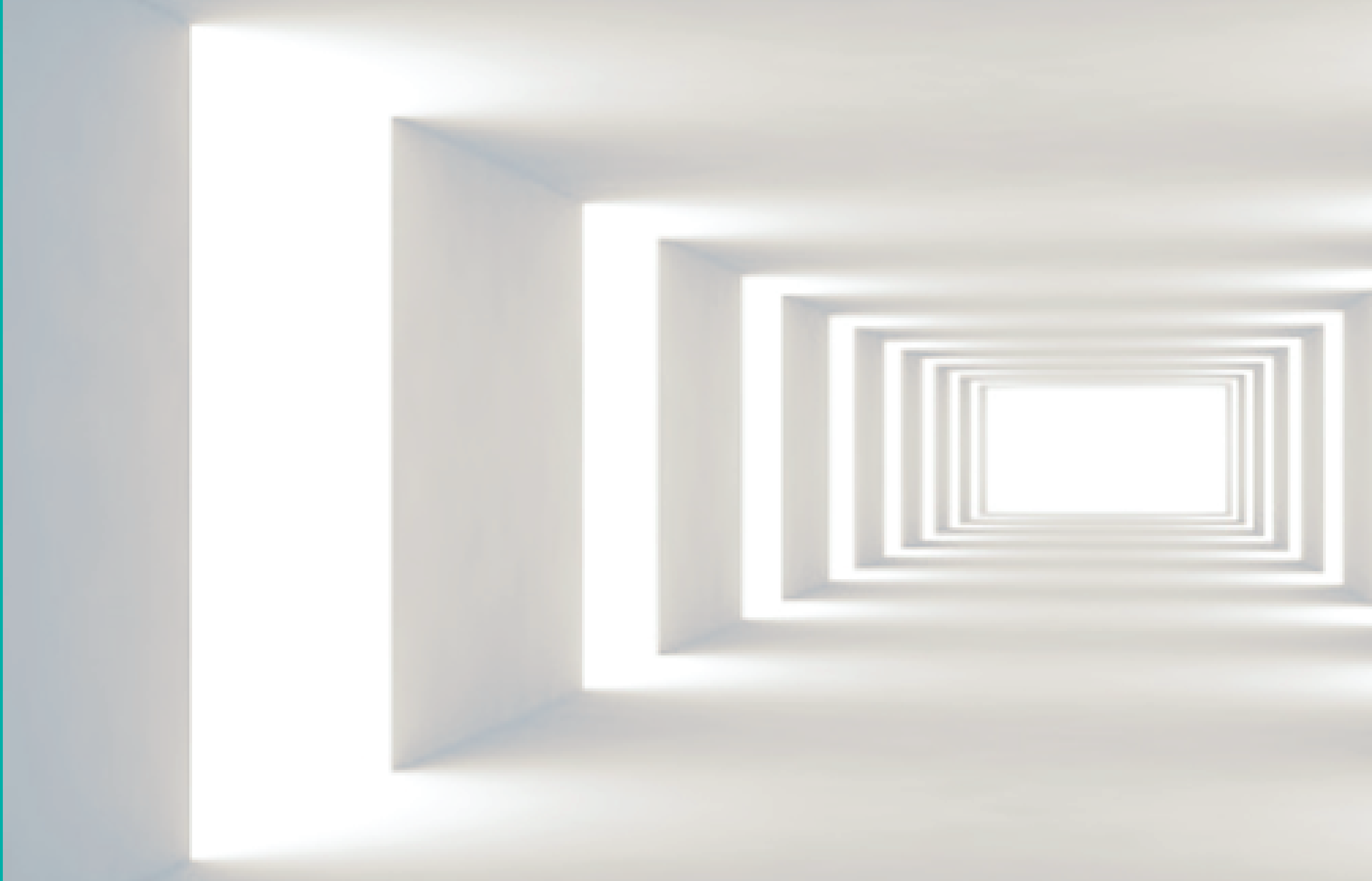
# Challenging perspectives

**In conversation with Challenger Bank CEOs**

Insight report



July 2017

# Content

# Introduction

## Banking's new inflection point

In 1967 the world's first ATM gave customers instant access to cash. At the time this was seen as revolutionary. Today, mobile banking is the norm. Debit card and contactless payments are set to overtake cash by 2021. Another banking revolution is well underway.

Millennials are driving this upheaval in the financial ecosystem. Their behaviours, especially as the first wave reach economic maturity, are shaping the future of banking. They are net borrowers; they save less. In spite of low mortgage rates, they are not buying homes – in part because the market has become harder to enter. Lifestyle assets are being leased, not bought. Their instincts – and increasingly those of other generations – are 'digital first'.

This evolving market dynamic coupled with new technologies and changes in regulation has seen the rise of a new breed of bank whose focus is disrupting the status quo – Challenger Banks.

## A search for purpose

The Challengers are designed for an ecosystem that rewards collaboration, responsiveness and new technologies. It's a system that's changing. Machine learning and data analytics reveal customer behaviour, helping build new products and processes. Open Banking will mean best-buy sites will no longer simply show customers the pick of mortgage or savings deals. They will match customers with the right bank, and tailored products, instantly.

All banks need to develop new managerial skills and organisational models to compete in such a dynamic ecosystem. And it's clear these may need to be adopted from outside the financial services sector.

Is this the beginning of the end for customer loyalty? How will banks that have relied on revenues from their mortgage back books respond? How quickly can they assimilate new technologies? How will they manage new business models alongside out-dated legacy systems and branch networks?

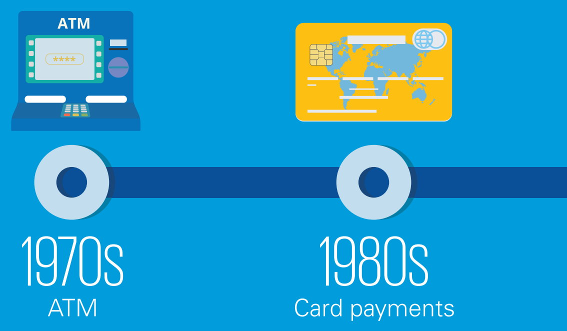
## Challenger bank CEOs insights

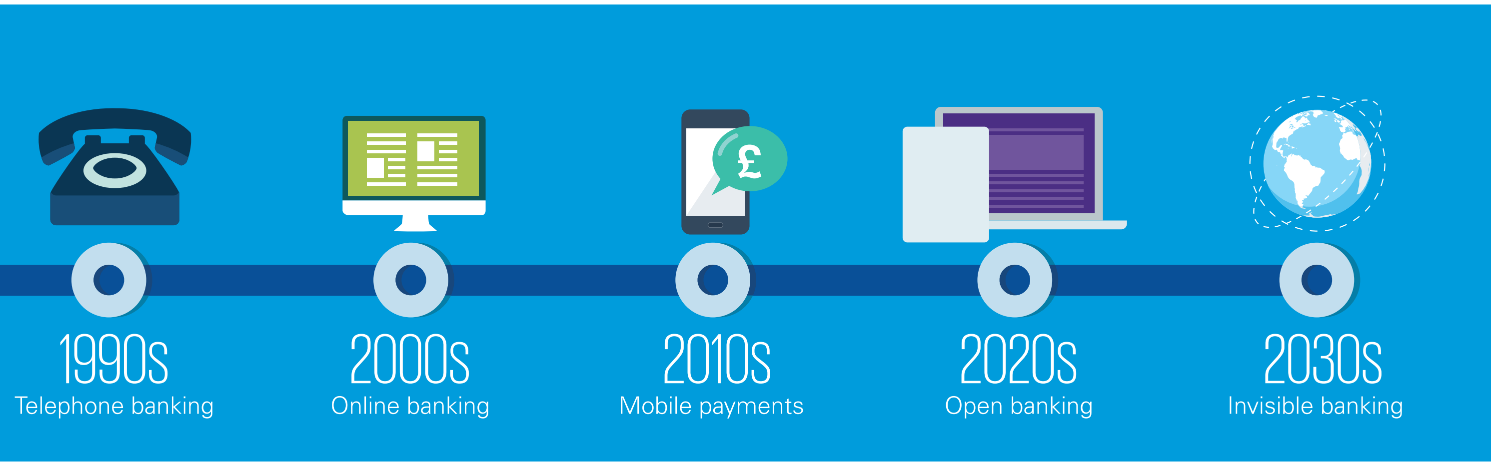
To explore these themes, KPMG interviewed CEOs from 12 Challenger banks to explore where they see the threats and opportunities. Their insights can inform leaders across the financial services industry.

Our 'banker's dozen' features every flavour of Challenger. Some are specialist savings and lending banks focusing on SMEs and individuals. Others are digital-only, promising personalisation and enhanced customer experience. Still others are offering a High Street revolution with new-style branches. And we spoke with ClearBank – the first new clearer in 250 years aiming to underpin further innovation and competition across the industry by applying low-cost, open technologies to core payments services.

These conversations make it plain: we have barely begun to see the change that their business models and technologies will bring to the financial ecosystem. Their insights have far-reaching implications for the financial services sector.

### Banking's decades of change

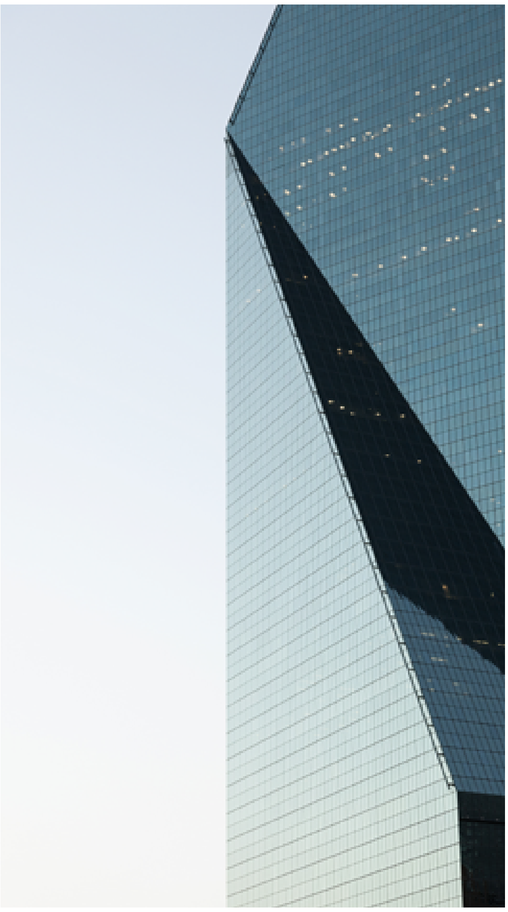




1990s
Telephone banking
2000s
Online banking
2010s
Mobile payments
2020s
Open banking
2030s
Invisible banking

# Differentiation

Challenger bank CEOs have an opportunity their incumbent peers don't: they get to define their market niche and their branding around contemporary themes, customers and technology. But in a finite market for accounts and services, it's not yet clear which kinds of differentiation will yield sustainable returns.



Almost every CEO we spoke to was quick to identify the points of differentiation that marked out their Challenger bank. That's not surprising. Almost all are competing with services offered by one of the big incumbent banks where, typically, familiarity in the brand, customer inertia and universal offerings are clear advantages.

This is already a crowded market for new brands, too. **Banking Technology** magazine lists 55 Challengers in its May 2017 run-down. There is also increasing competition from Fintechs such as Square, who are tapping into SME payment opportunities through technological innovation. That means it's also critical to differentiate against other insurgent players.

For many of the Challengers, the distinguishing factor is often their niche offering to an underserved market or a new technological approach.

In our conversations, we encountered varied interpretations of what it is to be niche in today's banking market. For example, Atom Bank CEO Mark Mullen reckons there's a clear opportunity to compete on value for money. "Fewer distribution and servicing channels ought to translate into lower costs and higher value for customers," he told us. "Price matters to customers, and I see no sign of that changing."

There were some common themes too. Most of the CEOs were explicit that customer experience was a key differentiator, for example. "Every business and investment decision made at Metro Bank is oriented around the customer," said Craig Donaldson, CEO. "I have three priorities: understanding who our customers are; understanding what drives their decision-making; and making sure that Metro Bank's corporate culture is enabling the creation of fans."

We look at customer experience later in this paper. So where else do the CEOs look to differentiate?

### Culture

Donaldson's point about culture is a good place to start. Tackling poor culture in traditional financial services businesses has long been a target of their leadership teams, boards and even regulators. So it's not surprising that the Challenger CEOs see their culture as a key differentiator.

Metro Bank spent less than £100,000 on advertising last year, but almost doubled its customer base - performance largely attributable to the organisation's culture and model. (As the bank's motto goes, "Hire for attitude, train for skills".)

Others are also adopting novel approaches to attracting and engaging talent. For example, owner-managed bank Masthaven offered 80% of their employees a shareholding of 10% in the bank. MD Jon Hall views the development of talent as a key enabler of its strategy to provide the market with "human digital banking." "As a human and digital business the culture is paramount," he explained.

Many of the CEOs talked about the kind of attributes that made them stand out from older rivals – being open, collaborative, showing attention to detail, curiosity and constantly looking out to create something better.

### Brand

Like any industry, banking is getting much more competitive as it diversifies. Brand development is essential for the Challengers as they seek to gain traction in their respective niche areas – or for their alternative business models. There may be a constant stream of new banks coming into the market – but there is a finite amount of customer demand for services.

"We're certainly investing in brand and broker relationships," said the CEO of a new bank focused on banking accounts. "Being known in the market for our specialism is key."

The CEO of one new bank agreed, adding that brand clarity matters a lot given the possibilities around digital. "Establishing a brand and reputation for the bank is key to its organic growth," he said. "Given that the bank is still so new, getting its name known will help increase customer base. Marketing, branding and communications will also be key, given that our business model is not based on physical office presence across the country."

Brand is a key differentiator for Challengers with a well-known marque carried over from another sector. "With the shoppers who are already interacting with the brand, who are warm to the brand, who we have additional data about, we can create financial propositions that other competitors can't," said Peter Griffiths, CEO of Sainsbury's Bank.

### Innovation

Several CEOs singled out investment in new technologies – to enhance customer experience, or create smarter products or platforms – as a way of differentiating.

CYBG plc CEO, David Duffy, sees innovation as a particular differentiator for businesses at scale. Larger Challengers like CYBG are positioned well to both leverage technological breakthroughs and experiment. "We have set up a new branch called 'Studio B', to spark digital innovation," he explained. "This branch facilitates data-led product development, as well as having the traditional capabilities."

Not every Challenger sees technology as their main differentiator. Some are leveraging established retail brands, for example, and for them the innovation must be tied more closely to the customer's perception of value. But that still means keeping the door open to third-party innovation.

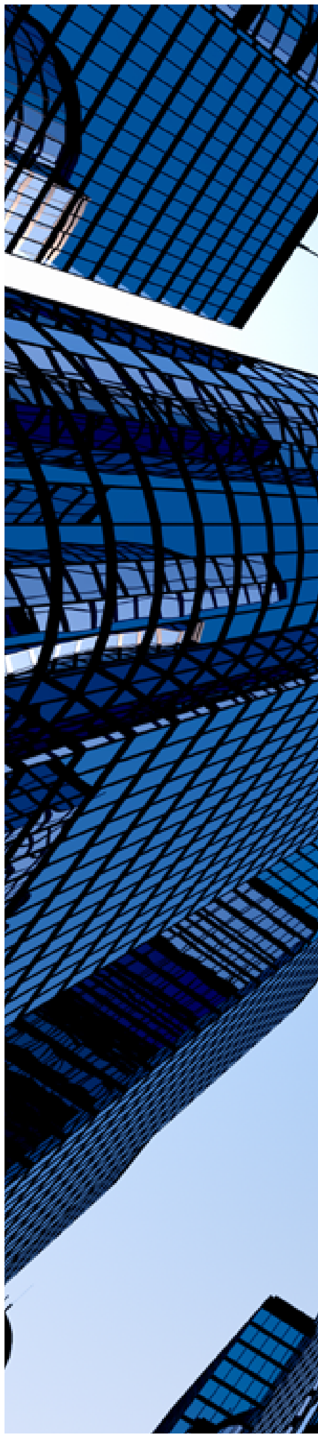
Differentiation cont...

"Sainsbury's Bank regards FinTech as a great opportunity to help accelerate our growth and create mutual value for us and our FinTech partners," said Colin Tate, Head of Digital Transformation at Sainsbury's Bank.

Having newer, faster, more flexible core banking systems differentiates many Challengers on cost. But the emergence of Open Banking and the rapid evolution of technology means, for several of our CEOs, that tech alone is not that big a differentiator.

"It needs to be understood in the context of how a bank makes money," said one. "There is too much monetisation of the 'tech', rather than the 'fin'. The primary benefit the customer expects in a commoditised market is a cheaper commodity. Money is that commodity. The goal is to reduce the friction of the business model to reduce the cost of the commodity – and compete."

Or, as another put it: "Everybody will arrive at the same technology at some point in the future. It is about the journey to get there, and having the optionality that APIs bring."



## Targeted niche offerings

Most of the Challengers we spoke to articulated their niche offering clearly – usually in terms related to serving a customer base neglected by the incumbents. This could be significant as we see the Challenger market evolve and consolidate.

"Given the increasing number of Challenger banks, there must be a question of whether we are reaching saturation point, despite the fact that many are operating in niche areas," says Richard Iferenta, KPMG Partner and Head of Challenger Banking. "I expect there to be some form of consolidation as the market continues to mature. That might include the bigger players gobbling up smaller Challengers who have niche products or technologies."

One CEO warned against chipping away at unique selling points when exploring deals – or even delivering growth: "We're investing in making sure that our specialist expertise stays at the heart of our proposition. Many of the Challengers that grew too fast have forgotten what niche they were serving and become too generalist." That ill-served their core customers – and potentially makes them less attractive to investors or acquirers.

Or, as Hampshire Trust Bank CEO Mark Sismey-Durrant, put it: "Building a really good and sustainable business is more important to us than building a really big business."

Half the CEOs we spoke to choose collaborations or strategic partnerships over acquisition to address customers' needs outside of their core niche. That way, they can deploy different technologies and access new markets without building undifferentiated capability in-house – a distraction for a leaner organisation.

## Managing expectations

A priority for Challenger Banks remains managing shareholder expectations. While this comes in many forms aside from profitability (investors are valuing potential as well as innovation) the Challengers are largely meeting these expectations.

In many cases, Challenger CEOs define themselves by what they're not in order to give investors real clarity about their future, and the investment case. One spelled out to us: "we do not want to be an IT consultancy." He also stressed that in banking, delivering on what they promise is key. "Shareholders are very keen we do things properly over the long term. If we on-board clients without due diligence, we slow down the process and annoy others in the queue, we get a reputation for all talk no delivery."

# Customer centricity

For Challenger Bank CEOs, customer experience is everything. Accessibility, relevance, outstanding service and personalisation are all key. The challenge is creating loyal customers for their niche in an industry where the one-stop shop is the 'old' norm.

Our conversations with Challenger CEOs were structured around several themes. But when we were talking about differentiation and risk management, much of their commentary was rooted in concerns about how they would drive customer centricity.

This customer obsession bleeds into every area. When we asked about Metro Bank's HR approach, for example, CEO Craig Donaldson's answer was clear: diversity and the development of the right culture is a "critical component" of the strategy. But the objective was optimising customer outcomes. So the policy is to have no incentives linked to product sales or profit in favour of Net Promoter Scores, which put the customer at the heart of performance.

## Customer insight

Delivering a differentiated, competitive customer proposition begins with understanding their needs and wants. Many CEOs are looking to digital to meet that requirement. The incumbents can't react as quickly, so the Challengers have a natural competitive advantage.

Data is a powerful tool in the development of new products and services tailored to specific customer segments. Smart analytics allows Challenger banks to find and focus on underserved segments of the market.

Small businesses, a highly diverse market segment, are a good example. Delivering new, non-standard products and services efficiently will allow banks to gain market share and margin from traditional banks.

"We are targeting a portion of the market that the big banks tend to not care about, providing a service to businesses who otherwise would have struggled to get a loan," said the CEO of one bank offering new concepts in structured lending. "Data analytics is the big investment. We're spending a lot of time looking into machine learning too. We're throwing large amounts of data at technology to arrive at tangible results – it's a clear area for improvement across banking."

Many new entrants specialise in niche areas and a narrow range of products in order to deliver an outstanding customer experience. Data analytics allows them to connect customers with the best product for their unique needs, managing applications to simplify the process benefiting the customer and the bank.

For other Challengers, existing customer insights are shaping new approaches. "Growth for Sainsbury's Bank will come from our focus on Sainsbury's shoppers," said CEO Peter Griffiths. "Listening to them and understanding their needs – and responding by providing the special products and services only we can, and rewarding them for their loyalty."

## Customer experience

"Challengers are not merely investing in digital for the sake of digital," stresses Richard Iferenta, KPMG Partner and Head of Challenger Banking. "They are investing in digital to provide good customer experience."

And it's here that the Challengers are looking most carefully at the successful tech and retail giants who have effectively leveraged their brands. "I'm directly inspired by Apple – my AppleCare replacement for iPad took 18 minutes in store, all synced with my information," one Challenger CEO told us.

"A compelling platform is one that integrates customer experience," Mullen explained. "Companies that can integrate and partner effectively will be more likely to succeed."

"Apple manufactures hardware, but is a consumer and branding company. We want to see whether these elements can be translated into banking."

Apple itself – like many other large tech brands that are trusted to handle data by consumers – is moving into areas traditionally dominated by banks. The new ability to use ApplePay within iMessage to make person-to-person payments is a great example. The advantages they carry into the sector are well-honed user experience around the front-end – the design of apps and workflows; and great customer experience.

But according to another Challenger CEO, we're far from the customer experience endgame. "No organisation has yet to crack meeting customers' needs effectively via online banking," he told us. "Joining up digital with a personalised sales engine that can offer private banking services to the mass market will be a differentiator."

**Choice and Open Banking**

While many Challengers have focused on their niche, several CEOs also told us that an era of unprecedented choice for the consumer is also opening up opportunities for their more agile business models, their technology – and their approach to partnership.

That emergence of a more empowered consumer is one reason building a brand is almost as important as functionality. "Glamorisation is the norm now," one CEO told us. "Companies such as Facebook and Amazon are leveraging their customer base by integrating TransferWise and credit card systems. These companies are already doing finance in a digital ecosystem, and we have to join rather than compete against that. We need to think and behave like a consumer company. This is where you start."

Several CEOs are aware that the risk in refining the customer proposition too far is that they could end up with pockets of under-served customers – an outcome that over-commoditisation of the product layer might also bring to pass.

Where customers can find an alternative, whether Challenger or Incumbent that then does deliver on their precise needs, there is a risk they will depart.

Open Banking crystallises some of those issues – not least by making it easier to compare banks and their products; and to quickly shift transaction habits. How do you maximise opportunities when customers feel empowered to chop and change? How do we offer assurance in this new world? What will be the Open Banking risks around data protection and leakage? Here, even Challengers don't necessarily have all the answers.

**Atom's five critical customer levers**

For many Challenger CEOs, keeping control of costs using off-the-shelf systems, strategic partnerships and outsourcing are a key to competitiveness. But, as Mark Mullen of Atom bank pointed out, the ownership of the customer is key to Atom Bank. He listed the five essentials Atom Bank would never relinquish, regardless of cost:

1. The presentation layer. Online, in-app or even on the High Street, Atom Bank need to ensure fast and engaging interactions.

2. Systems architecture. Atom Bank must be able to fine-tune the back-end to maintain customer experience.

3. The user journey. User experience, products and fulfilment are all key to customer experience.

4. Integration across systems. Customers expect divisions or product groups to treat them consistently.

5. Connections with others via open APIs. Open Banking risks alienating customers if it doesn't work as advertised.

# Risk management

Attitudes to risk management can make or break banking institutions. Even digital-first brands working within a well-established regulatory environment need a balanced approach that ensures compliance while delivering opportunities. Challengers' attitude to risk management can be a way of driving competitive advantage.

"The only things that keep me up at night are the 'unforeseen' risks - cyber threats and regulatory changes, essentially." The CEO of this Challenger was not being blasé about customer experience or growth. Both those factors are central to his strategy. But in terms of managing risk, especially on the downside, it is the ability to mitigate externalities that defines his bank's robustness. So where else are Challenger CEOs evaluating risk?

## Openness and privacy

Data privacy has become such a critical issue – and not just in financial services – that many CEOs are highly concerned about sharing sensitive information with third-parties. Under the incoming Open Banking rules, customers must give specific consent for their data to be shared – and that worries some of the Challengers we spoke to. Others, like Atom Bank's Mark Mullen, are concerned that fintech-driven API innovation will result in costs to consumers popping up in new places, rather than lowering their overall spend.

It is difficult to foresee how the privacy debate plays out – alongside other barriers to an open digital strategy. But adoption of a coherent and holistic digital strategy will be critical to managing risk, delivering growth, reducing costs and enhancing customer journeys whatever the regulations, or consumer sentiment, dictate.

Half the Challenger CEOs we spoke to want to partner with fintech firms to develop open APIs; most of the rest want to develop the capability in-house. But all the CEOs want to ensure that their digital and product offering keeps pace with the market, increasing share while enhancing customer loyalty.

All of them told us they are investing in technology – particularly cognitive technologies – to optimise both their conduct, regulatory and commercial risk management.

## Cyber security and data protection

Managing the risks of a new, Open Banking system is one thing. Keeping systems and data closed off from a cyber-attack is something else. "A cyber incident for a Challenger bank will have a far greater reputational impact than an incident in a larger bank as people will inevitably assume that the smaller bank has under-invested in cyber security. In actual fact, the inverse is often the case" said Nick Fahy, CEO at Bank of Cyprus UK.

For many purely digital outfits, any perception of vulnerability to hacking would fatally undermine their brand. "The need to appraise your vulnerabilities to cyber risk is not just a one-off event," Masthaven MD Jon Hall told us. "Penetration testing, physical security reviews, data protection – all of these safeguards need to be built into your culture if you are looking to stay ahead of the threat."

But good risk management is about trade-offs too. "There is no prescription or minimum standards for security protocols."

"There is a real danger that regulation will commoditise banking. That's great for the 'ideal' customer – but bad for those who aren't. It will marginalise them, stunt ambition and ultimately fuel division in society. The industry has a collective responsibility to address these fault lines."

**Steve Pateman**, CEO, Shawbrook Bank

"While your responsibilities are clear, the solutions are not," said one online Challenger. "It is necessary to strike the right balance between customer experience and the underlying concern that data needs to be protected and secured."

There are also opportunities around cyber preparedness. Streamlined operations and leaner business models bestow several cyber security advantages on Challenger banks. Many CEOs also told us about opportunities to maximise innovation as a means of guarding against vulnerabilities – for example, through investment in intelligent, self-repairing networks and virtual databases.

## Regulation

Each Challenger CEO had particular issues with regulatory risk, usually skewed towards their own niche or size. In a sense, that makes them no different from Incumbent bank CEOs, who also face the constant balance between regulations that reinforce trust and those that hamper business decision-making.

"The current regulatory environment in the UK does not provide a level playing field for challenger banks," Metro Bank CEO Craig Donaldson said. "Regulation such as MREL serves to encourage consolidation within the market and stifles competition. There needs to be some conscious thought on how we pave the way for growth banks in the UK."

Risk Management cont...

He has a point: MREL, the minimum own funds and eligible liabilities, regulation deems a bank with over 40,000 customer accounts as 'systemic' – so it's subject to the same strictures as one of the big five with 22m-plus accounts. On the other hand, PRA safety nets for consumers – such as the FSCS – create an environment where its easier for customers to trust newer players.

Some of the newer regulations aimed at addressing systemic problems in banking pre-date some of the Challengers. "SMCR could have quite wide-ranging implications for Challengers as it transforms personal accountability", said one of the CEOs. "The model of a Challenger is meant to be innovative. But will people be willing to take strategic risks when there are such high stakes with relation to personal accountability?"

Another summed it up: "Regulation is no longer an art. It is a science. You are after absolute certainty and outcomes. Banking has never been about that. It has been about interpretation of information and judgement. Regulation stifles that." That's particularly true of new banks.

## Capital: more risk?

Unsurprisingly, regulatory capital is ever present in the minds of Challenger banks especially as there is a widely held concern that they are disadvantaged by the current capital regime.

Standardised (SA) banks are being driven into higher-risk residential mortgages to achieve attractive returns on regulatory capital. Lower LTV lending helps them manage risk responsibly but the higher capital requirements compared with IRB banks creates an "uneven playing field," according to one CEO – means their returns are reduced. As another CEO identified, this can be seen as "penalising Challenger banks."

"It is not how little [capital] you can get away with, but how much you need to cope with an ever-changing and high stress environment," another CEO explained to us. A number of CEOs commented that allocating capital to comply with the current capital requirements is diverting resources away from investments that would bring greater value to the customer.

Mark Sismey-Durrant, CEO of Hampshire Trust Bank, said that Basel III "could constrain competition from newly formed banks in the future." The ongoing uncertainty around Basel IV on investment property lending means it is difficult to carry out robust future capital planning too.

The PRA, which is clearly keen on encouraging competition in the marketplace, recognises the concerns of Challenger banks in this space. It has issued CP3/17 in which it makes clear it proposes to adjust the capital requirements with a view to minimising or eliminating the current distortions.

# Conclusion

## Play the long game

After the surge of growth in 2016, the main focus for Challenger CEOs is now long term, streamlined and sustained growth. This encapsulates the conceptual shift away from the general term ‘Challenger’ as a means of categorising these banks. Businesses such as ClearBank are completely different from Atom Bank or Metro Bank or Sainsbury’s Bank. And while relative youth and attitude to innovation are common threads, it’s increasingly less useful to treat them as a homogenous group.

In any case, their CEOs are for the most part clear that they are planning to be the new incumbents at least in terms of brand power, trust, sustainable business models and financial robustness.

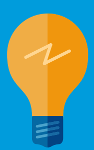
Many of these banks’ Chief Risk Officers have also come from incumbents, bringing mature approaches to conduct risk with them. That’s just one dimension of the Challengers’ priority on talent acquisition, designed to create a culture that delivers the right outcomes for the customer over the long term.

In many ways, their customer-driven culture is the ultimate long-term play. Agile enough to adopt new products and services; innovative with technology; responsive to the demands of millennials (and, in fact, every generation adapting to their power as digital consumers); open to partnerships in pursuit of customer optimisation; and built around a low-cost, high efficiency operating model, the Challenger banks are here to stay – however they’re categorised.

The banking industry has changed and the CEOs we spoke to are proud that they are the agents of that revolution. That means we need to consider new ways to think about them – and what they need from the financial services ecosystem to continue their mission of elevating customer experience and shareholder value.

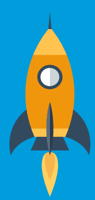
One thing is certain: the best way to move forward is to think a step ahead.

### What challenges face the Challengers next?



How will they ensure regulations don’t stifle their further innovations?

Who should they partner with to develop their unique propositions while minimising risk?



Where can they expand to maintain growth momentum in an increasingly homogenised market?

When will they achieve business resilience and competitive advantage – and who will challenge them in their time?

**We would like to thank all of the CEOs who contributed to our research for their support in producing this report.**

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