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DEAL OR NO DEAL: DO EU CHALLENGER BANKS HAVE A FUTURE IN THE UK (AND HOW TO BEST PREPARE FOR IT)?

By Dora Knezevic

In October 2018, N26, a European, digital-only, challenger bank or briefly, neobank, launched in the United Kingdom. With up to one in four British millennials banking with a challenger bank and the market attractive to other digital-only challengers, the Berlin-based neobank's UK expansion was hardly surprising.[1] N26 had already successfully launched across Europe and embarked on an ambitious marketing campaign in the UK, positive about achieving similar success in this new market.

A mere year-and-a-half later however, the neobank announced it will be leaving the UK and closing all UK accounts, citing overwhelming uncertainty about the future of its banking license in the UK following the end of the Brexit transition period. Although uncertainty surrounding the Brexit deal outcome is undeniable, Brexit itself was a certainty already when N26 entered the market in 2018. In the year-and-a-half the neobank spent in the UK market however, they did not action a particular contingency plan for addressing it. In fact, behind the scenes, N26 was already dealing with several other challenges, including compliance, a failure to differentiate from competitors and to capture a sufficient customer base.

The challenges faced by N26 in the UK are not exclusive to N26 – they are general challenges any European neobank will likely encounter as they enter UK and should consider during the planning of their potential UK expansion.

This article will further elaborate on these challenges, beginning with Brexit and subsequently the additional market challenges, overlooked by N26, relating to UK expansion with the goal of providing actionable insight for any European neobank considering entering the attractive UK market.

BREXIT

Firstly, as laid out by N26 in their leaving statement, Brexit and the potential subsequent regulatory changes are an undeniable difficulty and source of uncertainty for neobanks considering a UK expansion. There is currently no indication toward the potential outcome of the Brexit negotiations and with the current focus on the COVID-19 pandemic, it is unlikely any will be provided in the nearer future. Under the current withdrawal agreement, Great Britain and the European Union are in a transition period until the end of 2020 with the final negotiated deal (or lack thereof in case of 'hard' Brexit) coming into effect in 2021. Within this transition period, old regulation applies and European neobanks are permitted to use their European banking license to operate within the UK – i.e., 'passport' their license. If in the final Brexit deal 'passporting' is not permitted, (European) neobanks would likely need to consider either obtaining a UK banking license or setting up as subsidiaries within the United Kingdom.[2,3] Both of these processes are costly and lengthy, lasting 18 months and two years respectively, and would significantly increase the entrant's operational costs.

Within uncertainty, however, there is opportunity. Sam Woods, the head of the PRA, has indicated that the regulatory body would be open toward less strict regulation to small challengers as compared to large incumbents in order to enable market competition.[4] Additionally, Fitch Ratings have warned that UK-native neobanks might be underassessing the risks associated with a potential 'hard' Brexit and could consequently be more vulnerable to it.[5] This could potentially open up space for new neobanks in the UK market post-Brexit and provide opportunity for EU-native neobanks looking to expand into the UK. Moreover, the EU-native neobanks could have a particular advantage to UK-native neobanks post-Brexit by having a presence in the UK, as well as the EU, as they could provide better cross-border transactions' terms or be otherwise more attractive to frequent travelers to mainland Europe.

BEYOND BREXIT

Beyond Brexit, and subsequent regulatory compliance, there are other challenges relating to entry and success within the UK market, some of which are relevant not only to EU neobanks, but also their UK-native counterparts.

Firstly, the UK is a highly competitive market that is still limited in size, so it can be difficult for new entrants to differentiate themselves from competitors while reaching out to potential customers. Although increasing with the younger population, overall awareness of digital challengers is still low in the UK with less than 33 percent of people having heard of the three biggest UK neobanks in 2020.[1,6] This is partly due to the fact that the majority of Britons are not overly unhappy with their current, traditional banks which they still consider more trustworthy than the neobanks.[6] In fact, if the same financial product was offered by a neobank and a traditional bank, 45 percent of Britons would choose the traditional bank, whereas only 7 percent would choose the challenger.[6] Consequently, in order to capture a sufficient customer base, new entrants need to think beyond smart marketing strategies and differentiate themselves not only from other neobanks, but also the incumbents by offering financial products and services at more attractive terms or to underserved demographics.

Secondly, European neobanks have to be more conscious of their profitability and business proposition than their UK-native counterparts due to the potentially increased operational costs of achieving regulatory compliance in the UK post-Brexit.[3]

Currently, the majority of both European and British neobanks operate under a business model of fee-free banking with the majority of revenue coming from the interchange fee on card purchases.[7] As most customers don't use their neobank accounts as their primary currents accounts, this business model produces weak revenue streams at small scale.[8] While neobanks do have a cost-to-serve advantage compared to traditional banks, in order to achieve long-term profitability through this model, they have to increase their customer numbers, resulting in an increased average spend per customer on customer acquisition within the UK.[8] This leads to most UK neobanks operating either at a loss or with slim profit margins and while this may be viable for the UK-native neobanks, it doesn't leave sufficient financial buffer for the increased operational costs EU challengers might experience as they ensure UK regulatory compliance.[7,3]

Consequently, EU-native challengers might have to rethink their business proposition and develop an additional profit-increasing product/service strategy. In the case of N26, the German neobank focused on tiered products i.e. premium, monthly subscription accounts ranging from 5GBP per month to 15GBP per month.[9] This was not a new strategy, as several UK neobanks, including UK-native Revolut and, as of recently, Monzo favour tiered products, in price categories largely similar to those of N26, as an additional source of revenue.[10,11] This approach however, has not proven popular with their target demographics.

Currently, it is estimated only 5 percent of all Revolut customers pay a monthly fee.[11] Although N26 never revealed the numbers, it is likely their premium customer proportion was under the 30 percent they typically reach across Europe, and consequently not sufficient to bolster their profit margins in the UK.[10] That is not to say, the tiered product strategy cannot be profitable; Monese, another UK-native challenger, has a specific focus on a predominantly Eastern European, previously underserved demographic and has 46 percent of its customer base paying a 5GBP monthly fee.[12] This further reaffirms the idea from the previous section, that in order to achieve profitability and have a chance in the UK market, neobanks have to differentiate themselves from their competitors either by offering different financial products, different terms or to a different customer population.

The example of Monese leads us to the third and final challenge faced by European new entrants to the UK market; these EU-native neobanks have to have a deep understanding of their potential new customers. For example, as stated earlier N26 offered tiered products, expecting to attract "a little bit older, a little bit more mature" customers with its sleek design, as it has done successfully across the rest of Europe.[13] However, whereas the majority of Europeans are accustomed to fee-based banking and are consequently more open to paying for the premium service, UK customers expect fee-free banking.[11]

Understanding your customers does not only refer to the product offering, but also the marketing strategy.

That is not to say UK customers are not open to paying a monthly subscription fee for the right product offering; rather than sleek design, UK customers prefer innovative, useful add-on services and a personalized bundle offering.[11] For example, 45 percent of Britons would be interested in bundled account subscriptions including media services such as Netflix or Amazon Prime, rather than the more traditional offerings such as travel insurance or cash-back incentives.[14]

Additionally, understanding your customers does not only refer to the product offering, but also the marketing strategy to best advertise those products to your target demographic. When N26 first entered the UK market, they used the same marketing messages that have proven successful in Germany.[13] These direct, tongue-in-cheek slogans have however, proved to not be very popular with the British and the marketing team quickly adapted the messaging to local customer expectations of "too many words, very indirect, very overly polite", resulting in a better public response.[13] The examples illustrate that understanding your customer, what product to offer them and how to offer it to them, are critical knowledge components for any neobank entrant to the UK market.

WHAT ABOUT UK-NATIVE CHALLENGERS IN EUROPE?

The majority of this article so far has covered the opportunities and challenges for neobanks involved with expanding into the UK from Europe, including and beyond Brexit. It is interesting however, to also examine the reverse – UK-native neobanks expanding into Europe and the potential impact of Brexit on it. Europe is a highly attractive market due to its size and regulatory framework; any neobank that obtains a banking license in one of the EU member states is automatically permitted to 'passport' it across the whole EEA region. This introduces any UK-native neobank to over 450 million potential new customers across Europe. Although ensuring compliance with EU regulation post-Brexit might introduce increased operational costs in a manner largely similar to EU-natives expanding into the UK, the European market still offers ample opportunity for the UK-native challengers. For example, as introduced in the earlier section, European markets have a long history of charging for banking services, so tiered accounts or premium offerings might be a more suited profit-increasing strategy in Europe, as compared to their native UK market.[10]

Currently, Revolut is the only UK-native challenger primed for Europe-wide expansion post-Brexit as they hold a European banking license from the Lithuanian National Bank.[15] Other UK-native neobanks that do not want to miss out on the opportunity to expand to the attractive European market in case 'passporting' is not allowed, should consider applying for a European banking license as well. Lithuania and Ireland have emerged as particularly attractive candidates for obtaining European banking licenses due to ease and reduced costs of application and, additionally in case of Ireland, language familiarity.

Overall, the considerations UK-native neobanks have to make before starting European expansions are largely similar to the ones described in this article for EU-native neobanks expanding into the UK; like Great Britain, Europe is a highly competitive, but still growing market, in which new entrants will have to thoroughly understand their target customers and rethink their business models in order to differentiate from competitors and ensure sufficient profitability.

Conclusion

Although there are several challenges associated with UK (or European) expansion, both markets are still highly attractive for neobanks, due to the growing customer pool and positive regulatory attitude. This article has explored in depth some of the challenges, which are summarized below, together with actionable considerations any European or UK-native neobank should incorporate in their expansion planning.

1. Brexit still presents a large source of uncertainty – prepare for potential regulatory challenges
    - Develop a contingency plan in case banking license "passporting" is not permitted
    - Be aware that ensuring regulatory compliance will likely increase operational costs and might require a rethink of the business model
2. Great Britain is a highly competitive market and most Britons still prefer banking with traditional banks
    - Consider your USP and develop a "differentiation" business strategy – offer new financial products/services, offer existing financial products/services, but at more attractive terms or offer them to an underserved population
    - Reconsider your business model to account for increased operational costs due to regulatory compliance
    - Understand your future customers – what is the financial service/product they are interested in and what is the best way to communicate your offering to them
3. Europe is an equally attractive market to the UK-native neobanks, and an expansion into the European market will likely require consideration of the same challenges (i.e., Brexit, high levels of competition…) experienced by EU-native banks expanding into the UK.

HOW CAPCO CAN HELP

COVID-19 has put a stronger spotlight on the value of digital services, from the way we shop, communicate and work, to even the way we bank. While public attention has largely moved away from Brexit this year, the end of the transition period is approaching quickly (31st December 2020) and the UK is running out of deal time. If there is still no agreement by this date, there will be significant impact to the banking regulatory landscape which both UK and EU challengers must react to. No longer will fintechs be able to launch in the UK and enjoy the opportunity to passport into Europe and drive customer growth. This puts the onus on all UK players, both fintech and incumbent, to keep focused on delivering better UX, CX, more competitive FX rates (often a big selling point of challengers) to attract the digitally-focused UK retail and SME customer that EU challengers claimed.

Capco works with a broad range of banks and payments players to build, develop and strengthen digital business models, API strategies and exciting new customer propositions. Deal or no deal, quick COVID-19 cure or not, the demand for digital banking services is not going away. Find out more about Capco's banking & payments services by contacting us.

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AUTHOR

Dora Knezevic

CONTACT

Ian Hooper

Partner, Head of Banking & Payments, Capco UK

ian.hooper@capco.com

WWW.CAPCO.COM

CAPCO

JN_2631