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Financial Technology and Challenger Banks in the UK: Gap Fillers or Real Challengers?

Lerong Lu*

☞ keywords to be inserted by the indexer

Abstract

This article provides an in-depth analysis of rising digital-focused challenger banks in the UK and relevant regulatory issues. The author argues that the financial authority shall level the playing field for disruptive challengers in order to boost competition and deliver better financial services for consumers.

Introduction

Technological innovation plays a key role in driving the economic growth and social advancement. Over the past decade, the UK has witnessed a rapid growth of its financial technology (fintech) sector which is said to generate £20 billion revenue.[1] Fintech refers to the application of internet technology and innovation in financial activities like payment, lending, wealth management and insurance. The fintech revolution has been reshaping the landscape of the traditional financial industry by cutting costs and improving the quality of financial services, using big data to assess credit risks in a more intelligent way, and creating a more diverse and stable credit sector.[2] Clearly, fintech already has a substantial impact on our daily lives, from the convenience of making payments by mobile phones such as Apple Pay and Alipay, to the ease of borrowing a peer-to-peer loan at online portals like Zopa and Funding Circle. Recently, London has become a leading global fintech hub, as it is home to numerous industry disrupters like Transferwise, Nutmeg and Mondo. According to a survey, the UK's financial regulatory regime is considered the most fintech-friendly in the world, which can encourage innovation and competition whilst minimising financial risks.[3]

With the aid of fintech, an increasing number of new banks have been established after the global financial crisis, whose objective is to challenge dominant high street lenders for a larger proportion of market share. Currently, the UK has a relatively concentrated banking sector, as the five largest lenders (the Big Five: HSBC, Barclays, Lloyds Banking Group, Royal Bank of Scotland (RBS) and Santander) possess 85% of the personal current accounts in the country.[4]

Traditionally, people hold a view that the bigger a bank, the safer it is. However, during the crisis, this idea was challenged by the failure of some well-established banking institutions, like Lehman Brothers in the US and RBS in the UK. It suggests that large lenders, having a complicated corporate structure and complex business activities, often contain risks that are difficult to identify by their customers and even financial regulators. Besides, large lenders in the UK have suffered significant damage to their reputation as a result of the financial crisis and other notorious scandals, such as the Libor manipulation and mis-selling of payment protection insurance.[5]

At this juncture, by taking advantage of people's distrust in existing lenders, some entrepreneurs try to set up new banks that do not have historical legacy. A lot of challenger lenders, supported by cutting-edge information technology, have cut the complexity of conventional branch networks and have built a simple, straightforward and low-cost business model. These market disrupters have become an immediate success by providing products and services for customers who have been underserved by incumbent banks, such as small businesses and consumers. Apparently, the obvious competitive advantages enable challenge banks to grow fast and occupy the market. In 2015, the total lending volume of challenger banks in the UK increased by 31.5%, compared with a decline of 4.9% for the Big Five lenders.[6]

The objective of this article is to provide an in-depth analysis of the UK's rising challenger banks and relevant regulatory issues, with a particular focus on new lenders equipped with fintech. It consists of the following sections. The first section introduces and discusses how fintech has become a global phenomenon in the recent decade. The second section continues to examine the market concentration of the UK's banking sector, whilst the third section presents the fast-growing challenger banks and explains what contributes to their competitive edge. After that, the fourth section selects two successful examples of digital challenger banks, Aldermore and Shawbrook (which are now constituents of the FTSE 250 Index), to carry out a case study.[7] It explores how they use fintech to provide better financial services for small and medium-sized enterprises (SMEs) and other consumers. Next, the fifth section studies Atom Bank, a mobile-based bank, which might stand for the future of

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[1] EY, "Landscaping UK Fintech" (Commissioned by UK Trade & Investment), p.6 available at: *http://www.ey.com/Publication/vwLUAssets/Landscaping_UK_Fintech/$FILE/EY-Landscaping-UK-Fintech.pdf* [Accessed 28 April 2017].

[2] "The Fintech Revolution", *The Economist*, 9 May 2015, pp.13–14.

[3] Caroline Binham, "UK regulators are the most fintech friendly" (12 September 2016), *Financial Times* available at: *https://www.ft.com/content/ff5b0be4-7381-11e6-bf48-b372cdb1043a* [Accessed 28 April 2017].

[4] Elaine Moore, "Challengers line up to take on the big banks", *Financial Times*, 14 July 2012, p.3.

[5] Adam Jones and Jennifer Thompson, "RBS prepares for Libor settlement talks", *Financial Times*, 3 November 2012, p.10.

[6] Emma Dunkley, "Challengers prise open grip of larger rivals", *Financial Times*, 4 May 2016, p.23.

[7] The FTSE 250 Index consists of the 101st to the 350th largest companies, in terms of their market capitalisation, listed on the London Stock Exchange.

banking. After gaining a full picture of challenger banks, the sixth section analyses how they fit into the UK's current regulatory system, whilst the seventh section points out some regulatory issues that merit special attentions from the regulator. Finally, a conclusion will be drawn.

Fintech gains popularity in the UK and globally

Fintech describes the interplay of finance and technology. Market players have been offering innovative technological solutions to traditional financial services. As disrupters challenge the old business model and fight for market shares, digital transformation has been brought to every aspect of the existing financial industry. The fintech sector has experienced significant growth in the last decade, backed by heavy investments from venture capital funds around the globe. In the third quarter of 2016, the entire fintech industry raised $2.4 billion in capital.[8] Clearly, fintech appeals greatly to consumers, particularly the young millennial generation who are tech-savvy and dissatisfied with existing financial products. According to a recent survey, over one-third of financial consumers in Europe would move bank or insurer if they did not offer up-to-date technology.[9]

The fintech industry has a lot of diverse areas, covering banking, online lending, payment, wealth management, insurance and virtual currency. These are listed in the table below.

Table 1: The category of fintech industry and selected examples[10]

Fintech Sectors	Examples
Online-only banks (including mobile-based banks)	Atom Bank, Monzo, Aldermore, Shawbrook, "B" Smart Banking App
Online peer-to-peer lending (including peer-to-business lending)	Zopa, Funding Circle, Lending Works, MarketInvoice, Ratesetter, LendInvest, Iwoca
Payment & transfer	Apple Pay, GoCardless, WorldRemit, TransferWise
Insurance (Insurtech)	Cuvva, Cyence, Safeshare, SPIXII
Wealth management platform	Nutmeg, Wealthify
Virtual currency	Bitcoin, Blockchain

While most fintech firms have been set up from scratch by entrepreneurs over the last decade, there are also some established financial service providers trying to launch their own fintech products. For example, Clydesdale Bank and Yorkshire Bank released a smart mobile banking app called "B" which is able to learn the spending habits of its users automatically and offer tips to save money and make better budgets.[11] Some incumbent banks also establish a co-operative relationship with fintech start-ups, or even acquire some stakes in them, in order to benefit from the industry's rapid growth. In 2015, the Spanish lender BBVA spent £45 million purchasing 29.5% of the shares in Atom Bank, an online-only lender in the UK.[12] Compared to established financial institutions, fintech start-ups enjoy the advantage of low-cost operation since they do not have legacy IT systems and heavy assets like a branch network and a large number of staff. Currently, the novel fintech businesses are subject to lighter regulation from the authorities, which could be another advantage but also brings more risks. The disadvantage of fintech firms is obvious for they lack the scale, brand and distributional channels to contend with existing financial giants.[13]

It is clear that fintech is reshaping the UK's financial industry. In 2015, the then Chancellor of the Exchequer, George Osborne, announced the Government's ambition to build London into "a global centre for Fintech".[14] Fintech already has a strong presence in the UK. We have seen the frequent use of contactless cards and Apple Pay when people go shopping, replacing traditional PIN-needed credit and debit cards. Besides, the online peer-to-peer lending (P2P lending) is now popular, which removes banks from the lending chain and provides a better deal for both investors and borrowers. Take Funding Circle, a leading P2P lender in the UK, as an example. Investors can earn an estimated annual return of 7.2%, which is much better than rates offered by bank savings accounts.[15] Through the Funding Circle, the money from investors has been lent to small businesses in the UK which have limited access to bank credits. Lending to SMEs is critical in the economic recovery after the crisis. The UK Government, through its British Business Bank, has lent out £80 million so far to support small businesses borrowers who seek finance at the Funding Circle.[16] What is more, fintech lowers the threshold for the traditional wealth management industry, making it an affordable option for ordinary people. For instance, Nutmeg offers online low-cost wealth management service, which only requires a minimum investment of £500.[17] It provides professional diversified portfolios, stock ISAs as well as pension schemes for customers. By using new types of investments like exchange traded funds, Nutmeg charges fees as low as 0.6% to its investors.[18]

[8] KPMG, "The Pulse of Fintech, Q3 2016" available at: *https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2016/11/the-pulse-of-Fintech-q3-report.pdf* [Accessed 28 April 2017].
[9] Dunkley, "Challengers prise open grip of larger rivals", *Financial Times*, 4 May 2016, p.23.
[10] The table is compiled by the author.
[11] See B's official website available at: *https://www.youandb.co.uk* [Accessed 28 April 2017].
[12] Martin Arnold and Emma Dunkley, "BBVA enters UK with Atom deal", *Financial Times*, 24 November 2015, p.17.
[13] Emma Dunkley, "Fintech start-ups put banks under pressure", *Financial Times*, 12 September 2016.
[14] Peter Campbell, "Osborne wants London to be global centre for Fintech", *Financial Times*, 11 November 2015.
[15] See the Funding Circle available at: *https://www.fundingcircle.com* [Accessed 28 April 2017].
[16] See the Funding Circle available at: *https://www.fundingcircle.com* [Accessed 28 April 2017].
[17] Nutmeg available at: *https://www.nutmeg.com* [Accessed 28 April 2017].
[18] Emma Dunkley, "A tech take on wealth management: Entrepreneurship: Nick Hungerford, Nutmeg", *Financial Times*, 3 December 2014, p.14.

There is no doubt that fintech has become a global phenomenon. As London positions itself as a leading financial innovation hub, it has to compete with other fintech centres like San Francisco, New York, Shenzhen and Singapore. Silicon Valley in San Francisco's Bay Area is the world's most well-known technology centre, which has produced most influential tech firms like Apple, Facebook and Google. Therefore, the US occupies a leading position in technological innovation, including the latest fintech revolution. Many American fintech companies are market leaders in their respective fields and have gone public, such as PayPal, Square and Lending Club. As of March 2016, PayPal held customer money worth over $13 billion, exceeding that of many traditional lenders.[19]

Moreover, China has also seen the fast and furious growth in its internet finance sector. Pioneering Chinese fintech companies took up four positions out of the top five global fintech innovators in 2016, according to a recent study.[20] The largest Chinese fintech firm is Alipay (or Ant Financial), the financial service arm of the e-commerce giant Alibaba. It raised $4.5 billion private equity investment in 2016, giving the company a valuation of $60 billion.[21] Alipay is an online financial eco-system comprising e-wallet, mobile payment (both online and offline), wealth management products and personal credit rating. Currently, it has 400 million active users around the world.[22] Apart from the UK, the US and China, the rest of world has also seen the explosive development of fintech. For example, there are 54 fintech companies in the Middle East, including 20 in the United Arab Emirates.[23]

Market concentration of UK's banking sector

Britain has the largest banking industry in Europe and the fourth largest one in the world. It has more than 300 banks and 45 building societies and, in total, there are over 9,000 bank branches and 70,000 cash machines in the country.[24] However, the banking industry in the UK is highly concentrated in the hands of a few dominant banks as the four largest lenders (HSBC, Barclays, RBS and Lloyds) manage over 75% of personal current accounts and 85% of business accounts, as well as over £5 trillion assets and 560,000 employees.[25] According to a recent ranking, below, HSBC is the sixth largest bank in the world in terms of total assets, Barclays is 16th, RBS 22nd and Lloyds is 25th.

Table 2: Top 25 banks in the world in terms of total assets[26]

Rank	Bank	Country	Total Assets (USD billion)
1	Industrial & Commercial Bank of China	China	3,549.88
2	China Construction Bank Corp	China	2,981.85
3	Mitsubishi UFJ Financial Group	Japan	2,901.34
4	Agricultural Bank of China	China	2,818.89
5	Bank of China	China	2,656.07
6	*HSBC Holdings*	*UK*	*2,608.15*
7	JPMorgan Chase & Co	US	2,466.10
8	BNP Paribas	France	2,417.00
9	Bank of America	US	2,186.61
10	Japan Post Bank	Japan	2,022.02
11	Deutsche Bank	Germany	2,006.71
12	Credit Agricole Group	France	1,970.40
13	Mizuho Financial Group	Japan	1,923.72
14	China Development Bank	China	1,904.34
15	Wells Fargo	US	1,889.24
16	*Barclays PLC*	*UK*	*1,819.61*
17	Citigroup Inc	US	1,818.77
18	Sumitomo Mitsui Financial Group	Japan	1,764.69
19	Societe Generale	France	1,624.97
20	Banco Santander	Spain	1,494.39
21	Groupe BPCE	France	1,357.34
22	*RBS Group*	*UK*	*1,214.11*
23	Bank of Communications	China	1,200.63
24	Postal Savings Bank of China	China	1,163.10
25	*Lloyds Banking Group*	*UK*	*1,142.22*

Clearly, major lenders are too big to fall and too big for smaller banks to compete against. Early in 2000, the publication of the Cruikshank Report emphasised the ineffective competition environment in the UK banking industry regarding three areas: money transmission, services to personal consumers and services to SMEs.[27] It pointed out that

> "regulatory barriers to entry are high, producers are represented on the board of the industry's regulator, their exposure to competition law is diluted, and in many areas banks are allowed to write their own rules".[28]

[19] Telis Demos, "As Industry Evolves, PayPal, Peers Rise Up", *Wall Street Journal*, 2 June 2016, s.C1.
[20] Emma Dunkley, "China challenges London's Fintech lead", *Financial Times*, 24 October 2016, p.20.
[21] Kane Wu, "Ant Financial Now Worth $60 Billion", *Wall Street Journal*, 27 April 2016, s.C1.
[22] See Alipay available at: *https://intl.alipay.com* [Accessed 28 April 2017].
[23] Kadhim Shubber, "UAE states put Fintech sector first", *Financial Times*, 7 October 2016, p.4.
[24] Relbank, "Banks in the UK", available at: *http://www.relbanks.com/europe/uk* [Accessed 28 April 2017].
[25] Relbank, "Banks in the UK".
[26] Source: RelBank, "Top 100 Banks in the World" (30 June 2016) available at: *http://www.relbanks.com/worlds-top-banks/assets* [Accessed 28 April 2017].
[27] Don Cruickshank, *Competition in UK Banking: A Report to the Chancellor of the Exchequer* (The Stationery Office, March 2000) (Cruikshank Report).
[28] Cruickshank Report (2000), p.vii.

Following the Cruikshank Report, the Government has constantly called for the reform to increase competition in the banking industry. In particular, after the global financial crisis, politicians have urged for more banks to be built to promote competition and provide more choices of financial products and services for consumers. In 2012, Labour's Ed Miliband proposed that the largest lenders should be forced to sell 1,000 branches to spur competition and create space for challengers.[29] However, according to a study by the Competition and Market Authority in 2014, the market shares of the UK's personal current accounts (PCAs) have been extremely stable over time, apart from mergers and acquisitions, which indicates the difficulty of growth and expansion in this sector.[30] Besides, larger PCAs providers were reported to get a lower score in terms of customer satisfaction and received more complaints than their smaller rivals.

Who are challenger banks and why do they rise after the global financial crisis?

In 2013, the Financial Conduct Authority (FCA) was created with an operational objective to promote competition in the interest of consumers.[31] Under the economic and political environment that welcomes more competition, a number of challenger banks have emerged in recent years, together with some of the more established challengers, to contest dominant banks. It should be noted that great differences can be found among challenger banks in the UK. Some are perceived as a smaller version of major lenders as they offer traditional banking services and try to grab market shares from the Big Five, such as Virgin Money and Metro Bank. In January 2011, Virgin Money acquired the nationalised Northern Rock and it went to float its shares on the London Stock Exchange in November 2014.[32] Metro Bank, founded in 2010, was the first high street bank to open in the UK in over 100 years. It aims to bring personal services back to banking and opens every store seven days a week, from 08.00–20.00 on weekdays.[33] Accordingly, customers can walk into any branch of Metro Bank without an appointment. It even offers a same-day account opening service, which differentiates itself from other high street banks.

Moreover, an increasing number of retailers have entered the financial services industry.[34] Some supermarket chains joined the competition by offering reward point credit cards, low-cost personal loans, current and saving accounts, and other financial products. Examples of supermarket-backed challenger banks are Asda Money, Tesco Bank, Sainsbury's Finance and M&S Bank. Customers of Sainsbury's Finance can earn points for its Nectar reward scheme when they use any of its financial services like credit cards, insurance, savings and travel money.[35] Tesco Bank, relying on the extensive presence of its grocery and convenience stores across Britain, has already become a main competitor to large banks, having 6.5 million customers for its financial services.[36]

Meanwhile, a new breed of digital-aided challenger banks has been established to provide specialist financial services and products for customers who are ignored by traditional lenders. As fresh market players, they are said to have cleaner reputations and attract less public cynicism.[37] Moreover, these new lenders have adopted innovative and low-cost business models as they carry out most business online rather than via traditional branches. They focus on underexploited business areas like buy-to-let property finance, SME lending and consumer lending. In the remainder of this article, attention will be centred on this particular type of challenger bank, a group that includes Aldermore, Shawbrook, OneSavings, Atom, Monzo, Starling and Tande. Clearly, fintech gives these challenger banks significant competitive edge and allows them to survive, compete and prosper.

The rise of challenger banks can be explained from three perspectives. First of all, the public's trust in the British banking industry has been greatly eroded due to the financial crisis. According to a YouGov survey in 2013, only 16% of respondents agreed that "banks generally provide good quality products and services which are sold responsibly"; 83% of people believed "bankers are greedy and get paid too much"; and 80% said "banks aren't doing enough to support the economy".[38] Take the RBS as an example; it was bailed out by the taxpayers' money in 2008 but, afterwards, its business posted a total losses of £58 billion as a result of troubled takeovers, restructuring charges, bad lending and other poor trading decisions, fines and legal costs.[39] Recent financial scandals in the banking industry, like the Libor manipulation and the mis-selling of payment protection insurance and interest rate swaps, further undermined the public's confidence. It is evident that established lenders suffered severe damage to their reputation in the post-crisis era so the challenger banks, by creating new brands, are able to distinguish themselves from existing players, giving rise to an advantage of having no historical legacy.

[29] Hannah Kuchler and Elaine Moore, "Miliband set to up the ante over big banks", *Financial Times*, 9 July 2012, p.21.
[30] Competition and Market Authority, "Personal current accounts: Market study update" (18 July 2014), p.9.
[31] Financial Services and Markets Act 2000 s.1E.
[32] Andrew Bolger and Emma Dunkley, "Branson makes pound(s) 70m as Virgin Money floats", *Financial Times*, 14 November 2014, p.26.
[33] Metro Bank available at: *https://www.metrobankonline.co.uk/about-us* [Accessed 28 April 2017].
[34] KPMG, *The game changers: Challenger Banking Results* (22 May 2015), p.2.
[35] Sainsbury's Bank available at: *https://www.sainsburysbank.co.uk/doublenectar/index* [Accessed 28 April 2017].
[36] Moore, "Challengers line up to take on the big banks", *Financial Times*, 14 July 2012, p.3.
[37] Sharlene Goff, "Challenger banks have the Big Four in their sights", *Financial Times*, 16 August 2014, p.8.
[38] YouGov and Cambridge, "Public Trust in Banking" (Spring Symposium, April 2013), p.16 available at: *http://cdn.yougov.com/cumulus_uploads/document/ylf7gpof19/Public_Trust_in_Banking_Final.pdf* [Accessed 28 April 2017].
[39] Jill Treanor, "Losses of £58bn since the 2008 bailout—how did RBS get here?" *The Guardian*, 24 February 2017.

Secondly, challenger banks find their markets by accommodating the financing needs of some marginalised customers who are underserved by dominant lenders. For instance, many small businesses have been facing a financing dilemma for a long time as banks have become risk-adverse after the financial crisis and tightened the credit for risky start-ups. Obviously, SMEs play a vital and indispensable role in the British economy. As of 2014, there were 5,236,390 SMEs in the UK, representing 99.9% of the total number of businesses, employing 15.16 million people and generating a combined revenue of £1.65 trillion.[40] Moreover, SMEs contributed to 49.8% of the UK's gross domestic product.[41] However, it remains difficult for SMEs to secure a loan from banks as many of them cannot provide valid collateral or pass the strict credit test. According to the Bank of England, SMEs only received 37% of total bank credits in the UK, whilst the majority of 63% was granted to large corporations.[42] Accordingly, a number of challenger banks focus their businesses on SME financing, which not only helps smaller businesses to obtain funding to grow, but also wins them numerous clients overlooked by large lenders.

Similarly, many challenger lenders target the booming buy-to-let property market by offering mortgages to all types of property investors. In 2016, Aldermore originated £1 billion buy-to-let loans, with a 25% growth from the £0.8 billion in 2015.[43] Apparently, as challenger banks attempt to offer differentiated products and services to conquer market shares, they indeed fill the niches of the British banking industry. According to Andy Golding, the CEO of OneSavings Bank, challenger banks are "dancing in the gaps" left by major players.[44] Moreover, most challenger banks claim themselves as customer-centric, as they emphasise the fairness and ethical culture in their banking activities, which clearly contrasts with existing lenders which are known for profit-making (or loss-making) and bankers' bonus culture.

Last but not least, digital challenger banks adopt distinctive ways of distribution based on fintech, which cuts their costs significantly. Most of them have been relying on brokers and online platforms to reach customers, rather than constructing a large number of brick-and-mortar branches like their larger rivals do. Traditional lenders possessing a branch network face very high operating costs. For example, Barclays has 1,305 branches and 36,000 full-time employees in the UK.[45] In contrast, the publicly-listed Aldermore Bank does not have a single branch and only employs 569 members of staff.[46] Aldermore serves its customers online, by phone and face-to-face through its network of 12 regional offices across the UK. The low-cost strategy means digital banks do not have geographical boundaries for their businesses, so they can expand explosively in a short time without hefty IT and infrastructure investments. However, while the online-only banking service draws a lot of attention from the millennial generation who grew up with personal computers, mobile phones and the internet, most middle-aged and older people might still prefer to visit a physical branch to conduct their financial services.

Case study: Aldermore and Shawbrook

Digitally-focused challenger banks are the latest market players in the UK's banking arena. Most of them were incorporated over the past few years and backed by private equity firms. Despite the short history, they have been developing quickly. In 2015, their return on equity ratio (ROE) reached 17.0%, which not only outperformed the Big Five (4.6%) but also other larger challengers (9.5%).[47] Challenger banks also enjoyed relatively low expenses, as they had an average cost-to-income ratio of only 48.5%, compared with 80.6% for large banks.[48] In this section, we take a closer look at two successful examples of fintech challenger banks, Aldermore and Shawbrook, analysing how they developed into large banking business in a short time by serving the niche market.

[40] Department for Business, Innovation and Skills, *Business Population Estimates 2014* (26 November 2014), p.4.
[41] Matthew Ward and Chris Rhodes, "Small businesses and the UK economy" (9 December 2014), House of Common Library, SN/EP/ 6078, p.7.
[42] The percentage is calculated by the author from Bank of England's data, "BankStats (Monetary & Financial Statistics)", Table A8.1 available at: *http://www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx* [Accessed 28 April 2017].
[43] Shawbrook Bank, *Specialists in Good Sense: Annual Report and Accounts 2016* (Shawbrook Group Plc, 2016) available at: *https://www.shawbrook.co.uk/media/228610/Shawbrook-Report-and-Accounts-2016.PDF* [Accessed 28 April 2017]
[44] Ashley Armstrong, "One Savings Bank Targets IPO Valuation of Up to £600m", *The Telegraph*, 7 May 2014.
[45] Barclays, *Building the bank of the future: Annual Report 2016* (Barclays Plc, 2016), p.247.
[46] Shawbrook, *Annual Report and Accounts 2016* (2016), p.130.
[47] KPMG, *Challenger Banking Reports 2016*, p.4.
[48] KPMG, *Challenger Banking Reports 2016*, p.5.

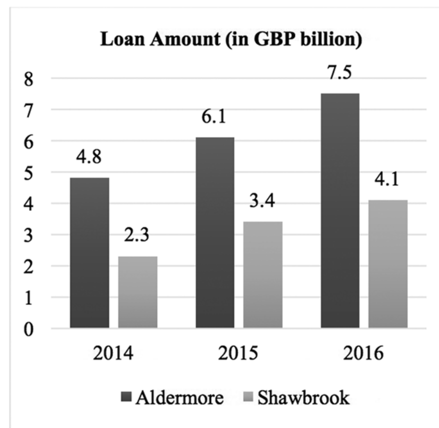

Figure 1: **Steady growth of customer loan**[49]

Aldermore Bank describes itself as "an SME-focused bank which operates with modern, scalable, and legacy-free infrastructure".[50] Founded in 2009, Aldermore has been growing rapidly since its establishment and now becomes one of UK's leading alternative lenders. In 2016, its pre-tax profits amounted to £133 million, up 34% from £99 million in 2015, which indicated its quick expansion and considerable profitability.[51] In March 2015, Aldermore launched a successful initial public offering (IPO) and raised £75 million from selling new shares to investors.[52] Currently, its shares are listed on the main market of the London Stock Exchange and it is a constituent of the FTSE 250. Aldermore has around 220,000 customers in the UK.[53]

The rapid success of Aldermore resulted from its accurate customer focus and low-cost operating strategy. The centre of Aldermore's business is to provide commercial finance, mortgage and saving services for British SMEs, homebuyers and savers. It attracts deposits from savers and then extends loans in four specialised areas: asset finance, invoice finance, SME commercial mortgage and residential mortgage. Instead of operating a branch network as most lenders do, Aldermore offers most services online, by phone or face-to-face in its regional offices, which reduces costs significantly. Besides, Aldermore aims to deliver the kind of banking as it is supposed to be delivering, which is featured for good service, full transparency and a community focus.[54] The superior and friendly service in combination with more availability of credit for smaller businesses is no doubt a strong selling point. Moreover, Aldermore claims that they are known for customer-focused innovation. For instance, it allows its customer to post comments about its products and services online without any moderation by the bank, which provides valuable suggestions for other customers. Up to now, the market share occupied by Aldermore is still relatively small compared to that of established lenders. As of 30 June 2015, its asset finance business took up 3% of the £14 billion market in the UK; the invoice finance had a market share of 0.9% of the £19 billion market and its SME commercial mortgage represented 1% of the £44 billion market.[55] Nonetheless, judging from its strong growth prospect, Aldermore has the potential to become a large lender in the future.

Similarly, Shawbrook bank has an objective to serve the financial needs of UK SMEs and individuals. It offers a variety of lending and saving products and its lending division is divided into five parts: commercial mortgages, asset finance, business credit, secured lending and commercial lending.[56] It has 520 members of staff and operates in 10 offices throughout the UK, including four principal locations and six smaller ones. In 2011, its primary investor acquired Whiteaway Laidlaw Bank and then rebranded it as Shawbrook Bank.[57] In the following years, its investors also bought several other financial companies like Commercial First, Link Loans, Singers Asset Finance and Centric Commercial Finance, and then incorporated them into the banking business of Shawbrook. In April 2015, Shawbrook raised £90 million in its IPO with the admission to the London Stock Exchange and later it was admitted to the FTSE 250

[49] This chart is compiled by the author by using the data from Aldermore, *Annual Report and Accounts 2016* (Aldermore Group Plc, 2016) and Shawbrook, *Annual Report and Accounts 2016* (2016) Shawbook's Annual Reports 2016.
[50] Aldermore, "Who we are: Challenging the established view of what banking should be" available at: *http://www.aldermore.co.uk/about-us/who-we-are* [Accessed 28 April 2017].
[51] Aldermore, *Financial Report 2016* (2016).
[52] Aldermore, *Financial Report 2016* (2016).
[53] Aldermore, "Factsheet" available at: *http://www.aldermore.co.uk/media/1781/aldermore-factsheet.pdf* [Accessed 28 April 2017].
[54] Aldermore aims to support the communities where they operate. For example, the deposits received by Aldermore are only loaned in the UK; its premises and members of staff are all located in the UK, which is close to the communities they serve; it greatly supports UK government policies and schemes, such as Help to Buy; Aldermore's corporate culture mirrors that of other UK SMEs, so it is able to appreciate the real needs of SME communities; and it actively supports young entrepreneurs in UK schools to develop business skills. See Aldermore, "Community: Bringing skills to schools through SKILL!" available at: *http://www.aldermore.co.uk/about-us/community/* [Accessed 28 April 2017].
[55] Aldermore, "Factsheet".
[56] Shawbrook Bank webpage available at: *https://www.shawbrook.co.uk/about/welcome* [Accessed 28 April 2017].
[57] Shawbrook Bank, "Our History" available at: *https://www.shawbrook.co.uk/about/our-history* [Accessed 28 April 2017].

Index.[58] So far it has made loans to more than 60,000 SMEs across the UK, making it a leading bank of SME financing. The success of Shawbrook within a short period of time shows the potential market scale of SME financing that has been greatly underestimated by dominant banks.

Generally speaking, challenger banks like all other lenders have a business model of taking deposits from the public and then make loans to potential borrowers. However, in terms of making loans and to whom, many challenger banks provide tailored financing services for SMEs, such as asset finance, invoice finance and SME mortgages. Asset finance, including leasing and hire purchase, refers to the funding for capital (asset) investments in machinery, plant and equipment.[59] By using the asset financing, the business does not need to make the one-off and large payments to buy the relevant asset upfront. Instead, it can break down the payment into an affordable monthly rent or instalment, while having the right to use the asset. At the end of the asset finance agreement, the business might have the option to purchase the asset at a nominal price (hire purchase). Invoice finance means lending to SMEs against their outstanding invoices, which includes forms of factoring and invoice discounting.[60] By utilising the invoice financing tools, the business will be advanced the value of the invoices they created. In terms of the factoring, the factoring lender will collect the debt instead of the business but the invoice discounting allows the business to maintain the credit control and collection facility to receive the payment from the customer. SME mortgage means lending to SMEs to fund their purchase of properties.

Another reason to explain the success of Shawbrook and Aldermore is their low-cost strategy. Obviously, mainstream banks on high streets have high levels of expenses as they have to purchase or rent offices in good locations. They also hire a large number of staff, have to maintain complex business structures and run their computer system. On the contrary, challenger banks rely on modern internet technology and have a simple and straightforward business model with limited branches as well as a small number of employees. The cost-effective operation, in combination with a specialised target market, brings challenger banks a lot of advantages over established lenders. For Aldermore and Shawbrook, the ROE ratio reached 18.2%—the highest in the banking industry. [61] Clearly, the success of challenger banks brings more competition to the UK's banking industry and forces mainstream lenders to pay more attentions to SME financing and consumer lending.

Case study: Atom Bank—the future for banking?

Nowadays, more and more people prefer to manage their finance on the go. Atom is a new challenger bank based in Durham, England, which just obtained its banking licence from the Prudential Regulatory Authority in June 2015. As of March 2017, it has raised capital of £219 million from institutional investors including Spanish lender BBVA, fund manager Neil Woodford and Toscafund.[62] Atom is the first UK bank that is built exclusively for smartphones, which means it can only be accessed via its app which can be downloaded from the Apple Store or Google Play. It is also known for its personal experience as customers are allowed to design their own logo for their personal banking and give it a name of their choosing.[63] They can log in to the Atom app using passcodes, fingerprint, face recognition or voice recognition. Clearly, the fintech not only brings convenience for financial consumers but also improves the security level by utilising people's biometric data to verify their identities. Customers of Atom can get instant help from its support teams by making a call or using the built-in chat service, which is be available 24/7/365. Currently, Atom offers a competitive rate for its savers and is planning to tap into other financial services like current accounts in the next year.

Table 3: Atom fixed saver interest[64]

Time	Interest Rate (AER)
1 Year	1.60%
2 Year	1.70%
3 Year	1.90%
5 Year	2.25%

Atom makes loans to small businesses and provides mortgages to first-time home buyers through its brokers. Atom has attracted a lot of attention from the public. During its pilot operation phase in 2016, there were over 40,000 potential users registering their interest.[65] As more people turn to mobile devices for banking, a consultancy firm predicted that the total number of branch visits in the UK will almost halve to 268 million a year by 2020.[66] Another digital-only bank, Monzo, provides a real-time balance sheet of users' accounts on their mobile phones.[67]

[58] Denise Roland and Ashley Armstrong, "Challenger Bank Shawbrook Fetches £725m Valuation on IPO", *The Telegraph*, 1 April 2015.
[59] Startups, "What is asset finance?" (2013) available at: *http://startups.co.uk/what-is-asset-finance/* [Accessed 28 April 2017].
[60] Startups, "Invoice Finance: What Can You Raise?" (2001) available at: *http://startups.co.uk/invoice-finance-what-can-you-raise/* [Accessed 28 April 2017].
[61] Startups, "Invoice Finance" (2001).
[62] Emma Dunkley, "Atom Bank raises £83m from shareholders as it eyes expansion" (3 March 2017), *Financial Times* available at: *https://www.ft.com/content/c075542e-fc09-3c27-bb98-7fe5f7d3df34* [Accessed 28 April 2017].
[63] Atom webpage available at: *https://www.atombank.co.uk* [Accessed 28 April 2017].
[64] Data source: Atom, "Fixed Saver" available at: *https://www.atombank.co.uk/fixed-saver* [Accessed 28 April 2017].
[65] Lee Boyce, "Atom Bank opens its doors to all savers with two best-buy deals—but fixed rates have been cut" (6 October 2016) available at: *http://www.thisismoney.co.uk/money/saving/article-3824910/Atom-Bank-opens-doors-savers-two-best-buy-deals-fixed-rates-cut.htm* [Accessed 28 April 2017].
[66] Emma Dunkley, "Atom Bank to offer residential mortgages", *Financial Times*, 6 December 2016.
[67] Monzo webpage available at: *https://www.monzo.com* [Accessed 28 April 2017].

How do challenger banks fit into the UK's twin-peak regulatory framework?

Despite the difference of distributional methods and customer focus, challenger banks' businesses remain similar to that of existing lenders. Therefore, whether challenger banks or incumbent banks, both have to comply with the same regulatory rules in most aspects. In the UK, any firm wishing to conduct deposit-taking businesses has to obtain a Pt 4A permission from the Prudential Regulation Authority (PRA), which the PRA will only give with the consent from the FCA.[68] An alternative way is that a bank authorised in any state within the European Economic Area (EEA) can exercise its "passporting" right to offer services or open branches in the UK. After the authorisation process, a bank will be subject to prudential regulation from the PRA and conduct regulation from the FCA, which together form the twin-peak regulatory model. Recently, the PRA and FCA have set up a New Bank Start-up Unit in order to facilitate the process of filing the application for becoming a bank.[69] Financial regulators provide detailed information and support for establishing a bank, which are split into the following five steps: early stages, pre-application, application, mobilisation and after authorisation.

Banks in the UK are registered under the Financial Services Compensation Scheme (FSCS) which is the deposit insurer, so savers money will be protected if banks fall into financial difficulty in the future. Deposit insurance is a vital component of the financial safety net that helps to maintain financial stability. From 30 January 2017, the deposit compensation limit in the UK is £85,000 per person, per bank, regardless of how many accounts a customer holds.[70] In the case of a joint account, the compensation limit will be £170,000. Clearly, depositors using challenger banks are protected against losses by the FSCS, which encourages more financial consumers to try the services of new lenders who can offer a higher quality service and more convenience. However, it can also lead to the problem of moral hazard.

The PRA and FCA were created by the Financial Services Act 2012 as the regulatory response to the financial crisis. During the crisis, the UK witnessed the failure of Northern Rock in September 2007, the first bank run in the country since the Victorian times.[71] In addition, HBOS and the RBS were nationalised by the UK Government to save the industry and prevent further crisis. Therefore, in order to safeguard the soundness of large financial institutions in the post-crisis era, as well as to maintain the UK's financial stability, the PRA was founded to be in charge of the prudential regulation of over 1,700 banks, building societies, insurers and credit unions in the UK. The PRA has a general objective of promoting the safety and soundness of PRA-authorised individuals[72] and it is empowered to make detailed rules contained in the PRA Rulebook for its regulated firms. In the past, the regulatory approach of the Financial Services Authority (FSA) was described as a "light touch". Even though the FSA was once sceptical about the funding model of Northern Rock, it failed to force the bank to make changes.[73] Currently, the PRA plays a more active role than its predecessor in supervising British banks. For instance, along with the Bank of England and its Financial Policy Committee, the PRA carried out a series of stress testing to examine whether the balance sheets of UK lenders can endure hypothetical situations of economic shocks.[74] In the first round of stress testing in 2014, the Co-operative Bank failed the test and was asked to recapitalise whilst the Lloyds Banking Group and the RBS were found at risk when facing the worst economic conditions in the test.[75] Thus, by utilising new regulatory techniques, the PRA seems capable of preventing bank insolvency and preserving financial stability.

However, the FCA was made to replace the FSA, and it is responsible for regulating conducts of over 26,000 financial firms in the UK as well as the activities of more than 23,000 firms not supervised by the PRA. The FCA has three operation objectives: protect consumers, enhance market integrity and promote competition.[76] After it took power, the FCA has been using its administrative power to correct the wrongdoings of banks to protect financial consumers. For example, lots of British consumers have been sold financial products by several large banks they do not really need, like payment protection insurance (PPI). Accordingly, in 2015, the FCA imposed a fine of £117 million on Lloyds Banking Group for its unfair practice regarding handling customers' complaints about PPI.[77] Clearly, the FCA plays an important role in protecting the interests of financial consumers and ensuring a high standard of business conduct in the banking industry.

Furthermore, promoting competition is another priority of the FCA's working tasks as it knows that allowing consumers to have more choice is key for effective competition. When customers are able to switch accounts

[68] Financial Services and Markets Act 2000 (FSMA 2000) s.55A.
[69] PRA and FCA, "New Bank Start-up Unit: What you need to know from the UK's financial regulators" (March 2017) available at: *http://www.bankofengland.co.uk/pra/Documents/authorisations/newfirmauths/nbsuguide.pdf* [Accessed 28 April 2017].
[70] FSCS, "Deposit Limits" available at: *https://www.fscs.org.uk/what-we-cover/compensation-limits/deposit-limits/* [Accessed 28 April 2017].
[71] "Britain's Bank Run: The Bank That Failed", *The Economist*, 20 September 2007, p.1.
[72] FSMA 2000 s.2B(2).
[73] House of Commons Treasury Committee, *The Run on the Rock: Fifth Report of Session 2007–08* (The Stationery Office, 26 January 2008), HC Paper No.56–1 (Session 2006–07).
[74] Bank of England, *The Bank of England's approach to stress testing the UK banking system* (October 2015).
[75] Joe Miller, "Co-op Bank fails Bank of England stress tests" (16 December 2014), *BBC News* available at: *http://www.bbc.co.uk/news/business-30491161* [Accessed 28 April 2017].
[76] FSMA 2000 s.1B.
[77] FCA, Final Notice to Lloyds Bank plc, Bank of Scotland plc and Black Horse Limited (together Lloyds Banking Group "LBG") (4 June 2015).

easily between different financial service providers, firms will have strong incentives to improve the quality of their products and services so as to retain and attract customers.[78] In 2013, the Current Account Switching Service (CASS) was introduced, operated by the Barc Payment System Ltd, which covers 99% of the UK market and cuts the time of switching current accounts to only seven days.[79] The simple and free CASS service has already helped more than three million customers to switch accounts, which benefits challenger lenders considerably as they can solicit customers who are fed up with their original banks.

Some regulatory concerns

Arguably, challenger banks and, in particular, those with a digital focus need different treatment from financial regulators. Currently, their relatively small market scale could make them endure high compliance costs as regulators set the same rule for all lenders whether it is a large bank with 3,000 branches or an online-based lender. It costs more for smaller banks to access payment services which are run by dominant banks.[80] This section focuses on three regulatory issues which are of particular relevance to challenger banks: capital requirement, data protection and privacy, and financial innovation.

"Unfair" capital regime for challenger banks

In most cases, the regulatory rules apply equally to all banks including challenger lenders. However, the current banking regulatory framework is said to favour incumbent banks rather than challengers, especially the capital requirement.[81] It is mainly about the PRA's regulatory approach to the Pillar 2A capital, which is a requirement for lenders about the add-ons of capitals which individual firms have to put aside above the sector-wide minimum standard. According to the rule of Pillar 2A, challenger banks have to calculate their capital requirements based on the riskiness of each loan they have extended, by using the PRA's standardised model. As challenger banks are new to the market, they lack long-term business data and loan records as well as having a more radical business model, so their businesses have been considered as having more risks. It results in a higher risk rating and therefore the higher capital add-ons. In contrast, established banks based on their historic lending data are able to use their own customised models to calculate the riskiness of loans, which normally results in less capital requirements compared with the standardised model. The variation between two models can be as much as 960% for residential mortgages.[82] It means that more of the challenger banks' capital will be held in reserve rather than being lent out, leading to a major competitive disadvantage. In this regard, the current regulatory practice could prejudice the further development of emerging challengers. The British Bankers' Association has already addressed this issue with the regulator by asking them to introduce a more flexible risk assessment regime which can reduce the impact of negative rating on challenger banks.[83] In February 2017, the PRA has issued a consultation paper and pledged to alter the Pillar 2A capital requirements to allow challenger banks and small lenders to provide more competitive mortgage services for UK consumers.[84]

Financial security and data protection

Digital-only banks such as Atom and Monzo, whilst offering better user experience and convenience, also raise concerns regarding security issues and personal data protection. In traditional banking, most financial activities such as opening accounts and applying for loans have to be done in person at a physical branch. As more and more banking activities are moving online, regulators have to ensure that such practices will be under the same supervision as they are when completed in branch to protect the interests of financial consumers. In particular, the identity verification of mobile users by employing facial recognition, voice recognition, fingerprint sensors and other bio data needs more scrutiny to enhance the safety level. Moreover, digital financial service providers have to pay more attention to safeguarding the personal data of their users as well as combatting phishing websites and mobile apps, and preventing other fraud mechanisms that might be exploited by financial crimes.

FCA's sandbox—financial innovation incubator

According to a recent ranking by EY, the UK has topped the list of the most fintech-friendly jurisdiction in the world.[85] Clearly, the FCA puts the competitive objective at the centre of its regulatory work, which stimulates disrupters in the financial industry to promote innovation and competition. Recently, its regulatory "sandbox" has caught worldwide attentions, which is said to consolidate the UK's position as a leading fintech centre. The regulatory sandbox allows business to test novel products, services, business models and delivery mechanisms under a temporary lighter regulatory environment, which is

[78] FCA, *Report: Making current account switching easier: The effectiveness of the Current Account Switch Service (CASS) and evidence on account number portability* (Practical Law Financial Services, Thomson Reuters, 12 March 2015).
[79] Bacs, "What is the Current Account Switch Service?"*https://www.currentaccountswitch.co.uk/Pages/Home.aspx* [Accessed 28 April 2017].
[80] Goff, "Challenger banks have the Big Four in their sights", *Financial Times*, 16 August 2014, p.8.
[81] KPMG, *The game changers* (2015), p.17.
[82] Kathryn Gaw, "Bank of England relaxes regulations for challenger banks", *FT Adviser*, 27 February 2017.
[83] James Barty and Tommy Ricketts, *Promoting competition in the UK banking industry* (BBA, June 2014).
[84] PRA, *Refining the PRA's Pillar 2A capital framework*, Consultation Paper CP3 (17 February 2017) available at: *http://www.bankofengland.co.uk/pra/Documents/publications/cp/2017/cp317.pdf* [Accessed 28 April 2017].
[85] Caroline Binham, "UK regulators are the most fintech friendly" (12 September 2016), *Financial Times* available at *https://www.ft.com/content/ff5b0be4-7381-11e6-bf48-b372cdb1043a* [Accessed 28 April 2017].

good news for fintech businesses, including challenger banks.[86] Clearly, financial innovation defies conventional business models, services and products, and thus, it is difficult for challengers to innovate under the existing regulatory rules which were designed for the existing industry. Accordingly, the FCA's sandbox can help firms to test their products in a safer and more flexible environment without the overhaul of current regulatory systems. It is a win-win situation for the fintech business, the regulator and financial consumers. At present, there are 24 firms selected by the FCA as the first cohort for sandbox testing and there will be more businesses included in the second round.[87] Surely, digital-focused challenger banks can take this opportunity to utilise the sandbox to carry out fintech experiments.

Concluding remarks

Fintech, by combining financial service with digital innovation, has bought radical change into the financial industry. This article has introduced and analysed the UK's rising digital-focused challenger banks as the most recent example of fintech revolution. The global financial crisis and continuous scandals of large banks have unleashed people's dissatisfaction about the financial industry. Conversely, challenger banks have no historical legacy and adopt a simplified and low-cost business model based on the internet and smartphones, which gives them a clear competitive advantage. Many of them target the niche market in Britain by serving customers such as small businesses and personal consumers who have been overlooked by incumbent banks. The special market focus, coupled with the customer-centric spirit, help these disrupters win significant market shares. Being gap-fillers, challenger banks have been enjoying fast growth and have become thriving businesses, despite their short history. In recent years, the publicly-listed challenger banks outperformed FTSE All Share Banks Index and generated substantial returns for their investors.[88]

However, it remains difficult for challenger banks to shake up the banking industry dominated by the Big Five. According to some analysts, it could take several years, if not decades, for new lenders to build up sufficient scale to rival dominant banks.[89] The current banking regulatory system is said to favour mainstream lenders rather than newcomers. At the moment, challenger banks have to hold bigger capital buffers than their larger competitors due to the different risk assessment models they are using. The FCA has realised this problem and tried to design a more suitable regime to minimise the negative impacts of existing regulation on the challengers' development. As we know, competition is critical in improving the quality of financial services and products for the benefits of financial consumers. Therefore, the financial regulators, including the FCA and PRA, shall endeavour to create a level playing filed for challenger banks and incumbent lenders. The recent effort of the FCA's regulatory sandbox is a great step forward, which contributes to London's leading position as a global fintech hub. Hopefully, in the upcoming years, we will witness some challenger banks becoming real competitors to the banking system, rather than being mere niche fillers.

[86] FCA, "Regulatory sandbox" (2017) available at: *https://www.fca.org.uk/firms/project-innovate-innovation-hub/regulatory-sandbox* [Accessed 28 April 2017].
[87] FCA, "Regulatory sandbox" (2017).
[88] Richard Stovin-Bradford, "Get Rich Quick with UK Challenger Banks", *Financial Times*, 11 October 2015.
[89] Goff, "Challenger banks have the Big Four in their sights", *Financial Times*, 16 August 2014, p.8.