Executive Insights

Volume XX, Issue 38

Deposits Strategy: An Inflection Point for Challenger Banks?

The financial crisis and the era of ultra-low interest rates that followed led to the emergence of niche challenger banks in the U.K. such as Aldermore, OSB and Shawbrook. They have prospered and some are now publicly listed.

In the past few years, there has been a second tranche of bank licence applications as lenders, funded by bank term loans, bonds and other means, have sought to take advantage of the low costs available from being deposit-funded. They have been encouraged by the Prudential Regulation Authority's (PRA) fresh approach to supporting the emergence of new banks, which includes simplifying the licence application process.

As a result, the first challengers are now being threatened themselves by a second wave of new specialist lenders with banking licences. In the 10 months to the end of 2017, the PRA approved 12 new banking licence applications, according to Specialist Banking, and in its latest annual report the PRA stated that it had met with 25 prospective banks considering applying for a licence[1].

The increasing crowding of this space is squeezing margins in a number of previously niche challenger markets. Head-on price competition is rife, especially in asset finance, second charge lending and invoice finance. This is forcing many challengers to take a renewed look at their funding and to consider whether they could generate the volumes of deposits required at lower savings rates than those needed to be ranked a best buy.

This *Executive Insights* examines the key considerations for the challenger banks.

Deposit dynamics

The deposit market has a wide range of player types: high street banks; building societies; well-known challengers such as the Co-op, TSB and Virgin; challengers with far less established brands; and the subsidiaries of foreign banks, many of which also suffer from poor brand recognition in the U.K.

The market also has a highly segmented customer base. The majority of people hold at least some savings with the bank that holds their current account, relationships that often last decades. Around £50 billion of savings is regularly moved to ensure it's always rewarded with a best-buy interest rate — these customers are content to save with a bank whose brand they do not know. A further £100 billion of savings is placed into new accounts by brand-conscious customers who are not readily accessible to challenger banks. A final segment is the wealthy, who want to diversify large deposits to maximise their protection from the government's guarantee scheme.

Competitive tension is based around access to savings, the interest rates offered and how they vary over time, including through bonuses, the strength of customer relationships, and marketing and distribution.

It is a tough market for challengers because the high street banks have two structural advantages. First, their brand strength is unrivalled — in spite of the damage to their reputations from the financial crisis — and with their scale they can market heavily at a national level. Second, as the main bank for most people, through

1. http://specialistbanking.co.uk/12-banking-applications-approved-10-months/

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a current account or mortgage, it is easier for them to offer an additional account to customers. These advantages are enough for the major banks to raise the deposit funds they want — they are all well-capitalised now — so they don't need to try harder by offering market-leading savings rates and features.

The challengers do not have the scale, resources or brand equity to compete with such marketing heft. In many cases they don't have any form of relationship with potential retail savers because they don't offer consumer banking products. And for those banks that do, their retail products tend to be in limited niche areas (for example, point-of-sale lending or near-prime motor finance) so can only ever provide a small target audience for deposit accounts. Offering very low interest rate products as the high street banks do is therefore not a realistic possibility for the challengers.

A few challengers do have standalone deposit accounts and have outsourced them to one of the few options, the Newcastle Building Society, saving themselves the cost and regulatory burden of setting up the business themselves. The flip side is that outsourcing to the same place makes differentiation very difficult, and the cost and regulatory burden argument becomes less compelling the larger the challenger becomes.

Challenger options

While the deposit market might seem impenetrable to many challengers, they should not write it off. There are two key strategies that they should consider to build share, recognising that they will not be able to compete head-on with the high street giants.

Focus on less competitive niches

Find market segments that are less well served and innovate to create savings products that are attractive to them with competitive savings rates. Good examples include Masthaven, which launched as a retail bank in 2016 and offers bespoke duration savings products, and German bank Fidor, which set-up in the U.K. in 2015 and offers savers access to online advice from other members of the bank's saving community (providing rewards for each question posted).

Succeeding with this strategy requires in-depth customer research to identify niches where new products can add significant value. This approach may also require insourcing the savings platform, a strategy Masthaven has followed.

Adopt a new channel and marketing strategy

Innovative ideas cleverly marketed to better served customer segments can also win. Other parts of the financial services industry have done this well: Octopus Cash has developed a competitive edge through offering better-off savers the best interest rates by continually moving their money for them to the highest-earning accounts, taking care to preserve their protections under the Financial Services Compensation Scheme by spreading funds across multiple accounts as required; and Hargreaves Lansdown has built a position as the go-to online platform for direct investment by sophisticated private investors.

Challengers should also consider affinity strategies, acting as the white-label bank for well-known brands and profitable segments. They can learn from the high street banks: Bank of Scotland and RBS set up Sainsbury's and Tesco's banks, both now self-operated, to access the supermarkets' huge customer bases, and M&S Bank is part of HSBC. Hard, yes, but there will be opportunities for the challengers that work at it.

Online affinity communities should also be explored, particularly for special interest groups and younger generations who have only known an online world. Again, examples from other areas of financial services demonstrate what can be achieved: Carole Nash is a successful motorbike insurance business that started out focusing on vintage models; Prodigy Finance is an online platform that provides what it calls borderless loans to internationally mobile postgraduates to study at leading universities. Both benefit from customers' affinity and engagement with the underlying product (i.e. the bike or the university) to drive two things: first, deeper relationships to achieve a combination of better underwriting results than technical underwriting criteria would imply are possible; and second, broader and more valuable customer relationships.

Bigger questions

Before aggressively pursuing an innovative deposits strategy, challengers must question the rationale for such a move — it's certainly something that investors and the market at large can be expected to do. There must be a sound commercial thesis that complements the overall business model.

Given the increase in competitive pressure, they should first be reviewing how to optimise the margins of their lending businesses, perhaps focusing on higher-margin subsegments[2] and driving margin through increasing prices, where possible, or by reducing the volume of loans provided where necessary.

The first wave of challengers should also put a renewed emphasis on minimising their operational costs, which will have grown in step with the development of their business, for example by automating the more "vanilla" elements of lending. This automation could also reduce the time it takes for a customer to receive a loan. This could be a game changer for people who need finance quickly, potentially at high margins for the lender.

More critically, boards should be asking how sustainable their business model will be when interest rates inevitably rise a few points from their current position. Companies that analyse these strategic questions now and take action will be at a significant competitive advantage over their rivals who don't.

2. See L.E.K. Consulting's How Challenger Banks Can Finally Live up to Their Name: Pursue a Multi-Niche SME Strategy

About the Author

Peter Ward is a Partner in L.E.K.'s London office. Having joined L.E.K. in 2000, his primary focus has been corporate strategy development, complemented by substantial experience in buy and sell side commercial due diligence, commercial bid support and litigation support. Peter has deep sector expertise in regulated industries, principally financial services, and his main areas of focus are retail and SME banking, retail and commercial general insurance, specialist (i.e., non-bank) lending and debt management.

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