Point of View

Specialisation Is the Key to Thriving as a New Entrant in the U.K. Banking Market

It seems that rarely a week passes without news of another proposed entrant into the U.K. banking market. With the major banks still scarred by the PPI and Libor scandals, and regulators driving for greater competition and with the growth of the fintech industry, potential participants are looking at the U.K. banking market and thinking "I can do better." But what does it take to succeed where others have gone before and failed?

Launching a new bank is a challenging proposition for a myriad of reasons. It's tempting to focus on just getting off the ground while leaving longer term strategic considerations to later. But making a lasting impression on the U.K. banking market means starting with the end clearly in mind. Success requires gaining a clear focus on who your customer will be, and how you want to differentiate your institution for that customer. That needs to be determined up-front as it will guide many important decisions with repercussions for years to come.

Choose Your Customer Carefully

The largest banks in the U.K. banking industry today serve broad cross sections of the community. The relentless logic of acquisition-driven growth and economies of scale has gradually diluted some of the differences that used to exist. But here's the interesting part: The trend is reversing. Regulatory action in the wake of the government bailouts has forced RBS and Lloyds Banking Group into the spinoff of Williams & Glyn and TSB. These new entities cannot thrive by just being sub-scale carbon copies of the bigger beasts they have come from. They will need to do something different. The same is true of start-ups.

To be successful, any organisation must have a compelling answer to a simple question: Why should a customer choose my bank over one of the existing alternatives? For the incumbent there are two classic answers to this problem: being cheaper (offering better rates and lower fees) or being better (offering longer hours, more convenient branches, better service, better products).

In the absence of a radical technological advantage, new entrants cannot compete head-on with incumbents on either of these dimensions. Instead new entrants must adopt a third strategy – laser focus on a defined customer segment. Going after a digital-savvy professional or a cash-reliant small business requires very different business models. Both are valid, but trying to take on the incumbent on their own turf by trying to be all things to all people is simply not going to work. By choosing a clear market segment and developing a proposition and business model to just serve that segment, new entrants can meet the needs of that segment better than the generalist players can, and through that gain a sustainable competitive advantage.

Understand Commercial Complexity

Let's face it: by any measure, banking is a complicated and risky business. Starting a bank is not the same as manufacturing and selling smoothies. Even understanding how much it is going to cost to service each customer and how much to expect to earn are by no means trivial tasks. Perhaps more so than most industries, customers are not created equally – many actually lose banks money. In the U.K. perhaps 30 percent of all customers actually cost more (in servicing and bad debt) than the bank makes. At the other end of the scale, a few customers with very large balances (borrowers or savers) can make up the lion's share of total bank profits. With differences like this, banks need to have a very good understanding of which customer segment they are targeting, and also the full range of cost and revenue drivers.

Expert help really is required to understand the relative importance of interest margin, transaction fees, interchange costs, card scheme costs and reward costs to name just a few. How much will each customer transact? How big will the balances be? How much can I charge per occurrence? All these questions require a solid and granular understanding of industry benchmarks. High level averages may be available, but remember these are only valid if you're targeting the U.K. population as a whole, and we've just illustrated why that is a bad idea.

You need to understand the financial dynamics as they relate to your target market. For that you need the advice of a partner with deep industry expertise. So do your research properly – a small investment here will help you make the right decisions early and avoid costly mistakes.

Put in Place a Solid Foundation

The banking industry is inherently fragile and also vital to the lives of its customers. If you don't balance your assets and liabilities, or if your systems go down for just a few hours, disaster beckons. Therefore, it is crucial to put in place an effective operating model.

Some banks with fintech origins claim to have more nimble systems than current industry participants and will look to this as a point of differentiation. At the other end of the scale are banks looking to differentiate in other ways – such as through focusing on a specific customer niche or via an improved servicing model. For these organisations, a good option is to obtain core banking systems under a Software as a Service (SaaS) model. Under this arrangement the start-up effectively rents space on a universal banking platform already designed to meet the needs of similar organisations in the market. This can offer many advantages; it can reduce initial capital outlays, reduce time to market and increase the robustness of the operating model.

Regulators are also likely to be happier that a new entrant is using a known and proven system rather than building afresh.

Moreover, it is inherently a more efficient model that can help to lower overall operating costs and increase competitiveness. Just think about how much time, effort and money are wasted by multiple banks all making the same regulatory-driven changes to systems at the same time. Under the SaaS model this only needs to be undertaken once by the provider of the shared platform. By sharing a modern core infrastructure, the small guys can ultimately be more efficient than their larger rivals.

It is rare for a single organisation, and particularly a new entrant, to be brilliant at managing IT while also delighting customers through warm human interactions. Both are important but require very different core competencies. It's not impossible, but be realistic: if managing the human element is where you're going to delight customers and create differentiation, hand the systems over to the experts.

Create the Right Culture

One of the issues often cited as an underlying cause for the difficulties faced by the banking industry in recent years is the banking culture. It's an emotive topic, and one we cannot do justice to here. However, what is certainly true is that it takes a long time to truly change the culture of an organisation, and this is where a new entrant has a distinct advantage over the incumbent. The culture can be set from the start exactly as it is intended. Whatever the envisioned culture, it is much easier to recruit the right people and put in place the right incentive structures in a new entity than it is to change an existing structure.

This can be a source of enduring competitive advantage. Just take a look at which market entrants have thrived and which have failed. Remember Intelligent Finance, Cahoot and Smile? As offshoots of major banks, they thought like major banks and tried to compete with fancy products and better rates without making the required investment to create an enduring, standalone operating model. Ultimately, all were just online sub-brands of high street banks. Fancy products are easily copied, at which point what is the differential? Better rates can work for a while, but to be sustainable you need to have a truly lower-cost operating model and that is just not possible while using the high-cost infrastructure of the parent organisation.

So what about First Direct or Metro Bank? First Direct has now become part of the establishment. Metro Bank is busily colonising London and the Southeast. Do they have better products, systems or prices than the competition? No they don't. What they do have is a clear view of their target customer and a distinct culture to match. In the case of First Direct, this is a remarkable achievement given its strong ties to HSBC. In the case of Metro Bank, Vernon Hill has brought a very different ethos to banking, borne partly out of experiences in fast-food retailing. In creating a bank that talks about "fans not customers" and claiming that "Dogs Rule", he has created a new entrant that looks and feels very different from the competition. Neither bank tries to be all things to all people. Instead they have built their organisations around a clear view of their target markets and do everything they can to delight that particular customer group. They won't appeal to everyone – but that is the point.

Vive la Difference

The banking industry has been through tough times in recent years for a variety of reasons. One reason the problems became systemic was because of the similarities among the major players. Monocultures are inherently vulnerable. With the banks so alike, a problem in one likely meant a problem in all. A robust banking system requires a diversity of cultures – different banks serving the disparate needs of different customer groups, each with its own culture.

Out of the problems rises the prospect for a far brighter future. With the tide now firmly turning and new entrants creating greater diversity of proposition and business model, the picture for consumers continues to improve.

About the Author

Jon Causier has been working in the financial services industry for over 17 years, both as a practitioner within a major U.K. bank and as the leader of an international consulting team providing advice to some of the world's leading financial institutions. He held a number of roles within the NatWest/RBS Group, most recently as head of strategy for transactional accounts. At Fiserv, Causier leads the ongoing development of the transactional banking proposition across personal and business segments. He earned a master's degree in social and political science from Cambridge University and an MBA with distinction from London Business School.

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