

**EXECUTIVE REPORT: No 19**

# **Supermarket Banking**

by

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## EXECUTIVE SUMMARY

The entry of the supermarkets into the financial services arena, sent shock waves through the sector and caused the traditional providers to reconsider the nature of their business. In particular, the supermarkets brought the convenience of banking by telephone to the mass market. The growth in remote distribution channels, such as ATM, telephone and internet channels, provide cost savings for providers, but distance on already lengthening provider-customer relationship. There are indications that customers are beginning to view banking as a commodity, hence reducing customer loyalty as they shop around for the best deal. Financial services are being sold as retail products, rather than as a bundle of complex services. Whilst the traditional banks have the necessary skills to explain and sell complex service products, the supermarkets have demonstrated that many products do not require a complex banking infrastructure to support them. In the past, the traditional banks have not been particularly successful at marketing their own products, relying on customers' current account inertia to cross-sell other products. As large retail outlets, the supermarkets have demonstrated their ability to cross sell financial products to their supermarket customers. Their ability to sell financial products results from the strength of their brand names and their recognition that customers are disenchanted with the services offered by the tradition providers. The supermarkets offered delivery channels that fitted customers' lifestyles, an essential factor that many traditional providers failed to grasp until recently.

## OBJECTIVE

This executive report provides a review of the UK supermarkets' entry into the financial services market. It considers the reasons why supermarkets entered the market, the strategies for entry adopted by the supermarkets and the impact their entry has had on the traditional providers of financial services.

## 1. INTRODUCTION

The entry of supermarkets into the financial services sector has been one of the most important developments in the sector in the late 1990's. Retailers have, for some time, skirted around the edges of the financial services arena, by offering their own in-house payment cards. Prior to the late 1990's, Marks and Spencer had been the most successful in this arena, having entered financial services in 1985 with the launch of their own account card. Marks and Spencer Financial Services became an authorised bank in 1987. Unit trust products were first offered in 1988, followed by personal loans in 1989. A range of PEPs, Life Assurance and personal lending products have also been introduced. By 1999, Marks and Spencer had over 5m account holders and profits from financial services were £110.7m. In 1997, the major UK supermarkets, headed by Sainsbury and Tesco, entered the banking arena on the back of their loyalty cards. In the early days, the supermarkets were successful in attracting savers by offering above average interest rates on instant access deposit accounts. Since their entry into financial services, the supermarkets now offer a comprehensive range of financial products, such as credit cards, insurance, pensions and mortgages. Whilst the supermarkets currently have a very small market share (Mintel

1999, *Current Accounts*, estimates that supermarkets have a 1% share of the market), their influence on the provision of financial services has been far greater. In particular, the key impact of the entry of the supermarkets into the financial services sector has been the recognition that a non-financial brand can be used successfully to attract customers to financial products.

## 2. THE UK SUPERMARKETS – AN INDUSTRY OVERVIEW

### 2.1 The State of the Market

The UK food retail industry is dominated by four companies – Tesco, Sainsbury, Asda and Safeway. These four companies account for more than 70% of total market share. The food retail industry sales account for 45% of all retail sales. However, market demand is relatively static, with sales of food through large retailers increasing by only 3.7% between 1997 and 1998. Furthermore, the growth in demand is expected to remain slow as the UK population is expected to grow by only 1.2% in the period 1998 to 2003. Food retailing in the UK is a relatively mature market with a slow rate of growth. This has meant that companies wishing to increase their own market share are forced to compete with each other for a static customer base. However, whilst the four companies appear to compete with each other for market share, the level of true competition within the sector has come under scrutiny. Following accusations of high profit margins and the lack of any real difference in prices offered to customers, supermarkets are currently under investigation by the Competition Commission. There is a suspicion that the major supermarkets have been unwilling to compete on price, in order to maintain their high profit margins. The emphasis has been on 'value for money', customer service and the retention of their customer base. A major part of their strategy has been the introduction of 'loyalty cards' aimed at strengthening the customer base and discouraging cross-store shopping.

### 2.2 Loyalty Cards

Tesco was the first supermarket to provide its customers with a loyalty card (the Tesco Clubcard) in February 1995. The benefits provided to customers of such a loyalty scheme were the accumulation of points for every £ spent; the points could then be exchanged for vouchers giving money off future shopping or saving on products with other retailers. The loyalty scheme proved very successful for Tesco, resulting in an increase in their market share, allowing them to overtake Sainsbury in terms of market share for the first time in their history. Tesco's share of the grocery market has risen from 19.3% in 1994 to 24.2% in 1998, compared with a decrease in the market share of Sainsbury from 22.0% in 1994 to 20.8% in 1998. Sainsbury's response to Tesco's loyalty card was scathing. The CEO of Sainsbury's described the loyalty scheme as 'electronic Green Shield stamps'. Safeway followed Tesco's lead by introducing its own loyalty scheme in April 1995 (the ABC card). Sainsbury were forced to change their initial scepticism of loyalty schemes as they saw their market share and profits fall. Sainsbury's introduced their own scheme in June 1996 (the Reward card). Asda remains the only one of the four major supermarkets that have not adopted a loyalty scheme (although they have trialled such schemes in a number of stores).

The loyalty schemes have been criticised for simply adding to the cost base of the supermarkets. Whilst the loyalty scheme provided real benefits to the first mover (Tesco) in terms of increased market share, once other supermarkets had adopted their own schemes, the benefits rapidly diminished and the schemes become a defensive, rather than an offensive, weapon in the battle to maintain customer loyalty. Mintel (*Food Retailing*, 1999) reports that over the period 1994 to 1999, only Tesco and Morrison's are being used by a higher percentage of people for their main shopping. This suggests that loyalty schemes such as ABC and Reward are of little consequence as 'golden handcuffs' in their current guises, so retailers may need to up the stakes, if they are to have any real validity as 'loyalty schemes'. Safeway has recently reintroduced 'triple points' and it has been rumoured (although not confirmed) that Tesco is proposing to introduce tiering, rewarding high spending Clubcard users with the most points. Mintel (*Food Retailing*, 1999) reports that two thirds of adults have supermarket loyalty cards and multiple ownership is commonplace, thus it is questionable whether cards have done much to increase a shopper's propensity to only use one store.

Loyalty cards do provide supermarkets with an invaluable source of data. However, it is still widely regarded in the retail IT industry that supermarkets are still not making sufficient use of the vast quantities of customer data at their disposal. Cost of running a loyalty scheme are high, on average around 1% of sales, so it is essential that retailers get the maximum return for their investment. There is still more data gathering going on than analysis. Safeway is reported to be the most advanced in developing relationship marketing, followed by Tesco. Loyalty data is starting to improve the profitability of shelf space and offer products that fit personal preferences, but anecdotal research suggests that the number crunching task has proved to be more awesome than retailers had anticipated on launching their cards. Some of the problems lie with the basic card technology, all supermarket loyalty cards are currently using magnetic strips, rather than smart cards, which make data storage and retrieval more cumbersome.

### 3. THE SUPERMARKETS ENTRY INTO FINANCIAL SERVICES

#### 3.1 Overview

Regardless of the current benefits of loyalty schemes, they enabled the supermarkets to enter the financial services sector on the back of those loyalty schemes. The supermarkets entered the financial services sector to find new profit streams to offset the maturity of the UK food retailing sector. As stated previously, the major supermarkets are facing a mature and saturated market in traditional retailing. In particular, grocery retailing is particularly competitive, with the main players fighting bitterly for the slightest piece of market share. However, despite the level of competition within the sector, the major supermarkets generate large profits that they find difficult to reinvest in their core business. Competition issues restrict their ability to expand via the acquisition of other supermarket chains, and organic growth is constrained by planning restrictions covering the building of new out-of-town superstores. Financial services represents an ideal opportunity for diversification into an area in which there are many synergies with their core business. Furthermore, by building on their existing resources (a large store network and popular brand names), the supermarkets were able to enter financial services with

relatively low costs and little risk to their existing operations. Customers were already used to accessing cash from supermarkets tills as a result of the growth in debit card technologies and the availability of 'cash back' from debit cards. A strong, and relatively loyal, consumer base coupled with the continuing growth of the financial services industry make almost perfect partners. Tesco was the first supermarket to enter into financial services, followed by Sainsbury's and Safeway. Asda is the only major supermarket that does not offer financial services branded under its own name.

### 3.2 Tesco

Tesco used its Clubcard to spearhead its entry into the financial services market. Tesco was the first major supermarket to enter into the financial services arena, with the launch of Clubcard Plus in June 1996. Members of Tesco's Clubcard loyalty scheme were offered the Clubcard Plus account, operated in conjunction with Nat West. Clubcard Plus is a pre-payment card which requires holders to make direct debit payment on a monthly basis for a pre-agreed amount to cover the cost of groceries each month. The scheme also offered overdraft facilities, a cash card and paid interest on credit balances. At the time of its introduction, Clubcard Plus offered one of the best current account interest rates in the market for credit balances and also earned customers double Clubcard points on their monthly shopping money. However, the alliance with Nat West was broken after only six months, due to the realisation by Nat West that Tesco's ambitions did not rest with the Clubcard Plus account. Nat West commented that 'it was clear from the start that they did not see us as an equal partner and they wanted to offer home mortgages, personal loans and pensions under the Tesco brand name'. The CEO of Tesco's at the time, Sir Ian MacLaurin, was a non-executive director of Nat West and resigned due to the conflict of interest. In March 1997, Tesco formed a joint venture with the Royal Bank of Scotland (Tesco Personal Finance Group Limited) offering customers a broad range of financial services.

Since the initial launch of Clubcard Plus in April 1996, Tesco has introduced an increasingly wide and sophisticated range of personal finance services in conjunction with Royal Bank of Scotland and more recently with Scottish Widows, with more than 1 million customers. Tesco have recently introduced internet access to their banking services. The Tesco Personal Finance Division has desks in every Tesco store (apart from their Tesco Express formats) and operates a telephone banking operation, based in Glasgow. In the year to February 1999, Tesco's share of the loss of Tesco Personal Finance was £12 million, compared with a share of a loss of £15 million in the year to February 1998. According to Tesco, the loss in 1999 was smaller than had been budgeted and it aims to break even towards the end of the 1999/2000 financial year.

### 3.3 Sainsbury's

Sainsbury's followed Tesco's lead into the financial sector arena, with the establishment of Sainsbury's Bank in February 1997. Sainsbury's Bank was operated as a joint venture with the Bank of Scotland (with 55% being owned by Sainsbury). In contrast to Tesco, Sainsbury opted to set up an authorised bank from the outset. Tesco did not apply for a banking licence until June 1997, piggybacking on the Royal Bank of Scotland's licence until that time. Sainsbury's Bank operated a direct line telephone banking service aimed at the Reward card holders and other customers. Sainsbury's Bank now offers a wide range of financial products, including mortgages,

pensions, insurance, loans, etc. Sainsbury's supermarkets have 'Bank Information Points' with literature on all products and offer a free phone service to their call centres. By March 1999, Sainsbury's Bank had over one million customers, £1.7 billion on deposit and £1 billion of lending and commitments. In the year to March 1999, the Bank incurred a loss of £5.6 million compared with a loss of £15 million in the year to March 1998.

Whilst the site would have the capacity to 'search for an IFA' (a function already universally available), it would also allow members of the public to transact a number of products directly over the web. It is clear that there are certain consumers and certain product types where this will be more efficient.

To achieve maximum impact and maximum traffic, the site will provide this functionality, although it is also clear that the implied market dichotomy will have to be managed correctly.

### 3.4 Safeway

Safeway's entry into the financial services sector came in February 1997 with the provision of the ABC bonus account linked to their ABC loyalty card. The account was managed by Abbey National. Customers set up a standing order to pay into the account, which features a standard debit card (which can be used in Safeway's and elsewhere and to withdraw cash at ATM's), and paid interest of 5% up to a balance of £600, 1% thereafter. In January 1998, an instant access saving account, managed by Abbey National and accessible by telephone, was launched.

Safeway's strategy differed from that of Sainsbury and Tesco, in that Safeway chose to leave the operation of financial services to Abbey National, rather than set up a joint venture.

### 3.5 Asda and Morrisons

Following on from the initiatives of the three major supermarkets, Asda and Morrison joined forces with retail banks to open bank branches in supermarkets; a trend which had proved popular in the US. Asda's commercial director Tony de Nunzio suggested that,

'Our competitors have rushed to invest in banking operations with bespoke products and services, but that's not for us. Having stand-alone concessions in-store leaves banking to the experts and lets us stick to shopkeeping.'

LloydsTSB opened branches within Asda under the TSB brand. Midland Bank (now HSBC) opened branches in Morrison stores and also offered a saving account under the brand name of Midland at Morrison.

### 3.6 The Banking Partners

The banking partners of Tesco, Sainsbury and Safeway – Royal Bank of Scotland, Bank of Scotland and Abbey National, respectively – are banks with smaller market shares in the banking sector. In particular, the Scottish banks, which have limited customer bases in England and therefore run less risk of cannibalising their own

businesses, have been more willing than the bigger British retail banks to help the retailers. Furthermore, the lack of a branch network in England meant that the Scottish banks, in conjunction with the supermarkets, can offer competitive products. Richard Chandwick, Director of Business Development at Sainsbury, commented that 'The problem with high street banks is they have high street branches adding to their cost structure. The Bank of Scotland is a low-cost provider and has no branch structure in England and, combined with our focused marketing, we can offer competitive products' (Mintel, *Fight for Distribution – New Players*, 1997).

There are advantages to both the supermarkets and the banking partners from their joint venture strategies. The banking partners are given access to business they may otherwise have lost to competitors and have access to a large customer databases. The cost of acquiring these customers is relatively low. The supermarkets gain knowledge and expertise quickly in an area in which they have no experience, they can experiment with entry at relatively low cost and risk, and the infrastructure costs can be saved. However, as Mintel (*Current Accounts* 1999) notes, as supermarkets gain experience in the financial services markets, some supermarkets are expected to offer financial products and services independently and therefore may constitute a more potent threat to the banks in the future. In addition, it is now clear that the banking partners themselves have ambitions to expand their business, as evidenced by the hostile bids for Nat West by the Bank of Scotland and the Royal Bank of Scotland. The impact of a successful bid by one of these banks on their supermarket banking operations remains to be seen.

## 4. ENTRY STRATEGIES ADOPTED BY THE SUPERMARKETS

The supermarkets' entry into the financial services arena can be characterised by a number of factors which eased their entry into the market. They came into the market offering high rates of interest and attractive terms on a selective products; they offered telephone access to their services, they had the ability to market their products through their store network and the opportunity to 'stretch' their trusted brand names into the financial services sector.

### 4.1 Rates of Interest Offered

The supermarket bank accounts initially offered market leading investment returns and low charges. At the time of the supermarkets' entry into banking, many of the traditional providers were offering very low rates of interest on instant access / low balance accounts. The demutualisation of building societies resulted in some building societies tying up their members' savings at low rates for a relatively long period of time before they could qualify for shares. This left many customers unhappy and more willing to switch accounts. From the beginning of the supermarkets' entry into banking, it was claimed that supermarket banks would be forced to bring down their interest rates in line with those offered by the traditional providers of financial services. The supermarkets' assault on the savings market was largely championed by the relatively high rates of interest they offered at the time. As predicted, the supermarkets have now come under attack for failing to remain competitive (*Times*, 24 July 1999). When first established, the supermarket banks dominated the 'best buy' tables of savings products. For example,

when Sainsbury's Bank was launched in February 1997, its instant access saving account with cash card paid gross interest of 5.75% on a minimum balance of £1, compared to a base rate of 6%. However, when its rate peaked at 6.75% in June 1998, base rates were 7.5%. In November 1998, Sainsbury introduced tiered rates of interest on the instant access account, a move that was followed by Tesco. In 1999 when base rates were standing at 5%, both Sainsbury and Tesco paid interest rates ranging from 4% to 4.75%. For balances of £0 to £2,499, the difference between the base rate and the interest rate offered, the difference had fallen from 0.25% to 1% since the launch of the Bank. In comparison, many of the non-supermarket new entrants have maintained more competitive rates. For example, on savings accounts which include a cash card, Egg guaranteed to pay a rate equal to the base rate until 1 January 2000 and no more than 0.5% below the base rate from that date. Other new entrants offering more competitive rates than the supermarkets include Scottish Widows and Standard Life and many building societies now also offer better rates.

As the supermarkets' savings accounts are instant access, savers are not locked in and can easily move their accounts elsewhere. However, as with many banks and building societies, it is likely that the supermarkets are relying on customer apathy and naivety to retain balances in the face of falling interest rates. Clearly, the rates offered initially were unsustainable, particularly on smaller balances. As Gordon Bowder of Scottish Widows Bank argues, although the supermarkets have been successful at attracting savers, the average balance is fairly low and the number of transactions high, which is administratively expensive. In comparison, Scottish Widows records an average balance of £13,000 and fewer transactions through accounts. Sainsbury's counters that it was never their intention to be a market leader at all times, but to provide 'excellent value for money coupled with high quality services' (*Times*, 24 July 1999).

## 4.2 Telephone Banking

Tesco and Sainsbury chose to operate their banking services largely as telephone banking operations. Whilst the use of the telephone as a channel by which to deliver financial services had been in operation for a number of years, its use in banking was relatively limited. A TGI survey in 1998 reported that whilst 43% of bank and building society account holders had access to a telephone banking service, only 15% of customers used such a service (Mintel, *Current Accounts*, 1999). The establishment of centralised direct operations in financial services was pioneered by Direct Line in 1985, offering motor insurance direct to the public over the telephone. Telephone banking was launched by First Direct, a subsidiary of Midland Bank, in 1989. First Direct offered a 24 hour telephone banking service offering a full range of financial products, including current accounts, credit cards, investments, loans and pensions. First Direct brought a new concept to the financial services arena: banking with a branchless organisation. Since the advent of First Direct, the majority of banks have implemented telephone banking as a delivery channel. However, the majority of traditional banks have introduced telephone banking as an additional delivery channel added to the existing branch network; hence banks have tended to offer telephone back-up for branch based accounts, rather than offering banking services by telephone only. The burden of history had made it difficult for many of the traditional high street banks to embark on direct banking with as much enthusiasm as they might have wished. The legacy of computer systems that process transactions in batches once a day makes it difficult to offer the sort of real-time answers demanded by customers.

The growing acceptability of telephone banking facilitated the entry of the supermarkets into the banking sector. Indeed, whilst the traditional players originally imitated First Direct by adopting the telephone as a mechanism for delivering existing products, the supermarkets and the other new players (such as Egg and Virgin) have used the telephone to offer simple products on very attractive terms. The use of telephone banking avoided the cost of running a branch structure, which allowed the supermarkets to offer many financial products at very competitive prices. The cost of operating telephone banking services is estimated as half that of running a branch network (*Marketing Week*, 22 October 1998). Furthermore, as the majority of banks operate telephone banking as an additional service to branch banking, it is likely that, at least initially, the operation of telephone banking services for high street banks simply adds an additional cost. In addition, unlike many of the other new entrants, such as Egg, Virgin and Standard Life, the supermarkets were able to use their large store network to market their products to a large customer base.

### 4.3 Marketing Through Their Store Network

Supermarkets are able to utilise their large number of existing stores as distribution for financial service products. As traditional high street banks continue to shrink their branch network, the large supermarkets are continuing to expand their network of stores. Whilst the number of bank branches far outweighs the number of supermarket stores operated by those diversifying into financial services, the frequency of visiting a supermarket far outweighs the frequency of visiting a bank. Mintel (*Retail Credit Cards*, 1997) reports that while 86% of customers visit a grocery store at least once a week, just one in three people visit their bank branch with the same frequency. Hence, the frequency at which customers visit a supermarket provides the supermarket with ample opportunities to market their products to potential financial service customers.

### 4.4 Product Choice

The supermarkets were selective in the products they offered and are not compelled to offer labour intensive and costly products such as cheque accounts. It is notable that the supermarkets have so far shied away from introducing current accounts and have concentrating on offering instant access savings accounts. The sheer size of the savings market together with the fact that savings are fundamental to most people's livelihood, have made it possible for non-traditional providers to enter this market and carve a profitable niche without the need to accumulate a significant share of the deposits market. Savings accounts are relatively simple financial products which appear transparent to the customer. Customers are much more willing to switch providers of savings accounts, as switching is relatively simple, unlike the difficulties attached to switching between providers of current accounts. As previously noted, at the time of the supermarkets entry into financial services, many of the traditional banks and building societies were offering very low rates of interest on instant access deposit accounts, particularly those with balances of below £1,000. The supermarkets were therefore able to take profitable accounts from the traditional banks and building societies. The high rates of interest offered by the supermarkets encourages customers to deposit excess cash in such accounts, rather than leave such monies in low interest bank deposit accounts.

## 4.5 Brand Loyalty

Despite the current media attention paid to the supermarkets in respect of their pricing and competition policies, one of the main core competencies of the major supermarkets is their trusted brand names. The success of the major supermarkets' own-brand products demonstrates the value of their own brand names. The trust attached to the major supermarkets' brands was a major factor in easing their entry into the financial services arena, as they were able to 'stretch' their brand from supermarket retailing into financial services – a strategy utilised by many of the new players such as Virgin. Using brand stretching as a marketing strategy reduces the launch costs of new products and services; the established brand is already well known, the task of building awareness is reduced and promotional costs are reduced. Given the number of customers visiting supermarkets each week, the supermarkets can easily market their financial services very cheaply in store. The supermarkets attempt to marry their financial service provision with grocery provision in the minds of their customers – Sainsbury, for example, has used the slogans 'Fresh Food from Sainsbury' and 'Fresh Banking from Sainsbury' in order to associate the brand value of its supermarkets with that of its financial services.

Clearly, confidence and trust in the provider are key factors in the success of the provision of financial services by providers. Despite disquiet from many quarters over the conduct of the high street banks, many customers demonstrate an unwillingness to change banks. A Mintel survey undertaken in December 1998 found that customer inertia is high; 50% of those surveyed has never changed their current account provider and of those that had changed, two thirds did so more than five years ago (Mintel, *Current Accounts*, 1999). However, indications are that younger age groups are more prone to switching current account provider, and if this trend continues, brand loyalty through inertia to the traditional providers will diminish, leaving banks and building societies exposed to 'cherry picking' of the more profitable customers by new entrants. The supermarkets have, however, chosen not to 'compete' with the high street banks in the provision of current accounts, but have focused their efforts on other forms of financial services, particularly savings accounts. In this area supermarkets have the advantage of having a well-known and trusted brand name in which customers have confidence. But supermarkets are not putting the strength of that brand to the test by attempting to operate current accounts which are more costly and, due to the large number of transactions current accounts attract, are more prone to error.

Brand stretching has the disadvantage that damage to the brand in one sector is likely to have adverse knock-on effects in other sectors. An excellent example of this is the damage to the Virgin brand caused by the poor service offered by the Virgin train company. The supermarkets do face the risk of damage to their brand name and an adverse impact on their core business if problems do surface in the operation of their financial services divisions. The dangers inherent in brand stretching were recognised by the supermarkets when they entered into the provision of financial services. In particular, offering mortgages and loans means that some customers will fail to meet the credit requirements and such refusals may alienate customers. Tesco approached this issue by installing terminals in supermarkets which allowed customers to test their own credit ratings, in the belief that alienation will be reduced if customers found out for themselves whether it was worth their while applying for loans

and mortgages (*Financial Times*, 16 June 1997). However, the long term nature of mortgages means that the adverse effects on the core brand of house repossessions by the supermarket banking arms has yet to be tested.