and savings accounts. Tesco and M&S have expanded their offering with products such as current accounts and mortgages, thus further challenging the big banks.

Highlights

On average, the Challengers offer the best rates for savers (easy access rates: Smaller Challengers 108bps, Larger Challengers 73bps, Big Five 36bps)

The Challengers' simple business models provide a cost advantage (cost as a percentage of income for the Smaller Challengers decreased from 52.1% in 2014 to 48.5% in 2015)

The Challengers outperform the Big Five in terms of return on equity (ROE) (Big Five 4.6%, Smaller Challengers 17.0%, Larger Challengers 9.5%)

The Challengers continue to grow in a shrinking market (lending assets have increased by 31.5% compared to a decline of 4.9% for the Big Five)

Results

Insights

Customer inertia remains a battle for the Challengers, particularly in the current account market

Simpler business models allow the Challengers to be more competitive than the Big Five

Changes in the buy-to-let (BTL) sector may hinder future profitability for many Challengers

Digitally Focused Challengers plan to distinguish themselves through transparency and superior data analytics



A new landscape

The rise of the Challengers continues

After the excitement of last year's initial public offerings, the 2015 reporting season has seen the Challenger sector continue its relentless growth. Balance sheets have continued to expand, with lending assets for the Challengers increasing by 31.5 percent compared to a decline of 4.9 percent for the Big Five UK retail banks: Barclays, HSBC, Lloyd's Banking Group, Royal Bank of Scotland and Santander.

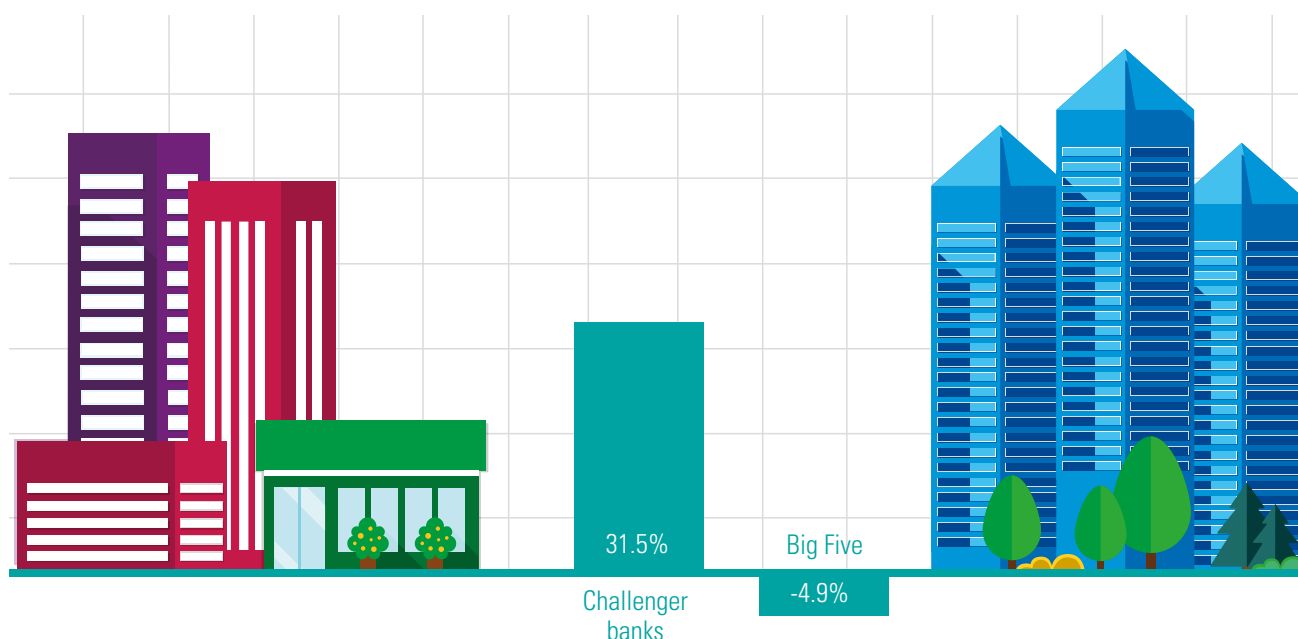
For many of the Challengers, this growth has also resulted in improvements in profitability. Total profits for the Challengers increased by £194m against a drop of £5.6bn for the Big Five (pre-tax figures).

In the group we categorise as "Smaller Challengers", the average returns on equity (ROE)¹ reached an impressive 17.0 percent² (against 15.8% in 2014), which contrasts with a 4.6 percent average ROE for the Big Five.

The "Larger Challengers" (excluding Clydesdale)³ have also improved returns with an average ROE of 9.5 percent (against 8.8% in 2014). The Challenger landscape remains diverse, with many different business models between the participants. In 2015 and 2016 a new breed of Challengers have emerged – the Digitally Focused Challengers such as Atom, Fidor Bank, Mondo and Starling. We discuss the impact these might have on the market in a later section of this report.

"In 2015 and 2016 a new breed of Challengers have emerged – the Digitally Focused Challengers such as Atom, Fidor Bank, Mondo and Starling"

Lending assets 2014–2015





What is driving this outperformance?

As we noted last year, established thinking would have us believe that cost advantage is driven by scale. However, in banking this is only true in part, as with scale also comes complexity. The scale benefits that should be gained by the Big Five have been partly eroded by unwieldy legacy IT systems, compliance issues, regulatory change and costly real estate. So in 2015, as in 2014, despite being significantly smaller, the Challengers have outperformed the Big Five on costs, with an average cost-to-income (CTI) ratio of 59.6 percent (excluding Clydesdale) compared to 80.6 percent. However as we have said before, this crude measure oversimplifies a complex picture: if we exclude conduct-related costs the differential is much smaller (63.4% CTI ratio for the Big Five in 2015).

Reasons for outperformance



Less complex IT systems



Simpler product set



Minor regulatory changes



Less costly real estate



More streamlined and automated operating models



Fewer legacy compliance issues

The Smaller Challengers produced a CTI ratio of just 48.5 percent in 2015 (against 52.1% in 2014, both excluding Metro Bank), which is significantly better than the market, while the Larger Challengers track much more closely to the market.

A splash of colour in 2016

In last year's report we focused on how the Challengers are seeking to be different, either through differentiation driven by resources (the things a bank has available to it) or the capabilities they have (how those things are deployed). These continue to be relevant.

For 2016, we have focused on two further specific aspects highly relevant to the maturing business models:



margin improvement through management of cost of funding (and how the Challengers suffer from higher funding costs)



the potential impacts from changes to the Buy-to-Let market, a core area of lending for many of the participants

“Challengers are seeking to be different, either through differentiation driven by resources ... or the capabilities they have”

1. Pre-tax return on tangible equity.
2. Excludes AIB UK as equity not disclosed.
3. Clydesdale excluded as loss-making. Williams & Glyn and Handelsbanken excluded as equity not disclosed.

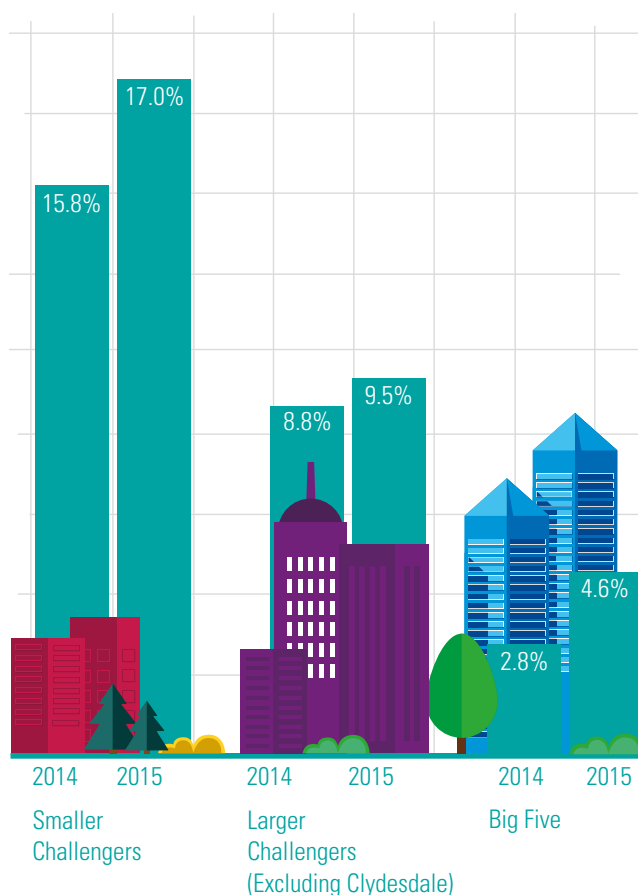
Financial results

2015 saw the Smaller Challengers build on their strong profitability metrics from 2014, while the Larger Challengers used their strong capital bases as a platform for growth. As a sector, Challenger banks are testing the concept that big is beautiful. One might ask whether the classic economies of scale argument holds true in banking, and that the simple business models of the Challengers put them in a stronger position to compete.

Profitability metrics strong and getting stronger

2015 has seen continued improvements in return on tangible equity across the Challenger bank sector, with both Larger and Smaller Challengers improving their average ROE to 9.5 percent, (excluding Clydesdale) and 17.0 percent respectively (versus 8.8 percent and 15.8 percent in 2014). On average, Challengers continue to significantly outperform the Big Five UK retail banks, which reported an average return on equity of just 4.6 percent in 2015.

Return on equity



The strong performance of the Challenger sector continues to reflect higher net interest margins (NIM) than the Big Five. The Smaller Challengers, which are generally focused on niche lending, reported an average net interest margin of 4.2 percent. The Larger Challengers, who are more focused on residential mortgage lending, reported an average NIM of 2.3 percent.

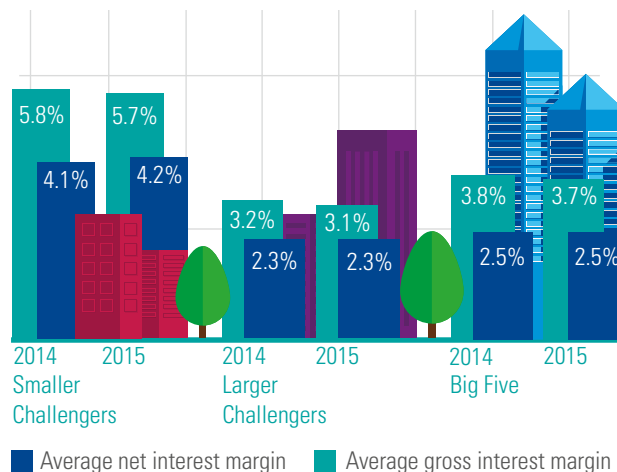
Competition may provide headwinds to future margin growth

Most of the Smaller Challengers have based their business models on targeting profitable lending niches within the UK banking market, which has delivered impressive gross yield figures. However it appears that competition within these niches is beginning to intensify, with the Smaller Challengers seeing a small decline in gross yield from 5.8 percent in 2014 to 5.7 percent in 2015. In order to prevent a further decline in gross yield, the Smaller Challengers appear to have marginally moved up the risk curve, with regulatory risk weighted assets (RWAs) as a percentage of total assets increasing from 58.7 percent to 60.5 percent.⁴

The Larger Challengers have reported a slight decline in average gross yield, from 3.2 percent in 2014 to 3.1 percent in 2015, although without the same degree of changes in RWAs as a percentage of total assets, suggesting that they have not moved risk profile in order to maintain gross yield.

The key question for both the Smaller Challengers targeting niche segments and the Larger Challengers will be how to maintain current NIMs should competition intensify further.

Net interest margins⁵





Costs of funds are improving, but a marked differential between Smaller and Larger Challengers remains

The Larger Challengers reported cost of funds at 1.1 percent in 2015 (1.2% in 2014), which was significantly lower than the Smaller Challengers at 2.0 percent (2.2% in 2014).⁶ This reflects the seasoned, stable deposit back books from which each of the Larger Challengers benefit. In addition, a number of the Larger Challengers also provide current accounts, which are not a significant feature of the Smaller Challengers, with the exception of Metro.

We discuss trends in retail funding later in this report.

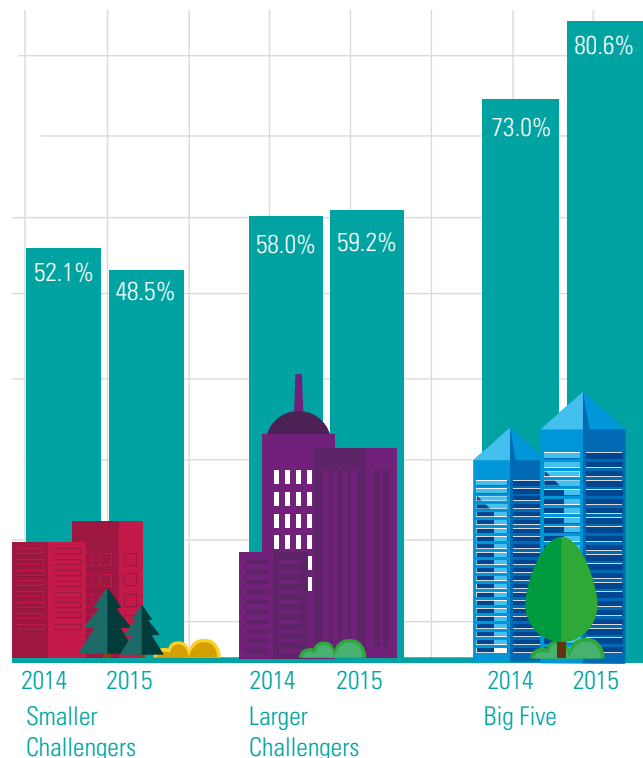
Challenger bank cost-to-income ratios continue to outperform

The Smaller Challengers reduced their CTI ratios during 2015. The Larger Challengers broadly maintained theirs.

The reduction achieved by the Smaller Challengers was from 52.1 percent in 2014 to 48.5 percent in 2015.⁷ This reflected rapid growth in total assets of 37.1 percent in 2015, outstripping growth in the underlying cost bases of 25.1 percent in 2015.⁸ The Smaller Challengers are well placed to continue to drive their CTI ratios lower, with several targeting ratios of around 40 percent on an underlying basis in the near future.

The Larger Challengers displayed a small increase in CTI ratios, however they still remain well ahead of the Big Five, reporting a weighted average of 59.2 percent in 2015 (58.0% in 2014).⁹ This compares to 80.6 percent for the Big Five in 2015, reflecting the increased complexity of their business models and ongoing conduct, litigation and other one-off costs. Excluding conduct related costs, the Big Five had a CTI ratio of 63.4 percent in 2015.

Cost-to-income ratios



CTI ratios presented on a statutory basis.

CTI for Big Five based on an "as reported" basis.

"The Smaller Challengers are well placed to continue to drive their CTI ratios lower"

- Excludes Metro, which doesn't disclose common equity tie 1 (CET1) or regulatory risk weighted assets (RWA) in 2014. Also excludes AIB who don't disclose RWA for the UK division.
- Gross interest margins (GIM) calculated as gross interest income divided by average interest bearing assets. Net interest margin (NIM) calculated as net interest income divided by average interest bearing assets.
- Cost of funding calculated as interest expense divided by average interest bearing liabilities.
- Excludes Metro.
- Excludes initial public offering (IPO) costs.
- Excludes Clydesdale.



Operational cost leverage of Challengers

Analysing how the Challenger banks and, in particular, the Smaller Challengers continue to deliver operational cost leverage is complex. At a high level, the operational leverage can be attributed to their simpler business models and reduced product sets. More specifically, our analysis of certain banks' operating models has identified several approaches that the Challenger banks have adopted.

From a CTI ratio perspective, OneSavings Bank (OSB) leads the field, reporting a CTI ratio of 26 percent in 2015. OSB noted in its preliminary announcement that its CTI ratio reflects "the benefit of the Bank's efficient and scalable low cost back office based in Bangalore, India." Our analysis suggests that the use of offshoring for around 50 percent of full time equivalent (FTE) could result in a benefit of approximately 10 percent to CTI for the Challengers.

As we discussed in our report last year, many of the Challengers have adopted distribution models that do not utilise a branch network, a significant fixed cost to those that do. Challenger banks that operate without a significant branch network have significantly lower costs across their customer and channel functions. These typically run at 6 percent of their overall cost base, compared to an average of 27 percent across the retail banking industry. This differential could give rise to a benefit of about 18 percent in CTI compared to those banks with extensive branch networks. However, there are offsetting savings in cost of funding that come from having a branch network.

As we noted in our report last year, the Challenger banks tend to have simpler product sets, particularly those focused on niche product areas. Estimating the impact of having large, multi-variant, product sets and the costs of operating current accounts is not simple. However, the efforts of the Big Five over recent years to reduce and simplify their product offerings would suggest that simpler product sets are clearly less costly to support.

Another key argument extended by many of the Challengers in support of their ability to deliver lower CTI ratios is their lack of legacy IT platforms. This is probably strongest for those Smaller Challengers focused on niche areas of the market. For many of the more established Challenger banks, they are operating older or in-house technology platforms inherited from

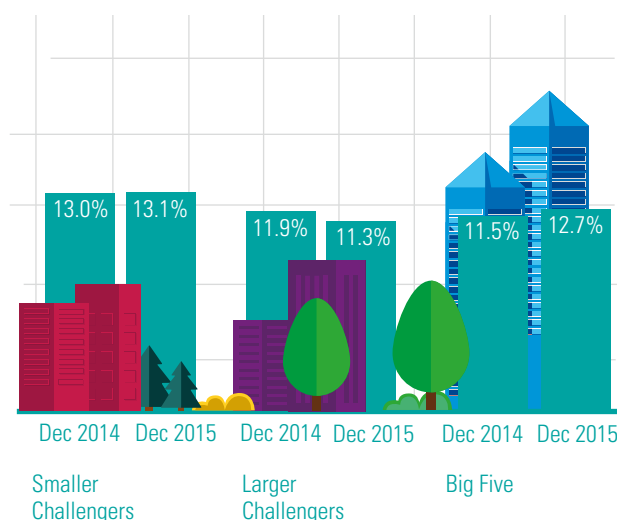
their predecessor organisations. Our analysis suggests that for the Smaller Challengers, the lack of legacy IT platforms or more focused IT infrastructure enables them to achieve a CTI ratio compared to the Big Five of about 6 percent lower.

Strong capital positions provide foundations for growth

Both the Larger and Smaller Challengers reported strong capital ratios, with an average common equity tier 1 (CET1) ratio of 13.1 percent for the Smaller Challengers at December 2015 (compared to 13.0% at December 2014).¹⁰ This partly reflects the new capital raised by some of the Smaller Challengers in 2015, with the largest increases seen at banks that successfully pursued an initial public offering (IPO) (Aldermore and Shawbrook increased their CET1 ratios to 11.8 percent and 14.4 percent at December 2015, respectively). The new capital raised by the sector was offset by continued strong growth in loan books. Metro joined the cohort of smaller listed Challengers in the first quarter of 2016.

Meanwhile, the Larger Challengers, several of which were listed prior to 2015, have grown into their post-IPO capital bases, resulting in a small reduction in CET1 ratios from 11.9 percent to 11.3 percent at December 2015. This has been achieved through a combination of acceleration of organic origination and the acquisition of seasoned portfolios, such as TSB's acquisition of a £3 bn portfolio of residential mortgages at the end of 2015.

Capital ratios



10. Excludes AIB UK, who do not disclose CET1 for the UK division.

“As we noted in our report last year, the Challenger banks tend to have simpler product sets, particularly those focused on niche product areas”



Buy-to-let



BTL changes a sign of things to come?

Recent fiscal and regulatory announcements may have left the Challenger banks and many of their buy-to-let (BTL) customers feeling sore. What impact will these changes have on banks' profitability and the BTL market in 2016 and beyond? And perhaps more importantly, does this change in direction mark the end of the season of goodwill towards the Challenger banks?

The BTL market is a significant contributor towards the overall profitability of the sector, accounting for approximately 15 percent of Challenger balance sheets. The revenue from BTL business is under attack from a series of changes that impact both the Challengers themselves and their customers:

- restrictions on the tax deductibility of interest for certain investors
- the loss of the 'wear and tear' allowance
- higher stamp duty on second home purchases
- higher regulatory capital requirements for many Challenger banks holding BTL loans.



Income tax relief restrictions on interest costs

The summer Budget of 2015 included a restriction on the income tax relief an individual is entitled to claim in respect of interest costs on rental properties. From 2020, relief for interest costs will only be available in the form of a 20 percent basic rate tax credit. During the phase-in period from 2017 to 2020, partial relief will be available.

These interest relief restrictions will have a significant impact on the profitability of BTL for individual higher and additional rate taxpayers who have leveraged their investments. This will push some investors with higher loan-to-value (LTV) into a loss-making position and others into very high effective rates of tax. Landlords in this situation will be faced with three options:

- accept short term losses in exchange for the potential capital gain
- increase rents to make up the shortfall
- sell the property.

It will be interesting to see which of these outcomes will be predominant and therefore whether the change fulfils its policy objectives. The Challenger banks will need to watch the first option carefully to ensure that it doesn't impact significantly on arrears rates.

The changes do not apply to limited companies, which are generally entitled to a full corporation tax deduction for interest costs incurred in a property rental business.

Anecdotally, some investors not already using corporate structures are considering transitioning or acquiring new properties using a company, which may, but not always, mitigate the increased tax. There is therefore an opportunity to attract BTL business by adopting a flexible approach to lending to corporates or to those looking to transition to a corporate structure. This is an opportunity that the nimble Challengers should be well placed to exploit.



Wear and tear scrapped

In addition to the interest relief restrictions, the government has scrapped the generous income tax wear and tear allowance deduction of 10 percent of net rentals. Instead, landlords will only obtain tax relief for the cost of certain replacement furnishings. This is likely to increase the tax burden on landlords still further and at the margin add a little more risk to the Challenger banks' BTL portfolios.



Stamp duty land tax charge on second homes

The 2015 Autumn Statement contained more bad news for BTL investors, in the form of a 3 percent stamp duty land tax (SDLT) surcharge on purchases of second homes (above £40,000 in value) from 1 April 2016. Ostensibly designed to help cool the housing market by reducing demand from investors, the measure is also a useful revenue-raiser, forecast to bring in almost £4bn over the first 5 years of operation.¹¹

The changes to SDLT resulted in a sharp increase in the number of sales in March 2016. This may dampen transactions for the rest of the year.

The government had proposed an exemption from the charge for large-scale investors who "significantly contribute to new housing supply". However, in the 2016 Budget it was announced that this plan had been dropped.



Updated risk weightings for BTL mortgages

On 10 December 2015, the Basel Committee published a second consultation document, "Revisions to the Standardised Approach for credit risk". This contained more bad news for Challengers with significant BTL portfolios, because the proposals add a risk-weighting

premium to BTL mortgages. This means that, assuming the proposals go ahead as planned, more regulatory capital will need to be held against BTL mortgages, increasing the cost of providing them. For example, risk weights could increase for BTL mortgages from 35 percent to potentially a maximum of 120 percent depending on the underlying LTV (in a worst case scenario). Any resultant capital shortfall would need to be met either by returning less to investors through dividends or by raising additional funds.

The stock market seemed particularly concerned about the potential impact of the proposed changes: share prices of a number of listed Challengers fell by up to 10 percent over the three trading days following the announcement.

Commenting on the announcement in its 2015 results statement, Aldermore noted its intention to pursue an internal ratings-based capital approach, which would allow the bank to use its own internal credit models rather than standardised risk weights. This could alleviate the proposed additional risk weights under the standard model. Others may be considering taking similar action.

It is also worth noting that having identified the BTL market as a potential risk to financial stability, the government is consulting on additional powers for the Bank of England's Financial Policy Committee (FPC) to intervene in the market, for example by restricting LTVs and/or imposing debt interest cover restrictions. On 29 March 2016, the FPC released for consultation proposals on updated underwriting standards for BTL contracts, which it estimates would reduce the number of cumulative new approvals for BTL mortgages by about 10–20 percent by Q3 2018. We anticipate that this reduction would occur at the racier end of the market, largely unserved by the Challengers, who may already meet the majority of the revised underwriting requirements. However, lending may be restricted at the margins.

11. Spending Review and Autumn Statement 2015 – Table 3.1.



Has the BTL bubble burst?

It is easy to look at each of these changes in isolation and point to the mitigating factors – landlords changing to corporate structures, pointing to long-term returns on property. BTL might not be the Achilles heel for the Challenger banks, but it is clear that conditions across the market are going to get tougher.

Challengers will need to be flexible in their approach to the market as a clearer picture of future demand emerges in the coming months. This could mean taking measures such as raising prices or tightening lending criteria to improve profitability and ROE. For some, it may be that scarce capital could be put to better use elsewhere in the business.

But BTL is only part of the story and the tide is turning

Of most importance though, is the broader significance these and other changes have as a marker of the overall goodwill towards Challenger banks.

In the Summer Budget of 2015, Chancellor George Osborne introduced a new 8 percent surcharge on the profits of banking companies with profits in excess of £25m. The surcharge, which took effect from 1 January 2016, was broadly designed to offset the forecast reduction in revenue from bank levy reform. However, given the £20bn liability/equity exemption within the bank levy rules, a potential reduction in the levy does little or nothing to offset the additional cost of the corporation tax surcharge for Challenger banks (who generally do not have large enough balance sheets to be subject to the bank levy). We estimate that the surcharge would have added approximately £70m to the Challenger banks' tax charge for 2015 (excluding Williams & Glyn).

While this would appear to be at odds with the government's intention to increase competition by supporting strong new market participants, there has been no softening of the impact of the banking surcharge to date.

Further, the long-awaited Competition and Markets Authority review into retail and business banking has so far not yielded the results that most of the Challengers had been hoping for.

But with the Challenger banks continuing to outperform the Big Five in terms of ROE (17.0% for the Smaller Challengers and 4.6% respectively) it is little wonder that the public support has started to wane. The message is clear, the landscape has changed, the Challengers have grown up and they should expect no special treatment as they continue their journey.

“We estimate that the surcharge would have added approximately £70m to the Challenger banks' tax charge for 2015”



Savings

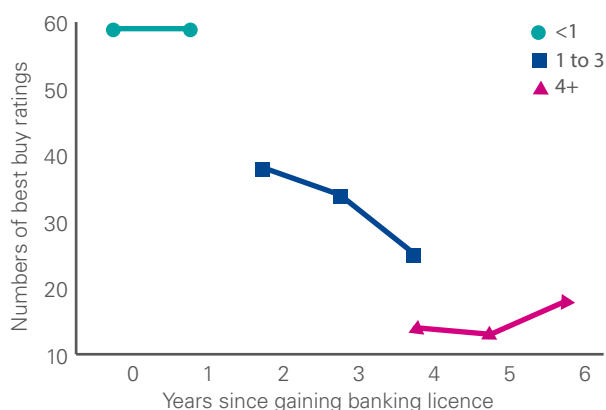
Better savings rates from Challengers

Together with savingschampion.co.uk we have analysed thousands of data points on the savings rates offered by the Challenger banks and the Big Five.

In summary – the Challenger banks offer consistently higher savings rates, great news for customers but expensive for the Challengers. The key question is whether customers of the Big Five are forgoing interest because of inertia, or some other perceived value such as the brand and/or the reassurance and convenience of a branch network?

Early stage Challengers rely on best buy tables for deposit growth

Number of appearances in best buy tables by Challengers, against age of banking licence



Changes to the rates for new customers – principally in notice accounts and fixed rate bonds – are an important tool for Challengers to manage both deposit volumes and also the cost of their new funds.

To identify trends in this area, we analysed the number of times each of the Challengers appeared in the top five spots in “best buy” tables for fixed rate bonds over each of the last three years. Results suggest that the more established Challengers spent less time in the top spots over this period. This may indicate a growing awareness of brand and less of a need to always top the table to grow the deposit base.

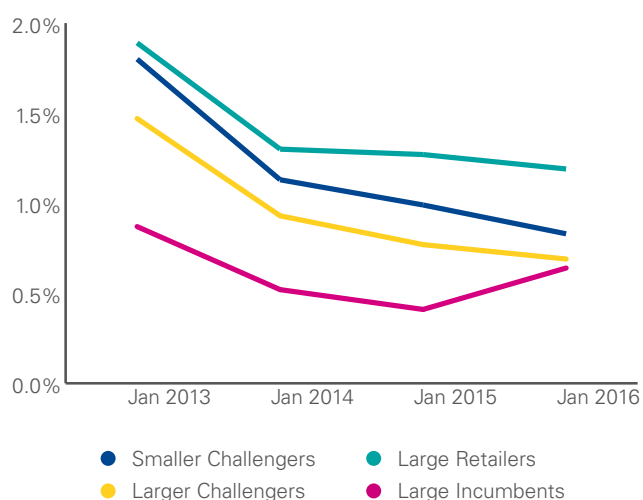
Reductions in existing customer rates

Whilst the Challengers and the Big Five banks have managed to successfully reduce the interest payable on existing accounts, Challengers have been able to achieve the biggest reductions. This is due in part to the higher rates they paid in the past as they sought to lure customers from incumbents. The Larger Challengers have now closed the gap on the Big Five, but the Smaller Challengers continue to pay a premium.

Challenger deposit costs remain above the Big Five

Analysis of average customer rates for two key product groups – easy access accounts and three-year fixed rate bonds – illustrates the continued higher cost of funding that Challengers face compared to the Big Five.

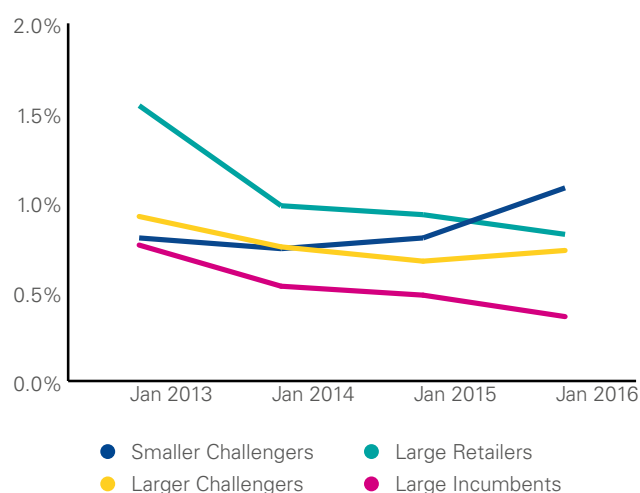
Reduced rates paid on existing easy access accounts



As at January 2016, the average rate for live easy access accounts with the Big Five was 36 basis points (bps) compared with 73bps for Larger Challengers and 108bps for Smaller Challengers. Over the last three years, the Big Five have managed to widen this differential by around 20bps compared with Larger Challengers, although the rates have reduced for both groups.



Growing cost for Challengers to attract new customers vs continued reduction for incumbents



Over the same period, the Big Five have also widened the differential on three-year fixed rate bonds, although all banks are offering lower rates in January 2016 compared to three years earlier. The price differential on fixed rate bonds at January 2016 between the best Big Five rate and Larger Challengers was 55bps, and 85bps against Smaller Challengers.

How Challengers are managing funding costs

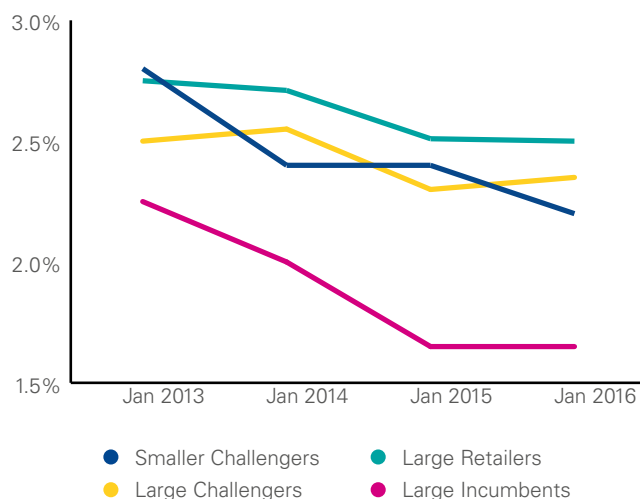
Deposits remain the most significant element of Challenger bank funding. They provide c.80 percent of total funding required, with retail customers the largest single source. Managing the cost of retail deposits is therefore a key driver of sector profitability.

Last year, we noted the positive impact of the Funding for Lending Scheme (FLS) on the ability of both the Challenger and Big Five banks to manage down their cost of funding, as well as the role this played in improving NIMs.

But with the FLS allowing banks to borrow from it until January 2018, Challenger banks will need to wean themselves off the drug of best buy tables. It has been commented that customer inertia is the most powerful force in banking and, whilst that holds true, the Challengers need to become more creative in their deposit gathering strategies.

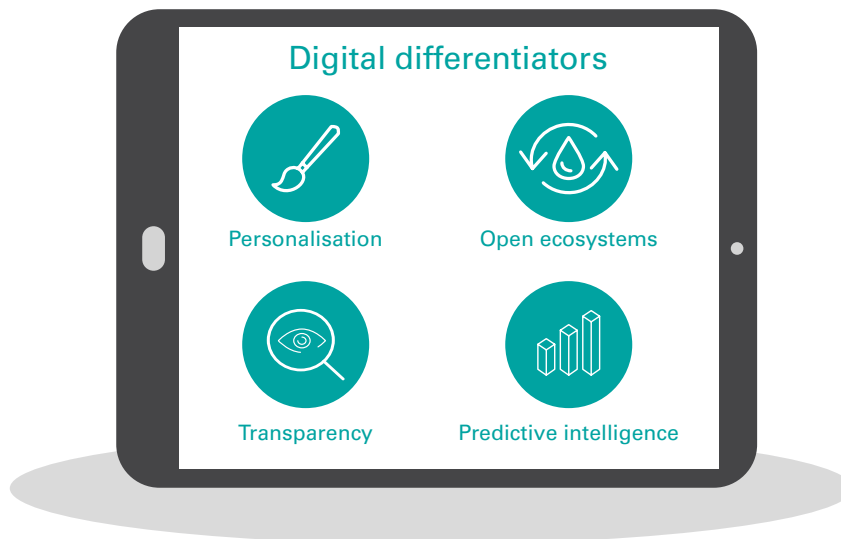
Innovative products, such as the Customised Fixed Rate Account launched by Aldermore for its small and medium-sized enterprises (SMEs), are a good example. More sophisticated marketing strategies or collaboration with non-bank channels such as technology or fintech companies are just two of the ways to start to bridge the gap.

The widening differential on rates paid on Bonds



“Deposits remain the most significant element of Challenger bank funding ... Managing the cost of retail deposits is a key driver of sector profitability”

The Digitally Focused Challengers



The new kids not on the block

Are digital banks pointing the way to the industry's future? The past 12 months have seen launches and a growing queue of digital Challengers are planning their debuts for 2016 and 2017. Although each of these banks has a different model or approach, there are common themes that could give the incumbents pause for thought.

In our 2015 survey we pointed to a need for Challengers to be cost leaders or provide genuine differentiation and it seems that the next generation have taken note.



Personalisation

Many of the digital banks are pushing personalisation as a key differentiator. When it comes to creating a highly personalised service, starting from scratch without an incumbent customer base or legacy technology can be a positive advantage for digital Challengers. Tandem, for example, is looking into ideas as to how their app can motivate its users in a similar way to a fitness app, such as spotting opportunities to help you save money or grow what you have with motivational nudges. The incumbents are increasingly struggling with how to create empathy with customers in a digital world – something they have long relied upon human contact to provide. In the KPMG Nunwood report, "Banking

the Customer Experience Dividend", we reported that personalisation alone accounts for 23 percent of the overall experience score. Mass personalisation is a tool that the new kids are well placed to deploy.



Open ecosystems

The new breed of Challengers are planning a more open approach to their platforms that contrasts with the way incumbents have typically worked. For many, there is a recognition that platform-based models (think Apple not BlackBerry) are the future. By encouraging third-party providers to work with them, they provide customers with access to "best in class" products and services and at the same time generate additional revenue for themselves.

This partnering approach is likely to make them more agile and flexible than the incumbents, both in terms of adding new products and adopting new technology. Fidor Bank, for example, has already partnered with more than 20 fintech businesses in Germany. In one case, the partnering concept has extended to customers: in March 2016, Mondo raised £1m through Crowdcube, inviting potential customers to co-invest alongside its existing private equity backer. The aim is to be a one stop shop for financial wellbeing.



Transparency

The new digital banks have a different mind-set as regards to the way they interact with customers – complete transparency. They might invite customers to create communities among themselves or to co-create products on social media groups for all to see. Fees and interest rates clearly communicated alongside balances on mobile apps, and even informing customers when they would be better off with competitors, become the norm. Fidor Bank recently rewarded a customer who told everyone on a public forum how to avoid ATM fees using cashback. Whilst many of the big banks aspire to this level of customer centricity, few have yet to achieve it in practice.



Predictive intelligence and commercialisation of data

What if your bank gave you a helpful notification before you went overdrawn, rather than hitting you with an unauthorised overdraft fee? And then offered a short-term authorised overdraft with a fixed price? Or maybe they could help you predict how much free cash you had to spend until the next payday. Many digital Challengers are looking to analyse customers' income and spending data in a way that proactively helps them to manage their finances more easily. Secco, an as-yet unlaunched Challenger, wants to go further.

Their aim is to commercialise the data we all give away freely on social media. So if you post on Facebook that you are thinking of going on a skiing holiday, and they can evidence your past behaviour from payment records, then that data has value. Who knows how much value each of us give away for free, some estimates run to hundreds of pounds each year. If a bank can capture that and give a share of that back to its customers it could significantly demote incumbents' offerings.

Challenges for the digital Challengers

Despite their innovations and attractive propositions, Digitally Focused Challengers face a number of obstacles. The first and most pressing is whether they will be able to attract customers away from their existing banks. Customer inertia, particularly in current accounts, is a big issue in the UK.

Just over one million people switched current account provider in 2015 using the current account switching service, 11 percent lower than in 2014.

The biggest winner in switching has been Santander, with its 1-2-3 product, although whether the recent tariff increase will change this remains to be seen. So Challengers will have to do more than just get a share of the switching market to be successful – they will need to create a market.

“If these new kids can successfully combat customer inertia, at scale they could blow the incumbents out of the water.”

Warren Mead

Fidor Bank



Fidor Bank is not exactly new to the digital banking landscape. Founded in Germany in 2009, the bank has received international awards for its transparency and cutting-edge online community. Sophie Guibaud, Vice President of European Expansion, is part of a strong team working on Fidor Bank's UK proposition, which launched in September 2015 with a current account and debit card, currency transfer and savings bonds. Further products will go live over the coming months.

So what makes Fidor Bank special? Guibaud believes it's the way the bank involves its customers in all stages of the decision-making process: "Our online community allows clients to ask personal finance questions and we pay them for it. We think it will help other customers."

Clients can also give public feedback about current products. "This is so we can improve them and decide which products to launch next. Our product team is looking into this regularly, as well as interacting," Guibaud explains.

Fidor Bank aims at being transparent and fair to its customers. Guibaud says, "we discuss with our clients interest rates and prices in the community, and aim at finding a fair ground for both the company and them," Guibaud says.

Such is the confidence of the bank's brand that it believes if it cannot fully meet clients' needs then it can meet their needs with others – through integrating third-party fintechs onto their platform. In Germany, these already include foreign currencies, crowdfunding, precious metals, social trading and lending services.

Unlike many other digital banks, Fidor Bank does not see digital natives as its primary target audience, but the digitally savvy, with 25–50 year olds being the bulk of their customer base. "Our clients are very interested in our sweet spot on target markets. They're also interested in personal finance and investment opportunities. They have the ability to discuss these topics with like-minded people in the Fidor Bank community — these are just some of the reasons why we provide a truly unique service."

Atom Bank



Mark Mullen's ambition is to help create a better banking industry than the one he grew up with. "To date the big banks have not been forced to compete for their lunch," remarks Atom's CEO. Together with Metro Bank founder Anthony Thompson, Mullen believes Atom Bank can change this.

"We are for financially literate people who don't use branches and want to do their own thing," he says. Indeed, Atom's user experience is planned to be almost infinitely customisable: from the way customers log in (biometrically or using a pin), are notified (email, text, phone, in-app messaging), through to the visual presentation of their account information. It will be the customer's choice.

Not only is Atom promising innovation, it could be making banking history by launching the largest number of products onto the market within a one-year period, to deliver a full business banking proposition. The emphasis is on offering simple but attractive and competitive products.

Mullen is convinced that ensuring a personalised experience whilst maintaining customers' trust will help Atom succeed. "I think we should keep as little customer data as we can. The customer expects banks and businesses to manipulate information, so it's up to us to earn their permission and trust to use data appropriately." He also promises contact centres will be UK-based, and emphasises, "What will transform the relationships between banks and customers is customers being treated well by their banks; banks keeping their promises and banks doing simple jobs well."

Atom launched its first products, one and two-year fixed-term savings accounts for iPhone and iPad apps in April 2016.

"The emphasis is on offering simple but attractive and competitive products"

Starling Bank

STARLING

For mobile lovers, Starling Bank are confident they are building the best current account in the world. "We're coming up with a proposition to do one thing very well. One bank account for your day-to-day needs, with a bit of lending and saving", explains Anne Boden, CEO of Starling Bank.

The motivation behind Starling stems from Boden's frustration towards the big banks and their lack of innovation in a digital world. As an industry veteran with over 30 years of experience, she knows all too well that it is easier to create excellence from scratch than transform banks from the inside. "Before you know it, this exciting, visionary project that is very do-able becomes watered down. I have the advantage of being able to create in a containable way, where we can hugely focus."

Boden admits that pure, mobile-based banking will not be for everyone. "Would I decide to buy a mortgage on a mobile? Probably not. Would I take out an SME leasing agreement simply by looking on a screen? I doubt it. But for a certain segment of the population, mobile banking is more than satisfactory."

She also isn't afraid of those who dismiss Starling as a niche bank. "*Niche* is not the same as *small*. We may be small now but intend to grow across Europe," Boden stresses. "Our aim is to make sure consumers buy the best products for their needs. We believe financial services is an ecosystem and we will be at the heart of people's financial lives."

Starling Bank is aiming to go live at the end of 2016.

"... for a certain segment of the population, mobile banking is more than satisfactory"



The next challenge is there for the taking

Bill Gates once said:

“Most people overestimate what they can do in one year and underestimate what they can do in ten years”

... and in banking he is right.

The success of the more established Challengers will likely continue through 2016. However, they are not immune from being challenged themselves. If 2015 was about the continued evolution of the banking landscape then the key story of 2016 will surely be the emergence of the Digitally Focused Challengers. Which of these business models will be successful and which will fall

by the wayside? And how will the wave of fintech non-bank challengers start to impact margins in the sector?

In ten years' time the landscape won't have changed – it will be completely re-invented. And so the next challenge is there for the taking.



Basis of preparation

- The Big Five banks: Barclays, HSBC, Lloyds Bank, Royal Bank of Scotland and Santander.
- Larger Challengers: Clydesdale and Yorkshire Banking Group, Handelsbanken (UK division), Paragon, TSB, Virgin Money and Williams & Glyn.
- Smaller Challengers: AIB (UK division), Aldermore, Close Brothers, Metro Bank, OneSavings Bank, Shawbrook Group and Secure Trust Bank.
- Large Retailers: Asda Money, M&S Bank, Tesco Bank and Sainsbury's Bank.
- For the first time this year, we have included Close Brothers within the Smaller Challengers in view of its size and categorisation by market analysts as a Specialist Lender. Whilst it has many similarities with the group it is a longstanding bank which has operated through the economic cycle.
- Gross interest margin: the gross yield for each sub-division of Challengers is calculated as interest income divided by the average of the total opening and closing interest bearing assets. GIM includes the impact of income recognised on an effective interest rate basis from portfolio acquisitions.
- Net interest margin: the NIM for each sub-division of Challengers is calculated as total net interest income divided by the average of the total opening and closing interest-bearing assets. NIM includes the impact of income recognised on an effective interest rate basis from portfolio acquisitions.
- Cost-to-income ratio: the CTI ratio for each sub-division of Challengers is calculated as total operating expenses divided by total operating income. Separately disclosed costs relating to stock exchange listings are excluded from total operating expenses.

Information has been obtained from published 2015 year-end reports (including results presentations and accompanying analyst packs) and company websites. Where total numbers are presented, it is the total of the sub-division of the banks as described above.

We have taken the following approach to calculate each of the measures used in this report:

- Return on equity: profit before attributable to the shareholders, divided by the average of opening and closing tangible equity (excluding non-controlling interests for the Big Five banks). ROE for the Smaller Challengers does not include AIB and Larger Challengers does not include Williams & Glyn or Handelsbanken, as these are segments of larger groups and do not disclose capital figures.

HSBC present their results in US dollars (\$). These have been translated into sterling using the relevant period end or period average rate. Where percentage changes are presented for HSBC, these percentages are based on the dollar amounts disclosed by the banks, rather than on the sterling translation of those amounts.

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