Executive Insights

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"Neobanks" — Who Will Win?

The U.K. Retail Banking landscape is evolving. Historically a stronghold of the "Big 5" banks (Lloyds Banking Group, RBS, Barclays, HSBC and Santander), the market has seen a number of entrants in recent times, partially driven by spin-offs such as TSB, but also by new "challenger" banks coming to market, such as Metro Bank in 2010 and more recently a wave of technology-enabled propositions.

These include U.K. start-ups Atom, Tandem, Mondo. Starling and Secco, as well as the more established Fidor Banks from Germany, which have collectively been described as "neobanks". This has attracted much attention, as many of them have recently completed successful capital raisings and some (notably Fidor, Mondo and Atom) have taken a "minimum viable product" approach which has led to partial proposition roll-outs to U.K. consumers.

In many cases, what these banks have revealed does not give full visibility of their strategies, but a number of alternative approaches (see Figure 1) can already be identified, raising the obvious question of "who is best positioned to win and why?"

Proposition approach: Savings-led vs. credit-led vs. current account-led

The different "neobanks" take three broad approaches on the key "anchor" products that drive new customer acquisition. All have their merits and are likely to resonate with particular customer segments.

A savings-led proposition is likely to appeal to yield-chasing savers: in aggregate this customer segment holds at least £50-70bn of deposits and enables banks to target an attractive profit pool beyond savings. For example, Fidor Bank has so far used this approach in the U.K. market, albeit that it has a much broader proposition in Germany, its core market — where it asks customers what they want ahead of launching a product.

Credit-led propositions, e.g. Tandem, hope to provide solutions for particular "pain points" in the consumer credit market, such as credit cards. Once customers are on board, there is a "customer journey" theme to explore, as individuals become wealthier, build their credit history, enter new life stages with different needs, and require new products such as mortgages. Data (own and third party) is a key factor underpinning these propositions.

Finally, some emerging players in this space, such as Mondo and Starling, have a current account-led proposition which focuses on user experience and app functionality, for example helping consumers manage their finances. These are valuable, but can arguably be replicated by large banks with deep pockets — in fact, there is evidence of this happening already. Of course, the "neobanks" can target a sizeable segment of consumers who have a higher propensity to move away from legacy brands, and in any case are not entirely reliant on Main Bank switching — many will aim for secondary banking relationships. Importantly, as explained

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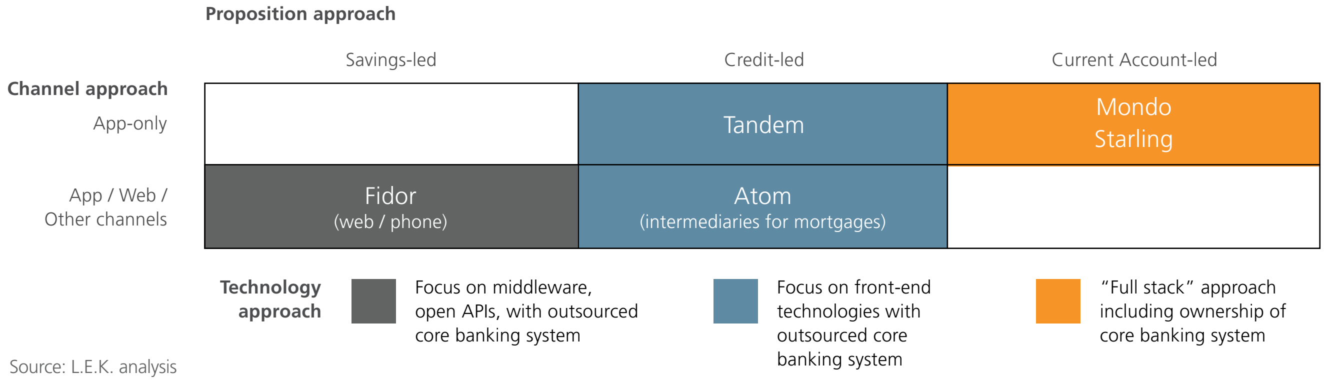
Figure 1
Strategies adopted by "Neobanks"



Source: L.E.K. analysis

later, their "full stack" ownership approach opens up possibilities to build additional services and propositions on their platform.

From our perspective the current account-led model is the most challenging of the three approaches, given low historical switching levels in the current account market. However, the whole raison d'être of "neobanks" is precisely to raise customer engagement and switching, so we should not assume that historical behaviour will necessarily be a reliable guide to the future.

In all three approaches, there is a core requirement for attractive economics on a per customer basis: this means acquiring them at an acceptable cost and managing for customer lifetime value. Similarly to other "fintech" businesses, this is easier said than done, but can be enabled by two main levers:

- "Neobanks" can be advantaged in customer acquisition through the semi-automation of KYC (Know Your Customer) and on-boarding processes, as well as the smart use of lower cost channels such as referrals, social media and engagement programmes.
- In addition, customer lifetime value can be maximized through the intelligent use of data to anticipate needs and target customers with relevant products.

Channel approach: Mobile app only vs. multi-channel

The debate here is not about the merits of having a mobile banking app — that is a must rather than a "nice-to-have". However, the jury is out on whether "app-only" banks will succeed, particularly those whose elevator pitch may be perceived as "we have a cool app".

In our view, there are two key issues to consider:

- The more important is whether app functionality and user experience is a sustainable competitive advantage, particularly against large banks investing or able to invest significant sums in technology and innovation. We would advise against having an equity story primarily based on front-end app functionality.
- The second issue is consumer engagement: clearly this is a success requirement, but is an app enough? Users of Uber and Deliveroo are happy to engage at the front-end entirely through an app, but at the back-end there is a driver with a Mercedes or a person ringing a bell to deliver a pizza — with whom it is hard not to engage. Would consumers engage end-to-end exclusively with their bank through an app? Is this desirable, or even possible? In our view, the winning propositions are those that use digital channels to understand the behaviours of their target customers, anticipate their needs and put forward bespoke propositions see "Digital, Digital, Wherefore Art Thou Digital? Why retail banks playing catch up need a clearer purpose for their initiatives" The actual fulfilment of those propositions (and broader customer support) may require customer interactions outside the app.

Technology approach: Focus on front-end vs. APIs vs "full stack"

As described above, the majority of "neobanks" have invested in a very slick front-end environment, and most also recognize the growing importance of open APIs with third parties to exchange data. For example, Fidor Bank has successfully partnered with other fintech providers using open APIs to extend the services they offer to consumers.

The approach to back-end systems varies considerably. Whilst most "neobanks" have taken the traditional step of procuring core banking systems from a third party, Mondo and Starling have opted for a 'full stack' approach which enables almost limitless functionality and integration to be built in, much of it by third parties. This opens up the possibility for these entities to effectively become the core transaction and payments platform on top of which others can build bespoke banking propositions for specific customer segments — a potentially powerful (but as yet unproven) concept.

Too soon to call?

The dotcom bubble saw the emergence of internet-only banks in the U.K. market, but ultimately these have not fundamentally disrupted traditional retail banking models. What is different this time?

We believe that there are two fundamental differences. The first is that consumer engagement with technology has grown significantly since the turn of the century: mobile apps are now used as a mainstream way for consumers to shop for goods and services, access online content and increasingly as a banking channel. The second is that data access and analytical capabilities have grown exponentially since the early noughties, enabling businesses to know a lot more about what their customers want, and to do something about it.

These two trends have enabled the development of much better propositions, which are likely to be taken up by what is now a large segment of highly digitally-engaged consumers. The bad news for "neobanks" is that the incumbents are aware of this and are investing heavily in digital capability. In order to stay ahead of the pack, new participants need to develop a successful and sustainable business model (see Figure 2) by focusing on a number of priority strategies:

- Generate positive engagement around their banking proposition — some "neobanks" have aimed to achieve this through innovative and targeted marketing efforts, for example Tandem's "co-founders" program. Given that lack of engagement is, in our opinion, the single most important barrier to switching in banking, this should be a clear priority for these new entrants.
- Make customer economics work from an early stage (i.e. effective customer acquisition and maximisation of lifetime value) and not be reliant on switching millions of customers away from large banks in order to break even – in fact, "neobanks" should be able to generate attractive returns at a much lower scale threshold compared to traditional banks.
- Focus the use of technology on customer needs anticipation.
- Use digital channels smartly, recognising that there is a lot more to this than a slick front-end app.
- Embrace open APIs as a way to add value to their underwriting processes and provide valuable services to their customers.

Old fashioned banking is conceptually simple — delivering what customers need at a fair price. Neobanks can deliver this by being more agile than large banks in their market approach and use of technology. The battle for the U.K. consumer has intensified and the winners will be able to provide outstanding customer value whilst generating high returns for their shareholders.

Figure 2
"Neobank" conceptual business model

Engagement	Acquisition	Lifetime value: Income	Lifetime value: Cost to serve
• Crowdfunding campaigns • Key marketing messages (e.g. "The Good Bank - Tandem) • "Cool challenger bank" factor	• Effective anchor products (e.g. savings, credit cards, current account) • Low cost acquistion channels • Streamlined onboarding process	• Breadth of product portfolio (own and third party) • Open APIs for additional services • Customer need identification • Cross-selling	• Slick digitised front-end • Low cost customer support channels • Peer-to-peer support

Source: L.E.K. analysis

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