Banks and the FinTech Challenge: How disruption has been a catalyst for collaboration and innovation

A Currencycloud Whitepaper

Currencycloud™

Contents

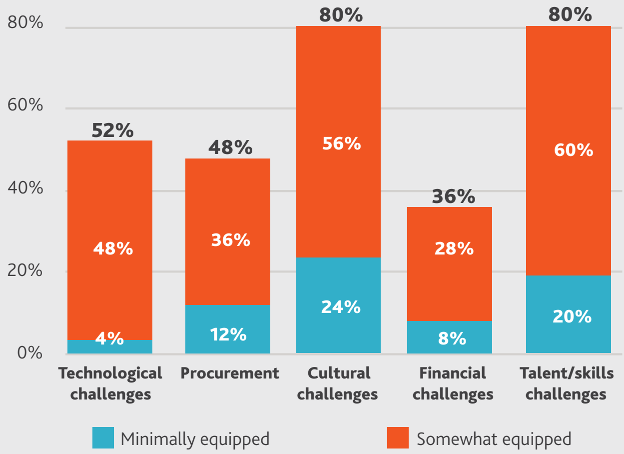
Introduction

The financial services sector is in the middle of a digital revolution that represents the most significant change in banking for centuries. In most markets, FinTech start-ups present a credible threat to incumbent banks. Using a combination of technology, consumer-centric service and flexible business practices, these new companies are reducing the cost of doing business, extending their customer base and taking market-share from established rivals.

To retain market share, banks are looking to change their own operations to compete, or considering opening partnerships with the very businesses that threaten them.

Despite this threat having been present for some years now, many banks believe they are still unprepared to compete properly. The majority claim they have at least some of the cultural structures and human resources required to address the challenge. However, they are much less confident in terms of procurement or, ironically, financial matters.

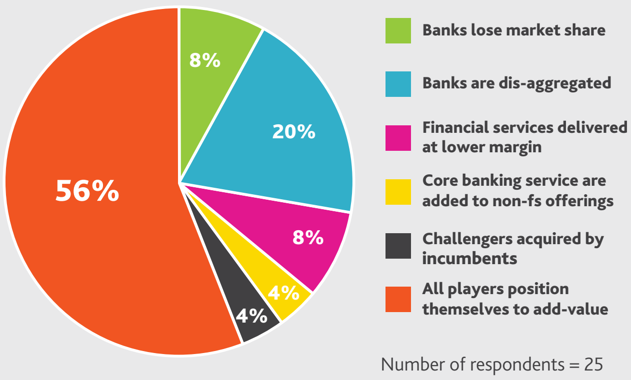
How equipped do banks feel to address the challenges associated with the next wave of digital innovations?



Source: The Future of FinTech and Banking: Digitally disrupted or reimagined? – Accenture

Despite uncertainty, incumbent banks believe the most likely outcome of the current disruption will be a repositioning within the sector. The majority of those surveyed by Accenture suggest that both FinTech start-ups and established banks will both have to reposition in order to offer their clients added value[1].

Hypothetical banking future



Number of respondents = 25

Source: The Future of FinTech and Banking: Digitally disrupted or reimagined? - Accenture

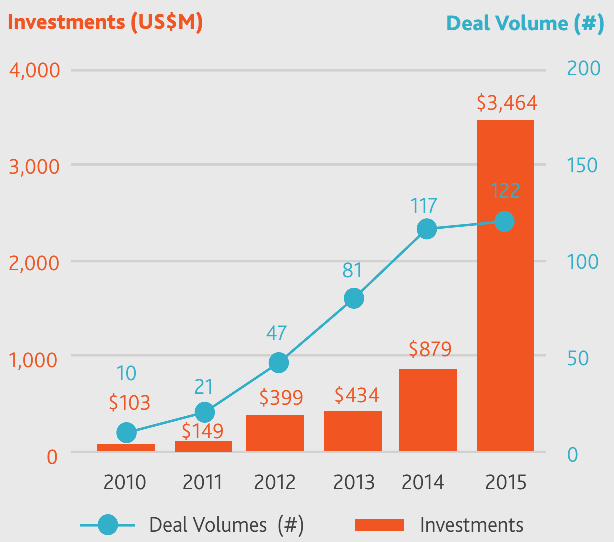
More surprising is that just 4% of those questioned expect incumbent banks to acquire FinTech challengers. On this basis, it would seem to confirm that banks are positioning themselves for a new era of partnership, sharing assets, expertise and even intellectual property with third parties to create new opportunities that benefit their customers and provide opportunities to sustain and grow market-share. The global marketplace means that banks across the globe are facing similar challenges. However local legislation and cultural differences mean that banks are taking different approaches in their respected geographies.

[1]The Future of FinTech and Banking: Digitally disrupted or reimagined? - Accenture

Asia

New entrants are gaining significant ground in the Asian financial sector, thanks in part to significant investment from venture capitalists and profit-hungry financial service companies. FinTech investment quadrupled between 2014 and 2015, topping $3.5 billion last year[1]. Many Asian FinTech start-ups have also been buoyed by a lack of financial regulation in their specific niches. Peer to Peer (P2P) lending remains relatively unregulated at present, reducing the overheads of operating such a service in the region. 800 P2P platforms in China traded over 100 billion yuan ($16 billion) during 2013[2], although the government still refuses to introduce 'proper' legislation, instead issuing industry rules to provide the necessary regulation.

Investment in APAC FinTech on the rise



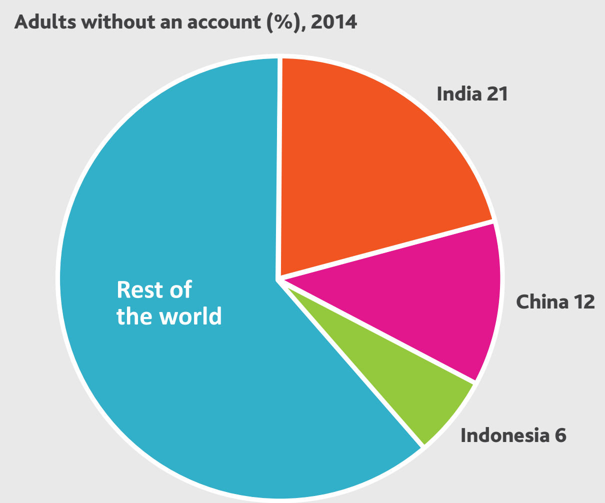
Source: Accenture

FinTech start-ups have been operating in the Asia-Pacific region since 2006, leading to the development of three major market entrant types.

1. Non-financial operators

Around 2 billion people worldwide do not hold a bank account, 38% of those live in just three Asian countries; India, Indonesia and China3. Emulating their successes in Sub-Saharan Africa, many non-bank operators (particularly telecoms businesses) have been introducing mobile banking equivalents.

Share of the world's unbanked adults in China, India and Indonesia



Source: Global Findex database

This presents a unique challenge to incumbent banks as technology has reduced the barrier of entry to new entrants, revealing a pool of customers who have previously not been exposed to any banking ecosystem.

[1] FinTech Investment in Asia-Pacific set to at least quadruple in 2015, According to Report by Accenture - Accenture

[2] Xinhua Insight: Rapid expansion of China's P2P lending spells trouble - Internet Society of China

[3] The Global Findex 2014: Measuring Financial Inclusion around the World - World Bank Group

2. Online payment providers

Providers such as Alipay in China are helping to drive e-commerce growth in Asia by simplifying the process of buying and paying for goods online – not unlike eBay in the US and UK. Having experienced early success, these providers are able to diversify. Alipay now operate a money market fund that has captured one third of the total Chinese market, equivalent to 0.5 trillion yuan[1].

3. Peer to Peer (P2P) lenders

The ability to lend money between individuals without bank involvement has been popular across the entire region. China has experienced enormous growth in the sector, as have Japan and Australia, at the cost of traditional lending mechanisms.

With FinTechs gaining significant momentum, banks are now looking at how they can co-operate with start-ups, rather than competing directly. As Zennon Kapron and Hadyn Shaughnessy noted in a report for Inno Tribe: "It seems churlish to suggest that these responses are misdirected or over-priced. Yet the growth of peer based finance, the shift to integrated platforms and the growth of integrated services are real. The only real solution for banks is to begin thinking of themselves as business platforms.[2] "

Rather than trying (and failing) to compete on the same level, banks need to merge with start-ups to create new innovations in partnership. Programmes like Accenture's 'FinTech Innovation Lab Asia-Pacific' are designed to bring leading banks (Barclays, HSBC, Bank of America etc) together with early stage FinTech start-ups to share experience, knowledge and funding.

> ***"We recognise that the leading banks of the future need to be at the forefront of FinTech in order to best service our clients."***
> *Samson Chan, HSBC3 .*

In return for support and guidance, the start-ups grant their investors some level of (unspecified) access to their technology or service, sometimes in exchange for equity. These programmes are also indicative of general support for FinTech solutions from banks; historically Asian banks have embraced innovation, rather than trying to fight it.

Asia remains ahead of the curve when it comes to FinTech services – P2P lending has been operating in Asia for over a decade. Banks operating in other regions will be able to somewhat predict future disruptions in their own region by watching the Asian market – and how Asian banks respond to respectively.

[1] Yu'e Bao Wow! How Alibaba Is Reshaping Chinese Finance - Institutional Investor
[2] The Platform for Disruption: How China's FinTech will change how the world thinks about banking - Zennon Kapron (Founder/Manager Kapronasia) and Hady Shaughnessy (Co-founder The Disruption House)
[3] Top Banks in Asia Launch 'FinTech Innovation Lab Asia-Pacific - Accenture

United States

Where the Asian finance industry has attempted to embrace and adopt FinTech, the US is more fragmented. Traditional banks such as Wells Fargo, Bank of America and Citi are under attack on all fronts from FinTech start-ups who are disaggregating their offerings, service-by-service.

For every service offered by major banks, there is at least one FinTech start-up offering similar deals at a lower cost and increased convenience. Mortgages, loans, payments and investment are all available from alternative providers, offering the kinds of deals and levels of service that modern consumers cannot resist and have come to expect.

The Unbundling of a US Bank

Source: CB Insights

The sheer size of the incumbent banks has always been a major strength, but in the face of agile new start-ups has become an Achilles' heel. With complex corporate structures, significant overheads and accounts in place, incumbent banks simply cannot keep up with the pace of innovation. Factor in legacy IT systems and regulatory burdens, such as the need to hold vast amounts of capital (which many start-ups are exempt from), it is little surprise that established banks are being steadily dismantled by the new competition.

With every service from their portfolio under attack, banks are losing customers and seeing reduced profits at an alarming rate. High profit services such as small business loans are being lost to companies akin to LendingClub and InvestNextDoor[1] because they are not only cheaper, but more consumer-friendly.

With their most profitable services at risk, US banks of all sizes need to act sooner rather than later. Many banks are now calling a truce in the battle against their FinTech rivals through greater collaboration.

> ***"It's not the institution versus the startup anymore; it's how to partner,"***
>
> *JP Rangaswami, Chief Data Officer at Deutsche Bank[2]*

Programmes such as Accenture's Partnership Fund for NYC provide early-stage financial start-ups with access to funding and resources from established banks[3].

Even closer collaboration can be found in the deal that sees start-up OnDeck Capital providing JPMorgan Chase with access to their automated loan approval platform[4]. OnDeck's service allows JPMorgan Chase to receive, process and approve a small business loan application within a matter of minutes, rather than the days their own processes take – offering a significant advantage over their competitors, advantages that are highly visible to the consumer.

The commoditisation of these services means that many FinTech providers are happy to partner with banks and other parties to re-sell or use as they need. "For us, the issue is not replacing banks. A lot of banks are happy to work with us because effectively I'm wholesaling and making it easier for businesses to access their services", explains Mike Laven, CEO of B2B cross-border payments specialist Currency Cloud5.

US banks do have one significant advantage that is not available to their Asian counterparts – a very well established customer base. In line with other OECD countries, around 94% of US adults have a bank account6 which serves as a useful tie between customer and bank. Larger banks will be able to use these relationships to shore up their core business; smaller State-based banks may not be so fortunate.

[1] Disrupting Banking: The FinTech Startups That Are Unbundling Wells Fargo, Citi and Bank of America - CB Insights
[2] Common Ground Trumps Disruption in Bank-FinTech Linkups - American Banker
[3] FinTech Innovation Lab New York
[4] Common Ground Trumps Disruption in Bank-FinTech Linkups - American Banker
[5] Ibid.
[6] The Global Findex 2014: Measuring Financial Inclusion around the World – World Bank Group

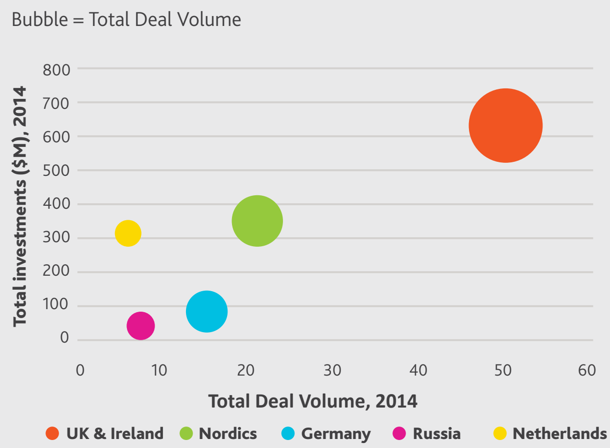
Customer data held by established banks also forms their trump card in the struggle to retain market share. Relative newcomers to the financial sector, non-banks simply do not have the information that allows them to build or maintain relationships in the way that incumbent institutions can. Instead they will continue to innovate in a relatively reactive manner – leaving them exposed to fluctuating trends.

In the short-term at least, established banks will need to continue finding common ground, providing knowledge, expertise and data to FinTech start-ups in return for access to their platforms. As well as direct investment into start-ups, more banks need to enter incubator-style programmes if they are to benefit from the developments that are set to continue the process of 'unbundling' for the foreseeable future.

For some pundits, European banks have more to be concerned about from FinTech companies than other regions due to a banking structure in which banks are organized by vertical silos, from the product to the client. Traditionally, the European 'Universal Banking' model banks offers a diverse product portfolio in retail, private, commercial, investment and transaction banking, along with wealth and asset management, plus insurance. In contrast, countries such as the US and Japan have generally separated banking and commerce as a means of promoting the stability of the commercial banking sector. The important point here is that, in terms of threat from FinTech, the very qualities which once made the Universal Banking model so robust now make incumbent banks exceptionally vulnerable.

It may be for this reason that the European FinTech market is now the fastest growing in the world. According to a new report by Accenture[1], the UK and Ireland (UKI) accounted for more than two-fifths of the European total, as investment in the region rose from $264 million in 2013 to $623 million in 2014.

Top 5 European Regions for FinTech Investment Activity, 2014



Source: The future of FinTech and Banking - Accenture

Whether or not, as former Barclays CEO Antony Jenkins suggested that: 'the universal banking model is dead', a recent McKinsey report[2] assesses a significant percentage of banks' profits are at risk from emerging new competition. 'The fight to hold on to customer relationships will be a high-stakes struggle,' McKinsey's report adds, 'We estimate that in five major retail banking businesses (consumer finance, mortgages, SME lending, retail payments and wealth management) from 10 to 40 percent of revenues (depending on the business) will be at risk by 2025, and between 20 and 60 percent of profits, with consumer finance the most vulnerable.'

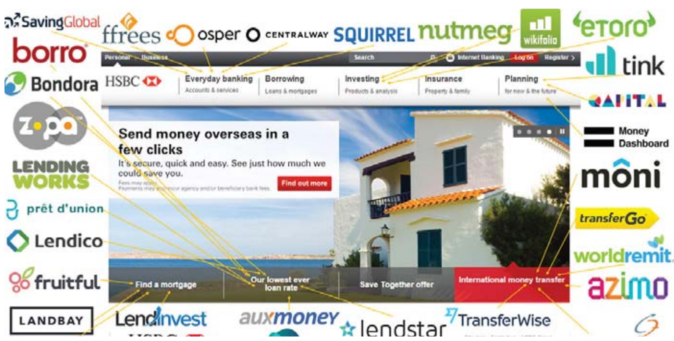
[1] Growth in FinTech Investment Fastest in European Market - Accenture
[2] The Fight for the Customer - McKinsey Global Banking Annual Review 2015

The European Innovators

Within the European market, significant FinTech startups are being watched intently as an indicator of overall trends. Firms such as Borro, Zopa and Auxmoney are leading the growth in P2P lending platforms, while Nutmeg and eToro are amongst those competing for wealth management business. In the world of money transfer Azimo, Worldremit and Transferwise have already started to undercut banks. The latter example, Transferwise, is a classic example of just why banks have everything to fear from FinTech. Started as recently as 2011, Transferwise identified a key area of the market where consumers have traditionally been tied to the banks: transferring money overseas. With its slick, simple user experience, and transparent pricing, Transferwise offers exactly the same service at a significantly lower cost. So successful has this premise been that Transferwise now facilitates the transferring of more than $760 million (£500 million) across the globe every month, owning 2% market share in UK-based global remittances. Subsequent to their recent $58 million venture capital funding, the Financial Times reported that the company is now valued at almost $1 billion, a momentous achievement for any five-year-old company.

Another disruptor worth mentioning is UK-based Seedrs[1] , who are enabling non-accredited investors to purchase shares in high-growth start-ups and small businesses. In the past, investment opportunities would have gone to the banks themselves, as well as investment funds and private clubs. Firms like Seedrs, however, (as well as Dutch competitor Symbid[2]) offer the public these potentially lucrative opportunities, a move which has radically democratized the financial services industry. "With open access to borrower information, held centrally and virtually", commented Andy Haldane, the Bank of England's Executive Director for Financial Stability, "there is no reason why end-savers and end-investors cannot connect directly… The banking middle men may in time become the surplus links in the chain."

The Unbundling of a European Bank

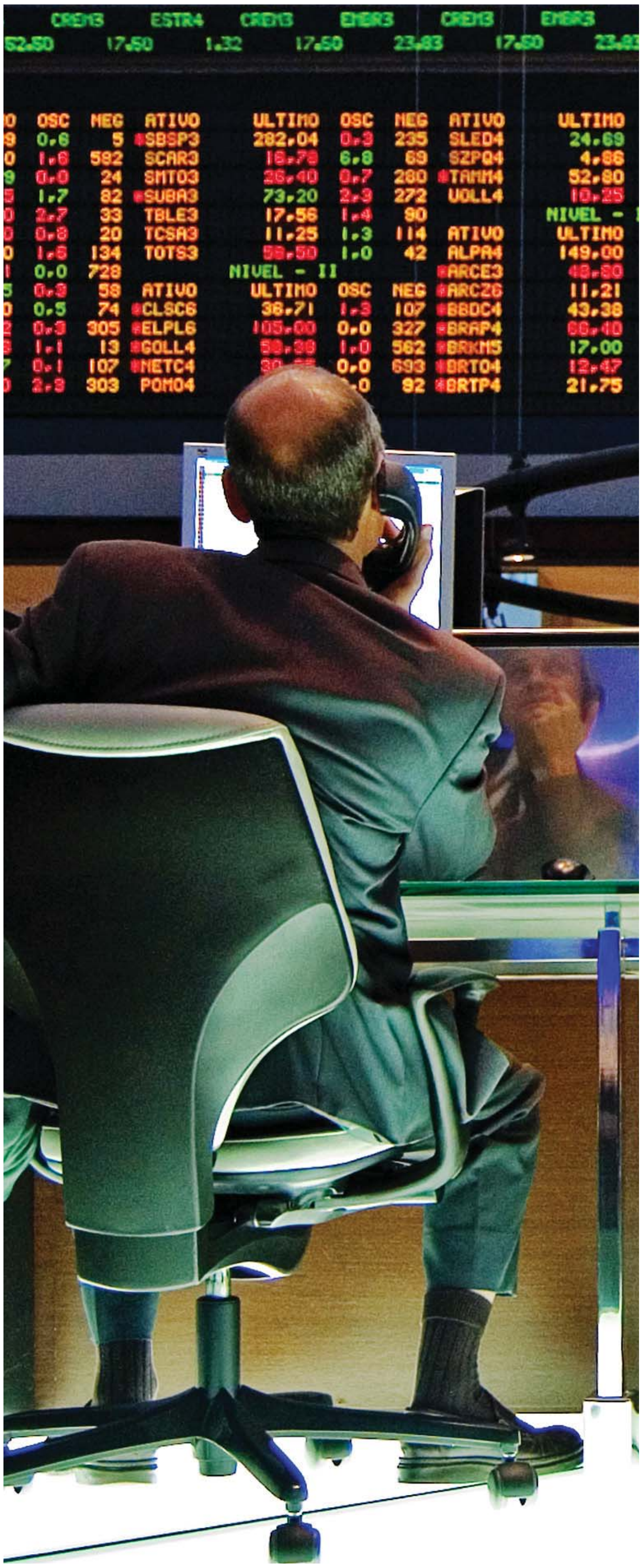


Source: Disrupting European Banking: The FinTech Startups that are unbundling HSBC, Santander and BNP - CB Insight

[1] Seedrs
[2] Symbid

Europe and the Single Digital Market Initiative

2015 saw some European countries securing record levels of investment in FinTech sectors. In the UK, British Chancellor George Osborne's appointment of Eileen Burbidge as an ambassador for FinTech sent a strong message throughout the industry that the government were fully behind it. While the UK is currently the European leader in FinTech, (some 60% of all European FinTech startups are based there) the variety of cultures and regulatory environments in Europe remains one inhibiting factor against overall European growth. The European Single Digital Market Agenda, however, could go a long way to changing this. With the goal of offering an environment where 'the free movement of persons, services and capital' is ensured and where the individuals and businesses can seamlessly access and exercise online activities under conditions of fair competition, the EU's efforts to facilitate cross-border, digital trade could go a long way to offsetting the difficulties posed by its fragmentation over 28 member states.

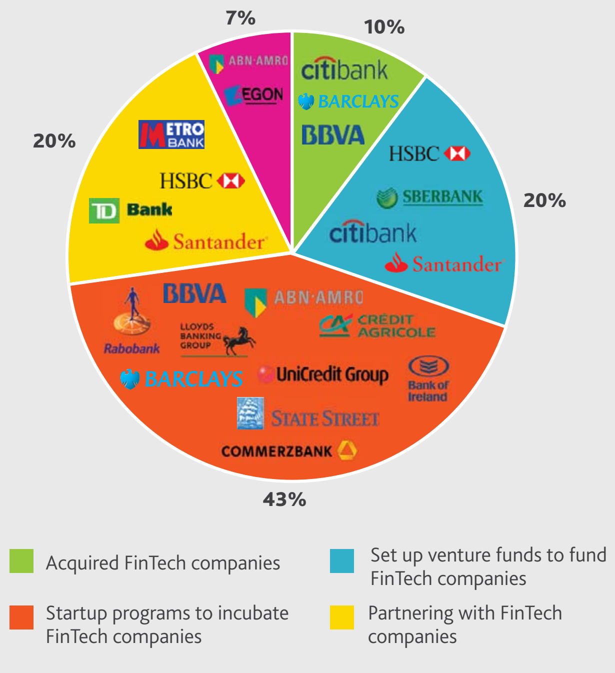


Collaboration between FinTech and Banks

As with any evolving marketplace, the nature of the emerging relationship between FinTech and banks is still in uncharted waters, and with no set protocols as yet. For Philippe Gelis, of UK based startup Kantox, there are two types of banks: "Large banks are more FinTech oriented and want to learn, collaborate and be partners. But then there are the domestic banks that are very aggressive because they feel very threatened, knowing that they do not have the innovation capacity to develop on a grand scale. These banks are going to have a very hard time[1] ", he comments. Writing in the Guardian, Christopher Holloman of FinTech startup Divido, concludes that the nature of the relationship between banks and interlopes is going to depend on mutual need[2]. Some FinTech startups (such as Aire and GoCardless) aim to either sell directly to banks or require banks to work with them as part of their way of doing business. Others, (Ratesetter and TransferWise) are set up to compete directly, meaning they're unlikely to form exclusive links to any one bank.

Over the last 12 months, numerous signals have been offered by major banks, however, which demonstrate that they're actively involved in recruiting the best FinTech talent. Swiss bank UBS has launched a competition dubbed "The Future of Finance Challenge" to try and find start-ups working in the fields of: 'client experience, products, efficiency, and security'[3]. With a $50k prize, the move is a bold piece of initial outreach for a bank beginning to fortify its ties with the FinTech community. Barclays Techstars Accelerator program is another move in the same direction, while Spanish banking giant Santander is teaming up with mobile payment company Monitise on a joint venture that will nurture FinTech start-ups.

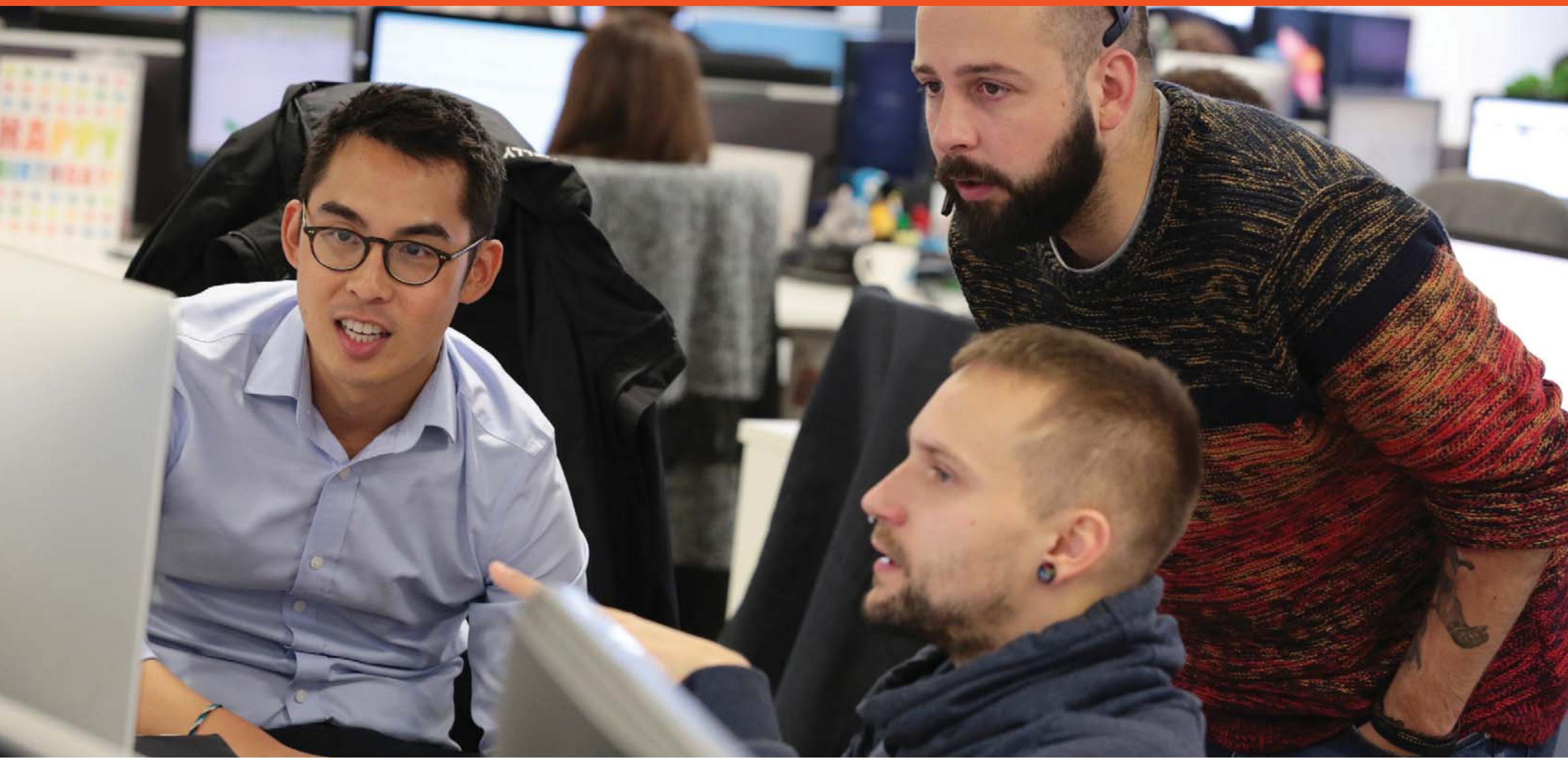
Joining Hands to serve Customers



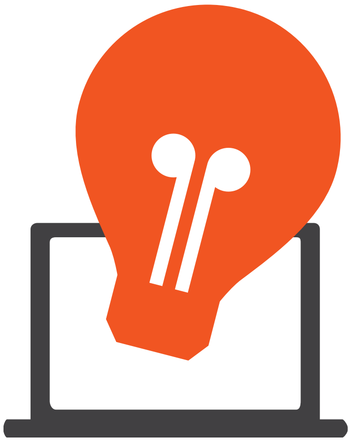
Source: How Banks Are Joining Hands With FinTech Firms to Serve Customers - Lets Talk Payments

[1] Partnership between Banks and FinTech startups, reality or utopia? - BBVA Innovation Center
[2] Should UK FinTech startups get into bed with the banks? - The Guardian
[3] UBS wants FinTech startups to help it keep ahead of the competition - Business Insider

Innovation Labs



Another approach gaining traction with many banks is the creation of innovation labs: semi-autonomous groups funded to accelerate innovation and incorporate new technologies and skill sets. Often using University students and 'out of the box' creative talent, these innovation labs begin with the notion that long term employees generally don't deliver the ground-breaking ideas which newcomers, unencumbered by conceptual models of how things should work, may offer. Accenture, UBS, HSBC and Deutsche Bank are just a few of the institutions who hope innovation labs will give them competitive advantage[1] . Often shrouded in secrecy, these labs are creative think-tanks where the future of traditional financial institutions is being nurtured.



UBS

accenture

HSBC

Deutsche Bank

1. How Banks Are Joining Hands With FinTech Firms to Serve Customers - Let's Talk Payments

The Russian Market

In contrast to the American, European and Asian markets, in which bank/startup collaboration is happening at break-neck speed through a variety of different methodologies, Russia represents one of the last great conservative financial service industries in the world. Legacy skills and culture represent one of the fundamental challenges to the way banks can successfully integrate FinTech into their business model. It seems likely that the Russian economy could be hit harder than others if this conservatism translates into a reluctance to innovate. In 2014, investments in FinTech comprised just $11.8 million in Russia[1] (compared with the US that soared to $9.89 billion). Despite the slower relative pace of growth, however, innovation is still breaking through into the Russian market due to necessity.

A new FinTech cluster (Future FinTech) has just launched in Moscow, facilitating potential collaboration partnerships between banks and FinTech startups in the Russian sector. LifePay, a credit card payment solution with guaranteed transactional security is one of the startups to watch in Russia, as is Touchbank, an online retail bank conceived by the OTP Group, one of the leaders in Central and Eastern Europe's banking market. Vladislav Solodkiy, Managing Partner, of Life.Sreda VC (a venture capital firm focusing on investments in FinTech projects), commented: "A whole pleiad of FinTech-dedicated funds, private and public, emerged last year, and one can hear recognized investors saying aloud what has definitely become a buzz phrase of the season: "FinTech is the next big thing!"[2] .

Russian FinTech Ecosystem

Source: Russian FinTech Ecosystem Is Gaining Momentum Despite Obstacles - Let's Talk Payments

Conservatism isn't the only hindrance to successful FinTech adoption in the Russian markets. Regulation is also significantly tighter in certain areas than for Russian FinTech's European and American counterparts. Bitcoin and blockchain in particular have faced tremendous opposition from the Russian government with a recent announcement by Deputy Finance Minister Alexey Moiseev suggesting the Ministry was working on a draft law that would seek to punish those converting cryptocurrencies into the ruble with up to four years in prison[3]. "We appreciate the potential relevance of blockchain technology for the development of e-commerce and therefore we feel that it should be allowed and developed, but bitcoin themselves, in particular, the implementation of the bitcoin transactions into the real economy, in the real banking system can be very dangerous," he concluded. Overall, an uncertainty about how much the Russian state wishes to regulate online transactions will continue to be a point of real concern for both domestic and foreign investors focusing on the Russian FinTech market.

1. Will FinTech Become A Buzzword Du Jour In Russia? - ArcticStartup
2. Investment in FinTech startups soars - Finextra
3. Russian Minister Confirms Plans to Ban Bitcoin-to-Fiat Conversions - Coin Desk

Predictions for the future

By working with banks, start-ups have the opportunity to acquire user data which can help inform innovations at a product level and gain an invaluable understanding of an established customer base within their market.

Despite the incontrovertible shifts that FinTech is bringing to the way we all do business, it seems unlikely that traditional banks will find themselves superseded altogether. A glance through history shows us just how entrenched the banks are in our economic and social structures, having had decades to build up their infrastructures, and develop solutions for compliance and regulatory challenges. Most importantly, they have consumer trust, an incredibly valuable resource in the sometimes fickle world of internet commerce.

That said, some of the savviest of FinTech startups aren't seeking to bypass the banks so much as to build on their existing infrastructure. By working directly with banks, start-ups have the opportunity to acquire user data which can help inform innovations at a product level and gain an invaluable understanding of an established customer base within their market. That said, some of the savviest of FinTech startups aren't seeking to bypass the banks so much as to build on their existing infrastructure.

In terms of the banking industry's response to this changing landscape, some will successfully embrace innovation, while others may fall by the wayside. A third tier will thrive through simply acquiring and assimilating the innovations led by entrepreneurs. Whether this is by facilitating their growth or partnering with those who provide market-leading solutions. Collaboration is changing the way that money is moving and empowering business to change for the better. Whilst alternative finance and distributed ledger technology have the potential to change the landscape of financial services (particularly payments) globally. There are exciting times ahead for change and innovation in the FinTech industry.

About Currencycloud

Launched in London, Currencycloud is driving the transformation of the payments landscape to make international business and new markets accessible to everyone. With its developer friendly Payment Engine, businesses can build and automate their products, benefiting from real time wholesale rates and a fast, secure payment network. Everything is delivered by its next generation API.

To date Currencycloud have processed $15bn transactions, for over 150 clients and more than 500,000 end users.

For more information about the company, please visit: www.currencycloud.com

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