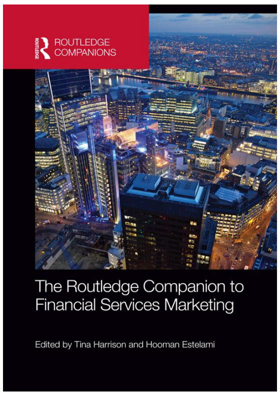

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'Challenger banks': Are they for real?

The impact of new entrants on financial services competition

Steve Worthington

Introduction

This chapter will examine the possibilities for new entrants into retail banking in the United Kingdom, such as those representing 'value brands' (for example, Virgin Money), those whose origins lie in the traditional retail sector (for example, Tesco Bank), and new entrants with entrepreneurial backgrounds (for example, Metro Bank). The chapter will discuss what the possibilities are for these new entrants, from whatever their origins, to both enter and prosper in the financial services market, that is, whether they can offer a 'real' competitive threat to the more 'established' players who have traditionally dominated the market.

Chapter 1 discusses the impact of regulation on competition in commercial and investment banking. Deregulation facilitated the formation of 'conglomerate' financial institutions, where a broad range of services and products were made available to clients, through different arms of the same bank. Following the financial crisis, further legislative changes have been put in place to reverse some of these impacts of deregulation in an attempt to restore confidence in the financial services institutions, in part by changing the structures within those institutions and in part by restricting their marketing practices. Banks, for example, are being encouraged to disaggregate their various activities and construct walls between their various divisions, so that investors' and depositors' funds are not used irresponsibly.

In this context, there has been a growing pressure for retail banking activities to be made separate from investment banking activities by the so-called 'ring fencing' of the two activities from each other. In a speech in February 2013, the Chancellor of the Exchequer in the United Kingdom gave a speech on the future of banking in which he suggested that the proposed 'ring fence' should be 'electrified' with draconian sanctions if retail banking was not protected from riskier investment banking operations. The Chancellor said 'My message to the banks is clear: if a bank flouts the rules, the regulator and the Treasury will have the power to break it up altogether – full separation, not just a ring fence' (Financial Times 2013). He underlined his determination to open up the United Kingdom's retail banking sector beyond its current domination by the large, well-established banks by facilitating the entry of 'challenger banks' to create a more competitive retail banking system, that would be more focussed on customers.

This situation where the market for banking services is dominated by a relatively few large 'players' is to be found in a number of countries; despite regulators and consumer groups calling for more competition, the challenges for new entrants are substantial. This chapter discusses those challenges beginning with the challenge of encouraging customers to move one of their key relationships (the personal current/cheque account) from one provider to another; the so-called 'switching' process. It then goes on to consider where new entrants might come from, to detail which 'challenger banks' have emerged so far in the United Kingdom and what their prospects might be.

Background to the situation

In the context of the United Kingdom (UK), the Office of Fair Trading (OFT) released a review of the personal current account (PCA) market in January 2013 (Office of Fair Trading 2013b). The PCA is equivalent to a check or transaction account in many other countries; it is a keystone product in the retail banking sector and often the starting point for the establishment and subsequent development of a relationship between the financial services provider and the customer (see Chapter 9 by Yu and Harrison). In 2013 the UK had 46 million PCA holders. However, according to a study by the Payments Council, the industry body in charge of managing the account switching system, less than three percent of these account holders switched their PCA provider in 2012, thus limiting the competitive impact of new entrants into this market.

The OFT review concluded that in the UK market, further significant changes were still required to tackle longstanding competition concerns and a lack of focus on customers' needs. The OFT found that since it last looked at PCAs in 2008, the major banks had increased their share of the market, that entry by new competitors remained infrequent and that consumers still only rarely switched their PCA to an alternative provider. The conclusion was that overall a combination of a lack of competition, low levels of innovation, ongoing customer apathy/inertia in the face of unclear costs and a lack of diversity in the choices of PCAs available meant that this market was not working well for consumers or indeed the wider economy.

The OFT in January 2013 made new recommendations to make PCA costs more transparent, the switching process more reliable and to improve the way in which managed overdrafts are provided. It called upon all providers to make rapid progress in implementing these recommendations, as well as being more proactive in ensuring that their products and services are better aligned with the needs of their customers. The OFT Chief Executive commented:

> Personal current accounts are critical to the efficient functioning of the UK economy. Despite some improvements, this market is still not serving consumers as well as it should. Customers still find it difficult to assess which account offers the best deal and lack confidence that they can switch accounts easily. This prevents them from driving effective competition between providers. Major changes are taking place in the personal current account market. For these changes to improve the effectiveness of competition in this market, banks and building societies need to act to improve the quality and value for money they provide their customers. The retail banking sector needs to become more competitive and customer-focussed to ensure that further action by the competition authorities is not required.
>
> *Office of Fair Trading 2013a*

Since September 2013 banks in the UK have been required to reduce the amount of time it takes to switch PCAs from one month to just seven days, all at no cost to the customer.

The issue of switching between providers is a vital one for new entrants, as according to the OFT (Office of Fair Trading 2009), the PCA market is the cornerstone of the UK's retail finance system and an essential service for 90 percent of the adult population. Thus, new entrants cannot rely on an 'unbanked' target market from which to gain customers. They must instead hope to win new customers by luring them away from their existing providers; hence customers' perceptions of the difficulty of switching providers will impact strongly on their willingness to switch to a new entrant.

Research conducted by the OFT (Office of Fair Trading 2013b) showed that perceptions of switching among consumers who have never switched PCAs before had not changed significantly since 2008, when only 26 percent had considered switching; by 2012 the percentage who had considered switching had actually reduced to 25 percent. Similarly, for those who have never switched, there has also been no real change in the level of confidence in the switching process running smoothly; in 2008, 52 percent were 'very' or 'fairly confident' about the process, but by 2012 this percentage had also fallen, to 50 percent.

This could be partially explained by changes in perceptions requiring time to occur, particularly if they are not based on the individual's own experience. However, even when individuals have had experience of switching their PCAs between providers, the perceptions of the switching process did not change significantly between 2008 and 2012: in 2008, 75 percent of those who had switched their PCA in the previous 12 months said that it was a relatively 'easy' process, but by 2012 this figure had only grown to 81 percent. Also, in terms of referrals/advocacy, there has been no real change in the likelihood of those who have already switched recommending others who have not switched to change their PCA provider. Thus the overall message arising from the OFT's research, is that switching levels remain low and are either constant or displaying a very gradual increase over time. The findings also suggest that although actual switching of PCAs from one provider to another has gradually increased, it still remains low in terms of the overall proportion of account holders.

The new entrants

How significant are the effects of the global financial crisis on the future structure of the banking sector? Clearly, the ramifications of the financial crisis have led to major changes in the capital, liquidity and accounting regimes for banks. But might the crisis also open up the sector to new competitors on a scale not seen before? Is the distrust of mainstream banks now so deep that ambitious companies in other sectors have an unparalleled opportunity to become major providers of banking services? Chapter 30 discusses the challenges ahead in re-building trust for traditional banks. Many of the potential new entrants to banking are however already well-placed in terms of established consumer trust.

Opportunities for 'non-banks' to enter the market have been discussed many times before. It has been said that 'Banking is essential to a modern economy. Banks are not. If some other entity performs the functions of banking faster, smarter or cheaper, it will replace banks' (Furash 1993: 20). Commentators forecasted that companies from outside banking would use their stronger grasp of information technology and customer service to shake-up financial services, taking lucrative business away from cautious and insular banks (see Worthington and Welch 2011).

In many markets, retailers have been perceived as the biggest threat. Their strong brands, marketing know-how, existing retail networks and store and loyalty cards offered a potential entry platform. In the UK, leading retailers took up the challenge and have been offering financial services for many years. For example, Marks & Spencer (M&S), a leading clothing, food and household goods retailer, entered the market as far back as the late 1980s and Tesco and Sainsbury's, then the two largest UK supermarket chains, launched banking services in the mid-1990s. In the US, Walmart has shown interest in entering the financial services market and made a bid in 2007 to acquire a banking licence; a bid that was subsequently abandoned under fierce opposition from some American lawmakers and community banks that were wary of Walmart's power as a retailer. This has not stopped Walmart from entering the market for financial services and it now has MoneyCenters in-store and offers both credit cards and a checking and debit card service called Bluebird, in partnership with American Express. Bluebird is directly aimed at Walmart customers (140 million visit Walmart every week) who are disillusioned with or excluded from traditional banking services. In China banking regulators are also inviting retailers to apply for banking licenses and their desire to enter this market is understandable as there are large margins to be made in Chinese banking.

Disruptive value brands, such as Virgin, that operate across structurally diverse consumer sectors (air travel, music retailing and mobile telephony) have also identified opportunities in financial services. Virgin Money launched in 1995 with an index tracking unit trust (mutual fund) and has since considerably expanded its range of services. However, prior to the crisis, the 'non-banks' concentrated on a select range of financial services and often operated through partnerships with existing banks. For example, the UK retailers concentrated principally on credit cards and other forms of consumer credit, simple savings accounts and insurance policies that could be sold directly. Tesco and Sainsbury's operated through joint ventures with Royal Bank of Scotland (RBS) and Halifax Bank of Scotland (HBOS) respectively, while M&S, after initially operating on its own, moved into a partnership agreement with the Hong Kong and Shanghai Banking Corporation (HSBC).

The crisis may have extended the opportunities for 'non-banks'. Tesco and Virgin Money in particular aspire to move from being niche players in financial services to full-service providers of retail banking. Both have sought to expand their offerings and the introduction of current accounts (PCAs) and mortgages are planned or in progress. Tesco bought out RBS's stake in its financial services joint venture in 2008 and re-branded Tesco Personal Finance as Tesco Bank. Virgin Money purchased a small regional UK bank (Church House Trust) in 2010 to expedite its acquisition of a banking licence and provide a platform for launching a retail banking business. In early 2012 Virgin bought, from the UK Government, the viable assets of the ailing Northern Rock bank, taking over the healthy loan and depositor base of Northern Rock and converted its existing 75 bank branches into Virgin Money outlets. Since taking over in 2012, Virgin has added 1.7 million new saving and mortgage accounts to its business and it is preparing to enter the PCA market, following Tesco and M&S.

Furthermore, these 'challenger banks' are ambitious in their visions for retail banking. Virgin Money talks of an ambition 'to offer a new kind of bank in the UK – one where everyone benefits'. Tesco says it will focus on 'being simple, straightforward and rewarding loyalty'. Moreover, Tesco and Virgin are not alone. In 2010 it was announced that another new entrant, Metro Bank had received a banking licence from the Financial Services Authority. The activities of each of these three new entrants are now analysed below.

Virgin Money

Virgin moved into financial services in the mid-1990s and originally operated as a niche player in personal financial services, with many of the services actually supplied by third parties but carrying the well-known Virgin brand. Virgin Money was initially founded as Virgin Direct in 1995 as a joint venture between a member of the Virgin group of companies and the insurance group Norwich Union, with the aim of offering equity savings products directly to the UK retail consumer market. It was one of the pioneers of index-tracking funds which carried low fees compared with actively managed funds, and it attracted £42 million invested funds alone in its first month of operation. In 1997, Virgin launched the One Account in a joint venture between

Virgin Direct Personal Financial Services and the Royal Bank of Scotland. The One Account was the UK's first current account mortgage direct to the retail market. However, in 2001, RBS bought out Virgin Direct Personal Financial Service Limited's stake in the joint venture and the management team transferred to RBS.

In 2002, Virgin Direct subsequently re-branded as Virgin Money and increased its product offering, adding a credit card offered in partnership with Bank of America and additional savings, personal loans and insurance products. In 2003, Virgin Money welcomed its millionth customer and launched the Virgin Credit Card in Australia, which was followed in 2006 by the launch of a Virgin Money Credit Card in South Africa. In April 2004, Virgin Group Investments Limited acquired full ownership of Virgin Money with Sir Richard Branson investing £90 million to buy out the existing shareholders. In January 2010, Virgin Money announced a recommended offer for Church House Trust, a small regional bank offering deposits and mortgages. The acquisition of Church House Trust gave Virgin Money a banking licence in the UK, which allowed it to offer its own banking products without the need to partner with established financial institutions.

In January 2012, Virgin Money acquired Northern Rock, the Newcastle-based ex-Building Society which had been nationalised by the British Government following a run on the funds as a consequence of the credit crisis. The earlier purchase of Church House Trust in 2010 had been expected to trigger Virgin's launch into mortgages and current accounts. However, this was repeatedly delayed as Virgin struggled to find a business model that would allow it to compete with the biggest UK banks. Virgin acknowledges that without the purchase of Northern Rock, it would have been difficult for Virgin Money to build a strong foothold in the UK market. Northern Rock had 75 branches and these were rebranded as Virgin Money stores in 2012.

Virgin Money aimed to offer PCAs with 'free banking' (i.e. no monthly or annual fees), however Richard Branson cautioned that free banking should have quotation marks around it, as customers would pay by accepting a small upfront fee, rather than the 'hidden charges' levied by the major banks. Following the acquisition of Northern Rock, Virgin Money had 4 million customers and 2,100 employees and aspirations to grow to 8 million customers and 200 branches. As a step in that direction, the first new Virgin Money Store opened in July 2012, which gave customers their first taste of the Virgin Money branch of the future.

As of 2014 Virgin Money was offering a range of financial services encompassing payment cards (credit, prepaid and travel cards), savings and investment products, general insurance products (motor, home, travel and pets), pensions, financial planning and mortgages. Work was continuing on developing a range of Virgin Money PCAs. In terms of product strategy, Virgin Money claims that it aims to bring simplicity to the UK banking market, which has traditionally been a complex sector, and that Virgin Money's focus will be on a strong retail deposit base with an approach to banking that is founded on developing a sustainable, savings based business.

Tesco Bank

Tesco, like Virgin, has been providing financial services for nearly two decades. The supermarket group began offering financial services in 1996 when it launched the Tesco Clubcard Plus, an in-house debit card, which paid interest on the funds deposited in it and rewarded its users with Clubcard loyalty points. In February 1997, Tesco announced the creation of Tesco Personal Finance (TPF) as a joint venture with the Royal Bank of Scotland (RBS). Tesco PLC and the Royal Bank of Scotland Group PLC held an equal number of shares in the holding company, Tesco Personal Finance Group Ltd. However, one of the shares held by Tesco was a non-voting share and, as a consequence, RBS was the ultimate holding company. In December 2008, Tesco completed its acquisition of RBS's stake in TPF for approximately £950 million, with TPF becoming a wholly-owned subsidiary of Tesco PLC and in October 2009, TPF was re-branded as Tesco Bank.

At the time of the acquisition of the RBS stake in TPF the UK financial services profit pool was estimated to be worth at least £20 billion per annum. The Tesco Personal Finance product offering at that time had material market positions in two of the core categories of financial services products: credit cards (6.9 percent of the market) and car insurance (4.3 percent of the market). Less meaningful market positions were held in home insurance (2.0 percent) and savings (0.8 percent), hence it was claimed that there was considerable opportunity to exploit Tesco's innovative capabilities and customer service skills, to both build share in existing categories and to enter new product segments successfully.

By 2013 Tesco Bank had become the UK's largest supermarket bank with 6.5 million customer accounts across a range of financial products and services. Its principal activities are credit cards, savings, personal loans, mortgages and general insurance, including car, home, pet and travel. Tesco Bank also operates a network of automated teller machines (ATMs) and customers can purchase products in-store, online or by telephone. In mid-2012 Tesco Bank also launched a range of mortgages, both at fixed rates and a base rate tracker. By 2013 it had over 3000 employees and according to the Tesco Annual Report 2012–13, for that financial year Tesco Bank generated £1.02 billion of revenue and a trading profit of £191 million (4 percent of the Tesco Group total), with a trading margin of 18.7 percent.

The 2012–13 Tesco Annual Report also describes Tesco Bank as having been in a period of transition since its creation in 2008. It now has a completely new infrastructure and is poised to move towards offering a full-service retail bank experience to Tesco's customers. As of 2014, Tesco Bank has 7 million customer accounts and is preparing to launch its first current account product (PCA) this year.

Tesco Bank also welcomed the initiatives being taken in the UK to make it easier for customers to switch their PCA between providers. Tesco Bank's ambition is to be Tesco customers' core provider of banking services. With regards to PCAs, Tesco intends to be its customers' main banking relationship and wants its customers to say 'I bank with Tesco'.

Metro Bank

Metro Bank was the UK's first new 'high street' bank in over 100 years when it was launched in July 2010, having been granted a banking licence by the Financial Services Authority (FSA). It promised to revolutionise the retail banking market. By the end of 2013, Metro Bank had opened twenty bank branches and planned to have a total of 200 by 2020. It had also attracted over 140,000 customers and businesses, based primarily on its customer service ethos. The bank operated typical retail store opening hours with extended evening opening. By May 2013, 136,000 customers held a PCA with Metro Bank, which, after only three years in operation, demonstrates just how difficult it is for new entrants to gain new customers in this key PCA market.

Metro offers PCAs, savings products, personal loans, credit cards and mortgages and various extra 'services' such as safe deposit boxes and free coin counting machines. Metro Bank has free online banking, instant in-branch issuance of bank cards and assistance with switching accounts from other providers. Its customer service focus is summed up by its tag line 'No stupid bank rules' and it encourages its customers to 'Love your bank at last'. Metro Bank's key point of differentiation is its focus on its customers, by offering them very high levels of service and convenience.

Metro Bank's business banking offers working capital, commercial mortgages or expansion funding for both start-ups and established businesses, clubs, societies and charities, with a dedicated business banker in each branch. Notwithstanding, Metro Bank has found attracting new customers problematic: in the four months following its initial inception it had only provided about 100 mortgage loans. The bank's lending capacity is limited by its reliance on retail deposits to fund the loans. These retail deposits often follow the opening up of a PCA by a new customer. Metro Bank acknowledges that there is a lack of public confidence in the switching process and that this is preventing customers from changing to the new providers.

Metro Bank views itself as a retailer of financial services and as a retailer it is open 7 days a week. The physical presence is important; Metro Bank claims that 93 percent of all its new accounts are opened in its bank branches. Metro believes that what matters most is the customer experience and hence its goal is to reclaim the banking values of the past by focussing on a more retail-orientated structure, hence the longer branch opening hours.

Analysis of 'challenger bank' competitiveness

An obvious way of structuring the analysis of the 'challenger bank' prospects is through a conventional Strengths, Weaknesses, Opportunities and Threats (SWOT) framework. The analysis looks first at the opportunities and threats facing the challenger banks in the financial services market environment. It then considers the new entrants' own strengths and weaknesses. How well the challenger banks fare will depend on their ability to minimise the effects of any external threats or internal weaknesses and use their strengths to capitalise on opportunities.

Opportunities

Market size

Given their current scale relative to the market, the sheer size of the personal banking market clearly presents a major opportunity. However, none of the new entrants have achieved a significant presence in the mortgage and current account segments. Even in those major segments where the new entrants do have a presence – retail deposits and consumer credit – it remains small relative to the market as a whole.

Table 2.1 Tesco Bank, Virgin Money and Metro Bank: SWOT analysis

Opportunities	*Threats*
• Overall market size. • Consumer anger at mainstream banks. • Disposals planned by government required under EC State Aid rules.	• Lower growth prospects for key personal banking segments. • Fall in structural profitability of banking (stronger capital and liquidity requirements). • Competitive dynamics/customer behaviour.
Strengths	*Weaknesses*
• Strength of brands. • Successful diversification records. • Product innovation. • Existing customer relationships/infrastructure.	• Lack of branch networks. • Lack of core skills. • Small size relative to the largest banks.

Source: Author's own analysis.

Impact of the financial crisis

The change that may justify a shift in the ambitions of the new entrants is clearly the fall out from the financial crisis. In the wake of the crisis, it is assumed that the level of consumer anger at and distrust of mainstream banks has significantly increased the opportunities for new entrants, particularly with regards to consumer appetite to consider alternative providers, including those from outside the banking sector. Above and beyond the market size, it is this change that appears to underpin the ambitions of Metro, Tesco and Virgin to move from a selective offering of financial services to full-service retail banking.

Divestments

A further major opportunity presented by the crisis is the possibility of acquiring an existing bank or branch network. Both Lloyds Bank and RBS have been required to make disposals as part of the conditions imposed by the European Commission under EC State Aid rules. As an example, the acquisition of Northern Rock brought substantial retail savings and mortgage portfolios to Virgin Money.

With regards to the required Lloyds and RBS divestments, the former looks potentially more attractive in terms of achieving greater competition in the personal current account segment because it is estimated that whoever wins the Lloyds divestment will have an extra 4.6 percent market share in the PCA market, gained through a network of at least 600 nationwide branches. In the case of RBS, the disposal is more focussed on SME banking and the mid-corporate market.

Threats

If the financial crisis has created new opportunities, it has also introduced new threats. While the crisis may have opened up the banking sector to new competitors on a scale not seen before, in several important respects it has also made retail banking a somewhat less attractive business proposition.

Prospects for key market segments

The key personal banking segments face lower growth prospects and/or intense competition. Both the mortgage and consumer credit segments are likely to grow more slowly during the coming years than during the years before the crisis. With wholesale funding less available, competition for retail deposits will be fierce. This will put pressure on lenders' interest margins and may limit the ability of new entrants to fund their growth in new market segments, most notably mortgages.

Stronger capital, liquidity and accounting requirements

Regulators are imposing tougher capital and liquidity requirements on banks as part of the reforms of the Basel capital adequacy framework. This is likely to reduce the structural profitability of banking, making it more capital-intensive and requiring banks to hold more lower-yielding assets. More generally, regulators are likely to be wary of banks earning the returns on equity they have enjoyed in the years before the crisis.

Consumer behaviour and pricing structures

In addition to the negative effects of the crisis, the new entrants also face the challenges of customer behaviour and pricing structures in retail banking. Despite all the moves to facilitate account switching, consumers remain instinctively reluctant to change their current accounts. Banks remain reliant on opaque and unpopular means of generating revenue from their current accounts, namely high overdraft charges and little or no interest paid on credit.

The failure of the UK Office of Fair Trading's court case against unauthorised overdraft charges and UK consumers' attachment to the misnomer of 'free banking', is likely to weaken the pressure on banks to move to a more equitable pricing structure (see Chapters 16 and 17 on consumer price perceptions and price management respectively). This leaves the new entrants with the challenge of offering PCAs on a profitable basis, without them relying on overdraft charges and negligible interest paid on credit balances as a means of generating revenue.

Strengths

Strength of brands

Whilst Metro faces the challenge of establishing itself as a new brand, a major strength of both Tesco and Virgin is the existing power of their brands as both are among the best-known consumer brand names in the UK. While the underlying strategies are a little different between the two companies, the strength of their brands has already enabled Tesco to expand successfully into adjacent sectors and Virgin to establish itself across a range of different sectors.

Tesco has diversified to varying degrees into petrol retailing, newspapers and magazines, health and beauty goods, kitchenware, household appliances, CDs, DVDs and online music downloads. The underlying model here is the supermarket as a 'one-stop shop'. This model extends the parameters of lateral diversification from the retailing of goods to the retailing of services. It is noteworthy that Tesco's ambitions to expand its services segment include Tesco Telecoms and Tesco.com/Tesco Direct, as well as Tesco Bank.

The strategy of Virgin is to enter and expand in consumer markets where it sees high prices and consumer dissatisfaction, bringing a fresh, unconventional challenging approach. The strength of its brand has allowed Virgin to operate across a range of structurally diverse consumer sectors, including air and rail travel, mobile telephony, health and financial services.

Innovation

Metro, Tesco and Virgin also bring to banking an innovative approach to products and services. This is already evident in their existing financial services businesses and their approach to customer service, for example via extended opening hours. Perhaps the nearest a retailer has ever come to literally retailing a financial service is Tesco's travel insurance. Members of the Tesco loyalty programme (Clubcard) can pick up a travel insurance pack in-store and take it to the checkout with the rest of their shopping. As soon as the insurance pack is scanned – along with the Clubcard to confirm the customer's identity – the customer is insured.

Virgin introduced the innovative One Account in partnership with RBS, combining a current account and a mortgage loan in a single product. Customers deposit their income and savings into the same account as their mortgage, so using their assets (on which they receive a lower interest rate) to reduce the balance on their mortgage (on which they pay a higher rate). The One Account also functions as a normal current account, which customers can use to make regular payments and cash withdrawals.

Metro Bank has sought to differentiate itself through its customer service ethos delivered via its branch network. Both academics and practitioners have questioned the continued relevance of the bank branch in the new digital banking world (King 2011). The core competencies of retail banking are credit scoring and customer relationship management, both of which can be carried out effectively without the need for bank branches. For a review of the decline of the bank branch in the UK up to 2013, see French, Leyshon and Meek (2013). However, for Metro Bank, its business model has as its central component the branch and the face-to-face service and advice that can be delivered in that environment. These service features are one of the innovations that new entrants could use to attract customers disillusioned by the impersonal service delivery of the large incumbent banks.

Existing customer relationships and infrastructure

Both Tesco and Virgin already have a substantial base of existing financial services customers to which they can offer new services. Tesco also has two additional resources at its disposal. First, it has the base of 16 million Clubcard holders. Second, it has its nationwide retail network through which to promote and support the offer of financial services. Given these resources, Tesco may be in a stronger starting position than Virgin to expand its financial services business. The retail network gives Tesco a potentially significant advantage in distribution. In comparison with other new entrants that have to rely more heavily on channels such as direct mail or advertising, Tesco stores offer a readily available and low-cost marketing channel for the display of product leaflets and other literature. They also offer a means of servicing existing customers, however, the extent of this success depends on how they are utilised as discussed in relation to weaknesses.

To support its expansion, Tesco Bank plans to develop its face-to-face proposition in store including branches, Travel Money bureaux and use of tills and this points to an ever-wider interaction between the parent retailer and its banking subsidiary. An important benefit is that the growth of the bank allows Tesco to internalise within the Group interchange payments that would otherwise flow externally. When Tesco Bank customers use Tesco ATMs, interchange is payable from Tesco Bank to the retail parent; when Tesco Bank credit cardholders use their cards in Tesco stores, interchange is payable from the retail parent to Tesco Bank.

There are also opportunities to build on customer loyalty and retention from across the Tesco group. Research commissioned by Tesco shows that 'retailing services' customers are its most valuable and most loyal. According to Tesco, customers who use two retailing services spend four times as much in store than those who don't use any services, customers with a Tesco credit card spend around 30 percent more with Tesco than 'lookalike' customers who do not have a Tesco credit card and customers with two retailing services (based on customers who have services from both Tesco Bank and Tesco Direct) are 25 percent less likely to 'lapse' over a 12-month period than 'lookalikes' without services.

Tesco defines 'lookalikes' as customers with the same life stage, share of spend, lifestyle and preferred store but who do not use a Tesco Retailing Service; 'lapse' is defined as customers who have dropped two or more share of spend categories over a 12-month period. The figures raise interesting questions about whether the most likely consumers of Tesco services are simply its most loyal shoppers or whether consumers of Tesco services subsequently become more active users of Tesco as a retailer. But clearly, the figures indicate a strong relationship between customers of Tesco as a retailer and Tesco as a service provider.

Weaknesses

Small size

Metro Bank is very small and both Virgin Money and Tesco Bank remain small in the overall context of UK personal banking, despite the size of their parent companies, familiarity of their parent brands and their presence in financial services for more than a decade. The current small size of Tesco Bank and Virgin Money relative to the market underlines the challenge they face in becoming mainstream players in full-service retail banking. Something is needed that involves much more than a continuation of their current organic growth. A massive expansion of their financial services activities will be required and in particular, with wholesale funding much less available following the crisis, Virgin and Tesco will need to increase the size of their deposit bases by an order of magnitude. This is most likely to be achieved by a significant acquisition.

Low levels of customer awareness

Despite the strength of their brands, achieving a step change in their financial services activities will require an uplift in the public's awareness and perception of Tesco and Virgin as providers of financial services. The awareness of Tesco Bank among Tesco customers has improved in recent years and there is now increased focus and impetus following full Tesco ownership of the bank. However, customer awareness remains well below that of the market leaders and is based on financial services that Tesco Bank has been providing for some time rather than new services such as current accounts and mortgages. Hence, there is a considerable task ahead in terms of raising awareness of any new products, such as personal current accounts.

Need for core skills

Having previously relied on partners, both Tesco Bank and Virgin Money now need to acquire and develop core banking skills in-house. The skills and expertise required may be very different from their existing businesses. Core skills needed to succeed in financial services include risk management, interest rate and liquidity management and regulatory compliance, with their importance underlined by the financial crisis. Compare these with the core skills in retailing: sourcing products, buying well, merchandising and fulfilment of the purchase by the consumer. These skills may transfer readily to other retail sectors, for example, supermarkets may use their superior buying power to secure competitive advantage over specialists in health and beauty retailing, but they transfer less easily to financial services.

Existing skills need to be applied in a commercial environment that is different – and that Tesco and Virgin want to be able to differentiate – from a traditional retail bank. For example, while Tesco may seek to combine the best of banking and retailing, financial services are not merchandised in the same way as tangible products sold in retail outlets. Only a limited number of financial services such as one-off travel insurance and foreign currency are purchased through a single transaction, at a set price in a similar way to a retail transaction. Core personal banking services such as current accounts and mortgages involve the provision of an account on a long-term basis for the customer. Customers have to go through an application process, with the possibility of rejection and the pricing is more complex; often expressed as a percentage of the loan or deposit balance. The discounts, special offers and sales periods, central to retailing work less well when applied to financial services.

Indeed, whatever the aspirations of Metro, Tesco and Virgin to cut through the complexity of financial services, compliance requirements related to data protection, identity confirmation and money laundering often push in the other direction. The post-crisis period is likely to mean a tightening rather than a loosening of financial services regulation (as discussed in Chapter 1).

Delivery channels

A further challenge for Metro, Tesco and Virgin is their lack of a large branch network. Tesco has largely operated as a direct bank to date, but will it be possible for it to become a major provider of current accounts and mortgages without a physical network? These services can be managed and delivered through direct channels. However, the resilience of branches, despite long-standing predictions of the death of branch banking, underlines that many customers still like to use a physical outlet to conduct their banking.

However, apart from the common feature of physical proximity, bank branches are very different from retail stores. Shops are essentially outlets for the sale of goods. Customers come to browse and/or purchase specific items. Bank branches are sometimes described as a distribution channel, but this is in many ways a misleading description. Banks are not in the distribution business (other than perhaps for cash itself), they are principally places for the management of bank accounts. Customers may visit a branch to enquire about/apply for a banking service, but most branch visits are for carrying out transactions on existing accounts (mainly current and deposit accounts), such as paying-in cheques, paying-in or withdrawing cash or arranging more complex transactions that cannot be arranged remotely.

Conclusions

Before the financial crisis, both Tesco and Virgin had provided financial services for more than a decade. However, both were happy to operate as niche providers and they concentrated on a select range of products, operating through partnerships with existing banks and insurance companies. Neither showed an appetite for directly competing as full-service providers in retail banking. In the wake of the financial crisis, both now harbour ambitions to become full-service retail banks. But are the changes flowing from the financial crisis sufficient to justify such an expansion? Existing banks may be more unpopular, making non-banks more attractive, but there is a debit as well as credit side to the post-crisis investment case. Banking is set to be less profitable, making the market less attractive.

The biggest challenge for Metro Bank, Tesco Bank and Virgin Money, as full-service retail banks may be to grow quickly and profitably, while at the same time doing banking in a way that is markedly different from the mainstream. Tesco admits that one of the challenges it faces is the industry's 'standard economic model'. The hurdles to overcome for both PCAs and mortgages are high. The pricing of retail banking products in the UK has in some ways been analogous to the famous description of the art of taxation of Jean Baptiste Colbert, French economist and Minister of Finance under King Louis XIV of France 'The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing'.

The traditional banks remain reliant on opaque means of generating revenue from their PCAs, namely high overdraft charges and little or no interest paid on credit balances. Existing pricing structures are reinforced by the attachment of UK consumers to 'free' current account banking, 'free' credit cards and 'free' ATM withdrawals. In practice, this attachment to notionally 'free' banking services acts as a significant barrier to innovation and competition in pricing and it has resulted in significant cross-subsidies between different groups of banking customers.

Metro, Tesco and Virgin, therefore face the challenge of offering PCAs profitably without themselves relying on the same revenue models as existing providers. They also face the challenge of acquiring deposits without either offering unprofitable rates or tempting introductory rates that are then reduced over time. In light of their stated 'visions' for banking, high standards will be expected. Their services will be closely scrutinised by consumer and personal finance journalists, and ranked in the many comparison sites on the internet. Reputationally, Metro, Tesco and Virgin, are likely to face tougher customer standards than their existing bank competitors.

Notwithstanding, one of the key challenges for the existing 'players' in the retail banking market is that they have collectively lost the trust of their customers and indeed the wider community. Financial intermediation which occurs when those lending money to the banks (savers) implicitly agree with it then being lent out to borrowers, relies on the trust that their money will be available when they want it back. The great debate in banking thus needs to be how to restore the communities' trust in banks. The regulators have demanded more capital and liquidity and less leverage. This means that for customers, banking will become more (rather than less) expensive, there will be higher interest rates on loans and less availability of credit. Increased levels of financial literacy will be essential if financial services consumers are to be empowered to choose between the traditional providers and the new entrants.

There has been research into both irresponsible borrowing by consumers and irresponsible lending by providers (see Worthington and Durkin 2012), which have combined to produce co-destruction of value in retail banking. Banking regulators have stressed that these 'irresponsible' behaviours from both consumers and providers are no longer acceptable.

Looking forward, changes to the 'macro' environment of retail banking outlined may help to restore trust in the banks, but they will combine with existing structural forces to make it even more difficult for new entrants to make an impact in the market. Switching providers continues to be fraught with suspicion by customers, capital requirements make new entry expensive, credit is being rationed making lending less profitable and the housing market remains flat, perhaps because of fears of another financial crisis. New entrants, from whatever origins they emerge, will need both patience and luck if they are initially to survive and then prosper!

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