Deloitte.

Fintech – Disrupting the way we bank

Background

The emergence of disruptive technologies in foreign markets in particular Asia, Europe and North America, has made their way to our shores. Disrupters include ride-sharing service Uber and accommodation provider Airbnb, who owe their respective successes to the disintermediation of traditional taxi and accommodation/rental market structures.

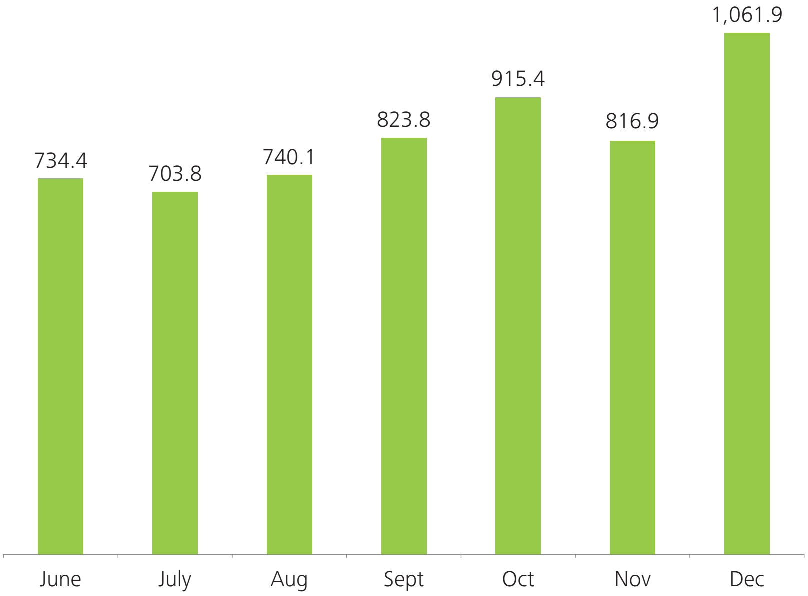
Traditional financial institutions such as the big four banks have long enjoyed a captive market that have provided generous profits. According to the IMF, Australian banks have market power that comes from market concentration. Strong balance sheets allow our banks to provide a range of services to a large customer base. Typical customers have strong credit ratings, and pay higher interest relative to alternative providers. This environment makes the banking sector ripe for disruption.

A set of interviews with small-to-medium business customers, consumers, sector participants and subject matter experts has identified several technology trends that will impact personal loans, credit cards and the small-medium enterprise (SME) lending markets.

The disruptors

Payday loans
With business models based on making short-term borrowing more simple and efficient, the agility of providing loans within 60 minutes has created a category for itself in the lending space and is experiencing rapid growth in Australia. The graph below indicates the growth in Cash Converters' online cash advances in the second half of 2014 alone.

Figure 1: Cash Converters online cash advances for 2014H2



Payday loans target customers who need smaller amounts of fast cash ($100-$1200); and are typically used by low-income, financially-disadvantaged borrowers who are frequently insensitive to the costs of borrowing. Revenue generation is based on charging very high interest rates and repeat customers: 76% of borrowers re-borrow at any period and often enter into an endless borrowing cycle. With low barriers to entry for a traditional bricks-and-mortar setup, in the US there are more payday lending outlets than Starbucks and McDonald's combined.

Interestingly through our interviews we found that white-collar affluent young males are active in using this service as a "Friday-night-top-up", this is likely to have interesting implications for the credit card market, offering another alternative.

Peer-to-Peer (P2P) lending
P2P lending matches lenders with credit-worthy borrowers through the use of an online platform. Based on our conversations, interviewees predict a 15-20% penetration of the Australian personal and SME lending markets within the next decade. This is similar to the rapid growth of P2P lending experienced in the US, following its introduction in 2007. In a post-GFC era of strict lending criteria, P2P lending appears to have become a viable alternative to banking institutions for individuals seeking smaller loans.

By enabling borrowing and lending without the intermediation of a bank, P2P lending reduces the cost of originating and funding loans, thereby providing more competitive rates to borrowers. Being unaffected by branch infrastructure, overheads and capital reserve requirements that drive up operating costs for traditional banks, there are significantly lower barriers to entry in the P2P lending space. The online process on a small scale also allows for a faster loan approval process. However, as the system is completely online, this also increases the risk of online fraud, and de-personalises the banking customer experience. When we spoke to small-to-medium businesses, the main theme was one of lack of trust, preferring the traditional more expensive branded big bank option. However, US-based Lending Club and Australia's Capify have formed alliances with the Chinese payments giant Alipay to offer supply chain finance to small businesses, potentially disintermediating banks in lending, trade finance, FX and international payments.

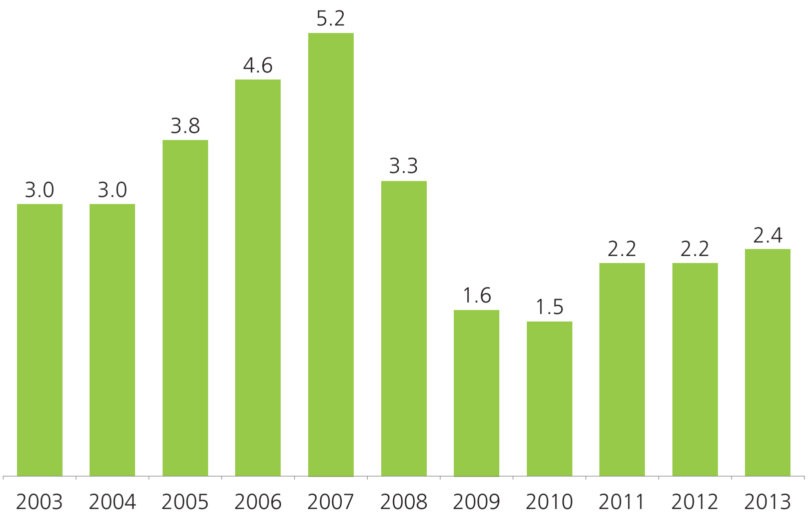
Credit decisioning platforms
New credit-checking platforms can be integrated into an institutional lender or a bank's existing platform, both expediting and broadening the data points that can be analysed for decisioning. Platforms such as Yodlee and Daric assess consumers and SMEs by aggregating the borrower's financial information and analysing their transactional data. Yodlee delivers financial data from more than 14,000 sources and Daric considers grades of potential borrowers who had been to university and performed well in courses. It is now becoming increasingly easier for smaller institutions to access these cloud solutions to level the playing field.

This made us think twice about what we post online, or how we use the web. Your social media antics and rants could be used to determine how much interest you pay. Consider yourself warned.

Payment platforms becoming lenders

Since the global financial crisis (GFC) of 2008, banks have significantly reduced their lending to small-medium businesses. This has provided an opportunity for online payment platforms to offer capital to their merchant customers in the form of cash advances. Providers such as PayPal and Square Capital are moving aggressively into the lending space and disrupting banks.

Figure 2: Loans originated to US small businesses fell significantly after the GFC ($m)



NB: Firms with $1m or less in revenue

Credit decisioning is based on borrowers' processing volume and cash flow data, not their credit score. Providers take a percentage cut from the merchant's credit and debit card sales and repayment is dependent on cash flow. However, the nature of this process limits the customer base to those who utilise the provider's payment platform. For those who don't fit the traditional model for bank financing, this is an attractive alternative.

Internet giants becoming digital banks

China's WeBank and Alibaba both received banking licences in 2014, drawing on big data generated from the information exchanges across their network to build a detailed understanding of their customer base. Both institutions offer higher interest rates on deposits compared to traditional banks. Alibaba's Yue Bao attracted 0.5% of China's total deposit within 8 months. Lending in China is traditionally a people-oriented business, and often requires personal contact to help determine the creditworthiness of a project or individual. A system without any personal contact may risk manipulation, ultimately resulting in higher loan default rates. New entrants are likely to face regulatory hurdles and an unprepared regulatory environment in obtaining banking licences, as the segment is in its infancy. Time will tell if face-less lending outperforms individual smarts.

Bitcoin and block chain

Bitcoin is a P2P system for online payments which does not require a trusted central authority. Since inception in 2008, it has grown into a technology, a currency and an investment vehicle but is also still in its development phase. The digital currency is tracked on a virtual ledger (called the blockchain) that is distributed across a network of computers worldwide and is backed by a strong encryption code. In fact, whilst Bitcoin has been the subject of much media attention, it may be the block chain technology (or variations such as Ripple) that will have greater long-term impact. It allows transactions of any type to be securely effected without the need for a trusted third party intermediary. Applications range beyond digital currency to stock exchanges, title transfers, identify registries etc. Globally, bitcoin/block chain is still in its infancy as legal and regulatory frameworks are still being defined and reputational issues resulting from black market activities and hacking attacks need to be overcome. However, positive steps are being observed as the recent Senate inquiry recommended creating a supportive legal and regulatory environment for digital currencies.

Where to, next?

There are several reasons why banks may yet remain significant players in the lending market, despite the emergence of more innovative alternatives.

Australian banks command over 80% of the Australian lending market and are likely to maintain their image as "traditional lenders," with a conservative lending approach. The emergence of new "quicker solutions" to borrowers unable to meet the credit check requirements of banks has increased supervision of and regulation of sectors such as payday lending. Given the reluctance of the banks to invest in what they perceive to be risky loans, it is expected that institutions catering to this demographic are subject to greater scrutiny from regulatory bodies. Time will tell if the conservative approach wins out, or loses significant market share to non-traditional lenders more willing to take a punt on less traditional lends, or even those who have a taste for Facebook drama. Typical disruptive scenarios start with new entrants entering less attractive segments and then "bootstrapping" themselves into more lucrative areas as their capabilities develop (as per the PayPal example), so there is a clear risk to banks as their services are unbundled and addressed by niche players with better agility, technology or customer propositions. Conversely, there are reasons why banks are asked to hold capital and why deregulated solutions have been eschewed. Once the first P2P lender fails and people lose money, then it will likely be a different story.

While banks will likely remain relevant, it is clear that the lending industry is facing the next wave of disruption that may alter the financial landscape of the future.

References

Interviews with borrowers and industry experts

FFIEC, 2014

Credit Suisse company data

Please note that this is a high-level summary reflecting the views of a focused set of interviewees. For more detailed Deloitte thought leadership on issues and opportunities in the Financial Services sector, please visit http://www2.deloitte.com/global/en/industries/financial-services.html?icid=top_financial-services

Deloitte
550 Bourke Street
Melbourne, Victoria
Australia
Tel: +61 39671 7000
www.deloitte.com.au

Contacts

Chris Wilson
Partner, Financial Services
+61 3 9671 7411
chrwilson@deloitte.com.au

Richard Miller
Director, Payments Advisory
+61 3 9671 7903
rimiller@deloitte.com.au

Jovita Gartlan
Partner, M&A Consulting Services
Strategy & Operations
+61 3 9671 6262
jgartlan@deloitte.com.au

Vincent Woo
Director, M&A Consulting Services
Strategy & Operations
+61 3 9671 6227
viwoo@deloitte.com.au

MCBD_HYD_09/15_052226