cutting through complexity

The changing world of money

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SETTING THE SCENE

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In the last 20 years almost every part of our lives has been transformed. We have experienced two decades of digital revolution. The internet, social media and mobile devices have changed the way we interact with friends and family, the way we buy and consume music, films and television, and the way we read books, newspapers and magazines.

This revolution has taken longer to penetrate and transform financial services, but increasingly the same forces are reshaping how and why we interact with our banks as well as the types of organisations we expect to perform some of the most basic banking functions, such as lending money, taking deposits and handling payments.

At the same time several 'challenger brands' have entered the banking market, with many having built a business around just a new approach whether that's digital-only, peer-to-peer (P2P) services or a more customer-oriented, data-driven approach. Indeed developments in handling data that allow banks to predict and map behaviours are allowing some of these challengers to take an evidence-based approach to shaping future services.

Meanwhile new payment systems and digital currencies mean the way consumers interact with their primary banking provider is changing. As in other markets, new entrants and challengers have begun to transform consumer expectations. Consumers comfortable with a fast and painless mobile and digital retail experience expect banks to offer something similar.

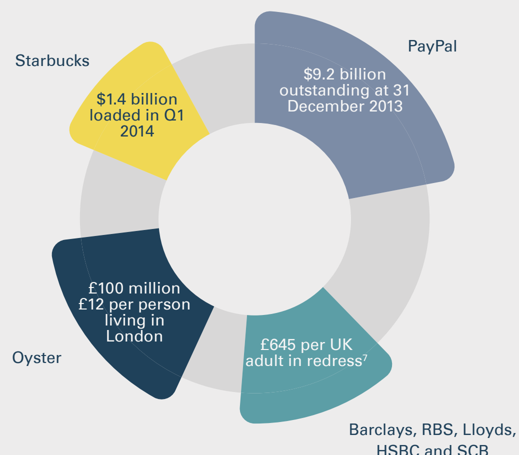
Pretty soon the executives at the top of our major retail banks will be looking around and wondering who ate their lunch.

The numbers speak for themselves. At 31 December 2013, $9.2bn was held in PayPal accounts[1] and PayPal transacted $7,118 in total payment volume[2] every second during the third quarter of this year.

I believe banking is approaching what I call its "e-book moment". There are strong parallels with the recent disruptions in publishing and the book market, where the combination of powerful new entrants to the market, especially Amazon, and changing consumption patterns driven by new technology (in particular e-readers, such as the Kindle) have transformed the business. Five years ago, 96.1% of books were sold in printed format but by last year that had fallen to 85%[3], with just 47% sold in physical stores[4]. It's a tough time to be an independent bookstore at the moment. How long before it is also a tough time to be a major retail bank?

Did you know...?

Closer to home, there's £100m sitting dormant on Oyster cards in London[5], which is equivalent to £12 per person living in Greater London. Meanwhile, $1.4bn was loaded onto Starbucks cards in the first quarter of 2014[6]. All these numbers are on the increase. In comparison, conduct related costs by the big banks since 2011 have amounted to £645 per adult living in the UK. While none are revolutionary in themselves, all of these developments speak to a dramatic long-term shift in consumers' relationships with money and their bank.



[1] Source: http://files.shareholder.com/downloads/ebay/3720743100x0xS1065088-14-10/1065088/filing.pdf
[2] Source: http://files.shareholder.com/downloads/ebay/3720743100x0x767730/6e8a9d06-5c19-40a3-a535-ab15678b5771/PayPal_Q1_2014_Graphical_FastFacts_Final.pdf
[3] Source: http://www.booksellers.org.uk/BookSellers/media/SiteMediaLibrary/IndustryNews/UK-Book-Sales-2001-2013.pdf
[4] Source: http://www.booksellers.org.uk/BookSellers/media/SiteMediaLibrary/IndustryNews/UK-Book-Sales-Source-of-Purchase-2009-2013.pdf
[5] Source: http://www.standard.co.uk/news/london/100m-of-your-money-is-stuck-on-unused-oyster-cards-8678423.html
[6] Source: Starbucks First Quarter Earnings Release, January 2014: http://investor.starbucks.com/phoenix.zhtml?c=99518&p=quarterlyearnings
[7] Source: KPMG publication Bank to the Future, Sept 2014

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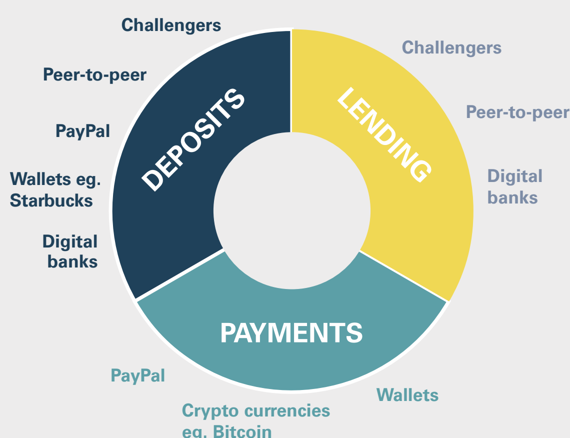
The point is that the forces combining to challenge the position of the established big name retail banks are the same factors that are shifting the balance of power in many other markets. This process is what Harvard Business School's Clayton Christensen dubbed "digital disruption". New challenger organisations, banks need to embrace the best elements of the new business models and combine these with the strong existing customer relationships they have. In this way disruption can be harnessed as a positive driver of innovation as well as a challenge.

The three pronged attack on retail banking

This report considers the three fundamentals of retail banking – lending, deposits and payments – and in each case identifies some of the threats, challenges and opportunities that lie ahead for all those operating in the retail banking market. It poses tough questions for bank leaders about the sort of organisations that will survive and thrive not only in the short to medium term, but also into the more distant, long-term future.



from banks to peer-to-peer lenders to PayPal and Bitcoin, are smaller, more agile and quicker to respond to changing trends. With few or no legacy systems and greater responsiveness to customer needs (and with few requirements to offer full-service solutions to non-profitable customers), they can attract affluent, intelligent and profitable consumers. These challengers are not looking to eat the whole meal. They will simply pick off the best bits.

Many of these challengers are free of any legacy or hangover from the financial crisis. They are more lightly regulated and have much lower costs. While much of the focus in the main retail banks remains on extensive remediation activity and reputation rebuilding, these new arrivals are perceived as a breath of "fresh air", free (for the time being) of the taint of scandal or corruption.

But there are also opportunities for any banks prepared to look to the challengers as beacons of opportunity, as exemplars of what is possible rather than just a threat offering services they can't match. The major

In order to fully appreciate that challenges and dangers to their business can come from unexpected quarters, it is valuable for those at the top of the big banks to learn to think disruptively themselves and to look to other sectors to learn lessons for retail banking.

In the face of this new wave of disruption it is more than likely that the major banks, with their smart employees and deep wallets, will swiftly develop the products and services that allow them to become 'fast followers' that with their long-established customer relationships and brand reach will make them strong challengers to the challengers.

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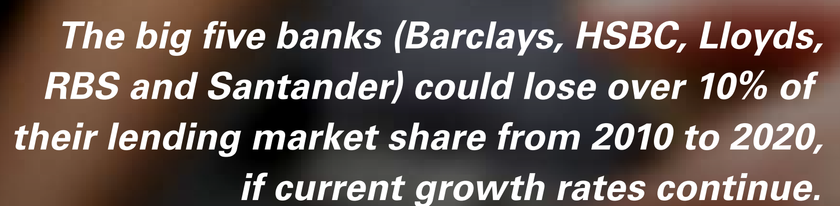
THE LENDING ENVIRONMENT



The big five banks (Barclays, HSBC, Lloyds, RBS and Santander) could lose over 10% of their lending market share from 2010 to 2020, if current growth rates continue.

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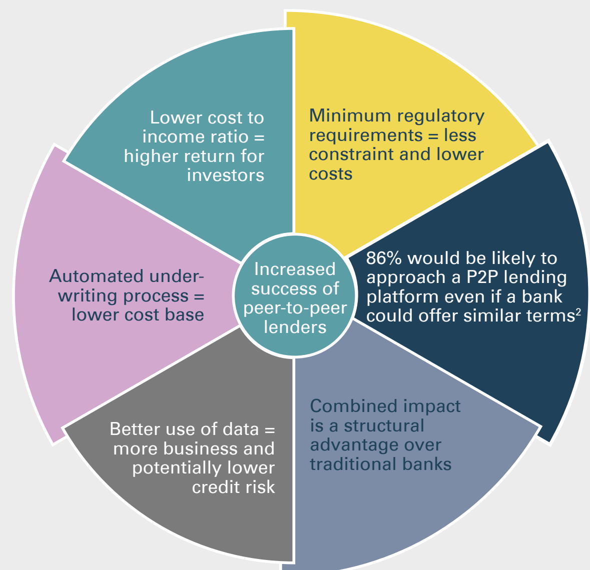
No longer is the local bank manager necessarily the first port of call when a small company is seeking working capital or expansion funds. The move away from the major high-street banks as lenders of choice has not yet turned into a stampede but the evidence is building that the days of their complete market dominance may be coming to an end.

Peer-to-peer lenders

Consider the growth in peer-to-peer lenders, such as Funding Circle and Thin Cats. By the end of 2014, they will have lent £1.74bn to around 7,000 small and medium-sized companies. That represents 2.4% of all bank lending to SMEs[1], still a vanishingly small slice of the market, but one that is growing at a formidable pace. And this picture is repeated for the wider retail lending environment as a whole.

If current growth rates continue, the major retail banks could lose over 10% of their lending market share in the next five years.



Challengers are focussing on services absent or underplayed in large banks

The main gains are likely to be made by the challenger banks as they adopt different business models focusing on competitive drivers that are absent or under-played in main banks.

Reverse decline in bank branch use
Metro Bank, which aims to have 200 branches in Greater London by 2020, seeks to reverse the decline in bank branch use by revolutionising service to clients opening for longer hours, providing in-branch services such as free use of coin counting machines and free dog biscuits.

Capitalising on mobile first mentality
In 10 years' time we will be looking at a drastically different retail banking industry, not just in terms of the number of players in the market, but because of the move from the local branch to laptop and now one step further to mobile. This trend is only going to increase as technology improves and more and more people become comfortable with the internet.

Diversified product range
The big banks will remain dominant in current account banking but the challengers will score customer wins by offering products other than current accounts or by targeting niche markets that the main banks have often overlooked. For example, Triodos, which attracts customers who are looking for "ethical banking" and publishes details of every organisation it lends to as a unique selling point.

Customer savvy flair
The challenger banks are seemingly better at being customer savvy. The Swedish-owned challenger Handelsbanken UK, for example, makes a point of delegating loan decisions to branch managers close to the customer. By giving their experienced branch teams everyday decision-making power, they are able to serve each customer individually, with care and consistency. In a similar move, HSBC is allocating £6bn of new lending direct to its 52 regional business centres empowering local relationship managers to identify and work with ambitious companies directly[3].

[1] Source: http://www.nesta.org.uk/publications/understanding-alternative-finance-uk-alternative-finance-industry-report-2014
[2] Source: http://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf
[3] Source: http://www.newsroom.business.hsbc.co.uk/press/release/new_climate_of_growth_for_brit

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The major players will not give up market share without a fight

For all this new activity in the market, it is important not to lose sight of the fact that the big banks still dominate both commercial and personal banking. Figures compiled by the Competition and Markets Authority (CMA) show the biggest four hold 77% of personal current accounts, 85% of small business current accounts and 90% of their loans.[1]

The entrenched positions of these traditional players will not change quickly. They carry the multi-billion pound legacy IT infrastructures which can restrict or slow down change. Many operate under the weight of damaged reputations, the hangover of a string of market abuse and mis-selling scandals.

And meanwhile these banks have the opportunity to learn from challenger innovations. Professor Andre Spicer, whose work as founder director of The Centre for Responsible Enterprise at Cass Business School includes studying British banks, expects the major banks to learn new tactics from the challengers and alternative finance providers driving a focus back to the customer rather than the bank[2]. This will bring suitable and sustainable offerings to the market.

Spotlight on: Zopa

For Giles Andrews, co-founder of Zopa, the world's first peer-to-peer lender, the concept came about through a classic entrepreneurial process of looking at existing markets and spotting the potential in a gap.

"We looked at the way big businesses no longer went to the banks for finance, but instead went directly to the bond market. We saw there was no equivalent for consumers. Big businesses are rated by the ratings agencies and thus there is a clear measure of their credit worthiness and security. We wondered whether we could do something similar for the consumer market. We also looked at the success of eBay, which we recognised was built largely on the social sharing aspect of the business. This was in the days before Facebook, but it was clear that people enjoyed the sharing and community aspect of eBay."

In the decade since launch Zopa has gone from strength to strength (and been joined in the market by some 50 other peer-to-peer finance providers in the UK alone) and by the end of this year will have lent over £1bn. Peer-to-peer lending relies on transparency of information to be effective and Zopa is about to open its entire lending book up for public scrutiny.

"Transparency is crucial for us to be able to build trust and we always look to be as open as possible. I can't imagine one of the main banks sharing this much detail on their loan book with anyone."

Having turned the market for small, short-term loans upside down, there are indications that Zopa may well extend its reach into new areas, with mortgages an obvious candidate for its model.

"Zopa deals in loans paid back in instalments and while at the moment that means three to five years, there's no reason it couldn't be over 25 years."

[1] Source: https://assets.digital.cabinet-office.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf
[2] Source: http://newcityagenda.co.uk/wp-content/uploads/2014/11/Online-version.pdf

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THE GREAT SAVINGS CONUNDRUM

"P2P lending is an exciting, innovative new sector and it's right that investors who want to lend money via P2P platforms should be able to hold these loans in their ISA alongside more traditional investments."

David Gauke, Financial Secretary to the Treasury

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If the Organisation for Economic Co-operation and Development (OECD)[1] is right then British households will save just 3.3% of their disposable income in 2015. That is better than the 2.2% they saved in 2008, the year of the financial crisis, but worse than the 7.3% in 2012, the best year since then. In a world league table of savings rates, Britain remains in the relegation zone.

Since the Second World War, British households have on average saved around 6% of their disposable income compared with typical European figures of between 11% and 15%. So blaming the lack of current saving on the unprecedented stretch of rock-bottom interest rates is only part of the story.

When David Blake, professor of pensions economics at the Cass Business School, says that the country has lost its savings culture[2], it is important to remember at this point that the culture was never very strong. Blake, who is also director of the Pensions Institute, blames some of the recent decline on the easy availability of low-interest loans.

But a detailed study he conducted earlier this year with Alistair Haig, a research fellow at the Edinburgh University Business School, throws some worrying light on the chances of stimulating a future savings culture. Blake discovered that just under half of his respondents claimed they saved regularly. He also found that too many savers have a "reckless conservatism" in seeking to attain their long-term savings goals. Either they don't save enough or they fail to take enough investment risk to ensure modest savings grow in line with their long-term target.

Blake's remedy for this conundrum: better designed investment products with clear risk objectives – such as defined volatility, downside risk or outcome targets – which are aligned with the savings goals and risk appetites of different savers. He says: "Recent responses from the fund management industry, including risk-targeted funds, target date funds, diversified growth funds and income targeting funds are examples of the industry's efforts to accommodate individual risk preferences and savings goals."

But although products such as these could help more savers meet their goals – and lead to a long-term improvement in the nation's savings culture – the financial services industry is struggling to get its message across to an audience of potential customers who are suspicious about integrity and intentions. A string of scandals, such as PPI mis-selling, has not blighted all banks and financial institutions equally, but it has blackened the image of financial services as a whole. In 2017, the government is due to review the progress of the auto-enrolment pensions process and the performance of the National Employment Savings Trust (NEST). Ideally, by then the industry should have demonstrated a vigorous determination to reform itself. But if the industry has failed to make substantial progress in promoting more savings by then, the government should step in. The challenge would then be to work out what legislation and regulation would deliver a transformational rather than incremental change in attitudes towards saving.

Changes are afoot

The growth of interest in peer-to-peer lending has stimulated some mainstream players to reassess their approach to this new market. Earlier this year, Santander UK formed a partnership with peer-to-peer lender Funding Circle. Santander executive chairman (and former UK chief executive) Ana Botin says: "Peer-to-peer financing is a useful way to introduce people to the concept of investing in entrepreneurs, an important element in a healthy economy."

This area of investment is on the rise. We know that most savers cite interest rates as the key determining factor of where they place their money and people using P2P sites generally earn higher rates on investments, although there is also a higher credit risk attached. This distinction between a savings product and P2P, which is an investment, is an important one. Not all consumers are aware of the difference and therefore the industry needs to tread cautiously. The current players are somewhat hampered by a lack of public awareness, something the major banks, with their long-established customer relationships, don't suffer from. This suggests the growth potential, when awareness is higher, is enormous and an increase in advertising and brand recognition will likely fuel faster growth.

Alternative finance players have certainly begun to attract significant numbers of investors. Zopa, for example, has more than 52,000 active savers with an average of £5,500 in their accounts[4]. Zopa's chief executive Giles Andrews says: "By cutting out the banks and offering returns of 5% – compared to bank savings rates typically under 1% – we are rewarding people for being sensible with their money."[5]

[1] Source: http://www.oecd-ilibrary.org/economics/household-saving-rates-forecasts_2074384x-table7
[2] Source: http://www.cityam.com/blog/1392812744/cheap-loans-have-destroyed-uk-s-savings-culture-says-pensions-professor
[3] Source: http://www.cass.city.ac.uk/__data/assets/pdf_file/0014/213323/SaversRisk.pdf
[4] Source: http://www.prnewswire.co.uk/news-releases/peer-to-peer-lending-hits-the-mainstream-as-zopa-lends-over-half-a-billion-pounds-253316391.html
[5] Source: The Future of Retail Banking Conference, November 2014

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The alternative finance industry has tackled two key confidence issues head on

First, it has taken steps to calm savers' concerns about losing their money. Earlier this year, the Peer2Peer Finance Association, which represents the major players, adopted a new standard for calculating default rates on loans. A standard measure which helps ensure that data is presented in a transparent and fair way and ensures that loan default data is also honestly presented.

Secondly, some alternative finance providers have begun to package saving products with the specific aim of attracting savers who are looking for a guaranteed return on a modest investment. For example, Wellesley Finance, launched by serial financial services entrepreneur Graham Wellesley in 2013, offers a savings bond for a minimum investment of £100 at an interest of up to 7% gross for a fixed term of five years.

On top of this the British Business Bank has teamed up with several alternative finance providers and P2P platforms to make the most of its funding, while the Treasury has announced a consultation on plans for a third ISA (alongside cash and stocks and shares), which would be exclusively for P2P investments. This would be an enormous boost for the sector, as the ISA market remains a core part of the UK's savings landscape.

Critical for the industry though is the need to continue to educate investors about the risks involved in P2P investments and that they are not the same as FSCS guaranteed savings products. Failure to manage this properly could spell the downfall of the whole industry.

A fundamental need to promote a savings culture

Market innovation may play some role in encouraging people to save more money. But there is a central fact that haunts policy makers who want to promote a more vigorous savings culture in a time of austerity. They must create the economic conditions which encourage saving – and that will always be a challenge while real wage growth remains negative.

If savings as a whole do not improve as the economic recovery strengthens, banking needs to look long and hard at the kind of further changes it should make to encourage – or compel – people to put more in their piggy banks.

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DIGITAL CURRENCIES FOR A DIGITAL WORLD

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The Royal Mint is in the middle of a four-year programme that will replace 3.8 billion 5p coins and 1.6 billion 10p coins with new money made out of cupronickel alloy. It is a reminder that coin of the realm will be jangling in peoples' pockets for many years to come.

But in the longer term, could the growth of electronic payment systems, crypto-currencies and local trading exchanges send traditional money the way of the groat, the mediaeval four pence which finally disappeared in Victorian times?

Pundits have been predicting the rise of the cashless society since credit cards first appeared in the UK in 1966. A survey of 2,000 British consumers by Kalixa Pro in June 2014 found it could be coming closer. Yet the changing world of money raises some important questions. Not least among these is whether we any longer know what we mean by money. For years, economists and business planners have used the Bank of England's M0 "narrow money" (notes and coins plus bank operational deposits at the Bank of England) and M4 "broad money" (notes and coins plus bank account balances) definitions as a guide to policy-making and business planning.

But an eclectic group of changes means that economists, policymakers and businesses may need to start thinking about money in a completely different way. In no particular order, those changes include the launch of mobile-based "digital wallet" apps, such as Apple Pay and Square, money being loaded onto prepayment cards, the emergence of digital currencies such as Bitcoin, the growth of local "complementary currencies" such as the Bristol pound, and the popularity of non-currency local exchange trading schemes (LETS).

Rewriting the rules

Some of these changes will rewrite business rules and create winners and losers. Consider, for example, mobile-based "digital wallet" apps. The launch of Apple Pay in 2014 could be the first skirmish in a battle involving rival app providers and credit card companies. CurrentC, a rival app developed by a consortium of big retailers led by Walmart, is likely to launch in the US in 2015. If successful, it is bound to make its way to Europe.

Meanwhile Twitter co-founder Jack Dorsey's digital payment business Square has launched a partnership with hot social app Snapchat to offer "snapcash" a simple system that will allow its largely teenage users to share money as quickly as they share pictures.

The stakes in this battle are high: not least the millions of pounds in "swipe" fees which credit card companies take when customers buy from retailers. The apps are said to deliver a double win – for consumers who can pay securely at the point-of-sale with their mobile phone and for retailers who stand to pocket some of the 1% to 3% total fees that would have been taken for processing the transaction.

But one of the biggest posers in the changing world of money lies in the potential of "crypto-currencies" such as Bitcoin. They need to operate as a medium of exchange, a store of value, and a unit of account. As a medium of exchange Bitcoin is constrained by the fact that so few outlets accept it in payment. Although this is expanding, in the US blue chips such as Dell, Expedia and Overstock now accept Bitcoin. It is not yet a reliable store of value because its price against national currencies can fluctuate by as much as 20% a day or more in exceptional circumstances.

It is however very early days but there are close parallels with the early days of the internet. Bitcoin is the internet of money. It would be wrong to write it off just yet. It's just in its infancy and will grow. With its open architecture it could develop into something very interesting.

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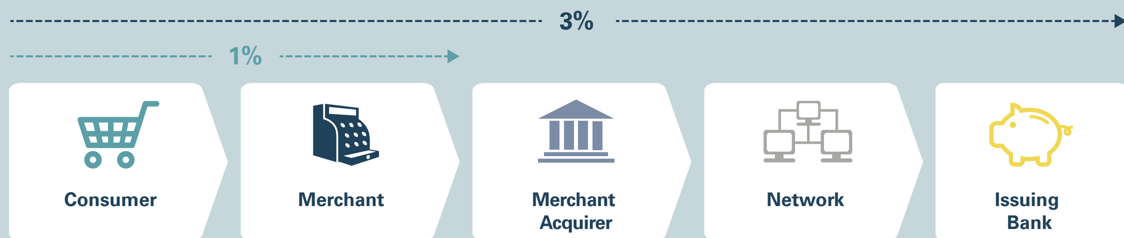
Spotlight on: Bitcoin

Describing Bitcoin as a "giant public ledger in the cloud"[1], Jon Matonis, executive director at the Bitcoin Foundation, claims that there was no reason that the major banks couldn't tap into the growing demand for the peer-to-peer crypto-currency. "There are opportunities for the banks to become Bitcoin exchanges or to set-up trusted e-wallets. There is no reason these need to be run by teenagers in their basements. There is no history of trust and this is somewhere banks certainly have an advantage. The trust business is the banking business."

The main retail banks could also look to operate the merchant processing for retail Bitcoin transactions and also set up systems of escrow for those transactions that require such a service. Bitcoin and the burgeoning blockchain economy around it is the major disruption in the world of banking. "You only get real disruption when you change the monetary unit of account and that's what Bitcoin does."



Spotlight on: Nymi

The future of payment includes all kinds of clever new technologies, many of them still in the very early stages of development. One of these is a project by Canadian firm Bionym, which has developed what it grandly calls 'the world's first biometrically authenticated wearable payment solution'.

The Nymi is a wristband that reads the wearer's individual heartbeat, which is unique to each person. Once authenticated, the wristband can already be used with existing contactless payment systems (thanks to a pilot running with Mastercard and the Royal Bank of Canada), but eventually, once developers get moving, the Nymi could be used in place of car and house keys, hotel room keys and even in place of passwords on computers and mobile devices. A spokesman for Nymi explains: "Using your unique cardiac rhythm to authenticate your identity offers security without compromising convenience, putting you in control of your identity."

Thanks to its clever proximity detection and authentication, the wearer will be able to interact with items as diverse as a car, house and mobile devices around them through the power of simple gestures. Quite how the major banks react in a world where payment can be made by gesture alone remains to be seen.

[1] Source: The Future of Retail Banking Conference, November 2014

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Other changes in the world of money are the result of a desire to marry social outcomes to financial ones rather than be led by technology. One example is the development of local complementary currencies, such as the Bristol Pound, designed to work alongside Sterling rather than replace it. Indeed, users have to purchase the Bristol currency on a pound for pound basis with Sterling. Because the Bristol pound is not legal tender, traders who accept it do so voluntarily.

Complementary currencies seek to generate extra trade for local SMEs at the same time as reducing the social exclusion of disadvantaged groups. The Bristol Pound is used to encourage people to set up food buying groups which can negotiate discounts with suppliers. The same kinds of social objectives are behind near-money projects such as local exchange trading systems (LETS) or community-based mutual help networks in which people exchange goods and services by using community credit points rather than money.

Complementary currencies and LETS use their social objectives to change the way people think and use money. But it could be that some of the biggest behavioural shifts will be generated where technology changes the nature of an individual's personal financial transactions. Paying with coins and notes was always an anonymous process. Paying with digital media won't be.

The brand consultancy Method conducted an experiment to discover what would happen when people's private spending habits become common knowledge[1]. The experiment's volunteers were told to keep a record of every purchase no matter how small by taking an Instagram picture of it. It soon became clear that most of the volunteers found the process so intrusive they wanted to become anonymous again. The conclusion: when people's spending becomes more visible, they seek to behave as they believe people would want them to behave rather than how they do.

Banks are aware of these trends and the challenge will be to use the next two to three years to build capabilities and flexibility whilst managing the priorities of regulatory change and legacy systems, and to use their full trusted brands. If the digitisation of money makes people's spending too transparent, it could be they will be sticking with those notes and coins for some time to come.

[1] Source: http://method.com/work/method-money

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LESSONS FROM PREVIOUS DISRUPTIONS

The impact of technology will be fundamental in shaping the UK's retail banking industry between now and 2024.

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Harvard Professor Clayton Christensen points out in his book, The Innovators Dilemma, that no matter how carefully you watch for it, you are unlikely to see the future coming and that the biggest companies fail because they don't see the disruption coming. They are busy innovating in existing product areas, often at the more sophisticated, complex and expensive end of a market and fail to spot new, younger, cheaper and simpler entries that end up stealing huge chunks of their core business.

Some of the main challengers in the retail banking space are not banks in any traditional sense of the word. Retail banks are competing with start-ups, supermarkets, tech giants and coffee shops.

As companies tend to innovate faster than their customers' needs evolve, most organisations eventually end up producing products or services that are too sophisticated, expensive and complicated for many of their customers. This has certainly been the case in retail banking, where more product complexity hasn't led to greater customer satisfaction or better customer experiences.

Disruptions within niche customer segments

Christensen defined a disruptive innovation as one that allows a whole new population of consumers at the bottom of a market access to a product or service that was historically only accessible to consumers with a lot of money or a lot of skill.

Characteristics include lower gross margins, smaller target markets and simpler products and services. These products may not appear as attractive as existing solutions offered by traditional providers and may indeed be within niche or lower end customer segments.

Some of the major disruptions in retail banking are aimed at the lower end of the payment market. Hence the likely success of the tie up between Square and Snapchat. The ability to exchange money between friends instantly and simply is not a product likely to excite the heads of innovation at the major banks. There is simply not enough margin to make it profitable. And so a generation emerges with little or no sense of their bank as the key provider of payment services.

Spotlight on: Kwik-Fit[1]

At the age of 27, successful young entrepreneur Tom Farmer (now Sir Tom Farmer) was in the US having sold his first tyre business for a healthy £450,000. He was meant to be enjoying a break, but instead found inspiration for his next business.

In the US he noticed there were 'muffler shops' which specialised in just fixing exhausts. In the UK this work was still carried out by universal car dealerships, who at the time undertook most, if not all, post-sales service work. The service was inconvenient for customers (being located in large out-of-town dealerships) and parts were often over-priced, while labour charges were opaque and usually extortionate. Sir Tom recognised there was an opportunity to specialise in a small, low-cost element of the post-sales service market (tyres and exhausts) and to offer a more customer-focused and convenient service. He set up the first Kwik-Fit in 1971, thereby establishing a new sector that took some £1bn of the total £8bn post-sales service market. By the time he sold the business to Ford in 1999 the company was valued at £1.2bn.

This is a classic example of a new challenger entering a market and stealing a slice of business by focusing on products and services at the lower value end of the market.

[1] Source: The Future of Retail Banking Conference, November 2014

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Digital disruption through intelligent use of data

Digital disruption is a reality in most markets and the financial sector won't be immune from this fundamental force. The rise of social media has led to a significant amount of personal data being readily available including level of education, current and previous jobs, living situations, hobbies and interests. New entrants to the banking sector are increasingly using this type of data to assess the worthiness of borrowers. Providers such as SoFi, a US-based peer-to-peer lender specialising in student loans, uses a student's GPA and school to determine their credit worthiness. Payoff, another US-based peer-to-peer lender, has recruited Galen Buckwalter, the scientist famous for developing the model used to make relationship matches on the online dating site eHarmony. He has been looking at implementing a similar psychometric formula to revolutionise the finance market.

There is already widespread recognition of the need for more modern, flexible technologies for data management which can help banks develop innovative products and alternative business models more quickly and provide more efficient controls and risk management. The wider issue for challengers and traditional banks alike is how they overcome inappropriate use of data, inflexible systems, and how they replace ineffective or overbearing controls.

Changing consumer habits drive disruption

In the book trade the combination of a powerful new challenger entrant, (in the shape of Amazon) combined with changing technology and consumer habits (the arrival of e-readers, such as the Kindle) totally transformed the book selling business. Five years ago, 96.1% of books were sold in paper or hard copy format. By 2013 that had fallen to 85%, of which just 47% were sold in physical stores.

Retail banking could well be approaching its own 'e-book moment'. Under the twin threat of new challenger entrants and new technologies that allow consumers to easily access new ways of interacting with their bank, it is highly likely that the existing players will see their market share eroded in the same way unless they act quickly and decisively.

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AN EXCITING FUTURE OF POSSIBILITIES

Major banks have faced minor disruptions for decades, from the invention of the ATM through to the arrival of previous challenger brands and new technologies, such as IF, Egg and First Direct. The difference is that these innovations came from within the large banks and most were driven and directed by the banks themselves. The current wave of disruption affecting the industry is more profound. This is partly because it is occurring (and being fuelled by) market reactions to the financial crisis. Consumers, unimpressed with the worst excesses of the large banks, have begun to embrace new challenger brands and platforms, particularly where these are built on direct peer-to-peer interactions, rather than being controlled by large, faceless institutions. These innovations and developments are therefore more consumer-led.

The major banks need to respond quickly and react nimbly, and yet they are increasingly hampered not only by their legacy systems and data management, but also by the increased costs of regulatory controls and the need to focus so much energy on remediation. There is therefore a widening gap between the desire for change on the part of consumers and the inability to serve their changing needs on the part of the established banks. This has attracted the attention of a new wave of financial pioneers. Entrepreneurs from all sorts of different backgrounds, perhaps most notably technology, have leapt at the chance to develop new models and build new businesses that meet the unmet needs of consumers. With so many developments and challengers coming from outside the industry, it is not surprising that the major players haven't reacted very quickly. As in most industries the largest players spend the most time watching each other and developing products and services to match those of their rivals. It is easier to launch a new kind of current account to match a close rival's new offering than to work out the opportunities that a digital currency such as Bitcoin presents or to see the value in social media or biometric authentication.

Should the current pattern of changes in market share continue, the big banks stand to lose a total of 10% market share by 2020. This would be painful but not fatal for any of the main banks. However, there are clear indications that the rate of change and the development of challengers will accelerate. Should that projected 10% market share loss turn into 20%, 30% or 40% then we'll be in a very different climate.

Regulators will continue to pile the pressure on to ensure that banks develop sufficient protections to prevent a further financial collapse. But they will also have to start to take note of some of the new challengers. It is therefore encouraging to see them showing positive signs towards investigating the potential of digital currencies. Indeed the Treasury has launched a consultation on digital currencies and set up a payments regulator. The form and effect of regulation remains to be seen, but it is unlikely to act as a major brake on the growth of new ideas, new services and new ways for consumers to interact financially with each other and with retailers, not to mention their money and their bank.

The future of retail banking is more uncertain than it has been for a generation, but that future is also highly exciting and full of possibilities. To succeed I believe the major banks will have to overcome existing legacy issues, and embrace new models of behaviour and new ways of interacting with their customers. Offering great value for money and excellent customer service have been prerequisites for genuine success in banking for all eternity and will remain at the heart of those who succeed in this brave new world of banking. Beyond those certainties, the rest is up for grabs. While it is tempting to see the current challengers as presenting huge threats to established banking players, it has to be remembered that these institutions have survived many previous disruptions. They are full of smart people and have deep wallets relative to the smaller players. With intelligent leadership, it is not beyond the major banks to develop new services or indeed to buy up challengers to become fast followers and protect their market share well into the next decade and beyond.

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