Social connectivity, data accessibility and technological advances have come together to create the right conditions for a surge in fintech start-ups. Add in a growing capital stream – global investment in these ventures tripled to more than $12bn in 2014 – and there seems to be no shortage of bright ideas.

An estimated 15,000 fintech companies worldwide are successfully eating away at the banks’ revenues with innovative products and business propositions in areas such as alternative finance, peer-to-peer (P2P) lending, crowd funding, robo advisors and payments.

The industry has witnessed a dramatic lowering of the barriers to entry, costs of deploying modern technologies and time to market, all which have contributed to the ‘democratisation’ of financial software development, according to David Webber, managing director at digital banking software provider Intelligent Environments. “It is the ability to innovate, deploy quickly and, if necessary, fail fast that has allowed the alternative finance operations and challenger banks to emerge,” he says. Intelligent Environments provides the software platform underpinning Atom Bank’s mobile apps.

“The role these alternative finance and fintech firms play in developing and taking new ideas to market is critical,” adds Matthew Hatch, partner, advisory services, at EY. “These start-ups can spin up a server and compete at scale in a matter of weeks.” Cloud computing has been a major contributor to the increase in pace and drop in cost, but so has design thinking and agile and lean development methodology.

Fintech start-ups are not looking to reinvent the whole bank. Instead they are focused on discrete segments of the value chain, with the aim of doing one piece better, faster and cheaper. Colm Lyon, CEO at Fire Financial Services, calls this trend the “dismantlement” of financial services. “It isn’t really disrupting because it is still the same products under the bonnet,” he says. “Financial services are being unbundled and these new companies are offering different sections of the banks’ overall proposition.”

**NEW BUSINESS MODELS**
There is no denying that these new start-ups are disintermediating incumbent financial services providers. Nutmeg, the first online investment manager, is a case in point. “Most people don’t have time to manage their own money, and while they know they don’t have the expertise either, they struggle on and do it themselves. They want the best bits of all worlds: lower costs, access to great service and someone to manage their investments. The internet is how we make that happen,” says Nutmeg CEO Nick Hungerford.

The pain points are clear: lack of time and transparency, high fees and low returns, plus what Mr Hungerford refers to as “cultural misalignment”. “Financial advisors don’t look or sound like the vast majority. They tend to be in their 50s, white and male. They aren’t used to doing business with people who are tech savvy,” he explains.

Nutmeg’s aim is to provide clients with a transparent online money management service and help to educate them so that they can do it themselves. Self-service, as well as 24/7 availability, is seen across fintech start-up offerings.

In the remittance space, Xendpay intends to overhaul the traditional money transfer model, where firms profit from foreign exchange spreads and high fees by offering international money transfers on a ‘pay what you want’ basis.

Xendpay CEO Rajesh Agrawal says: “I wanted to make a difference in the world and saw that people are being ripped off when they send money back home. The only way to change the status quo was by disrupting the traditional mechanism of money transfers, whether through technology or pricing.”

A customer can use Xendpay via mobile and online to send money to a bank account anywhere in the world and also mobile wallets in many countries. The company suggests a small fee on its website; while 90% of
people pay something, 70% of those pay the suggested fee. “This proves that a new model can work,” says Mr Agrawal.

PROVIDING FUNDING FOR SMES
Alternative lending is mainly associated with consumer P2P platforms; however there has also been a sharp rise in fintech start-ups focused on the small and mid-sized enterprise (SME) segment. SMEs have long been poorly served by the banks, yet account for 99% of global businesses, contribute about 50% of GDP and play an important role in a dynamic economy.

UK-based Iwoca, for example, provides financing for the ‘S’ in SME. Its technology pulls data from different sources, including Alibaba, Amazon, eBay, cloud-based accountancy software and bank statements, and uses it to assess the lending risk for small businesses.

“Customers share information about their business to streamline the application process,” says CEO Christoph Rieche. “It takes minutes to apply and funds are in their bank account within hours or days of an application, versus weeks or months for banks.”

The banks historically ignored this segment because it proved too costly to do in-depth due diligence for each customer. “Technology can really make a difference,” he says, “because it can help to understand every single customer in a better way. We have reduced the cost of underwriting by 90%.” In the UK banks will soon be obliged to share rejected leads with alternative lending players through platforms designated by the British Business Bank.

US-based Kabbage also leverages data accessible online to provide SMEs with capital. Importantly, it is not just a one-time data pool but continuous access. “This means that it is possible to truly understand the small business’s cash flow over a longer period of time and therefore to create products that fit that business,” says Rob Frohwein, CEO and founder. Kabbage’s offering is a “fully automated, living, breathing line of credit” that can move up or down depending on the business’s performance.

While having banks refer rejections to alternative lenders is a good first step, Mr Frohwein argues that a deeper strategic relationship is needed. “To bring long-term benefits, both organisations need to partner in a technically integrated way,” he says. For Kabbage, that means the customer experience lives on the partner bank’s site. “We provide the underlying end-to-end technology. While the bank’s look and feel guides the customer interface, we consult with the bank to ensure they engage in a way we know small businesses love. In addition, we assist in monitoring and servicing the customer,” says Mr Frohwein.

PayPal – which successfully made the journey from fintech disruptor to financial services heavyweight – has also moved into the SME finance space, leveraging the deep relationships it holds with its customer base. PayPal Working Capital launched in the US in late 2013, and then expanded into the UK and Australia a year later.

“Many small businesses process the majority or potentially all of their sales through PayPal, which gives us access to an extremely rich data stream and a window into the health of their business,” says Norah Coelho, director of PayPal Working Capital UK. “The principles behind PayPal’s innovative platform are fast, flexible and fair funding.”

The solution offers a single fixed fee, which is transparently displayed at the point of application; a short application and funding process, taking minutes instead of hours; 24/7 availability; and a ‘repay when you get paid’ mechanism. “The customer pays a fixed percentage of their daily sales and that allows the repayment to flex accordingly,” says Ms Coelho.

HARNESSING BIG DATA
Being able not only to capture but successfully apply ‘big data’ is another characteristic of many new start-ups and one that will produce significant advances in overall customer experience within the next five years, predicts Jan Bellens, global emerging markets leader and Asia leader, banking and capital markets, at EY. “This advance will be driven by fintech, not necessarily entrepreneurs but larger ecommerce players or other institutions with access to data lakes and data scientists,” he adds.

The next frontier for Kabbage is to use big data to develop ‘hyper-personalised’ experiences and products. “We want to be

Alibaba could capture maybe 80% of a person’s behaviour, compared with a credit card risk model of a bank, which might see 15% to 20% of a customer’s activity Jan Bellens
There is compelling case to enter into partnerships because of the speed by which things are changing

Colm Lyon

able to dynamically generate a product for a small company that is based on its unique circumstances that we can assess very rapidly,” says Mr Frohwein.

Mr Hatch suggests that even referring to a ‘demographic’ will be out-dated in the future when each consumer can be personalised based on their data.

Additionally, Mr Bellens sees fintech companies using big data for advanced risk modelling. He highlights Alibaba, which has built its own credit score based on customers’ retail activity and payments via Alipay. ‘Alibaba could capture maybe 80% of a person’s behaviour, compared with a credit card risk model of a bank, which might see 15% to 20% of a customer’s activity,’ says Mr Bellens. ‘If Alibaba can leverage the data and perform the right analyses, it could have a much better view on the actual credit score and credit risk of a customer than a bank has.’

Eugene Danilkis, CEO at Mambu, a software-as-a-service banking platform provider, sees innovation in automatically pulling data from different sources into specific business processes. “For example, if a company is evaluating agriculture loans, it could pull in or estimate weather and market forecasts over next 12 months into the financial assessment process,” he says. “Today that process is done manually, which takes a lot of time and is prone to error.”

Mr Hungerford, on the other hand, does not think that the wealth management industry has got to grips with big data, including Nutmeg. “However, I can imagine a future where we track what a customer is saying on Twitter about having a baby and then offer them the option of creating an investment fund for that child,” he says.

COMPETE OR COLLABORATE?

There has been much debate over whether fintech companies are pure disruptors, able to change the world on their own, or whether they need to co-operate with banks in order to gain scale. “More often their business model is designed around collaboration with traditional banking and infrastructure players in the market,” says Mr Hatch. Eighteen months ago he saw a fair amount of ‘disruption denial’ from banks, whereas today he sees greater collaboration and investment.

The challenge for banks, according to Mr Danilkis, is that they are trying to play both defence and offence at the same time. “They are trying to defend existing market share, while figuring out how to stay relevant in a digital future. Some of the organisations are approaching the market by either funding platforms, such as alternative lending, or putting money behind start-ups, which is a way for them to get into the game,” he says.

Alternative SME finance is one area seeing a lot of interest from tradition banks. For example, Commerzbank invested in Iwoca in July 2015 through the bank’s venture capital subsidiary, CommerzVentures. Kabbage signed a deal with ING in June, followed by Santander InnoVentures and Scotiabank.

Mr Lyon is of the opinion that banks are better off partnering than doing it themselves. “There is compelling case to enter into partnerships because of the speed by which things are changing,” he says. “In the next five to 10 years banks will do a bit themselves; they will partner with third-party payment service providers, foreign exchange gateways and alternative lending platforms; and then over time they will look to acquire some of those players.”

THE POWER OF BLOCKCHAIN

While new technology is erupting across financial services, none has received more attention this year than blockchain, or distributed ledger technology. Both Mr Bellens and Mr Hatch believe it has great potential for transforming financial infrastructure. “Many pilots and prototypes for blockchain technology are being deployed with good results,” says Mr Bellens.

For example, London-based start-up Everledger has used the technology to protect insurers against diamond fraud. “Every diamond has a serial number and the policy against that number is accessible via the blockchain to all diamond insurers,” says Mr Bellen. “That is an example of where blockchain can rapidly make a vast difference.”

Thirty global banks have now joined R3’s distributed ledger initiative. According to CEO David Rutter, the goal is to build a shared ledger approach that works for members, based on the premise that existing technologies are not fit for purpose. The consortium has received 40 suggestions from its members and is currently working on trade finance, issuance and derivatives smart contract use cases.

Mr Bellens believes that blockchain could play an important role in the regulatory and compliance arena, for example Know Your Customer, anti-money laundering and sanctions, where to date there has been less focus and investment. “This will be the new battleground for innovation, at least from the incumbents,” he says. He hopes to see more initiatives that will help decrease the banks’ burden, as well as ensure that fintech companies are up to scratch on regulatory issues.