KPMG
cutting through complexity

The game changers

Challenger Banking Results
May 2015

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The Challenger Landscape

THE FUTURE FIGHTERS
LARGER CHALLENGERS

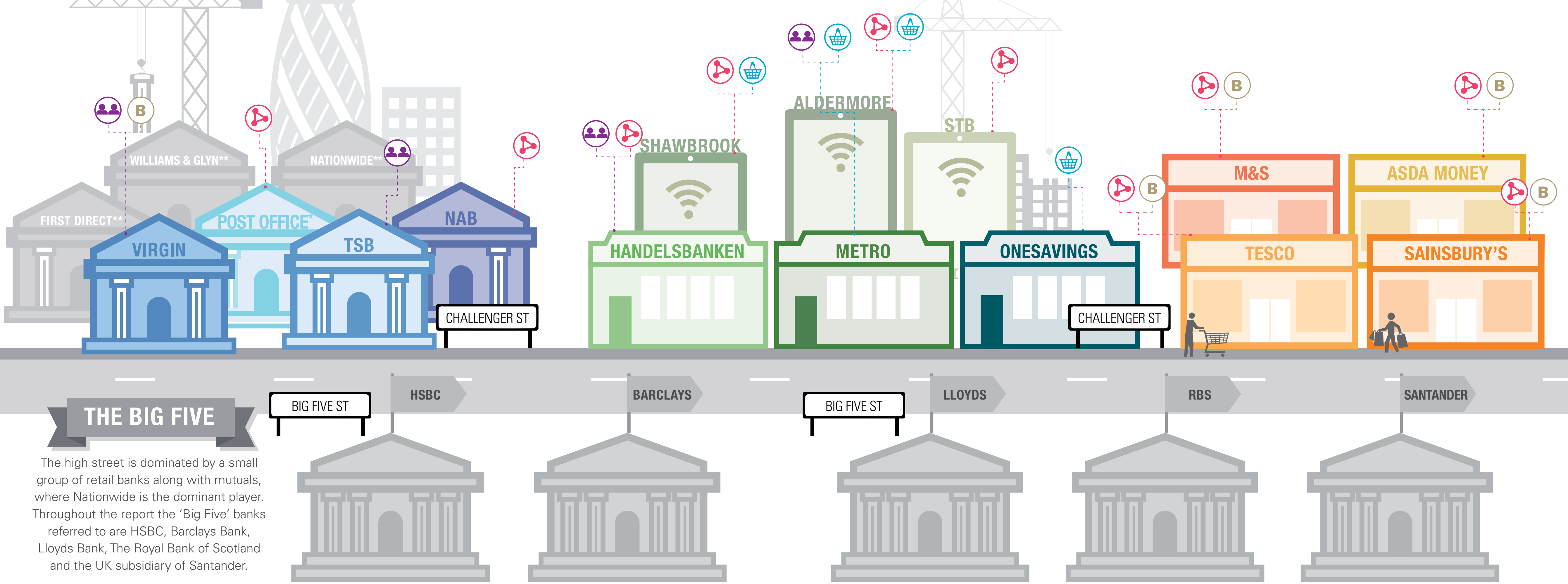
The Larger Challengers are typically longer established. Two of them are relatively new in terms of branding but have inherited relatively large portfolios of loans and advances to customers.

THE NIFTY NEWCOMERS
SMALLER CHALLENGERS

The Smaller Challengers have typically been incoprorated in the past five years and were private equity backed through their initial growth phase. Four of them are now listed banks.

THE SMART SHOPPERS
LARGE RETAILERS

The increasingly large existing retailers have entered the financial services market offering unsecured products and savings accounts. The longer established Challengers, such as Tesco and M&S, are expanding their offering with products such as current accounts and mortgages thus further challenging the big banks.



THE BIG FIVE

The high street is dominated by a small group of retail banks along with mutuals, where Nationwide is the dominant player. Throughout the report the 'Big Five' banks referred to are HSBC, Barclays Bank, Lloyds Bank, The Royal Bank of Scotland and the UK subsidiary of Santander.

DIFFERENTIATORS

BRAND
Major banks have suffered reputational damage since the financial crisis. Some Challengers are differentiating themselves by focusing on their brand and reputation.

PRODUCTS
Some Challengers offer different or niche products that are not necessarily offered by the big banks to gain custom.

CULTURE & CUSTOMER SERVICE
Some Challengers are presenting themselves as more customer focussed and embedding a fair and ethical culture in their approach to banking.

DISTRIBUTION
New retailers are focusing on a less traditional distribution model, relying more on brokers and online platforms. Large, non-banking retailers such as supermarkets are utilising their already existing outlet network to distribute and facilitate day-to-day transactions.

* Post Office financial services are provided by Bank of Ireland UK
** Nationwide, Williams & Glyn and First Direct data not included in analysis

A game changing year

The last year has been an important one for the Challenger sector. Five banks have listed on the London Stock Exchange, raising over £350m of new capital to fund growth and strengthen balance sheets. Over the same period, lending assets for these banks increased by 16% compared to a decline of 2.1% for the Big Five.

For many of the Challengers, this growth has also resulted in improvements in profitability. In the group categorised as Smaller Challengers, return on equity (RoE) reached a staggering 18.2% in 2014, which contrasts starkly with a market where single digit – or even negative – RoEs are the norm. However, this isn't the case for all Challengers. For the group categorised as Larger Challengers, RoEs were more closely aligned with the market. The picture is therefore much more complex than many commentators allude to. With many different business models between them, analysis of the Challenger bank market is a tricky task.

Some Challengers have a cost advantage
Theories of competitive advantage help to show that banks need to either develop a cost advantage or differentiate in order to compete effectively.

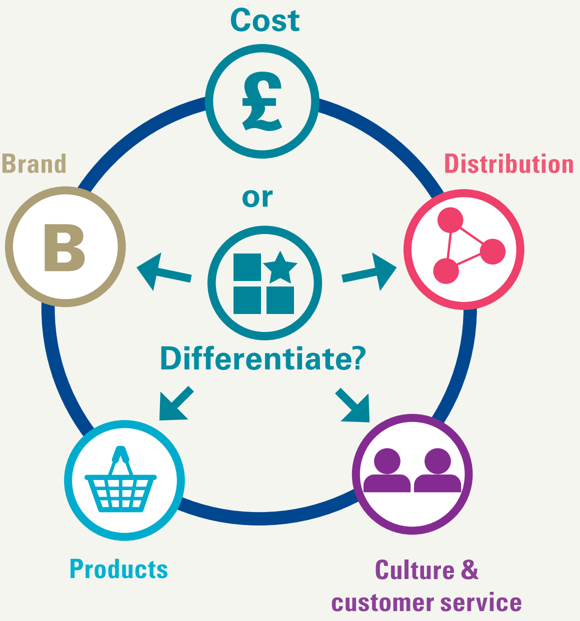
Established thinking would have us believe that cost advantage is driven by scale. In banking this is true in part, however, with scale also comes complexity. The scale benefits that should be gained by the Big Five have been partly eroded by unwieldy legacy IT systems, regulatory change, costly real estate and compliance issues. So in 2014, despite being significantly smaller, the Challengers reported only slightly higher costs, with an average cost to income (CTI) ratio of 64% (excluding National Australia Bank) compared to 63% for the Big Five. However, this crude measure oversimplifies a complex picture.

The Smaller Challengers produced a CTI ratio of just 53% in 2014, significantly better than the market, while the Larger Challengers track much more closely to the market. This can be down to a range of factors, including a number of one-off costs offset by a simpler business model and product set.

Is differentiation alone enough?
In theory, differentiation can be driven by resources (the things a bank has available to it) or capabilities (how those things are deployed).

In banking, resources are driven by the brand, distribution and product set. Capabilities are driven, above all, by culture and how this manifests itself through customer service.

In this report we examine how the Challengers measure up on each of these four attributes and question if these sufficiently differentiate them within the market. Our findings suggest that while the foundations are there, for most, the journey ahead will require continued rapid change. Digital banking is a great example – we found that the mobile functionality of the Challengers is at best equal to, but often worse than, the Big Five. For those Challengers focussing on customer service or cost as a differentiator this could be a major hurdle for the future.



Highlights

RESULTS

The **Challengers are outperforming the Big Five** in terms of growth (compound annual growth rate 8.2% between 2012 and 2014 compared to a reduction of 2.9% for the Big Five)

Despite being significantly smaller, **Challengers have on average similar cost to income ratios** to the Big Five

Challengers have on average a greater return on equity than the Big Five banks

Smaller Challengers **beat their Larger counterparts on RoE and growth**

INSIGHTS

In order to compete, the **Larger Challengers need to further differentiate themselves** from the competition

Large Retailer Challengers need to **capitalise on their brand power**

The **Big Five have lessons to learn** from the Challengers on more effective culture

The **future of Challengers** is technology

Financial Analysis

Returns across the sector continue to grow

Between 2012 and 2014 the average return on equity across the Challenger banking sector continued to grow – from a negative RoE of 4.0% in 2012 to a positive return of 3.8% in 2014. This compares to average RoEs of 0.7% and 2.8% in 2012 and 2014 respectively for the Big Five.

Of course, RoEs based on reported profits are a crude measure at best, given the complexities of accounting and the scale and frequency of so called 'non-recurring' items. However, directionally the picture is clear.

A wide range of factors have contributed to this improvement, including scale benefits, clever targeting of niche markets and benign market conditions.

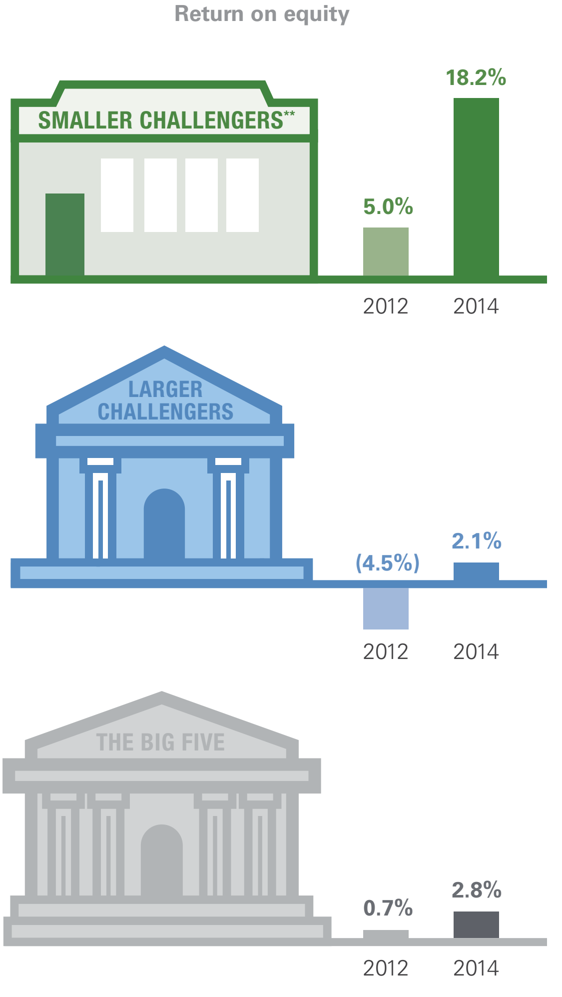
The performance of the group as a whole is only marginally better than the Big Five with their entire legacy IT and conduct costs. So, on this measure it would be easy to conclude that there is much more the Challengers should and could do to improve performance.

Larger Challengers vs. Smaller Challengers – a very different picture

Taking the analysis to a further level of detail shows that the RoE for the Smaller Challengers significantly outperform the Larger Challengers. The 2014 average RoE for the Smaller Challengers of 18.2% is better than Google (under 15% at March 2015)[1] or Facebook (under 11% at March 2015)[2]. This is a phenomenally good result, which demonstrates that despite record low interest rates and intensifying market competition, there are pockets of profitability in UK banking.

What almost all of the Smaller Challengers have in common is that they are niche players. As Andy Golding, CEO of OneSavings Bank put it, they are "dancing in the gaps" left behind by the major banks[3].

On the flip side, the Larger Challengers achieved an average RoE of only 2.1% in 2014 with a relatively wide range of results – from minus 7.2% to plus 10.4% – reflecting (at the lower end) conduct related charges and accounting adjustments.



Sources: 1. https://ycharts.com/companies/GOOG/return_on_equity. 2. https://ycharts.com/companies/FB/return_on_equity. 3. www.ft.com/cms/s/0/d777f408-aac9-11e3-83a2-00144feab7de.html

Note: *Return on equity is a weighted average and is calculated as profit after tax attributable to shareholders divided by average shareholder's funds.
**Metro Bank is not included as its 2014 annual accounts are not yet available.

Challengers are on the up

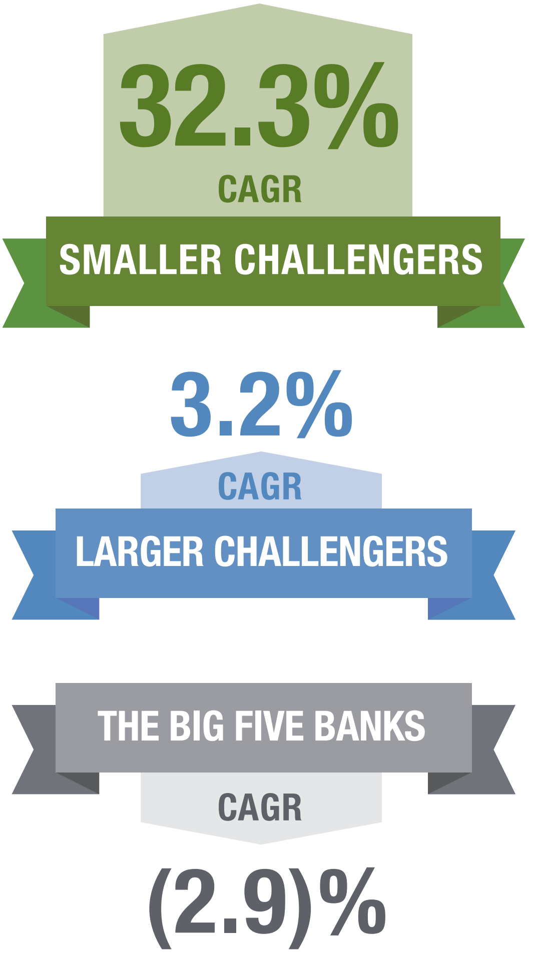
The Challenger banks have grown their loan books year-on-year, achieving a compound annual growth rate (CAGR) of 8.2% between 2012 and 2014. This compares to a CAGR of negative 2.9% for the Big Five.

Growth is rapid
The Larger Challenger banks are longer established and have a greater amount of inherited loans than the Smaller Challengers, hence their loans and advances to customers only increased by a CAGR of 3.2% between 2012 and 2014. This is higher than the negative 2.9% CAGR achieved by the Big Five. The Smaller Challengers meanwhile, have grown their loan books at a CAGR of 32.3% over the last three years.

Niche is king in the growth game
Growth trajectories are very different between the two groups. The Smaller Challengers are typically earlier in their life cycles, having been established after the financial crisis. This has enabled them to achieve significant year-on-year growth, as they have built their loan books from relatively low bases. For example, Shawbrook and Aldermore grew their loans and advances to customers at CAGRs of 82.8% and 52.7% respectively between 2012 and 2014. The Smaller Challengers have focussed their growth on niche retail lending and SME markets which they believe are underserved by the traditional lenders.

Opportunities abound
Only 23% of current account users hold any type of account or financial product with a Challenger bank[4]. With the Challengers being dwarfed in terms of sheer size by the Big Five there is arguably plenty of scope for continued growth.

Growth in loans and advances to customers



Source: 4. YouGov Reports – Challenger Banks, 2015.

So far, so good, on profitability measures

Over the past three years, the Smaller Challengers have earned higher net interest margins (NIMs) than the Larger Challengers. This is largely due to the markets they operate in and the customers they target.

The Larger Challengers mostly offer retail mortgages, while the Smaller Challengers offer a mix of SME lending, second charge mortgages, asset finance, invoice financing and unsecured lending – all of which, for the moment at least, generate higher margins.

Funding for Lending is a major driver
The Smaller Challengers have achieved an 80 basis points (bps) increase in average NIM between 2012 and 2014, primarily as a result of cheaper funding. The reduction in cost of funding is largely a result of the introduction of the Funding for Lending Scheme (FLS), which has reduced competition for savings and allowed the Challengers to re-price their deposits and diversify their deposit products.

The Larger Challengers have also benefited from the introduction of the FLS. However, this has been offset by an average reduction in asset yield of 60bps between 2012 and 2014, primarily reflecting increased competition in prime residential mortgages lending.

A big question remains for some of the market around how the unwind of FLS will impact upon their future results.

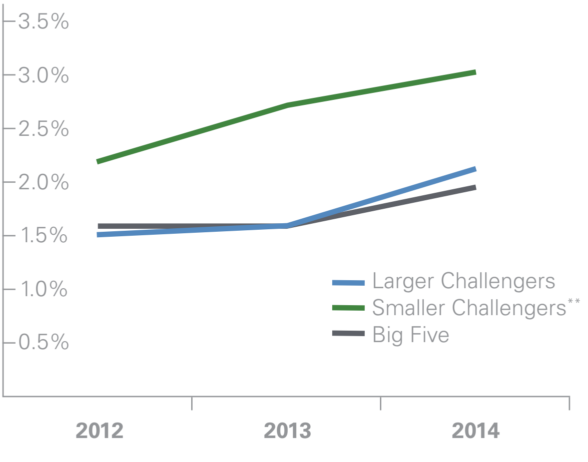
Niche wins in the cost stakes
The Smaller Challengers are, on average, achieving a lower cost-to-income ratio than the Larger Challengers, as many of the Larger Challengers have inherited a higher cost base, which has yet to be fully optimised.

The Smaller Challengers have continued to benefit from cost efficiencies and economies of scale as they grow, resulting in a reduction in the average CTI ratio from 65% in 2012 to 53% in 2014.

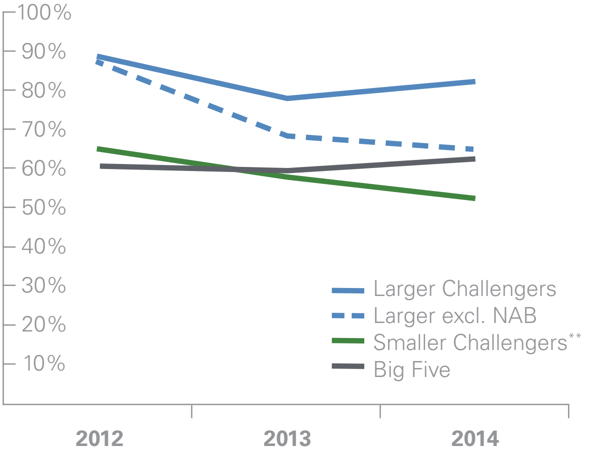
The big story is the direction of travel
In comparison to the improvement made by the Challengers, the Big Five have witnessed a year-on-year increase in their average CTI ratios, from 60% in 2012 to 63% in 2014.

If this trend were to continue, as the Challengers grow and benefit from economies of scale, it poses an interesting question for the Big Five – will too big to fail become too big to compete?

Net interest margin*,5



Cost-to-income ratio*,5**



Sources: 5. Banks' annual accounts, TSB Price Range Prospectus.
Note: * Weighted average cost to income ratio is calculated as operating expenses divided by total operating income. **Metro Bank is not included as its 2014 annual accounts are not yet available. ***Weighted average cost-to-income ratio is calculated as operating expenses divided by total operating income. Weighted average net interest margin is calculated as net interest income divided by average interest bearing assets.

Differentiators

Brand

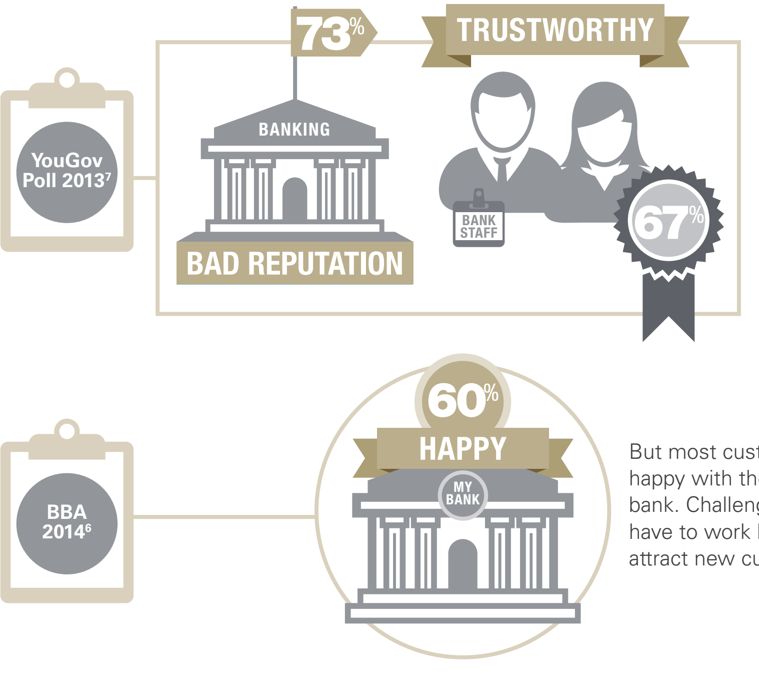
One way to succeed in a marketplace where Barclays, RBS, NatWest, Lloyds, Santander, Halifax and HSBC are the most familiar names is to differentiate through brand strength. The Challengers have the opportunity to create a brand image afresh – which may give them an advantage over the established brands.

Reputation and trust are complex animals

The financial crisis has taken its toll on the brand reputation of major banks. A poll carried out by YouGov in April 2013 for the Public Trust in Banking symposium, found that 73% of respondents believed the reputation of banking was bad. However, attitudes are not straightforward, as 67% of respondents also said they thought that staff in their own banks were trustworthy. In a later survey 60% of respondents said they were happy with their provider[6].

What you can say is that trust in the banking sector as a whole has declined. Arguably, that wariness extends to Challengers, but they have the advantage of what might be described as an absence of mistrust.

Banks of all shapes and sizes are working hard to re-establish their social purpose and the Challengers are at the front and centre of this. However, that is not the main reason why Challengers appeal to customers – it is a more basic desire for a good deal.



Customers trust bank staff but not the banks themselves – a great opportunity for Challengers?

But most customers are happy with their current bank. Challengers will have to work harder to attract new customers.

Sources: 6. YouGov poll for BBA, June 2014. 7. YouGov poll for Public Trust in Banking symposium, April 2013.

B

Consumers love freebies
The top reason given by Challenger bank customers for choosing to bank with one of the Challengers is the ability to earn loyalty points or get discounts[8]. This is a trend that is most apparent in relation to the Large Retailers.

It might be argued that consumers act irrationally in this respect – overvaluing such schemes when compared to more fundamental measures such as price and customer service. Nonetheless, this represents significant opportunities for some Challengers.

Big opportunity for retailers: brand awareness
Despite the huge geographical footprint and brand promotion of Large Retailers, only around 50% of customers are aware of the financial services they offer. This is lower than the Larger Challengers who also have a retail focus but don't have the benefit of behemoth parents. The first Retailer to really crack this conundrum stands to do well.

Reasons for choosing a Challenger bank[8]

Average brand awareness[8]

Source: 8. YouGov Reports – Challenger Banks, 2015. Survey of 463 adult current account users aged 18+ who hold an account or product with a Challenger banking brand.

Culture

The old adage of 'culture eats strategy for breakfast' is being taken to heart by many of the Challengers. Creating a distinctive culture, so the theory goes, allows a bank to differentiate on customer service, as well as attract and retain great employees, and protect and build its reputation and brand. As one Challenger CEO put it: "We want to be marmite – unless some people don't like us, we are not different enough". Carefully curating a different kind of culture could also help the Challengers avoid the conduct issues that have been so prevalent in the traditional banks over recent years.

Culture wars – who is winning?
When it comes to culture wars, the Smaller Challengers have an advantage, with the ability to create a culture purposefully from scratch. Metro Bank is a good example: it is able to align branch design, hiring practices, HR policies and leadership behaviours to the culture it wants. It has handpicked the best retail experiences of the US (outside of banking) and set out to create a completely new banking scenario, to create 'fans' rather than customers and a vastly different branch experience.

Handelsbanken is another example of a relatively new (to the UK) bank that is growing quickly and profitably on the back of a local strategy. This sees a focus on hiring local people who are passionate about supporting their local communities. It also fiercely protects this culture through careful recruitment. The dilemma these banks face is how to maintain their cultures once they reach a certain size and scale, when the COO or CEO cannot be involved in every hiring or promotion decision.

Legacy cultures are always difficult to change
The Larger Challengers with a legacy heritage have to contend with past cultures, which can be difficult (though not impossible) to change. They have perhaps less of an advantage here, although a smaller scale always makes cultural change more achievable. Virgin Money continues to leverage the broader power of their brand and the culture associated with their non-banking ventures. It now offers lounges where "local communities can come together".

From a retail perspective, TSB, Virgin Money and Metro are positioning their customer experience in a variety of ways. For example, TSB is focusing its marketing on a return to "local banking", whilst Metro focuses on "love your bank" and Virgin Money on "building a better bank". Whether these strategies work will only be evident in the longer run, but the early evidence is that they are attracting customers from the big banks.

Meaningful innovations in customer experience or gimmicks?

Metro	Virgin Money	TSB	Metro
Free dog biscuits	Lounges	Truth and banking	Debit cards printed in store

Getting the culture right is critical

The pure-play digital Challengers are perhaps closer in culture to a traditional start-up. It can be incredibly powerful to create a culture where people are obsessed about customer behaviour online, customer data, customer experience and 'failing fast' – trying new ideas, testing them and moving on (like many successful large tech businesses that have grown very rapidly). History suggests that not all will survive and the winner is often the one that scales most rapidly. Getting the culture right is therefore critical to these banks but in a different way to the physical retailers.

"Much like the traditional banks, culture must remain a boardroom issue."

Board diversity lags behind the Big Five

Publically available measures of culture are harder to come by, but if the tone is set at the top then how different are the Boards? When it comes to gender diversity at least, there is not a great difference. In fact, the Challengers lag behind the Big Five. With the weight of research behind the benefits of a diverse Board, are the Challengers missing a trick here?

Big Five banks – 26% female[9]

Challenger banks have 26 female board members – 19% of the total. There is one challenger with an all male board[9]

Culture has, and will, continue to play a key role in success

The Challengers are clearly doing something right – given the amount of business they are taking from the traditional banks. Culture has, and will, continue to play a key role in this, albeit differently for the various types of Challenger. Much like the traditional banks, culture must remain a boardroom issue.

Source: 9. 2014 Annual reports.

Product

There has been little product innovation over the past few decades in the banking market
A harsh critic might say that retail banking products have seen little real innovation since the offset mortgage was introduced 18 years ago. Instead, there has been a proliferation of marginal tweaks in product features, dreamt up by marketing teams in an attempt to differentiate in a crowded market. The end result is that consumers are left confused. How can the typical first-time buyer work through the 50+ mortgages offered by each of the big banks?

In the savings market, it can be even more difficult to work through the range of 'introductory offers' to understand real longer-term economics. Consumers default to best-buy tables for advice and find that they need to switch regularly in order to avoid losing out. Such a model – that relies on customer apathy to deliver financial performance – doesn't sit well with delivering great customer service.

The Challenger approach to products

1. **Simplicity:** the number of products in each category is limited.

2. **Transparency:** there are few Challengers offering teaser rates for example.

3. **Niche:** the Smaller Challengers target a very specific set of needs.

The big banks have started to adopt similar approaches. For example, RBS has made a big play of removing introductory credit card rates. So, for the Challengers, other than niche players, this could quickly erode any point of difference from the Big Five.

Keep it simple

Increase transparency and long-term value

If small, stay niche

Distribution

Views on the importance of a branch network vary
There are many varied views on the strategic importance of a branch network for banking services. From a retail and business banking perspective, a branch network is regularly considered as an important channel for customers to have access to, particularly in relation to the provision of the primary current account. Indeed, 57% of banking customers themselves believe access to a branch is important, even if they choose not to use branches.[10]

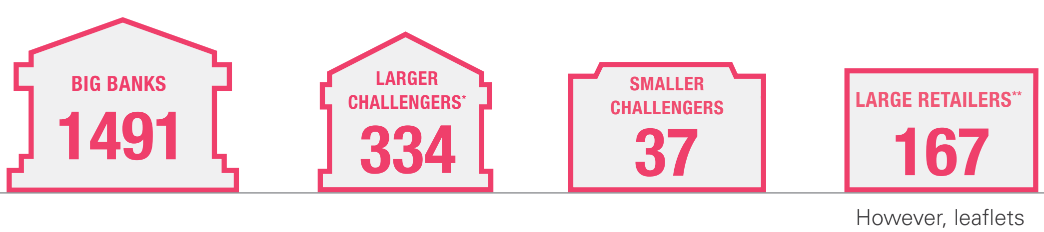
The Challengers have adopted a wide range of different distribution channels and these vary according to the nature of the product offering. If we consider the current Challengers for personal current accounts (PCAs) and related products, there is evidence that a branch network is still considered a key channel. TSB has the largest network with 631 branches, although it has plans for some rationalisation. Virgin Money has a network of stores inherited on its acquisition of Northern Rock, which are primarily used for deposit gathering, and Metro Bank continues to build its network of stores. It can even be argued that the Large Retailers targeting PCAs (Tesco and M&S) also have the benefit of a virtual branch network from their retail stores.

The absence of a network has not hindered the Smaller Challengers
There is clear evidence that for secondary savings the absence of a branch network is not a hindrance to customers. This is due to the growing willingness/preference to use online/mobile and, to a lesser extent, post and telephone.

For lending products, the use of intermediaries for the distribution of mortgages, asset finance and similar products is well established by both the Challengers and the high street banks.

There are new start-up banks who are planning to offer a purely digital banking experience using online and mobile platforms. Our analysis suggests that the current Challengers do not offer a better mobile banking experience than the big high street banks. Functionality is generally the same, if not worse, than that offered by the bigger lenders. The Challengers have some work to do if they are to achieve their goal of offering customers the best experience available.

Average number of branches



However, leaflets are in most branches and therefore have a much larger distribution

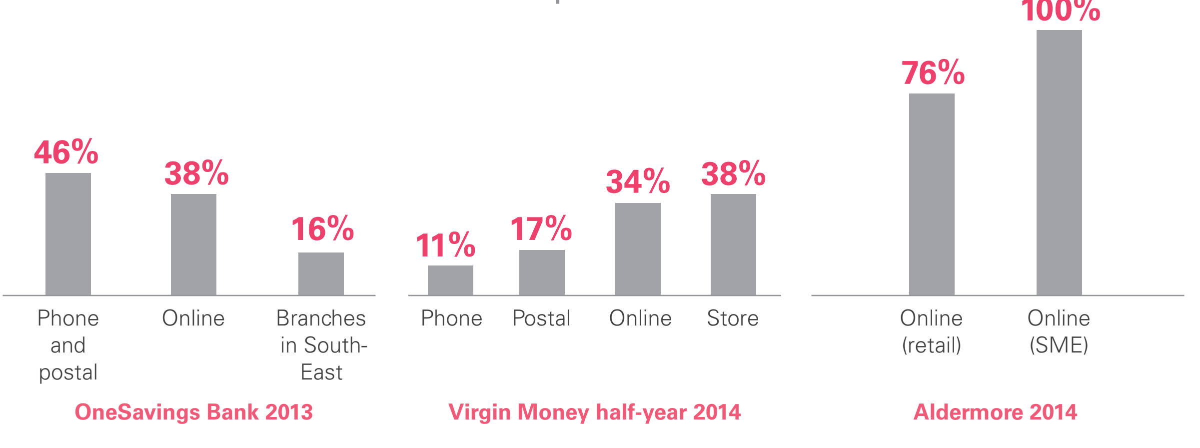
Source: 10. YouGov poll for British Bankers' Association, 2014.
Note: * Excluding Post Office
** Financial services branches located in-store only. Excludes all other stores. Tesco and M&S only.

A key consideration to be made is that establishing a branch network is expensive and results in a significant element of fixed cost. At first glance, it might appear that this would give those without a branch network a cost advantage. However, in reality, those without a branch network incur commission costs payable to the intermediaries/brokers. Thus, in terms of total spend, the cost advantage is reduced. A side benefit of the intermediary channel is that it provides a more flexible and scalable element to distribution.

There are no easy answers to this particular inhibitor, although it is possible that Challengers could share physical infrastructure with other operators – the Post Office is a natural contender for this role.

"57% of banking customers themselves believe access to a branch is important, even if they choose not to use branches.[10]"

New deposit volumes[11]



Source: 11. Annual reports

Is regulation holding back growth for the Challengers?

A potential inhibitor to Challenger growth is a regulatory regime that in some respects tends to favour incumbent banks over the emerging Challengers. This is particularly true with regard to the regulatory capital regime. In theory the rules apply equally to all banks, in praxis however, they don't. Challengers have to hold more capital in comparison to the big banks.

The reason for this is perceived risk. By definition, a Challenger is new to the market and consequently lacks the trading record and evidential data that an incumbent can offer the regulator. The direct consequence of this is that, under the current tests, the emerging institutions are seen as riskier propositions than the Big Five. This results in a higher risk rating and a larger capital requirement.

In practice, this can emerge because the more established banks have 'advanced' model status and therefore enjoy risk weightings lower than those banks with a 'standard' model. The sums involved are not small. It can result in a new bank having to hold several times the capital of an established bank against a loan to the same counterpart.

"If Challengers are to thrive in the mass market, something must be done to recalibrate the regulatory regime."

Recalibration is required

If Challengers are to thrive in the mass market, something must be done to recalibrate the regulatory regime. To attain the 'advanced' model rather than 'standard' designation requires access to data that few Challengers have, as well as a huge commitment of time and money.

That doesn't mean they are riskier propositions. In fact, given their focus and simpler business models they may well be less risky. However, when the regulator applies the same tests across the board the new generation of institutions are placed at a disadvantage.

One possible answer is to apply the same regulatory standards to all banks but to allow Challengers to provide an average of the weightings that are applied to the major institutions. Some progress has already been made: the British Bankers' Association (BBA) has urged the regulator to adopt a more flexible approach to risk[12], effectively asking it to think small in its approach to rating Challengers. The problem is recognised at the Basel level. In December 2014 the Basel Committee issued two papers on a revised standardised approach[13] and internal ratings-based floors[14], which should introduce more consistency in the capital requirements between banks (although significant differences may remain).

In addition, the global systemically important financial institutions have some additional capital requirements, which in part, bridges the gap.

Sources: 12. BBA - Promoting Competition in the UK Banking Industry report, 2014. 13. www.bis.org/bcbs/publ/d307.pdf. 14. www.bis.org/bcbs/publ/d306.pdf.

Can the rise of Challenger banks continue?

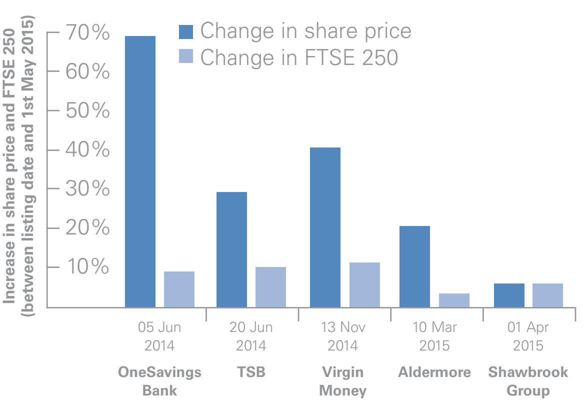
Some clues from the capital markets
The last year has been busy with five of the Challengers listing on the London Stock Exchange. When OneSavings Bank (OSB) listed on 5 June 2014, it was the first new bank to list on the main market in London in over a decade. OSB was swiftly followed by the listing of TSB and then, in autumn 2014, Virgin Money. The first quarter of 2015 has seen both Aldermore and Shawbrook list, as they rushed to beat the potential stock market volatility that might have arisen as a result of the UK General Election.

Timing is everything
What has caused this flurry of activity? Two things: the first one is timing. Many of those listing had reached a key stage in their life cycle, having demonstrated the sustainability of their respective business models and an ability to grow profitability. This provided the right timing for their financial backers to seek a partial exit and raise external capital to fund further growth. The second cause, which reflects TSB's listing, was the EU rules around the State Aid provided by the UK Government, which required Lloyds Banking Group to sell off part of its branch network.

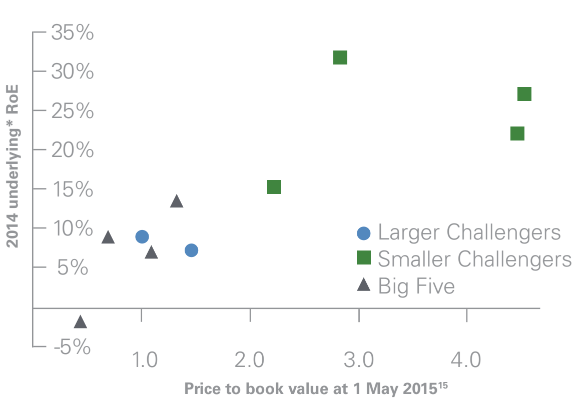
A great start to listed life
At listing, many Challengers achieved book multiples that the established banks can only dream of. These valuations were achieved through the expectations of growth, the returns being generated (or expected to be generated) and without the significant legacy issues and their associated costs. Since listing, the shares of the newly listed banks have performed largely above the market and, in particular, the established high street banks. They also continue to mostly trade at book multiples above those of the high street banks. This reflects the expectation that their business models and market segments will enable them to deliver higher RoE in the medium term compared to the big banks. Whether these returns will be delivered is a question that only time will tell.

More to come
Further listings over the next couple of years should be expected as Metro Bank readies itself for a potential listing in 2016, and there is the expected listing of Williams and Glyn, the new bank to be formed out of RBS as part of its state aid actions. National Australia Bank has announced its plans to divest its UK operations, most likely by listing. Santander's UK operations are also frequently rumoured to float a minority stake. In the future there may also be the listing of some of the newer digital-only banks, should they be successful.

The Challenger banks' share prices have outperformed the market



Challenger banks are achieving higher returns resulting in higher price to book values**



Source: 15. www.londonstockexchange.com.
Note: *TSB did not disclose an underlying RoE and so the statutory RoE per our calculations has been used. ** Only UK listed banks included

The real 'challenge' is mindset

The term 'Challenger bank' is widely used and often misunderstood. The vast majority of Challengers are not 'challenging' the Big Five banks at all. Instead, most focus on underserved markets, products or channels. As the Prudential Regulation Authority (PRA) put it in March 2015, they are "not yet making big inroads into the market share of the large, long established banks"[16]. Indeed, taking the largest five Challengers combined, their total loans are just 5% of the size of the loan books of the Big Five. However, these so-called Challengers are providing two important economic functions. Firstly, they are in themselves picking up the white space left behind post-financial crisis. But perhaps more importantly, they are starting to drive incremental innovation in the wider market.

You might say the real challenge is to the 'mindset' of banking. There have been innovations in customer service: Metro Bank's 34 branches are open 362 days a year and on 4 May 2015 RBS broke a 144-year-old tradition and opened 34 of its branches on a bank holiday. Coincidence? Possibly, but clearly the big banks are starting to spot both the threat and the opportunity to learn from the Challengers.

The next wave is all about technology
In the last two years, the PRA has granted 11 new banking licenses. Many of these are overseas entrants, with a greater focus on treasury or capital market operations. However, amongst this new group – and included in the pipeline of future launches – are the next wave of challenger banks, amongst them OakNorth, Atom, Starling and CivilisedBank. There's a good chance that these banks will bring with them the next wave of innovation – banks built for the digital age with mobile apps that integrate with social media and have features like predictive balances.

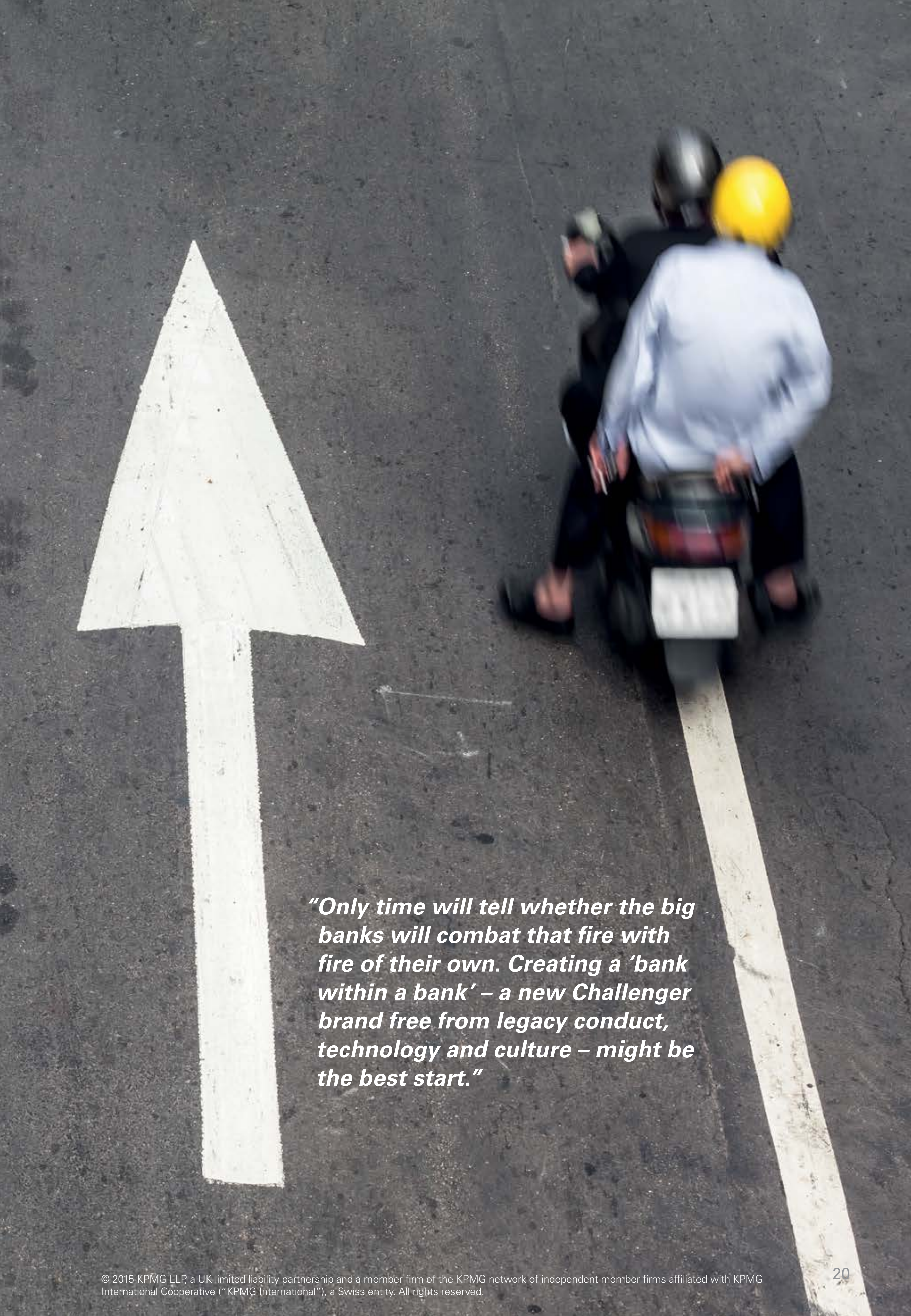
Much has been made of what might happen if one of the big tech companies – Google or Alibaba – turned its hand to banking. But the banks have arguably more meaningful customer data than these firms. And in the long run, who will customers want to trust with their precious data?

So, could the next wave of banks actually take on the tech giants? Could the data on your credit card improve the way you shop? Could your bank offer you a more meaningful web search facility having learned your likes and dislikes from your spending patterns? Perhaps a little far-fetched for now, but as banks – like those mentioned – become more tech savvy, the lines are starting to blur.

In the short term, culture remains key
The Competition and Markets Authority review into banking is currently in mid flight and may also have a significant impact on the fortunes of the Challenger banks and their willingness to push further into the SME and current accounts markets.

For the next few years at least, the Challengers should be expected to continue to outperform the market in terms of pure financial results. The Smaller Challengers may have to start making trade-offs – returns of 18% will be difficult to maintain at 30% plus rates of growth. One or the other may have to give. For the Larger Challengers and the Large Retailers there is plenty to go for if they accelerate their differentiation journey. But for all Challengers, the main point of difference is their culture. Being largely free of the legacy problems of the past contributes to a sense of social purpose that puts fire in the bellies of their executives and frontline staff alike. Only time will tell whether the big banks will combat that fire with fire of their own. Creating a 'bank within a bank' – a new Challenger brand free from legacy conduct, technology and culture – might be the best start.

Source: 16. www.bankofengland.co.uk/publications/Documents/speeches/2015/speech807.pdf.



“Only time will tell whether the big banks will combat that fire with fire of their own. Creating a ‘bank within a bank’ – a new Challenger brand free from legacy conduct, technology and culture – might be the best start.”

Basis of preparation

This report makes reference to the 2014 results of the UK headquartered banks grouped as follows:

- The Big Five banks: Barclays, HSBC, Lloyds Bank, Royal Bank of Scotland and Santander.
- Larger Challengers: Bank of Ireland UK (Post Office), National Australia Bank, TSB and Virgin Money.
- Smaller Challengers: Aldermore Group, Handelsbanken, Metro Bank, OneSavings Bank, Shawbrook Group and Secure Trust Bank.
- Large Retailers: Asda Money, M&S Bank, Tesco Bank and Sainsbury's Bank.

Information has been obtained from published 2014 year-end reports (including results presentations and accompanying analyst packs) and company websites. Where total numbers are presented, it is the total of the sub-division of banks as described above, excluding Metro Bank who had not released their full 2014 results at the date of drafting this report.

We have taken the following approach to calculate each of the measures used in this report:

- Return on equity – profit after tax attributable to the shareholders, divided by the average of opening and closing equity (excluding non-controlling interests for the Big Five banks). RoE for the Smaller Challengers does not include Handelsbanken, as this is a segment of the Group and therefore does not present capital.
- Net interest margin – the net interest margin 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. Net interest margin includes the impact of income recognised on an effective interest rate basis from portfolio acquisitions.
- Cost-to-income ratio – the cost-to-income ratio for each sub-division of Challengers is calculated as total operating expenses divided by total operating income.

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

Contact us

Bill Michael
EMA region Head of Financial Services
bill.michael@kpmg.co.uk

Richard McCarthy
Head of UK Banking
richard.mccarthy@kpmg.co.uk

Warren Mead
Head of Challenger Banking
warren.mead@kpmg.co.uk

Robert J Hibbert
Director
robert.hibbert@kpmg.co.uk

www.kpmg.co.uk

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