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Retail Therapy

Are Financial Services a core competence for retailers?

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Are Financial Services a key competence for retailers?

Given their strong brands and responsiveness to customer needs, retailers have been seen as a threat to retail banks. But are financial services really a good fit with mass-market retailing or have the differences between the two sectors been under-estimated?

Retailers and financial services: the UK experience

For large European and North American retailers, their core businesses are mature and growing slowly. Maintaining growth therefore depends on a combination of expanding internationally and on expanding the range of goods and services offered. The latter is particularly important to sustain growth in the retailers' domestic markets. In this regard, large retailers look to use their brand strength and frequent contact with consumers to offer additional goods and services. Among the additional goods and services, banking and insurance products have appealed to many of the major retailers. Leading European chains such as Tesco, Sainsbury's, Marks & Spencer, Carrefour, and Auchan have diversified into retail financial services. More recently, Wal-Mart, the world's largest retailer, has announced plans to expand its provision of financial services.

UK retailers in particular have taken up the challenge of diversification and have offered financial services for many years. Marks & Spencer (M&S), the leading clothing, food and household goods retailer, entered the market as far back as the 1980s, while Tesco and Sainsbury launched banking services in the mid-1990s. Their record offers a valuable case study of the strengths and weaknesses of retailers as providers of financial services. In terms of size, the retailers' banking arms are now substantial businesses. Each has several million customers and loan/deposit portfolios of several billion pounds.

Financially, two of the three retailer banks have proved successful. Tesco Personal Finance (TPF) is now paying its shareholders substantial dividends (though profits have been flat during the last two years). M&S sold its financial services business (M&S Money) to HSBC in 2004 at a substantial premium to net assets. In contrast, Sainsbury's Bank has struggled, reporting an underlying operating loss of £10 million in 2005/06 and little more than breakeven in 2006/07.

Retailer banks – overview	
M&S Money	▪ Originally set up by M&S to launch and run the company's store card ▪ Originally wholly-owned by M&S, but acquired by HSBC (subject to a profit share arrangement) in 2004 ▪ Total assets of £3.2 billion at end 2006
Tesco Personal Finance	▪ 50/50 joint venture between Tesco and RBS ▪ Total assets of £7.6 billion at end 2005
Sainsbury's Bank	▪ Set up in 1997 as a 55/45 joint venture between Sainsbury's and Bank of Scotland (HBOS), though HBOS increased its stake to 50% in early 2007 ▪ Total assets of £3.6 billion at March 31 2006

However, the impact of the retailers on the UK retail financial services market has not been transformational. The retailers' banking arms remain small compared to both the major UK banks and insurance companies and to their own core retail businesses. Looking at their track record in financial services, two characteristics in particular stand out:

- The retailers have been highly selective in the financial services offered. TPF and Sainsbury's Bank have focused on credit cards, unsecured loans, savings and insurance. Neither supermarket has competed head on with the banks by offering a full suite of products based around current accounts, and both have withdrawn from the mortgage market, with neither building a large portfolio.
- Even in their chosen markets, the second characteristic to note is that the retailers' market shares remain small. Collectively, the three retailers have unsecured lending (credit card and personal loan) portfolios probably approaching £10 billion. But the U.K. market is more than £210 billion, implying a combined market share of probably no more than 5%.

Retailers and financial services: the case for…

First, the retailers had already expanded into adjacent sectors. M&S successfully moved from being a non-food (clothing) retailer into providing food and other products to its customers. The supermarkets had already diversified to varying degrees into petrol retailing, newspapers and magazines, health and beauty goods, kitchenware, household appliances, CDs and videos/DVDs. The concept of the "one-stop shop" extends the parameters of lateral diversification from the retailing of goods to the retailing of services. The offer of financial services adds to the cluster of adjacent household goods and services around the core grocery range.

Second, the offer of financial services builds on the retailers' existing position in the market, their store networks and other infrastructure. At a general level, there are similarities. Both the retailing and banking sectors serve personal customers, both have a physical presence in shopping locations, and the provision of credit is important to both banks and (some) retailers. The retail stores are a valuable resource for promoting and supporting the offer of financial services. In comparison with new entrants having to use channels such as direct mail or advertising, they offer a readily available and low-cost marketing channel for the display of product leaflets and other literature. In addition, those retailers issuing store cards in-house already have-a platform capable of supporting other financial services.

Finally, the financial services market is attractive to retailers because of the combination of high profitability and the often poor reputation of banks among customers. Retailers' stronger brands and expertise in marketing and customer service appears to give them a source of competitive advantage over the banks when delivering financial services.

Retailers and financial services: the case against…

As a starting point, it is worth noting that while retailers have moved into financial services, it is inconceivable that bankers would move into food or general merchandise retailing? It would be astonishing to hear Barclays announce plans to open supermarkets or RBS announce plans to move into department stores. So why do retailers see retail banking as an opportunity while banks would not contemplate the reverse? Do retailers have a comparative advantage over banks that justifies this asymmetry in their perspective?

A more detailed comparison of retailing and retail banking suggests that there are good reasons to doubt this, and that the commercial rationale for retailers offering financial services is less compelling that it first appears. First, the core skills remain very different in retailing compared with retail banking. Retailers' core skills are sourcing products, buying well, merchandising, and fulfilment of the purchase by the consumer. These skills may transfer readily to other retail sectors. For example, supermarkets may use their superior buying power to secure competitive advantage over specialists in health and beauty retailing – but they transfer less easily to financial services. The buying power of large retailers is a much less effective competitive weapon when competing against banks and insurance companies.

Second, financial services are not merchandised in the same way as tangible products sold in retail outlets. Only a limited number of financial services such as one-off travel insurance and foreign currency are purchased through a single transaction at a set price comparable to a retail transaction. Core personal banking services such as current) accounts and mortgages involve the provision of an account on a long-term basis for the customer. Customers have to go through an application process, with the possibility of rejection. The pricing of financial services is more complex, and often expressed as a percentage of the loan or deposit balance. Therefore the discounts, special offers and sales that are fundamental to retailing work less well when applied to financial services.

Perhaps the nearest a retailer has come to literally retailing a financial service is Tesco's travel insurance, where its Clubcard holders can pick up a pack in-store and take it to the checkout with the rest of their shopping. As soon as the insurance pack is scanned along with the Clubcard, the customer is insured. But there are very few financial services that can be sold in this way. Indeed, whatever retailers' aspirations to cut through the complexity of financial services, compliance requirements related to data protection, identity confirmation and money laundering often push in the other direction.

Third, despite the fact that they may be neighbours in the local shopping centre, retail stores are very different from bank branches. Retail shops are outlets for the sale of goods, where factors such as the presentation of the store and packaging and display of goods are central to business success. On the other hand, customers visit a bank branch much more infrequently as mortgage agreements, current and credit card accounts may last for many years. Compare this with the frequency of visits to the supermarket for core grocery items.

Bank branches are principally places for the management of bank accounts. Most branch visits are for carrying out transactions on existing accounts rather than to make a 'purchase':

- Paying-in cheques
- Paying-in/withdrawing cash
- Arranging more complex transactions that cannot be arranged remotely, for example large value or foreign payments
- Carrying out transactions which require a signature

Retailers, particularly supermarkets, have successfully combined retailing and cash acquisition at the checkout through offering 'cashback' on debit card purchases. However, there are practical limits to the use of checkouts as proxy branch tills. For large retailers, and particularly for supermarkets, it is essential to maintain throughput at the checkout. Allowing what may be time-consuming transactions at the checkout of the kind often undertaken in bank branches would significantly disrupt the core retail business. There is also the issue of maintaining privacy at the checkout.

However, retailers can buy in the necessary banking infrastructure and expertise. Tesco and Sainsbury's both moved into financial services through partnership with banks. In theory, the banking expertise can then be combined with the retailer's brand strength and reputation to a winning effect. But having to buy-in operational expertise from a bank may restrict the scope for the retailer to do banking in a different way. Banking partners may be reluctant to sanction financial services that are critical (even implicitly) of their own services.

Fourth, a retailer's brand needs to be broad and flexible enough for it to be credible with consumers as a supplier of financial services not directly linked to the retail business. But this brand strength and reputational advantage may not prove sustainable. For example, in the case of M&S and Sainsbury, their credibility as providers of banking services was damaged by the well-publicised decline in performance of the parent retailers during the late 1990s.

This points to an inherent problem for retailer banks; the retailer's strength as a consumer brand has to be sustained over time if it is to provide its banking business with ongoing support. When the core business is performing strongly, the retailer's strong reputation provides the incentive and functions as a platform for investing in the supply of other consumer goods and services, but when the core business performs poorly, senior management will inevitably be under pressure from investors to focus on sorting out its problems. The retailer's senior management may conclude that ventures such as financial services are too peripheral to the core business and decide to withdraw. In some respects for example, M&S' sale of M&S Money represented a partial exit from financial services at a time when the incumbent management was faced with the threat of takeover.

What works…

Even if a retailer's brand is broad and flexible enough for it to be credible with consumers as a supplier of financial services, success is likely to depend on the retailer being selective in the services offered. Credit cards are in many respects a special case. Retailers with no, or very limited, further ambitions in financial services may want to issue a credit card because of the importance of credit as a support service to the core retail business, and because of the value of the card as a loyalty tool and source of data on customers. It is worth noting that many companies in other sectors (from airlines and hotel chains to football clubs) offer cobranded credit cards for similar reasons without wider ambitions in personal banking and insurance.

Beyond credit cards, the challenge is to identify those financial services that are closest to retailing – that can benefit most from the application of the retailer's core skills. Those financial services most attractive to retailers are likely to be:

- Simpler, transactional services (as opposed to those requiring complex, ongoing account management)
- Services already "disengaged" from traditional banking and insurance models and delivery structures (such as many types of insurance in the UK)
- Offer opportunities for growth and competitive pricing

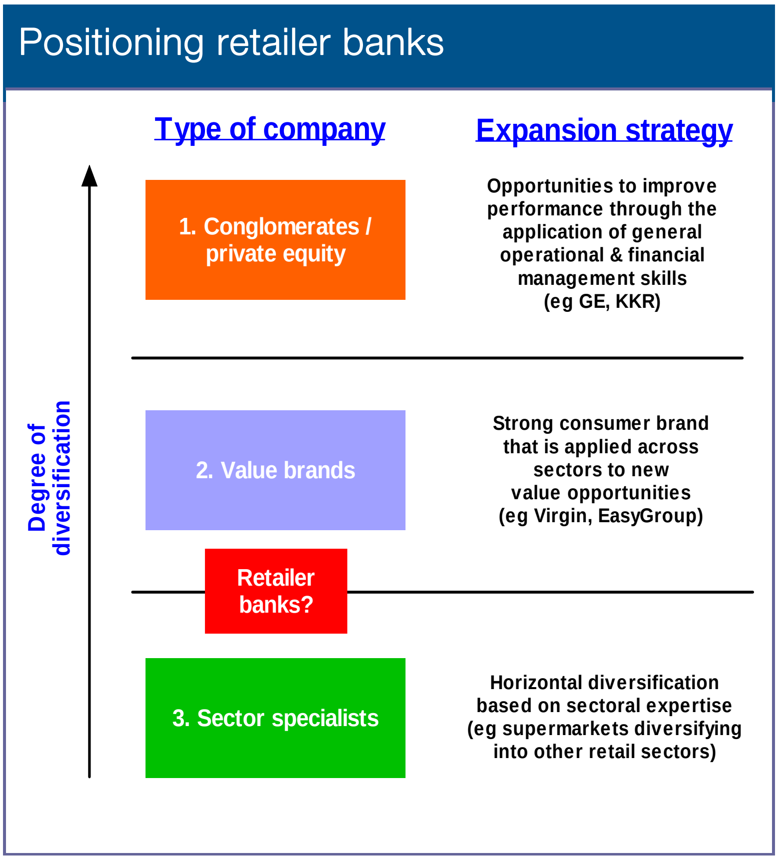
The accompanying table is no more than a broad summary (in a UK context) of the product appeal of mainstream financial services to retailers. However, it highlights the variations in appeal between different financial services depending on the detailed characteristics of each service.

Product appeal to retailer banks		
Service	Appeal	Comments
Credit card	Special case	▪ May appeal to retailers with no wider ambitions in financial services because of value to the core retailing business
Personal loans	Strong	▪ Suited to direct provision ▪ Easy to administer (repayments by direct debit) ▪ Builds on any in-house credit card platform (M&S) ▪ Strong growth in market (at least until 2004/05)
Insurance	Strong	▪ Already migrated to direct provision (impact of Direct Line, etc) ▪ Simpler, "quote" based pricing rather than complicated percentage rates (£x per year to insure your car/pet/home….) ▪ Lower marketing & recruitment costs compare with insurers reliant on TV, radio & other forms of advertising ▪ Easy to administer (premium payments by direct debit)

Savings accounts	Strong	▪ Suited to direct provision (excluding branch based accounts) ▪ Scope to compete on price ▪ Easy to administer (scope to use stores – see examples cited in text)
Mortgages	Limited	▪ More complex customer assessment process ▪ Potentially long-term agreement ▪ Strong competition from existing providers
Current accounts	Weak	▪ Heavy infrastructure demands ▪ Difficulty in competing on price in the context of "free banking" in the UK ▪ Customers' reluctance to switch accounts ▪ Regulatory pressures on key revenue streams
Note: This table has been put together from a UK perspective and in part reflects UK market structure and pricing. However, many of the points are likely to have a wider application to retailers offering financial services.		

Conclusions

In conclusion, from a strategic perspective how is diversification into financial services by retailers to be understood and positioned?



The provision of financial services takes retailers beyond the natural boundaries of horizontal diversification based on sector expertise. However, by moving into financial services, retailers are hardly reinventing themselves as conglomerates comparable to GE or private equity specialists such as KKR.

In some respects, retailers moving into financial services is most comparable to the way in which brands such as Virgin and EasyGroup move between structurally diverse consumer sectors (air travel, music retailing, mobile telephony, hotels). The 'value' brands enter a market where they see high prices and consumer dissatisfaction, bringing a fresh, convention-challenging approach. However, it is worth noting that value brands are not always successful in their ventures, and have (in the UK at least) made only a limited impact on retail financial services.

The implication is that diversification into financial services can leave retailers in a strategically ambiguous position. They are unlikely to succeed as full-service competitors to banks and insurance companies. The greatest opportunities lie in simpler, transactional financial services that best fit their core skills and competitive approach. A selective approach to financial services may make good business sense. M&S built a highly profitable, if niche financial business based largely on using its in-house store card platform to expand into personal loans.

To succeed it is necessary to have a pragmatic willingness to launch and, if unsuccessful, discontinue particular services – this suits the traditional grocery retailing behaviour. Food and other grocery products are continually being launched, tested and withdrawn by large supermarkets. However, the gaps in their banking product ranges sit a little uncomfortably with the supermarkets' 'one stop shop' approach to core household shopping. Unlike with groceries, an unwillingness to offer current accounts and mortgages leaves the supermarkets unable to meet their customers' core financial needs.

Ultimately, while it may make good business sense, a selective approach limits the retailers to being niche players in financial services. Further, with all of the major UK retailer financial services ventures now at least partially-owned by a major bank, they remain firmly within the ambit of their notional competitors. The willingness of the major banks to partner the retailers suggests that the banks see the direct competitive threat to their own core retail businesses as limited.

About the authors

Peter Welch is an independent consultant specialising in the banking and healthcare sectors. Recent reports written by him include, 'UK Credit Cards – an Industry in Decline?', a major report analysing developments and prospects for the UK credit card industry. Peter's other reports include 'Rethinking Banking Efficiency', a landmark study that challenges established approaches to the measurement of bank efficiency and which is published under the BankEcon brand.

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About the Australian Centre for Retail Studies

The Australian Centre for Retail Studies provides research driven education to those involved in the retail sector through broad based research and information generation, management education programs and the promotion of retailing as a career.

As a commercial centre within Monash University's Business and Economics Faculty and Department of Marketing, the ACRS is a bridge between the academic and the commercial retail worlds, enabling clients to access resources and knowledge that may not be otherwise available to them.

The centre engages in the following areas of activity throughout Australia, New Zealand, South East Asia and Asia.

- Management development programs
- Presentations, conferences and seminars
- Retail research, reports and publications
- Study tours

The ACRS builds skills, knowledge and understanding at all levels of management from first line appointees to CEOs; because of its unique retail focus the Centre offers advantages over other general management training providers.

Enquiries

Please contact us if you have any enquiries about Retail Therapy or the centre itself. Also if you would like further information about this paper or contributing please feel free to contact **Jeff Rogut.**

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