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FinTech – Challenges and Opportunities

How digitization is transforming the financial sector

The financial services sector in Germany is facing unprecedented change. Startups and other attackers are jostling for their place in the market, backed by new technologies. Known as FinTech (Financial Technology) companies, they provide alternative solutions and business models that could render traditional banking processes obsolete in many areas. This worldwide trend will become very evident. In Germany, it may jeopardize around a third of all bank revenues over the next few years.

On the flipside, disruption offers new opportunities not just for FinTechs, but also for banks. Banks can even drive the digital transformation ahead themselves, open up new sources of revenue, and spearhead developments.

Other industries are already familiar with this. First someone has an idea about how to digitally transform a business. Then a startup develops a commercializable offering out of the idea, and just a few years later even the market leaders have simply disappeared. This was the fate of the manufacturers of analog films, encyclopedia publishers or video stores, despite all attempts to save them. Is the financial services industry in the throes of similar disruption?

It would certainly appear possible. Alongside large, international digital enterprises, young, innovative companies have for some time now also had their sights on segments of banking's value chain. They are entirely focused on digital financial technology. Compared to the dot-com hype of 2000, it seems that this time, the trend is based upon more solid fundamentals (see illustration). Despite some recent concerns about overvaluations, FinTech as a broader trend is here to stay. All the indications are that these FinTechs will also gain an even stronger foothold on the German market over the next years. Customers are open to change as never before. By 2020 almost half of all German bank customers will have opened a digital bank account. The share of mobile banking is increasing rapidly. FinTechs are strong in these areas. In the mid-term they can challenge but also partner with banks.

Numerous, fast, innovative – and successful

Who are these 12,000 FinTechs worldwide, and what makes them successful? McKinsey has analyzed 1,500 of these new companies in more detail – of which more than 200 are in Germany – as well as their services and business models. In particular, FinTechs are characterized by the following features:

- **FinTechs are lean, agile and innovative.** Startups rely on leading-edge technology, don't have to worry about any legacy architecture, and are only partially subject to the regulatory constraints that apply to conventional banks. They require fewer but highly specialized staff, and hardly any physical infrastructure. Their dynamism attracts digital talent. FinTechs disrupt the sales of banking products by fulfilling customer expectations using agile processes and greater customer orientation, and accelerating their speed of innovation. They establish a"new normal" for mobile and online user journeys using unique, intuitive features, with regular new releases. They disintermediate client relationships from banks by providing aggregator services, putting banks in the position of pure providers of infrastructure and commodity products in extreme cases. As well as offering old products in a new guise, FinTechs develop completely new services, such as cross-border peer-to-peer (P2P) payments, micro-lending or robo-investment platforms where almost all processes are based on algorithms, and barely any human intervention is required. This makes some established offerings obsolete, and diminishes the profit pools of banks.

- **FinTechs focus on individual segments of the value chain.** Payment transactions, with their lower barriers to entry and the enormous volume of identical transactions, were their prime focus from the outset. Their largest growth arena is incoming and outgoing payments via smartphones or tablets. Around a quarter of FinTechs operate in the sphere of payment transactions. One of the largest company among them is PayPal, the former eBay subsidiary. FinTechs can often substantially undercut the fees for payment transactions charged by incumbents. A UK-based P2P money transfer service provides certain international

FinTech made in Germany – two examples

Auxmoney from Düsseldorf runs one of the largest marketplace lending platforms in Germany, already has over a million registered users (according to its own information), and has granted around 70,000 loans. The company, founded back in 2007, relies systematically on better credit scoring by leveraging Big Data. However, Auxmoney still lags considerably behind the level of the world's largest marketplace lenders, whose annual origination volumes exceed USD 1 billion a quarter, but is growing considerably.

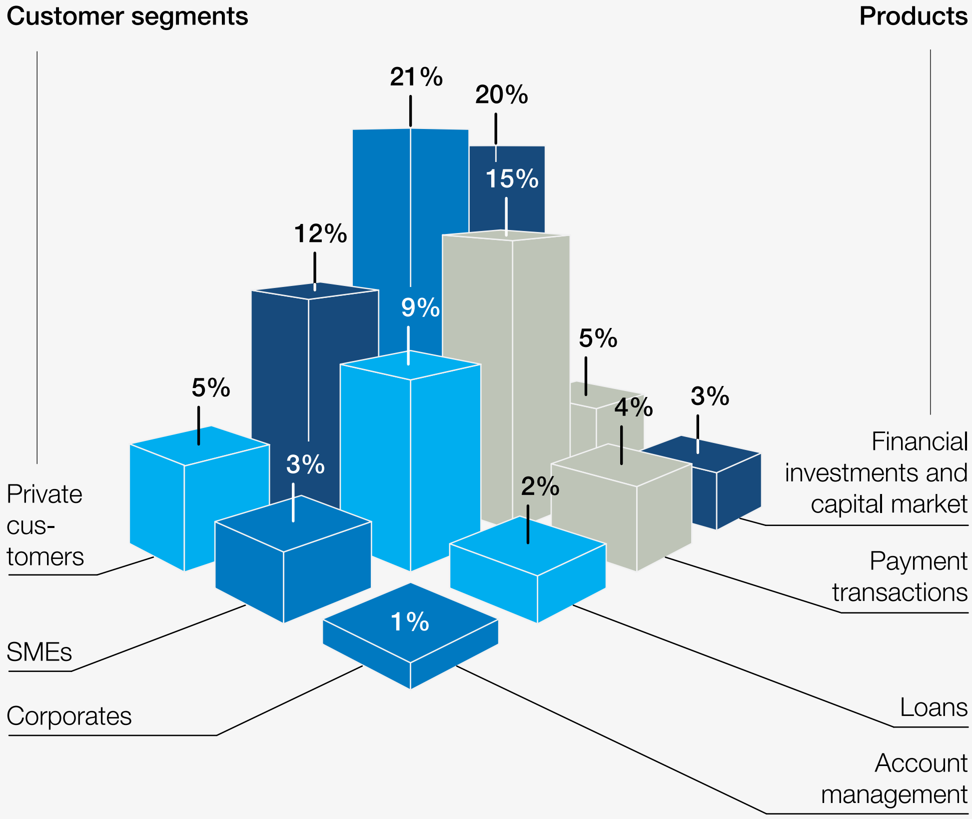
Number26 is offering the first account that can be entirely managed from a smartphone. It markets its service with the assurance that that you can open an account in just eight minutes thanks to real-time identification using IDnow. The Berlin-based startup has acquired over 140,000 users in Germany and Austria since it was established. The company is now already expanding into other European markets such as France and Spain.

transactions at fees which are up to 90 percent below those of traditional banks. Beyond payments, FinTechs have also developed products for handling accounts, loans and financing arrangements, as well as for asset management (see box).

- **FinTechs have so far primarily targeted private customers – substantial untapped potential exists among German corporate customers.** The key reasons for the focus on private customers are the low barriers to entry and that less expert know-how is required for founding a Fintech. The altered preferences of private customers also play into the hands of FinTechs: one German in two now has a smartphone, mostly a prerequisite for mobile transactions. Over 20 percent of all savings and investment products are now bought online. By 2020 this figure will have risen to 35 percent. Solutions for corporate customers are harder to realize. In the corporate arena it is not enough to be cheaper, more convenient and more user friendly. FinTechs also have to also be familiar with many nuances, invest more time in rather complex products, and build up specialist know-how for marketing them. Nevertheless, business with SMEs offers particularly high potential. Over 200 million SMEs worldwide are not being receiving financial services, or not being served sufficiently. In Europe alone, 60 percent of SMEs would be prepared to utilize the benefits of online service. FinTechs are likely to soon offer more good services particularly for Germany's strong SME sector.

FinTech landscape in Germany by segment

Share of startups and innovations in the Panorama database



Market share in Germany (revenues)

< 5% | 5 - 8% | 8 - 11% | > 11%

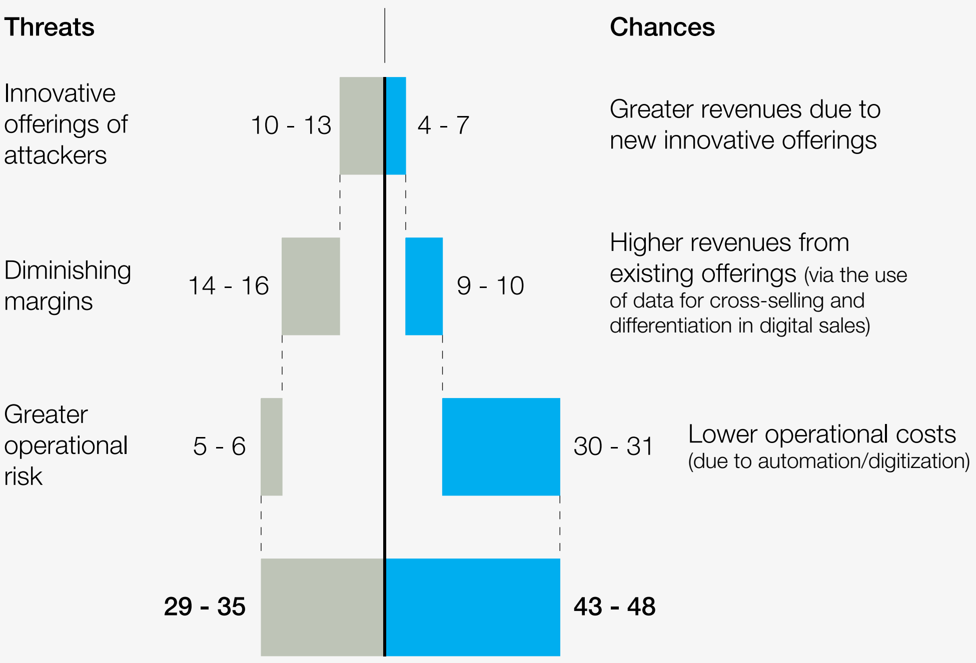
Source: McKinsey Panorama FinTech

Many FinTechs are successful – and they have potential. Investments in these new companies amounted to more than USD 19 billion in 2015. Several FinTechs, such as Funding Circle, SoFi as well as the Lending Club and Prosper are already valued at over USD 1 billion by their investors.

A particularly large number of FinTechs operate in the US, UK and Israel: some of them are increasingly active on numerous international markets simultaneously. In Germany at the end of 2015 there were over 200 reasonably sizable FinTechs, some sponsored by incubators such as FinLab (Frankfurt) or FinLeap (Berlin). The German FinTech loan sector has now also gained international attention, as evidenced by the acquisition of the Berlin-based corporate loan broker Zencap (only founded in 2014) by the London based company Funding Circle in autumn 2015.

A great deal is at stake

Partial impact of digitization over 2 - 3 years
Share of profits, percent



Source: McKinsey analysis

Banks facing challenges – but also opportunities

For banks, the growing competition with FinTechs represents a challenge. Banks could lose around 29 - 35 percent of their revenues to the new attackers via customer churn and shrinking margins if they do not act, according to McKinsey calculations. If banks undertake digital transformation of their entire value chain themselves, on the other hand, they could in a best-case scenario increase their returns. However, this will require a fundamental change in thinking. Innovation has to become part of banks' DNA, comprising all areas of their business.

Banks are well positioned for keeping pace with their competitors in future. Their large customer base enables them to implement new digital solutions fast and highly efficiently at scale. Beyond this, many banks have a broad product portfolio and strong, trustworthy brands, which is particularly important in asset management. The German Banking Act (Kreditwirtschaftsgesetz) also offers advantages. For example, FinTech startups in Germany are only permitted to offer loans if they cooperate with a partnering bank. This could lead to new business opportunities. And banks generally have sufficient funds to forge ahead with innovation on a large scale, invest in alliances and acquisitions and overcome technological as well as regulatory barriers.

Some banks, however, are insufficiently armed for the new competitive environment, however. They have rested on the laurels of their profitable results for too long and had little incentive to push innovation and cannibalize their own businesses. Now innovation is on their agenda, but is not always implemented systematically as a result of conflicting objectives. In contrast to FinTechs, banks do not always take targeted action to pursue specific ideas, instead trying to tackle many things all at once. A further weakness is banks lack of customer orientation. Thinking outside-in rather than inside-out is not (yet) part of many banks' DNA. Going forward, digital transformation must become a key strategic priority, starting at the board level.

Acquisition or competition?

How can market participants – both banks and attackers – best adapt themselves to the competition? The prime requirement is to keep an eagle eye on key pioneering developments. Which of them could radically alter the current environment? Which could perhaps even help improve current processes? Proactive market surveillance is essential. But competition is also dynamic between the FinTechs themselves. Not every startup will succeed with its idea on the market long term. In this competitive situation banks and attackers should define for themselves whether and with whom alliances could be advisable. This could for example be within the framework of a joint venture or a partnership in providing a service. From a bank's perspective, a so-called acqui-hire could also be worthwhile – i.e., taking over a FinTech to get access to the skills and competences of its key employees. A further avenue of cooperation is via corporate venture funds and incubators. The Commerzbank Group for example operates three enterprises of this kind in the form of their corporate venture arm CommerzVentures, their main incubator, and the comdirect start-up garage. Deutsche Bank is investing up to a billion euros in digital technology, and is expanding its innovation labs in London, Berlin and New York and has just recently announced prominent partnerships with domestic Fintech companies. The Sparkassenverband is working on alternative payment transaction solutions, and the Berliner Volksbank has opened its own venture capital enterprise (Berliner Volksbank Ventures). Where the promising future topic of blockchains is concerned, both Deutsche Bank as well as Commerzbank have joined the international consortium R3CEV for the development of mid-term solutions for this technology.

The market is in constant upheaval – this applies to FinTechs and banks alike. Each player should investigate new technical opportunities and build its strategy on its own strengths. Customers in Germany are open to change as never before. Companies that have a compelling customer proposition with transparent products and superior service will continue to succeed in the future.

FURTHER INFORMATION

Learn more about FinTechs and McKinsey's Panorama FinTech database here: http://www.mckinseypanorama.com/products-services/panorama-fintech.aspx.

The database contains information on over 2,000 companies and 2,500 innovations in the field of financial technology.

The companies are described by customer segment and type of service they provide. The key elements of their offering and the underlying business models are examined in more than 700 analyses.

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