Framing new futures

Challenger banking report 2017

October 2017

Content

Foreword

Shifting landscapes

We titled the 2016 Challenger bank report 'A New Landscape'. The past year has shown that the banking scene remains in flux.

The complexity and diversity of UK banking is typified by the sheer amount of time we spent debating what to call the non-Big Five banks and how to categorise them.

'Challenger banks' looks like an increasingly poor term – a gross generalisation. Nevertheless, it has stuck as a way of describing almost any organisation that does something the traditional Big Five do, but which isn't a member of that group. So we stick with it. Next year? Maybe not.

Trying to find types of 'Challenger banks' that help us and our clients understand the forces at work in any useful way is equally frustrating. We debated chronological waves of new banks; categories based on size; on breadth of offer; on digital adoption; and on business model.

In the end, however, the platformisation of the banking sector not only makes such labels misleading, it also fails to account for rapid changes both across the sector and within individual players. Even just categorising new entrants that have strong existing brands in other sectors makes this a fruitless task.

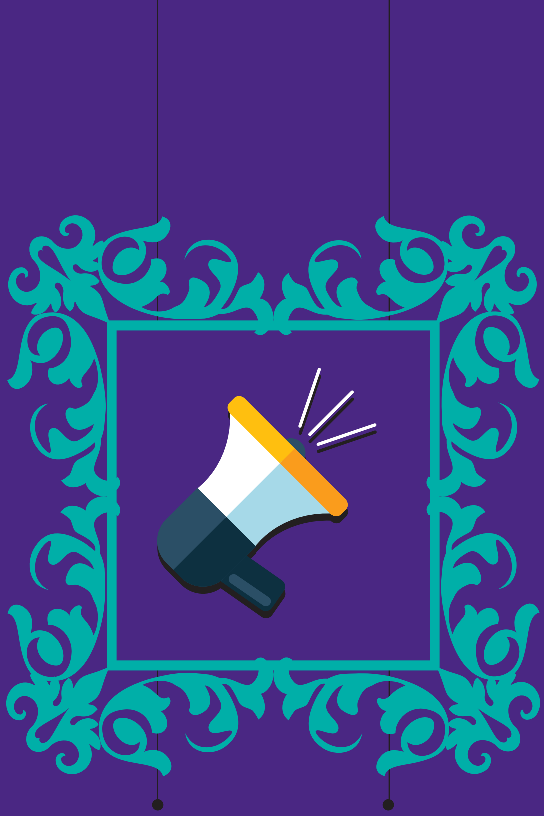
As you'll see, to overcome this problem we ended up with three very broad groups: Classic, Contemporary and Nouveau Challengers.

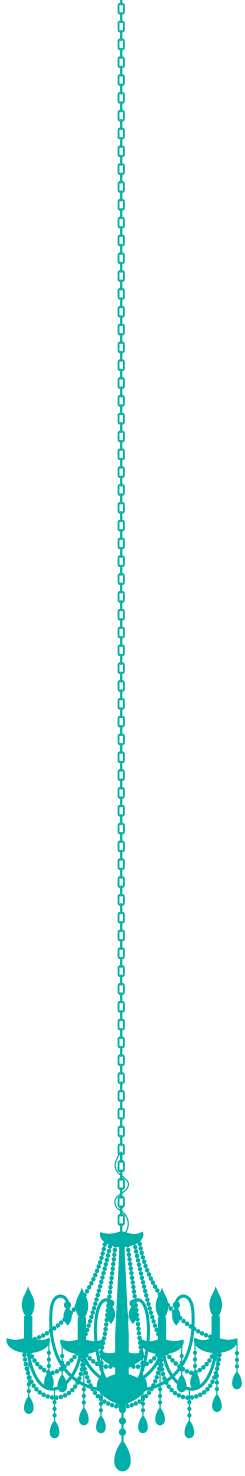
The really interesting strategic decisions for banks – big or small, branch-led or digital, niche or mass market – will be driven less by where they come from and more by where they are heading. So while this report summarises the state of play with today's Challengers, its main purpose is to outline how they might respond to the drivers of change.

The Challenger banks continue to get more numerous and diverse. But many will not pass the threshold for further growth. The evolutionary forces and revolutionary change will result in acquisitions, partnerships and even extinction for some entities and potentially whole types of banks.

What's clear from our own work with Challengers is that creativity and adaptability – as in all evolutionary systems – are the key. Read this report in conjunction with Challenging Perspectives, our companion report featuring the views of a dozen bank CEOs, and that message will come through loud and clear.

Richard Iferenta, Head of Challenger Banking





Challenging definitions

'Challenger bank' is a catchall term that describes any organisation outside the Big Five. But it does little to explain the breadth of their ambitions or the complex business models they employ. Is there a better way?

Since the financial crisis in 2008, more than 50 institutions have been granted a banking licence in the UK – there were 13 applications to the Prudential Regulation Authority in 2016 alone.

Countless others have launched services that don't require a licence, but that have traditionally been offered by banks. We have also seen brand new approaches that seek to disrupt the market, providing a step-change in customer experience or technology deployment.

A significant proportion of these new players exploit underserved niches, and all strive to differentiate from the Big Five banks.

Many Challengers argue that the challenge has already taken place, and that the label is now redundant. They're more interested in dominating their chosen area of opportunity than competing with those High Street incumbents.

'Challenger' remains little more than convenient shorthand, But the diversity of an ever-changing market suggests we need some new ways of looking at the strategies of these banks.

Classic Challengers

Blending traditional and innovative models, these banks seek and exploit scale in their customer base and often a branch network. Their relative cost of regulatory compliance remains lower than for smaller Challengers. Classic challengers, including the Co-operative Bank, TSB and Virgin Money, feature elements of classic banking, having a branch network, taking deposits, making loans – they're flexible enough to exploit new technology and business models for innovative, customer-focused services.

They have the resources to innovate in-house – but they're not averse to partnerships or acquisitions to stay competitive. Many in this group are not full-service provision, nor do they intend to be. By blending traditional and innovative banking services, many Classic Challengers have achieved strong balance sheet growth over the past few years.

These banks might be considered to be beating the Big Five at their own game, using more modern systems free of legacy conduct issues and building resilient, trusted brands.

Contemporary Challengers

Technology focus creates value in these banks' distribution channels and brings life to commoditised products. Banks in this category are predominantly planning to be digital-first (and likely digital-only), offering customer support via online chat or call centres. Cloud architectures, streamlined third-party systems and open application programming interfaces (APIs) offer a low cost base with high efficiency.

Contemporary Challengers may be more likely to partner with, or even consider themselves to be, Fintech companies. Riding the wave of platformisation, these banks are gateways to a rapidly growing network of interlinked, specialised product providers and financial technology. Contemporary Challengers such as Atom, Monzo and Starling hope to create a marketplace for financial services, with banking operations at the core.

Contemporary Challengers need to meet the expectations of shareholders by gaining scale, creating value and carving out definitive, differentiated niches of products or customers.

Nouveau Challengers

Nouveau Challengers tailor their services to customers in underserved markets, around cutting-edge technologies or with services that bleed outside the boundaries of traditional banking – for example, Revolut, B-Social and Iam Bank.

The Nouveau Challengers do not seek to compete with the big High Street players at all, recognising that customers in the future are more likely to use banking services from multiple organisations channelled through platforms and apps. These businesses reduce competition by creating "blue oceans" of uncontested market space.

The main trial for Nouveau Challengers will be in raising brand awareness and winning over customers to new ways of thinking about money as a series of lifestyle choices. Reliant on technology, they also need to stay at the cutting edge and ensure new risks around data and conduct are managed without creating a costly compliance burden.

Five key drivers

Brand

A diverse and crowded market means consolidation is inevitable. Brand differentiation and strength will be a critical component towards high levels of customer engagement to ensure survival.

We expect significant additional attempts to build brand awareness. In many cases that will mean partnering with better-established brands – as Tandem sought to do with House of Fraser.

Challenger banks are now fighting a 'personality' war, with trust and recognition the spoils.

Technology

We've seen many Challengers focus on technology that allows them to plug into external services, such as investing or shopping. Platformisation is here to stay.

In the short-term, we expect to see more Challengers use technology to create flexibility in their operation and control infrastructure costs.

Cloud services (well-established), open APIs (soon to be mandated through Open Banking), AI (more compellingly in the longer term) and a host of newly emerging technologies will be significant factors in deciding which banks will win.

Customer experience

Challenger CEOs told us this year that differentiated customer experience sits at the heart of their offer. It's the foundation of organic growth and helps them to carve out a market niche.

Challenger banks must now make their services sticky as well as easy to use and available. Customer experience is about expectations, and across customer and B2B markets, those expectations are rising in line with experiences from a host of other sectors, such as retail and – most importantly – consumer tech services.

Great customer experience and customer propositions must clearly drive value for the Challengers and their investors.

Deal-making

The strategy, timing and execution of acquisitions and partnerships is critical for the future of all breeds of Challenger.

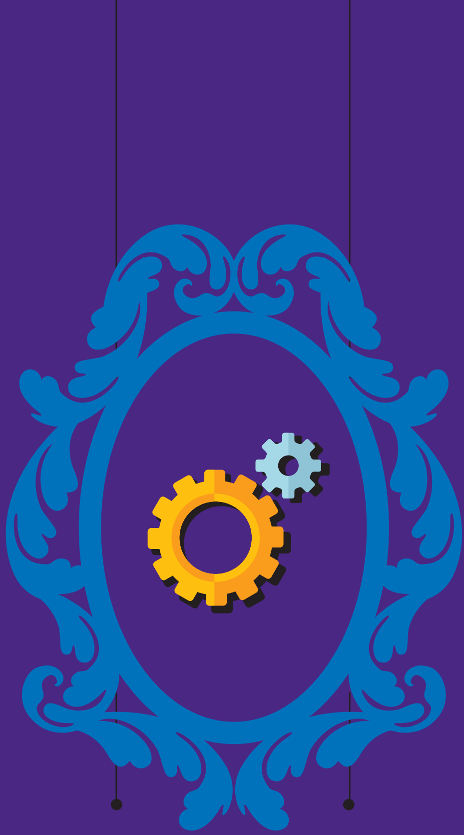
Inevitably, some of those deals will involve larger, incumbent players buying up capabilities, technology, loan portfolios, brands or customers developed by Challengers. As markets evolve, new opportunities emerge thanks to changes such as Open Banking and even Brexit, so we can expect a solid run of partnerships of all kinds.

Regulation

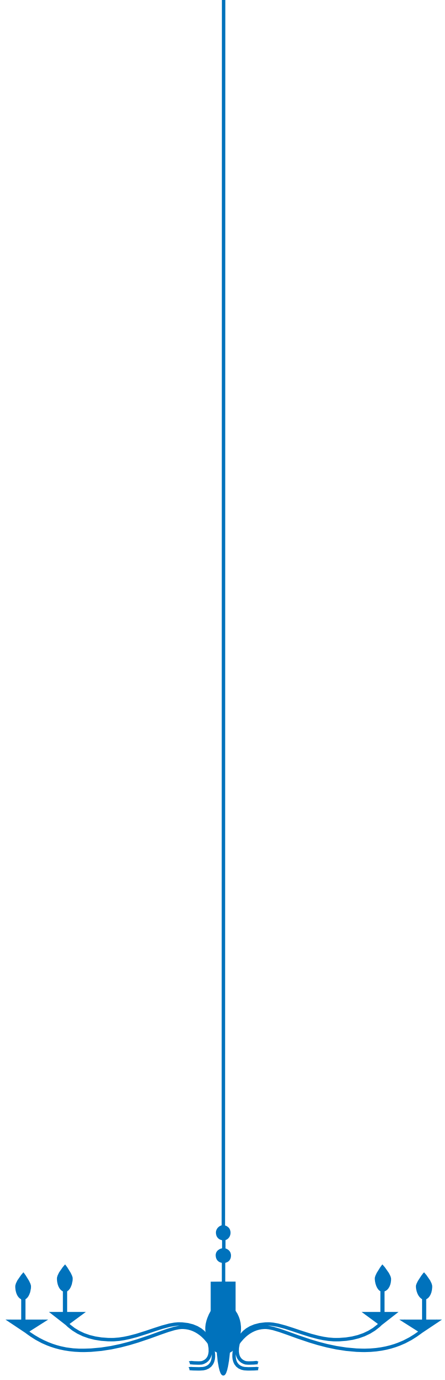
Challenger banks have seen rapid growth in the wake of increased openness, as well as customer desire for tailored, cheaper and more modern banking services.

Emerging capital rules in Basel IV will continue to shape Challenger appetites for different products and services, as well as defining their drive for scale and stronger balance sheets.

Brexit also creates significant regulatory upheaval that Challengers must begin preparing for now.



Introduction



We were right to question the idea of the 'Challenger banks' as a homogenous group last year. Their aims, methods, opportunities and challenges are incredibly diverse. Based on the perspectives of their CEOs and the forces now in play, further upheavals are inevitable.

Financial performance: sustaining momentum

The robustness of the sector is evident from the financial results (see page 9). Aggregate return on equity is up; the Challengers are reducing their cost ratios; and have maintained net interest despite the on-going low rates environment.

Capital ratios are also improving, and many of the larger Challengers are self-sufficient as their balance sheets grow – up 22.5 percent over 2015 among the smaller entities.

We continue to watch for potential impacts of Brexit. As yet, there's no visible impact on the financial performance or valuation of Challengers. This may change as negotiations unfold.

Regulation: a critical year ahead

The regulatory landscape is shifting – not least with the Second Payment Services Directive (PSD2), Open Banking, International Financial Reporting Standard (IFRS) 9 and the General Data Protection Regulation (GDPR). But changes to capital adequacy rules might also make a huge difference for Challengers (see page 16).

The Prudential Regulation Authority (PRA) is shifting to help insurgent banks make the change to the Internal Ratings Based (IRB) approach. But as the Basel rules continue to put pressure on all banks, we see potential pitfalls for Challengers. Many need to attract capital in order to meet their customer growth ambitions, and higher adequacy requirements could decelerate those plans or require a shift in strategy.

Technology: cost and flexibility

Data privacy and cybersecurity have moved up the agenda even without the additional pressure of GDPR. Open Banking will see new risks – especially with non-banking brands becoming 'trusted third parties' for banking data and transactions – and opportunities around shared customer data.

For Challengers, this should be a simpler task than for incumbents with a tangle of legacy systems (see page 13). Newer, more open, simpler and cheaper technology infrastructure has long been a competitive advantage for Challengers, although that may be narrowing a little as they mature and some enter new markets and layer on functionality.

Customers: scale and experience

In our Challenging Perspectives: CEO insights report published earlier this year, the Challenger bank CEOs we spoke to agreed that relentless customer focus is key (see page 19). For the app-only players – such as Atom and Starling – the proposition is convenience and user experience, and we see continued advantages from smarter, simpler technology in maintaining this edge.

Retailer banks – such as Sainsbury's or Tesco – have expertise in value transfer, turning shoppers into banking customers. As the retail side of their businesses becomes driven by data and analytics (and by granular customer insight), their banking offer should also yield more value.

Brand is expensive to build, particularly in banking where trust is so important. With the benefits of Open Banking set to materialise in 2019, new players might enter the market with ready-made brand propositions.

The most compelling entrants will offer value beyond banking, perhaps in the form of a digital 'concierge' that wraps banking more seamlessly into day-to-day life (see our report on 'The future face of the invisible bank: Meet EVA'). Expertise in brand, data and customer engagement will be decisive – strengthening the hand of tech giants, who already fill that concierge role and also happen to have ready access to capital.

Choppy waters ahead

Organic growth is clearly still on the agenda for many Challengers. We expect to see more deal activity – whether in mergers and acquisitions, less rigid partnerships or platform sharing – as the market evolves. Consolidation is clearly one potential endgame.

There are deep currents at work as the market strives to maintain enough flexibility to adapt.

Areas to watch in 2017/18

App-only banks

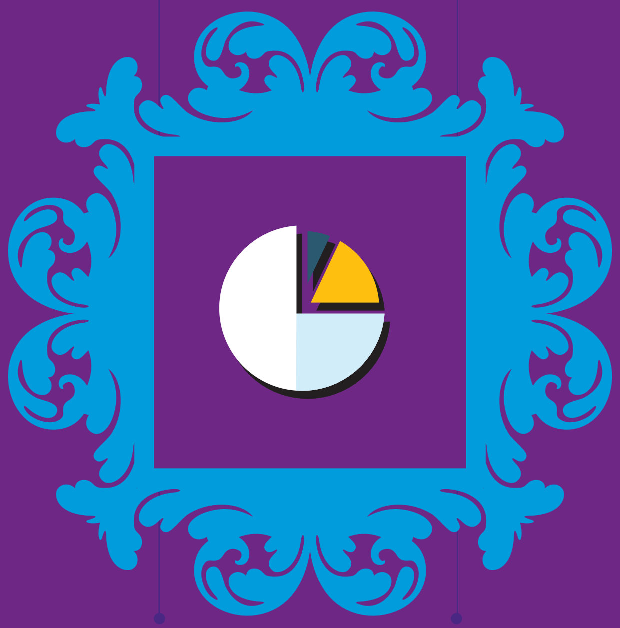
These new entrants are trying to capitalise on customer use of digital technology. Since they have no costly branch networks or call centres, it's all about the app. Monzo reported 240,000 active customers earlier this year and estimates that this will go up to half a million by year end with the launch of their current accounts. The secret to success for all app based banks will be large scale customer capture.

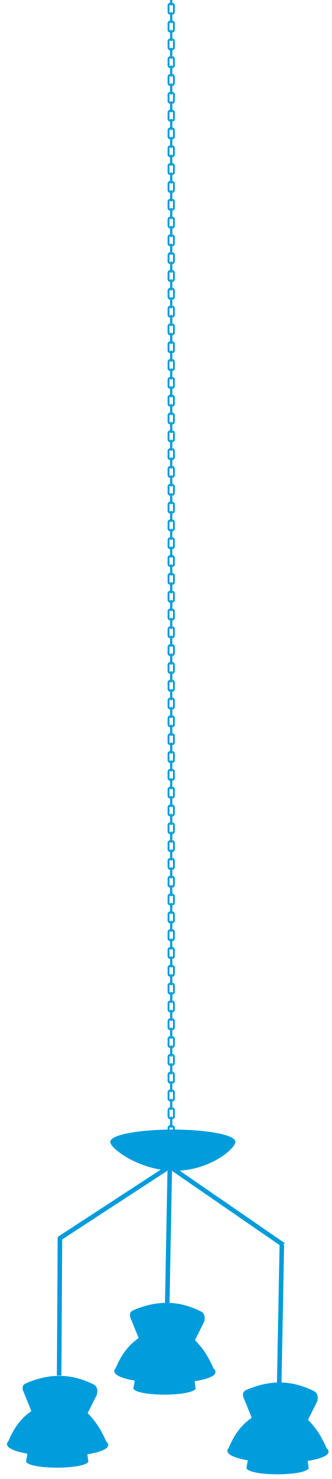
Open Banking and PSD2

Customer centricity is a fundamental value of Open Banking and could result in a new wave of 'customer layer' entrants and payment initiation service providers.

Payments

Even before PSD2, the payments space was evolving fast – see the recent Vantiv/ Worldpay merger. The UK's Payment Systems Regulator believes up to ten new providers could gain access to the interbank payment systems this year.





Challenger bank financials: plain sailing?

With the wind at their back, most Challenger banks have built on last year's improving financial results. They have shrugged off Brexit fears and continued to grow. But there are signs of choppier waters ahead.

Profitability continues to improve for Challenger banks as they become more diverse, but we continue to watch for potential road bumps that could impact financial performance.

Returns continue to improve for the Challenger sector. The smaller Challengers continue to report sector-leading performance, with pre-tax returns on tangible equity at 23.6 percent in 2016, from 20.5 percent in 2015.

Larger Challengers (excluding the Co-operative Bank) reported returns on equity up from 8.6 percent in 2015 to 11.5 percent in 2016. These figures benchmark well against the Big Five incumbent banks, which achieved an average return of 4.4 percent in 2016.

A key driver of improved returns for the smaller Challengers has been leveraging of the cost base. The average cost-to-income ratio of the smaller Challengers reduced from 66 percent in FY14 to 58.8 percent in FY15 and 40 percent in FY16. The scalable, flexible operating platforms deployed by new entrants allow them to expand lending books without associated increases in operating cost base. The smaller Challengers also lack the fixed costs of branch networks and high-maintenance legacy IT systems.

Both the larger Challengers and the Big Five have maintained margins, despite the reduction in the Bank of England base rate to 0.25 percent in August 2016, with net interest margins for the large Challengers stable at 1.9 percent.

The smaller Challengers, excluding Provident Financial[1], maintained their net interest margin (NIM) at 4.3 percent, in line with 2015. Despite small improvements in cost of funding, the smaller Challengers continue to have cost of funds that are more than double those of the Big Five, at 2.0 percent compared to 0.8 percent, reflecting both the age of their deposit books and their product propositions.

Credit quality: so far, so good

The larger Challengers' lending books are still predominantly secured on residential property. As a result, they continue to report a low cost of risk of 0.12 percent, down from 0.14 percent in 2015.

The small Challengers reported a higher cost of risk at 0.56 percent, an increase from 0.48 percent in 2015[2]. We've seen increases in cost of risk among three out of nine small Challengers, as their lending books continue to mature and season. The small Challengers, predominantly recent entrants to the market, have not been through a full credit cycle, and the impact of potential adverse changes in the wider UK economy on their financial performance remains to be seen.

Growth: no Brexit dip… yet

The Brexit referendum saw the share prices of the listed Challengers fall an average of 22 percent by the end of June 2016, compared to H1 performance. All the Challengers remain almost exclusively exposed to the UK economy – and investors feared a stalling or reduction in growth in the Challenger bank sector in the event of a downturn, whether prompted by Brexit or not.

But there is little evidence of a slowdown in their growth, with the small Challengers growing their balance sheets by £8.6 billion, up 22.5 percent over 2015. The large Challengers have accelerated balance sheet growth from 2015, to 7.8 percent. Challenger banks and their investors will be asking how they might best deliver growth and manage credit performance if the UK economy dips.

Capital ratios: strengthening, despite lending growth

Capital ratios within the Challenger sector remain strong. Smaller Challengers increased their average CET1 ratio to 15.5 percent in 2016, from 14.4 percent in 2015. This partially reflects the significant impact of corporate activity at Metro and Secure Trust Bank. Excluding these banks, the small Challengers saw a more modest increase from 14.7 percent to 14.9 percent.

The larger Challengers reported a reduction in their average CET1 ratio from 16.6 percent in 2015 to 14.8 percent in 2016, as they continued to grow their lending[3]. The larger Challengers will be seeking to become capital self-sufficient in the near future, with organically generated capital supporting their organic growth ambitions.

Many of the Challenger banks – in particular the smaller ones – continue to be at disadvantage compared to the Big Five incumbents in the way that they calculate their capital requirement. They calculate risk-weighted assets – a key input to capital ratios – on the standardised approach, in contrast to the larger participants use of internal models. These varying approaches, combined with the differences in lending mix, mean risk-weighted assets represent 27.1 percent of total assets for the Big Five, compared to 45.1 percent for the small Challengers.

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1 Provident Financial has been excluded, reflecting its different funding structure compared to the other members of the 'smaller Challenger' segment.

2 Cost of risk excludes Provident Financial, reflecting the different structure of its lending book compared to the other small Challengers.

3 Average CET1 excludes Handelsbanken, for which no CET1 ratios are available for the the UK business.

Technology: the great leveller

Although the large incumbent banks are investing heavily – and often very successfully – in new technology, we've continued to see Challengers of every description create new opportunities with their own digital expertise and willingness to experiment.

Customers and driving cost reduction were the twin objectives of Challenger tech investment in 2017.

The past year has also seen artificial intelligence (AI), automation and algorithms play increasingly important roles in Challenger thinking. One of the most notable examples saw Nouveau Challenger Revolut partner with Trussle, a London-based startup, to provide AI-powered mortgage services.

Underpinning it all is data. From raw transactions to softer behavioural analysis, it's data that is helping Challenger banks transform from offering a point-in-time service to providing lifestyle experiences around financial products. OakNorth, for example, are now investing in data analytics to free up employees for other areas in the customer pathway. Their aim is to improve customer experience.

Larger Challengers and the Big Five are increasingly emulating digital banks. CYBG, for example, has launched new digital banking services. Virgin Money is building a personal finance management app, Virgin Red. Yolt (which describes itself as 'a FinTech owned by ING') is a new platform consolidating bank accounts, credit cards, utilities and even media subscriptions in one app.

As we all know, banks don't stand still. People talk about a tsunami of change, but we think it's more like global warming, where the seas rise at an unnoticeable pace. If you stand still you'll still drown. But most of the banks are facing shore and walking up hill. Success will be with those that walk the fastest.

Maintenance and security: new costs

The past three years has seen cyber attacks on Lloyds, RBS and HSBC as well as Tesco Bank – but the truth is, like every significant organisation, banks are being tested daily by hackers. As the Challengers' profiles increase, the need for good cyber security simply redoubles.

Challengers accept that convenience in banking must not come at the cost of security. It's high on the agenda for many consumers thinking about changing banks, or even just at their current bank. After the Tesco breach, it is increasingly important that Challengers take their security measures beyond compliance considerations.

New technology such as machine learning can help identify and address new attack vectors and we expect to see renewed investment in this area in the year ahead.

Open Banking: the big shift

The strategic ramifications of imminent Open Banking are clear: this is nothing less than a decomposition of the banking value chain. In fact, the question is not whether the technology is viable – open APIs are inevitable – but will customer behaviour change? And will third parties win their trust for banking transactions? Protecting and improving the experience of the consumers should be a priority.

But if the Open Banking endgame is uncertain for now, we can say that many Challenger banks, with newer, more flexible systems, are likely to be able to adapt quicker to new levels of market transparency and consumer control.

Open Banking also highlights the importance of guarding data use. The General Data Protection Regulation (GDPR), due May 2018, will set the ground rules. While GDPR affects numerous sectors, financial services firms will be hit hard if they fail to become compliant, not least because of longstanding scrutiny of customer-related conduct risks.

Platforms: the evolution of an ecosystem

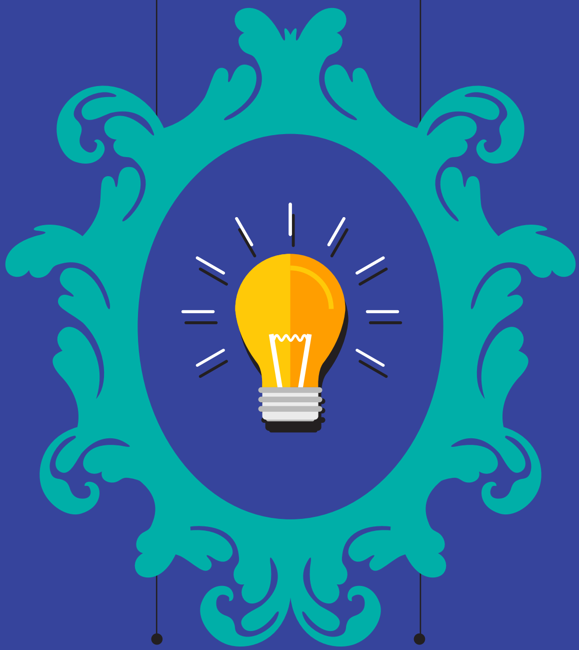
Open APIs are also driving banking platformisation. Consumers expect the same all-encompassing experience in financial transactions that they get from Amazon or Apple, and tech-driven platforms allow deeper partnerships between big banks, Challengers and FinTech providers to ensure they get it.

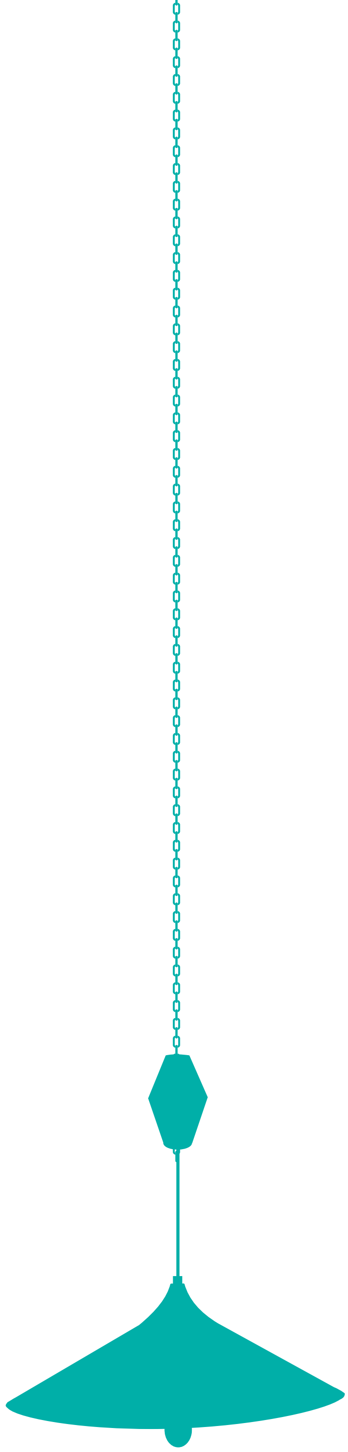
Data-driven tech giants like Facebook and Google are well placed to develop true 'marketplace' banking. Partnering with a tech giant means a relatively small Challenger could access a large, growing customer base while tapping into the trust consumers have for the likes of Apple or Amazon.

However, both tech giants and the Challenger banks have a tricky problems to address. They must have the technology in place to on-board customers properly; reliable and secure APIs; compliance with Know Your Customer rules; and a host of other regulations. Failure on any of those scores risks massive reputational damage.

Contemporary Challengers such as Fidor already offer an Open Banking platform onto which third parties can plug in services. Note that Fidor has been bought by French giant BPCE, and has also done a deal with Telefonica to offer banking via the O2 mobile network. Its new alternative investment marketplace Finance Bay also features a partnership with the Nutmeg online wealth management platform.

While many in the sector see platformisation as a threat, there are opportunities to be grasped in increased collaboration, cost efficiencies and more efficient use of data. The knock-on effect is improved customer experience.





Capital ideas: avoiding inertia

When it comes to capital requirements, newer, nimbler players operate at a disadvantage to the incumbents. New rules and business models are posing questions for both banks and regulators – with big implications for customer outcomes.

The Internal Ratings Based (IRB) approach: how can regulators set a level playing field for Challenger banks?

The PRA has changed course to provide more help to support Challengers but its still too early to tell how this will impact capital requirements in practice.

Regulatory capital requirements pose a problem for Challenger Banks because most apply the standardised approach for credit risk capital calculations.

The IRB approach used by most incumbents (and some larger Challengers) generates capital requirements depending on risk parameter inputs determined by the bank which in general (and particularly for low risk residential mortgages) leads to fewer capital requirements than the SA.

Many Challenger banks argue this incentivises them to lend to slightly more risky customers rather than in the prime space (especially in mortgages), where they struggle to compete given the differential on capital required.

IRB status is understandably hard to achieve. Younger banks, in particular, don't have the required data (up to seven years worth) to support the development of robust internal credit models. Many won't even have the three years of experience using their models to demonstrate how well they've integrated them into business processes.

Capital rules: the PRA and beyond

In the past, the PRA has tended to be more reactive that proactive towards firms seeking IRB approval. But in the past 18 months, it has noticeably changed its modus operandi.

The PRA has set out a staged process to getting to IRB, with a focus on earlier discussion and interaction, and a series of gates to provide more clarity for firms on how they will interact with the regulator during their IRB journey. It has also issued clarifications on what firms can do with limited data for probability of default (PD) and loss given default (LGD) model development, and it's made clear the requirements of the use test and the experience requirement.

Good news for Challengers? Many of them have made positive noises about the PRA's shift. But we shouldn't get carried away. The procedural changes are welcome, and the new attitude shows a willingness to engage with banks. But until we see how the regulator applies these new practices, it's too early to call this a turning point.

Basel accords: What Challengers can expect

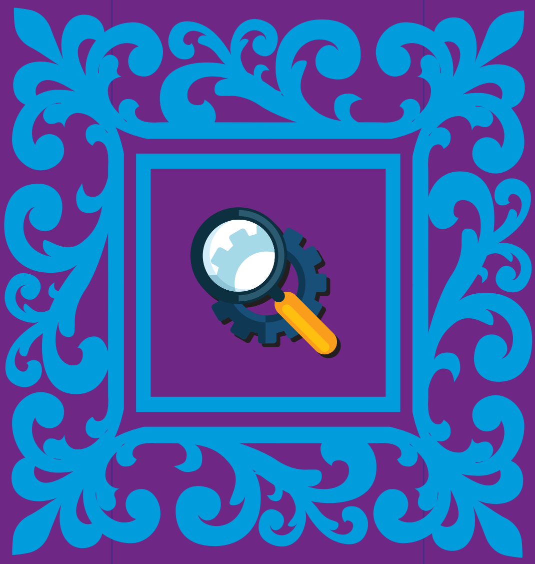
Furthermore, the shift to IRB might not be as attractive as it has been in the past. At the time of writing, 2017 has seen numerous disagreements between members of the Basel Committee, creating uncertainty for both big banks and Challengers alike. A crunch meeting to finalise global capital rules for banks has been postponed, with no decision on when the next talks will take place. Not only has 'Basel IV' been delayed, but the full implementation of Basel III in 2019 is somewhat becalmed.

The most contentious requirements are the application of a capital floor and the shift to a single standardised approach to operational risk for banks.

But neither incumbents nor Challengers can avoid preparing for change elsewhere in the rules. For standardised approach users, there are new requirements for real estate transactions, with increases in risk weights for exposures where repayment of the loan depends on the income generated by the underlying property – a significant change for many Challengers.

There may be new restrictions on when IRB can be applied to different portfolios, and parameter floors have also been proposed. Firms using internal models would have to calculate a floor based on standardised approach to limit the benefit from internal models such as IRB.

In short, then, Challengers need to make the most of their fleet-footedness in adapting to new regulatory realities around capital, and ready themselves for new opportunities as those rules bed down and their options develop with support from the PRA.



Conduct and customers: the edge

Challenger banks all have unique strategies, but ask CEOs about the overriding priority, and they agree: it's customer experience. That focus is serving them well in shaping their approach to conduct risk, new data regulations and strategies for growth.

Conduct and culture have become dominant risk factors for all banks. For Challenger banks, this is good news. With newer, more dependable systems, little legacy from the back book, and a can-do attitude to customer experience, they're well placed to redefine how risk is considered as part of strategy.

Risk: have Challengers changed the game?

A dynamic approach to risk management, allowing faster, bolder decisions in the face of fast-changing conditions, delivers competitive advantage for any business.

In banking, risk is also tied up with regulatory compliance and reputation. For incumbent banks, scarred by the financial crisis and hit with fines for long-past conduct failings, this makes it a constraining factor. Challengers have none of that baggage and can define their approach to risk in line with clear market opportunities.

For example, most Challengers have a very simple product set targeted at a defined customer segment. Most large players have many different (often legacy) products across different segments, such as mortgages and savings accounts. The Challengers are better placed to use newer, faster, more flexible systems making it easier to test and refresh sales journeys quickly, using information gathered to inform its management of conduct risks.

Since much of this advantage is predicated on technology platforms, there is a new risk that products and services are properly explained, especially to vulnerable customers who must be shown to be aware of what they're buying. This is a potential conduct risk.

Trust matters: where risk meets culture

Although they have to guard against any kind of misselling complacency, Challengers can still influence banking culture for the positive. This, as FCA chairman John Griffiths-Jones highlighted in the foreword to the regulator's 2017 business plan, is a huge factor in delivering the expected standards of conduct.

This means not only embedding conduct risk in strategy discussions – that's crucial for all banks – but also making a positive of risk by combining it with customer and culture considerations. Every bank has to evaluate new products for risk and optimise customer journeys with clear executive accountability. Challengers can come at the problem with an entirely fresh outlook – one many of them are happy to promote in marketing.

It's not all one-way traffic. Having a customer-focused target culture is one thing. Complying with the conduct rules is another. Larger banks tend to have the resources and experience to run a standardised conduct risk self-assessment process across the firm or develop a firm-wide taxonomy for conduct risk types. That's a stiffer proposition for a smaller bank.

Growing pains: the need for structure

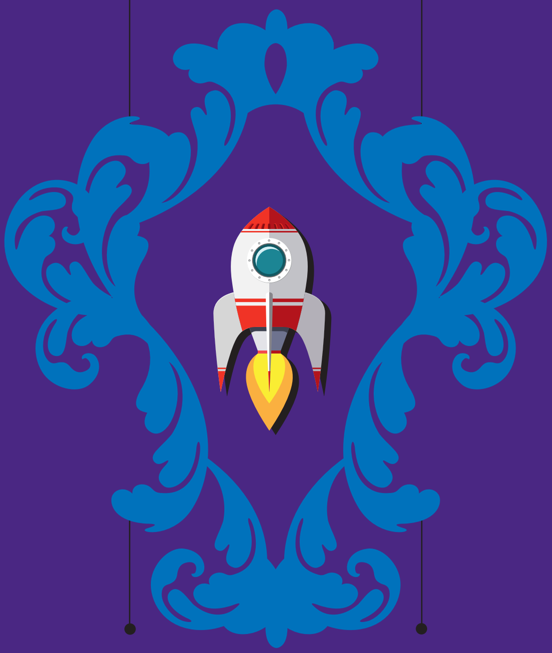
Those kinds of formal structures are likely to remain important regardless of – and perhaps even because of – the Challengers' new approaches. The platform model, Open Banking and use of third-party systems could create unforeseen conduct risks that are not all within the control of a Challenger's own board. There is even a risk that today's new architectures could become the issue-laden legacy systems of the future.

Many Challengers are focused on niche markets. That heightens the risk around clarity on the boundaries of customer ownership – especially as PSD2 mandates open APIs – which could create poor customer outcomes.

The regulatory and reputational impacts around the provision of advice – not least on the promotion of third-party products – also makes the picture cloudier.

Algorithmic approaches to offering advice as well as automation of processes can create new types of risks around customer outcomes. These risks are still poorly understood, and are under review by regulators.

In short, then, while we see many Challengers rightly focused on their customers and deploying innovative approaches and technologies to serve them, their strategies will increasingly rest on how they choose to manage the operational and conduct risks those decisions create.



Conclusion: natural evolution

Over the past few years, Challenger banks have successfully made their mark in the financial services industry, but how big will they get? As the landscape continues to evolve, their importance will become increasingly apparent to customers whose expectations of speed, ease of use and personalised services have been set by the internet giants. That doesn't mean categorisation will be any easier. By 2020, our efforts in this report may seem simple by comparison – and that's no bad thing. The 'challenge' has just begun.

In an effort to summarise our findings, there are a number of key areas to reflect upon.

01

The Challenger bank sector is thriving. We have seen aggregate return on equity increase and cost ratios decrease. Many of the Challengers are now self-sufficient, and have maintained net interest margins.

02

Regulation – in the form of Open Banking, the Second Payment Services Directive, and the General Data Protection Regulation – will deliver as many risks as it does rewards. Challenger banks must be prepared for the pitfalls.

03

Technology is set to play an increasingly important role, with artificial intelligence (AI), automation and algorithms coming of age. Underpinning it all is data.

04

Customer experience and frictionless finance will separate the winners from the losers. While brand will play an important role in this equation, the most compelling new entrants will offer value beyond traditional services.

Notes on preparation

Within the financial analysis section of the report, the banks are classified as follows:

- **The Big Five banks:** Barclays plc, HSBC Holdings plc, Lloyds Banking Group plc, The Royal Bank of Scotland Group plc and Santander UK plc.
- **Larger (Classic) challengers:** CYBG plc, Svenska Handelsbanken AB (publ) (UK division), Paragon Banking Group pl, The Co-operative Bank plc, TSB Banking Group plc, Virgin Money Holdings (UK) plc and Bank of Ireland (UK) plc.
- **Smaller (Contemporary) Challengers:** AIB Group (UK) plc, Aldermore Group plc, Close Brothers Group plc, Metro Bank plc, OneSavings Bank plc, Shawbrook Group plc, Provident Financial plc, Cambridge & Counties Bank Limited and Secure Trust Bank plc.

Banks with consolidated total assets of in excess of £10 billion in their 2016 year-end annual financial statements have been classified as 'larger Challengers'.

Information has been obtained from published 2016 year-end annual financial statements (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 Handelsbanken, as these are segments of larger groups and do not disclose capital figures.
- Gross yield: 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. Gross yield 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.
- Cost of risk: Impairment charge on loans and advances to customers divided by the average of opening and closing loans and advances to customers.
- Standardised Approach (SA): the default approach to the determination of regulatory capital requirements for credit risk where a firm does not have regulatory approval to use internal models. Under this approach, banks allocate exposures to a series of regulatory prescribed categories and in most cases use external credit ratings to determine the risk weight to be used.
- Internal Ratings Based Approach (IRB): an approach used for the determination of regulatory capital requirements for credit risk, where the firm has obtained regulatory permission to use internal models to derive risk parameters for its portfolio exposures which are then used in regulatory prescribed formulae to determine the risk weight to be used for the exposure.

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 are based on the dollar amounts disclosed by the banks, rather than on the sterling translation of those amounts.

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