Fintech

Rising to the challenge

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5 June 2019

> With the introduction of the Open Banking regime in the UK in 2018, the growth of challenger banks has accelerated. Yet, there remain some hurdles these challenger banks must overcome to win the trust of clients.
>
> In this report we look at the investment opportunity in this field and where we expect growth to be strongest going forward.

The investment opportunity of challenger banks

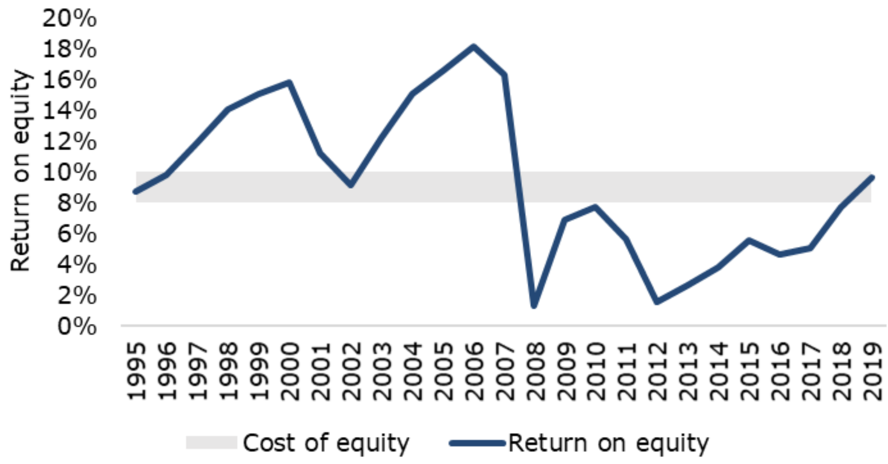
Back in the day, being disruptive would have got you sent to the headmaster's office. Now if you're not a disrupter, you're no one.

'Disrupter' has become the investment cliché of the decade – a portfolio of upstarts messing up the day of ponderous industry incumbents is a must-have. That said, often clichés are such because they express a truth. In some areas of the economy, the disrupters have done their thing, and are now the establishment. Retail? Already disrupted. Logistics? Ditto. Media? I'm sure we all miss our trips to BlockBuster and HMV. But financial technology (fintech), while well-known, is earlier in its development. Here, the disrupters are still picking at the threads of traditional finance but have yet to unravel its garments. But it is underway.

Banking is one area where profound change is happening. A century of consolidation is being eroded, as everything from insurance to invoice financing moves from the leviathans in Canary Wharf to a hotdesk in Hoxton. Moving up the cap scale somewhat, challenger banks are doing as their name suggests.

The confluence of the take-off of fintech and the weakening of the major banks' hold on the personal and SME market is transformative – and investors are taking note. With regard to the latter, there's a combination of internal and external factors at play that make traditional lenders both vulnerable and reluctant to play in certain markets.

Fig 1: European banks' return on equity and analyst estimates for 2019



Source: Bloomberg, Fidante Partners.

For the past decade, Basel II capital adequacy regulations have been making it difficult for banks to lend in certain markets, particularly to SMEs. Stringent regulatory capital requirements and higher ongoing compliance costs made it a tough decade for traditional bankers. As a result, "European banks have been unable to generate returns above their cost of equity since before the global financial crisis. Analysts estimate that profits will continue to lag behind cost of equity until 2019," reckons Deloitte (see Fig 1).

Incrementally over the past decade, the banking market has started opening up. Metro Bank became the first new High Street bank in a century in 2010. Other challengers that have been, or are in the process of being, authorised include Atom Bank, Starling Bank, CivilisedBank and OakNorth.[1]

It's easy to dismiss the current threats to banks, given that they've seen off plenty of changes historically. The flurry of mass affluent and consumer launches in the noughties had the lifespans of mayflies. However, Deloitte suggests, it's different this time: "Why? Because of the potentially significant impact of open banking, driven by regulation and enabled by advances in technology."[2]

This has the potential to revolutionise the market in personal current accounts (PCAs), business current accounts (BCAs) and loans to small and medium-sized enterprises (SME). Regulation, in Europe and the UK, is driving this (see box).

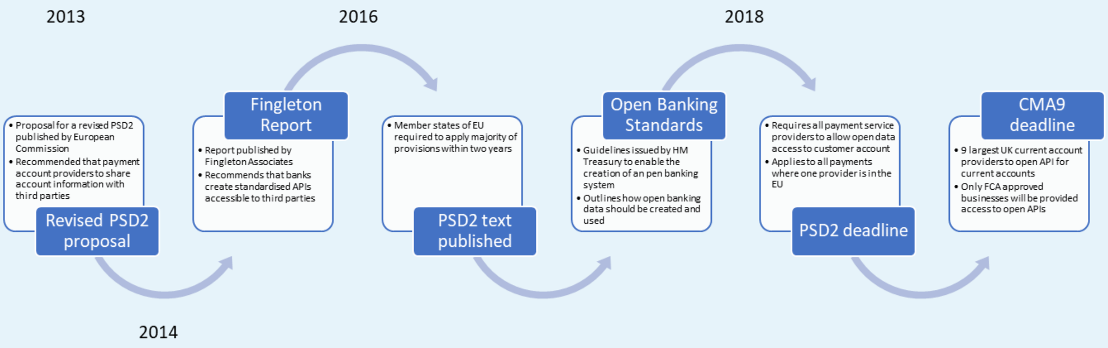
The regulatory enabler: Open Banking and PSD2

January 2018 saw the start of a fundamental transformation in personal and SME banking, opening up customer transactional data to third parties. This is taking place:

- across the EU, through the revised Payment Services Directive (PSD2)
- in the UK, with the Competition & Markets Authority (CMA) requiring the big banks to adopt the Open Banking Standard

It has been the result of a lengthy process of market analysis, consultation and rule-making, starting back in 2013 (see Figure 2).

Fig 2: The development of Open Banking in the UK



Source: Fidante Partners.

PSD2

While Europe's PSD2 sounds like a Star Wars robot that didn't make the final cut, its objectives are more earth-bound. These are to:

- contribute to a more integrated and efficient European payments market;
- improve the level playing field for payment service providers (including new players);
- make payments safer and more secure;
- protect consumers.[3]

[1] https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf

[2] Deloitte, How to flourish in an uncertain future, Open banking, 2017

[3] http://europa.eu/rapid/press-release_MEMO-15-5793_en.htm?locale=en

Alongside opening up banking, PSD2 has also unleashed a flood of acronyms. Institutions wishing to act as Payment Initiation Service Providers (PISPs) or Account Information Service Providers (AISPs) must be authorised Payment Service Providers (PSPs).

While this legislation opens up the field for disrupters, the release of all such account data is not automatic, but at the discretion of the account holders. Providers will therefore have to navigate GDPR, ensuring that account holders give consent for the use of their data.

Open Banking

In the UK, the CMA, responding to "concerns that retail banking may not be working well for customers", released the final report of its investigation into the retail banking market in 2016. The proposals in the report made it mandatory for the UK's nine largest current account providers to open up their retail customer and SME account data.

Open Banking rules require banks to share their current account holder data through an integration technology called Application Programming Interfaces (API). The CMA required "the largest retail banks in both GB and NI to develop and adopt an API banking standard so as to share information to a specified timetable and we are requiring it to be an open standard so as to enable it to be widely accessible."[4]

As a result, customers can use payment and account information services for accounts accessible online. UK Finance anticipates that these changes will result in the development of products and services that allow customers to optimise the use of their account and transaction data: "The value-added services which could result could easily go beyond payment and financial services and e-commerce. PSD2 could help open up new markets and encourage new market entrants, some of whom will offer services that will assist people who are currently financially excluded. There are a whole host of opportunities that it may not be possible to fully anticipate which could hugely benefit customers."[5]

This legislation will drive new technologies, new market entrants, and over time, a whole new market. The applications themselves will give consumers the ability to share their banking information securely with other banks, building societies and regulated companies. These APIs can then be used by third parties, such as challenger banks, to open up the financial services industry.

The crux of the matter – and why there's so great a market opportunity for challengers – is because such standardised data can be run through AI and machine learning systems, giving a much deeper insight to providers while maintaining data security for customers.

Deloitte believes that this will mean "more lenders, better credit decisions, and fewer bad loans".[6]

The areas targeted by this legislation are consumer and SME accounts and lending. These look ripe for transformation.

Consumer market

People are notoriously reluctant to move their personal banking arrangements: everyone moans about their bank, but few do anything about it. In the past, that's been due to just how difficult the process is. This, of course, is exactly what Open Banking has set out to address. And there are signs that they may be pushing on an open door.

According to Deloitte, 58% of consumers with a mobile banking app could be persuaded to switch to a mobile-only bank to gain the "ability to perform a greater number of banking-related actions through the mobile banking app". PwC research has found that 39% of bank customers would share their financial data with other banks

[4] https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf
[5] https://www.paymentsuk.org.uk/sites/default/files/PSD2%20report%20June%202016.pdf
[6] https://www2.deloitte.com/uk/en/pages/financial-services/articles/changing-world-of-sme-lending.html

and third parties if it gave them an overall view of their accounts in a single app, or to compare tailored product offerings from third parties.

That is a lot of people, which financial disruptors are queuing up to take a chunk out of.

SME market

There are about 5.6 million SMEs in the UK, employing 16.3 million people, with a combined annual turnover of £2tn – 52% of all private sector revenues, according to the Federation of Small Business. Their relationship with traditional lenders is a difficult one: "For almost a decade, banks have been given the ultimate mixed-message: 'lend' and 'don't lend'. Regulators want them to be less risky, but politicians don't want to see small businesses starved of funding."[7] As a result, SME lending has declined significantly since the financial crisis.

Nature abhors a vacuum – and doubtless other household appliances – so it's no surprise that all this regulatory paper shuffling in Whitehall and Brussels has attracted new entrants. After all, had it not, it would have singularly failed in its purpose.

There has been a flowering of fintech offerings as disruptors have attempted to pluck their own niche from the disaggregation of traditional banking services, like a crazed game of Jenga. Particular examples include:

- consumer and SME lending: a broader field than challenger banks, also including marketplace lenders such as Funding Circle and RateSetter;
- wealth management: digital platforms such as Moneybox and Nutmeg;
- cross-border payments: payment providers such as TransferWise, CurrencyFair, Revolut and Azimo;
- payment acquisition: mobile point-of-sale solutions such as Square and iZettle;
- distributed ledger technologies: companies such as Ripple and BitPay.

The simple term "challenger bank" itself covers a multitude of different offerings. PwC divides them into four broad groups with different models, aspirations and challenges:

Some 46% of UK SMEs report experiencing barriers to accessing finance, according to one study by Close Brothers. Business owners reported that their main challenges were the cost of finance (16%), lenders not understanding their sector (12%) or not understanding their needs (10%). "This lack of understanding and bespoke support is a recurrent theme, given that only a fifth of SMEs say their bank's advice always meets their needs," says the study.[8]

Look who's lending

- mid-sized full-service banks, typically with one million to five million customers;
- specialist banks with 80,000 to 600,000 customers and a more focused proposition;
- non-bank brands, such as Virgin, Sainsbury's and Tesco, targeting their parents' customers;
- digital-only banks, who are largely new (or newish) market entrants.

The digital-only banks are the real pure-play fintechs in the challenger world, and it's on these that we will focus. There are many new offerings coming to market, but a brief look at four will indicate the breadth of innovation on offer:

Consumer

Zopa was the world's first peer-to-peer lender, founded in 2005. This is important, as few other fintechs can demonstrate a track record that encompasses a financial downturn – and Zopa sailed through the GFC. As well as being a P2P pioneer, it's also now a bank, having obtained its banking licence, with restrictions, at the end of 2018, which should lead to faster earnings growth and a more diversified income stream. Last July, Zopa announced a £1.5m profit as revenues increased by 40% to £46.5m,

[7] https://www2.deloitte.com/uk/en/pages/financial-services/articles/changing-world-of-sme-lending.html
[8] Banking on Growth: Closing the SME funding gap. Understanding the changing needs of Britain's SMEs November 2016. https://www.closebrothers.com/system/files/press/Banking-on-Growth-Closing-the-SME-funding-gap.pdf

having made more than £1bn in loans since its foundation.[9]

Monese is the UK's first digital challenger bank, responding to "a vast opportunity to help bank tens of thousands of migrants who were moving across Europe, struggling to open bank accounts." It has expanded out of this niche, and is now positioned as "the best digital bank for global travellers and digital nomads," according to the UK's most comprehensive news source on alternative finance.[10] Last year, Monese had 400,000 account holders, with 70% having switched their primary account to the bank. Today that figure is well over 800,000 accounts.

SME

In April, alternative lending platform **iwoca** (SME) claimed its lending at the end of 2018 reached 12% of the UK's SME overdraft market. In the final quarter of 2018, iwoca had approved just over £74m of lending to 3,802 companies.[11] The lender aims to fund 100,000 SMEs in the next five years, with an eventual goal of reaching one million customers across Europe.

Tide is an SME challenger bank offering a broad range of online business banking services. At the end of 2018, it had 1% of UK's business banking and 10% of new accounts in the SME banking sector. It has applied for a slice of Royal Bank of Scotland's £775m fund aimed at increasing competition in Britain's business banking sector. Further developing its SME service offering, "upstart digital business bank Tide is working on a feature to let customers electronically register new businesses with Companies House … the first UK banking provider to do so."[12]

Such operations are focused and lean, without the broad tangle of interests and legacy systems that bog down established banking businesses. Not least, they're ahead of the curve with their technology. These new entrants do not have legacy systems to contend with. Why does this matter? If you want to feel good about your job through an extra-large helping of schadenfreude, spend a while talking to the CTO of a large bank to get a sense of their Sisyphusian battle with legacy systems. To be able to approach this issue with a blank sheet of paper is a massive advantage.

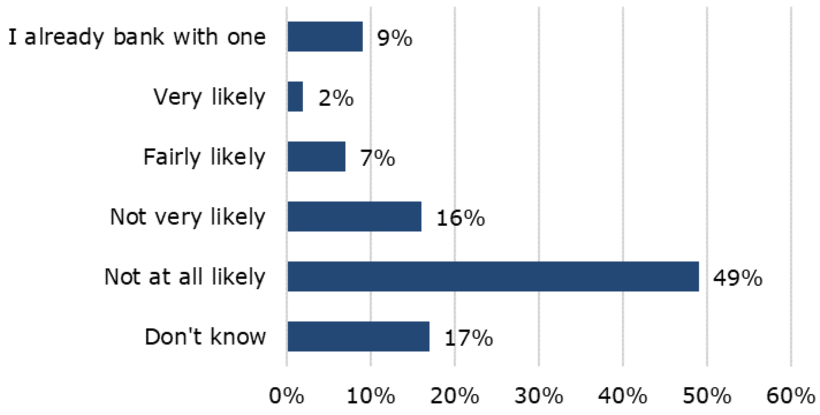
The sheer volume of data available through Open Banking also means those who have the capacity to slice and dice it, using AI and machine learning, can efficiently price risk across a whole number of areas. To be able to operate nimbly in this market, in a way that allows challengers to milk the data for all it's worth, and to provide modular solutions with appeal to targeted client segments, will mark out the winners in this data gold rush. Or golden data rush, if you prefer.

[9] https://blog.zopa.com/2018/07/02/zopa-celebrates-1-5m-profit-revenues-climb-40-46-5m/
[10] http://www.altfi.com/article/5089_monese-avios-apple-pay-digital-bank-challenger-monzo-revolut
[11] AltFi
[12] http://www.altfi.com/article/5257_exclusive-tide-launch-company-formation-uk-banking-first

Bridging the trust barrier

It is not all plain sailing for the challengers, though. Customer mistrust is a key hindrance. After all, in a world where phishing is a lot more than a dull hobby for dyslexics, people's anxieties about the online world are not without foundation. "For those that are familiar with the concept of Open Banking, the risks of data management, fraud and loss of privacy are a major concern for both customers and SMEs," reckons Deloitte, and almost two-thirds of respondents said they would be not very, or not at all, likely to use such a service (see Figure 3).

Fig 3: Customers who would consider a digital-only bank in the next three years

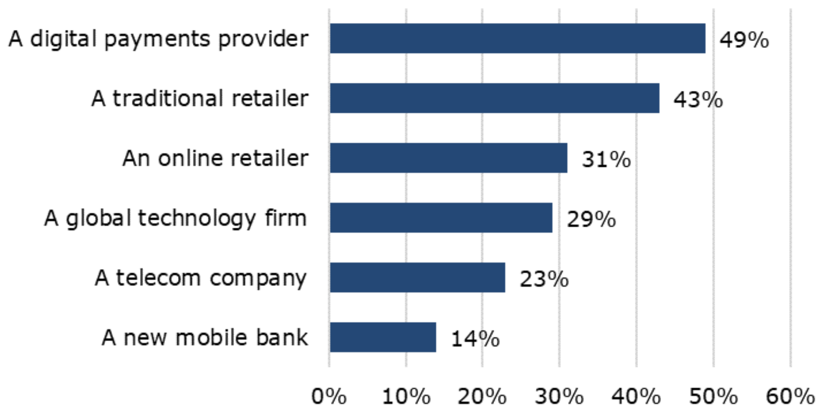


Source: PwC, Fidante Partners.

To thrive in this world, banks and third-party providers will need to reassure consumers that they have robust security measures in place to safeguard their data and respect confidentiality. In a PwC consumer survey, 58% of its respondents said they would not open a current account with any financial provider, new or established, if it shared their financial data with third-party providers. Even with the assurance from GDPR that such sharing is entirely voluntary, this is still a considerable hurdle to overcome.

Indeed, continues PwC, "customers and SMEs generally prefer incumbent banks to manage their financial products over challenger banks, digital banks and technology companies," a view also reflected in a Deloitte survey, where a 'new mobile bank' was the least trusted of providers to provide such a service (Figure 4).

Fig 4: Who do consumers with mobile apps trust to provide a banking interface?

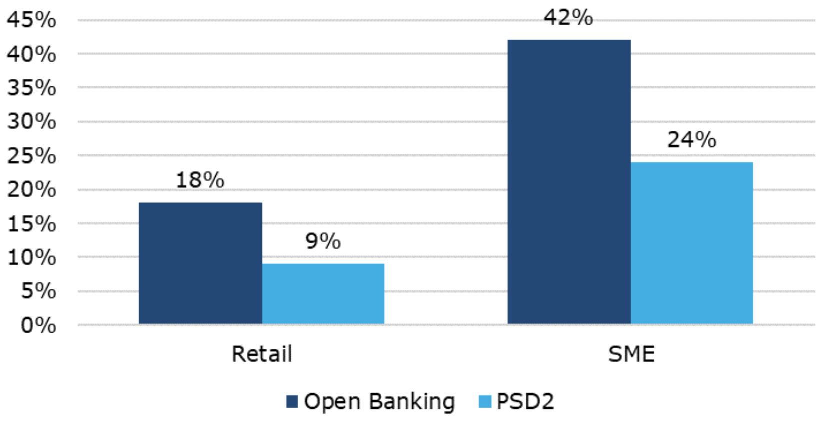


Source: Deloitte, Fidante Partners.

A lack of knowledge

Another issue is one of knowledge: just one in four people have heard of Open Banking, according to a Financial Times survey earlier this year.[13] Another study, by PwC, shows a greater understanding by SME customers, but even worse in the retail world (see Figure 5). Ultimately, this will become less of an issue, as knowledge spreads and dissemination speeds up as it does so. And having heard of the term is far less important than having a practical understanding of what you can gain from it.

Fig 5: Awareness of Open Banking and PSD2



Source: PwC, Fidante Partners.

As one study from PwC points out, "examples of successful banking technology deployments have shown that a slow start can often be followed by a rapid exponential uptake," citing the example of contactless cards where, despite being in circulation since 2007, contactless payment usage was low until 2015, but now accounts for about 40% of all card payments: "Similar to Open Banking, customers were initially reluctant to use contactless due to security concerns. However, uptake was accelerated by merchant adoption of contactless Point of Sale platforms and in particular through the accelerated adoption of contactless payment for public transport."

Regulation

Lastly, while regulation has made this possible, it hasn't removed all obstacles for incumbents. According to PwC: "Many of the CEOs we spoke to cited a number of challenges, including: regulatory capital requirements that they believe put them at a disadvantage; a perceived lack of proportionality in regulation; a model for accessing payments systems that is expensive and constraining; and lack of comparability between products which is potentially to the detriment of consumer outcomes. By far the most commonly cited structural challenge in our CEO interviews was the regulatory approach to capital requirements."[14]

Smaller banks also do not have the infrastructure to respond to the high level of regulation as is applied to larger banks, which have substantial compliance resources to draw upon. That said, there is the regulatory will to level the playing field: for example, the Financial Conduct Authority has launched 'Project Innovate' to help fintechs navigate regulation, among other things.

[13] FT, 11/1/19

[14] Who are you calling a 'challenger'? How competition is improving customer choice and driving innovation in the UK banking market, PwC, 2017

Market size and growth

There is a lot to play for in the UK market, with about 70 million active PCAs, which generated revenues of about £8.7bn in 2014. Some 5.6 million PCAs were opened in the UK in 2015, despite the sticky nature of current account business.

With regard to the SME market, there are around 5.5 million business current accounts, which generated £2.7bn in 2014. Outstanding general-purpose business loan balances at the end of 2015 stood at £96bn, with a further £9bn of invoice finance loans – a market that disrupters such as MarketInvoice have been very successful in accessing, and which iwoca is making a play for – and £25bn of new asset finance loans. Just under 20% of all SMEs have a loan, according to CMA research.[15]

Estimates of the market size differ, not least because there's no standard definition of what constitutes a challenger bank. However, growth expectations are consistently strong. Analysis from Orbis predicted global market size will reach $14.2bn by 2024, from $2.8bn in 2019. Another study put the expected CAGR between 2017 and 2020 at 50.6%, with the UK following the largest global market – the US – given its "impressive customer base, owing to favourable regulations and substantial investments funding such fintech start-ups".[16]

The UK alternative finance market grew by 35% year-on-year to reach £6.19bn in 2017 – the last full year for which data is available – according to the authoritative Cambridge Centre for Alternative Finance.[17]

Drilling down into the potential unleashed by Open Banking, PwC estimates that it could create revenues of at least £7.2bn by 2022 across retail and SME markets: "Examples of the numerous use cases enabled by open API data include account aggregation, better financial management, credit scoring thin-file customers, and integrated lending and accounting platforms for SMEs."[18]

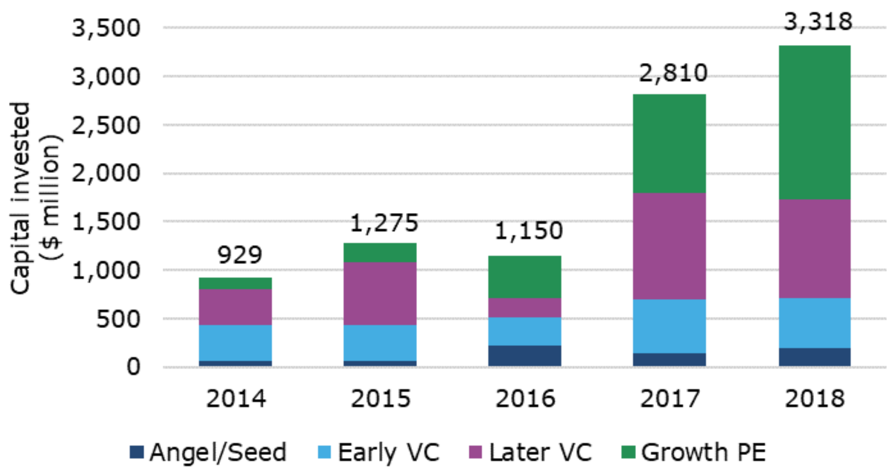
Investment volumes

Given this potential, it's unsurprising that fintech is attracting a lot of investor cash. Some $36.6bn of venture capital was invested in fintech globally in 2018: a 2.5x increase from 2017 and a 4.3x increase over five years (see Figure 6 for a fuller breakdown). Deal sizes have been increasing over the past five years, across all segments. The second quarter of 2018 saw China's Ant Financial raise $14bn – both a record for fintech as well as for venture capital.[19]

UK investment last year rose by 18% to $3.3bn, with private equity investments rising 57% to $1.6bn, with venture capital volumes at $1.7bn. Challenger banks have raked in the majority of venture capital investment at 27% of the total (see Figure 7 for the five largest of 2018).[20] Revolut, Monzo and Monese in the UK, and N26 and Solaris Bank in Germany, raised record amounts. The UK ranked third for venture capital fundraising – unchanged from the previous year, with $1.7bn invested across 261 deals.

[15] https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf
[16] https://www.alliedmarketresearch.com/press-release/neo-and-challenger-bank-market.html
[17] https://www.jbs.cam.ac.uk/faculty-research/centres/alternative-finance/publications/5th-uk-alternative-finance-industry-report/#.XMBy3-hKg2w
[18] PwC Open Banking Report, 2018
[19] Innovative Finance, 2018 FinTech VC Investment Landscape
[20] http://www.altfi.com/article/5057_uk-fintech-investment-hits-new-highs-as-industry-matures-ahead-of-europe

Fig 6: Investment volumes in fintech in Europe



Source: Innovative Finance, Fidante Partners. VC = Venture Capital; PE = Private Equity.

Conclusions

Almost a year and half into Open Banking, financial disruptors continue to build momentum, attracting ever greater volumes of customers and investments.

While this will allow a wide range of challengers – from smaller banks to offshoots of supermarkets – to take a chunk out of the big banks' account books, the most interesting area of the market is likely to be those operations that exist to do just that, with business plans focused on this, no legacy systems to overcome and technology that is geared for exactly this market. They are the Open Banking 'pure plays', and potentially have the greatest upside.

Challengers who have the systems to use the wealth of data that is available to them – not just through a nifty-looking app, but "a customer centric operating model, strong data analytics capabilities, integrated and secure technology platforms as well as an agile and open working culture"[21] – could take significant market share, with more profitable business models than the high street dinosaurs.

Fig 7: The five largest fintech VC deals in the UK in 2018

Revolut	Monzo	EToro	Liberis	BitFury
$250 m	$111 m	$100 m	$81 m	$80 m
Challenger Bank London	Challenger Bank London	Personal Investment Platform London	Alternative Lending & Financing London	Blockchain London

Source: Innovative Finance.

[21] The future of banking is open. How to seize the Open Banking opportunity, PwC, 2018

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