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How Challenger Banks Can Finally Live up to Their Name: Pursue a Multi-Niche SME Strategy

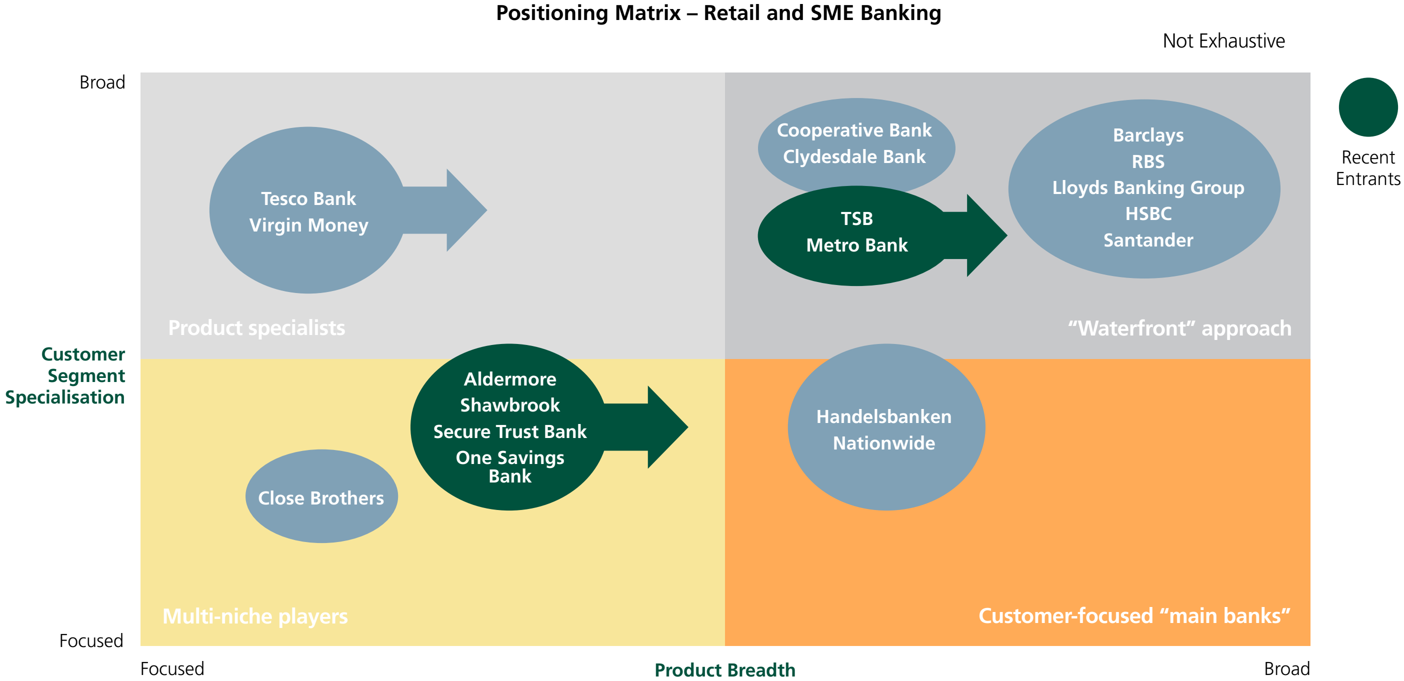
The Environment for Challenger Banks is Good and Improving

It has always been difficult for small banks to compete with the U.K.'s largest players. In the past numerous upstarts – often called "challenger banks" – have failed to move the needle in either retail or corporate banking. They have tended to stall at early stages because they were not able to offer customers a compelling alternative. Now, according to the *Financial Times*, HSBC, Lloyds, Barclays and RBS control 77% of the U.K. personal current account market and 85% of small and medium sized enterprise (SME) business current accounts.

A new generation of challengers, however, have recently entered the market. This is a diverse group with a variety of strategies and business models: some are narrowly focused niche players; others want to serve a broad range of corporate and retail customers (see Figure 1). More are on their way. According to the Financial

Figure 1

Positioning Matrix – Retail and SME Banking



How Challenger Banks Can Finally Live up to Their Name: Pursue a Multi-Niche SME Strategy was written by **Diogo Silva** and **Peter Ward**, partners in L.E.K. Consulting's London office. For more information, please contact financialservices@lek.com.

Conduct Authority, 26 banks are in discussions with regulators about applying for a banking license and four are currently going through the application process. Since April 2013, regulators have authorized six new banks.

The market and regulatory conditions for challengers are promising. Since the financial crisis of 2008, the image of the big banks has taken a sustained beating among the public (see *Executive Insights* 'It's Not You, It's Me: Why Customer Relationships Should be the UK Retail Banking Battlefield'). Meanwhile, the Competition and Markets Authority is looking at measures to make it easier for consumers to switch products. There are also on-going initiatives amongst regulators and trade bodies about levelling the playing field for challengers by, for example, enabling them to access the payments infrastructure at a reasonable cost. The basic problem for challengers and their investors, however, remains: how to lure customers away from the big banks and achieve attractive returns doing so.

One answer is by identifying and targeting multiple segments of the U.K.'s underserved SME market. The big banks generally focus more on large mature corporate customers and are product-centric in their approach. This creates an opportunity for challengers who can develop a deep understanding of the dynamics and risks SMEs face in different industries, who can anticipate SME needs at each stage of their development, and who can offer SMEs products designed to meet those needs, often at better prices than the largest banks.

UK SMEs Have Banking Needs that Are Unmet by the Largest Banks

The Bank of England estimates the aggregate size of the U.K. SME lending market to be £160bn (outstanding balances as of October 2014). The size of the overall opportunity suggests that there are segments of the market large enough to warrant developing a differentiated banking proposition. Moreover, current growth fundamentals for SMEs are attractive. At this point in the economic cycle they need more working capital and financing for capital expenditure.

While the big banks offer large corporate customers bespoke products and services, they often take an off the peg, generalist approach to SMEs. Relationship management is primarily organized on a geographical basis, rather than on industry sector or corporate life stage. As we discussed in a recent paper, big banks have product-centric organizational structures and systems that make it difficult for them to understand and anticipate customer needs holistically. They are also distracted by more pressing day-to-day operational priorities, as well as other calls on their time such as regulatory investigations.

To take full advantage of the SME opportunity, challengers need to target specific segments within the SME market and offer a differentiated proposition. We believe the two most promising areas of focus are industry sector and corporate life stage. Addressing both in combination can be very powerful.

- **Industry Sector**. Different sectors have different specialized banking product needs. Agriculture, real estate, financial services and healthcare are examples of sectors with specific customer needs, which are often not addressed specifically.
- **Corporate Life Stage**. Many SMEs are businesses in early stages of growth and need a different portfolio of banking products to mature corporates. Tracking growth trends enables banks to anticipate future business needs.

Challenger bank relationship managers should be specialized by business function or industry sector, rather than by geography or product. This requires the development of customer-centric management information to support credit decisions and to help identify and anticipate customer needs. Relationship managers with specialized knowledge of specific industries will be able to:

- Develop deeper relationships with clients via a more natural and personal framework for discussion
- Propose new products to serve unmet needs

Figure 2

Shawbrook Case Study – Multi-niche Strategy

Corporate Segments

Example for Asset Finance

Commercial Vehicles	Recovery Vehicles	Machinery	Aviation
Bus & Coach	Agriculture	Marine	Cars
HGV	Plant & Equipment	Waste & Recycling	Specialist

- Multi-sectoral approach within a given product
- Enables a deep understanding of the specific requirements of customer groups for that particular product
- However, does not fully capture customer needs in a holistic way

Consumer and Individual Business Segments

Unsecured Lending	• Home improvement loans • Luxury holiday loans • Point-of-sale, e.g. dental • Unsecured personal loans
Secured Lending	• Second charge mortgages for prime and near prime owner-occupiers and landlords • Bridging finance for prime landlords

- Shawbrook has identified product niches with attractive margins and a large / growing addressable market
- However, this strategy requires an on-going 'refresh' as market opportunities may become less attractive over time

Source: Shawbrook; L.E.K. analysis

- In some cases, offer more competitive pricing. A challenger that has a deep understanding of agricultural asset finance, for example, is likely to be able to price a loan more accurately and competitively than a large bank with only a general knowledge of the area

Creating sector specialisms is a strong opportunity for challenger banks to penetrate the SME market. Handelsbanken, Aldermore and Shawbrook have all started to implement this strategy to some extent. Their sectoral approach, however, is still often tied to a single product, as opposed to a more holistic approach to SME banking needs (See Figure 2).

In developing multi-product SME strategies, challengers will need to analyze target markets carefully and develop products that are appropriate for the banks as well as for their customers. Smaller challengers, for instance, will probably find offering business current accounts too expensive, while larger challengers may have the scale to justify the required investment in systems and access to payments infrastructure.

Retail Banking is Less Attractive for Challengers

We believe retail banking in general is a less attractive stand-alone opportunity for most challengers. The "cost-to-serve" associated with a differentiated, holistic customer proposition is harder to justify in terms of the size of the revenue / profit "prize" available from doing so. As for developing niche products, as Shawbrook has done in secured lending and other specific areas of consumer finance (See Figure 2), this is possible although difficult. It requires the ability to find a consistent stream of new niches as opportunities close. Prime second charge lending, for instance, attracted several challengers and as result has become less profitable.

One promising retail strategy for challengers, however, is to leverage a SME corporate banking strategy to develop a high-end retail niche. The big players have already explored this to some extent and the niche is not large enough to support a successful stand-alone business. Handelsbanken, however, has attracted highly affluent retail customers who were first introduced to the bank through its SME operations.

Successful Challengers will Focus on SME Needs, Not Products

Favorable conditions in the U.K. have attracted numerous new challenger banks and will continue to attract more. While some of these new banks have had success focusing on the SME opportunity, fully capitalizing on that opportunity requires a new strategy. This strategy requires a deep understanding of the needs of SMEs in select industries at different phases of development.

Moreover, it requires a different perspective on customers and products. The way for challengers to succeed with underserved SMEs is not a product-centric one, in which generic products are marketed to customers across industry groups. Instead, it is a strategy in which an analysis of the needs of SMEs in specific industries leads to products and services designed to meet those needs. Challenger banks need to identify the industries and corporate life stages in which SMEs are significantly underserved. The challengers that can do this can create sustainable businesses capable of generating attractive return on capital for their investors.

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