What doesn't kill you...

UK challenger banks see themselves as the future of banking. The virus crisis means that future is approaching faster than expected and it's not all good news. ***Gren Manuel*** *reports*

Pressures and problems that were building slowly in UK challenger banks have ramped up in recent weeks, causing quick changes to plans and, in at least one case, senior leadership. Meanwhile, their traditional rivals have suffered a shock to the system that might turbocharge their digital offerings.

Chris Ward, principal consultant at Mapa Research, part of Informa Financial Intelligence, a financial research service, says the crisis has put long-standing questions of profitability into sharper focus: "What Covid-19 does is to accelerate everything."

Focus on profits

There is a Wall Street saying that 'No one rings a bell at the top of the market' but for challenger banks, and indeed all fintechs, the bell has been ringing loud for months. Buzz phrases such as 'unit cost economics' were becoming common, reflecting a new drive to make money on each customer instead of simply trying to acquire new ones.

The reason was that the outlook for venture funding was already darkening, thanks in large part to the dismal post-IPO performance of Uber and the governance fiasco over the listing of WeWork, both lavishly funded.

Any funding freeze threatens all UK challenger banks, as they are not yet profitable and consume capital to survive. Many other high-profile fintechs face the same issue.

Carlo Gualandri, the serial digital entrepreneur who is chief executive and founder of fintech Soldo, remarks: "In January, we were in a world where only the top line was relevant and no one cared how much money you were spending to get there. All of a sudden, we went back to normality and everybody needs to become thrifty again."

Boards may ask whether the existing team has the right skills, and the stomach, for thrifty times. Tom Blomfield, the co-founder of online bank Monzo, who has a background in financial start-ups, gave up the chief executive position in May to TS Anil, who has worked for Visa, Citigroup and Capital One. Expect more moves like this.

Diversifying revenues

The first income stream for Revolut, Monzo and the bank-like challengers such as Monese was card transaction revenues, but these have fallen sharply in the wake of lockdown – and proper recovery may be a long way away. Yes, people are using cards more to make payments during lockdown (one challenger bank has found payments to Amazon have risen more than 20%) but these are not the sort of payments that generate the most revenues, which is international payments. The collapse in international travel is a double blow: not only are cross-border card commissions higher, but many challenger cards were used exclusively for overseas spending because they offered keen rates.

Anne Boden, chief executive of Starling Bank, said in an Alt-Fi webcast in mid-June: "You'll have a division among fintechs, between the ones who are going to thrive in this new environment...and then those that haven't got a business model that can be resilient when international travel isn't as prevalent, and people have less money to pay for luxury, premium products."

> *"One lesson from the dot-com crash was that the companies that survived were those that adapted to lean times fastest*

Revolut and Monzo were both developing new income streams before Covid-19. These campaigns have now been stepped up, with fees introduced for some previously free services and extra services introduced, such as crypto investing. But the real diversification is more strategic: moves into business accounts. Monzo launched its business account the week before UK lockdown and Revolut has been steadily enhancing its business offering. SMEs have traditionally been the more profitable part of UK banking – given a retail service but charged a business price.

Boden said Starling's earlier move into SME lending was "profitable on a per-account basis from day 1". Starling's offering, and that of challenger SME bank Tide, have been helped by offering the "bounce back loans" guaranteed by the government.

Controlling costs

I was a reporter covering the tech industry during the dot-com crash of 2001. One lesson was that the companies that survived were those that adapted to lean times fastest. Amazon, for instance, hunkered down and cut 15% of staff early in the crisis. Stock markets punished it, but it survived while deluded rivals ran out of dollars. Some challengers have already cut jobs. More may come when the furlough scheme ends. With much of their spending on marketing, challengers have many other ways to tighten belts.

Also, the funding taps are not yet turned off. Monzo and Revolut raised funds after UK lockdown, although Monzo took about a 40% cut in its valuation to do so. (Revolut raised a blockbuster US$500m a month before.) Their runway – the period they can operate for without needing further funds – looks long. The outlook for less high-profile players is mixed.

Even apart from these operational challenges, other pressing problems remain unsolved. For instance, they are not yet making significant inroads into the massive account bases of the high-street players.

The most recent detailed account-switching data, from the last quarter of 2019, showed that of the 235,000 accounts switched using the official switching service, fewer than 5% went to Starling and Monzo, the two challengers whose data is visible.

Privately, executives at challengers are concerned that peeling customers away from big banks may become harder in a recession where customers may have a safety-first mindset.

The dinosaurs can dance

Incumbent competition is also not standing still. Andy Ellis, head of ventures at NatWest, told an Innovate Finance online seminar in May that the changes needed in the wake of lockdown, such as quickly moving requests for mortgage holidays to an automated system, had shown "we can spin on a dime when required". He said: "That would never, ever have happened without this discontinuity."

Big banks are also keeping the cash flowing for their digital efforts. Santander announced in June it would hire 3,000 extra IT staff to accelerate its digital transformation across Europe.

Even before the kickstart, traditional banks had been closing the gap with new players in terms of online experience. Ward says: "Maybe the interface for the neo bank brand is looking a little bit nicer, and it might be a little bit easier to use. But the actual capability gaps are not what they were."

Branching is out

It would be wrong to portray the virus crisis as undiluted bad news for the new players. Although it has brought forward some tough decisions, it is no smooth ride for their traditional banking rivals either.

The advantage of a traditional branch network is certainly reduced if customers have to queue 2m apart from other customers for 10 minutes to enter. Any UK economic downturn will hit the high-street banks' mortgage and car loan books hard. The impetus given to their digital plans in the first weeks after lockdown may also fade. Ellis conceded the challenge, saying: "The bigger question is how you don't rubber-band back and go back to slower times."

But perhaps most important is that the megatrends that helped create London's fintech explosion remain unchanged. Regulators remain keen to inject new competition into consumer banking; technology costs are still falling thanks to the cloud; and although traditional banks are having a "good crisis" (compared with the last one), they are hardly much-loved brands. Plus, the move towards digital finance broadly has been given an additional push as consumers shun cash. [For more details of the shift in payments, and the policy response, see Tim Green.]

> *Digitally, for high-street banks the bigger question is how you don't rubber-band back and go back to slower times*

It is easy in the middle of a storm to think that everything has changed. But the winds eventually die down. Many of the global internet giants of today only found a viable strategy during the dot-com collapse. And many of the second wave of global tech firms were founded in the years after the 2007–08 crisis.

Giles Andrews, co-founder of Zopa, now a bank and one of the few fintechs that had to weather the previous crisis, told a Centre for the Study of Financial Innovation seminar in May: "If I look back to 2008, when Zopa was much younger, the crisis was the making of the company."

The fintechs that survive in the near term will be lean and efficient. But whether they can grow from that base will depend on factors outside their control – including the bank rate and the regulatory environment.

And some fintechs – just like some dot-coms 20 years ago – were founded with an eye to being acquired. They may not get the megavaluation they hoped for, but they will at least see survival of sorts. ■

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