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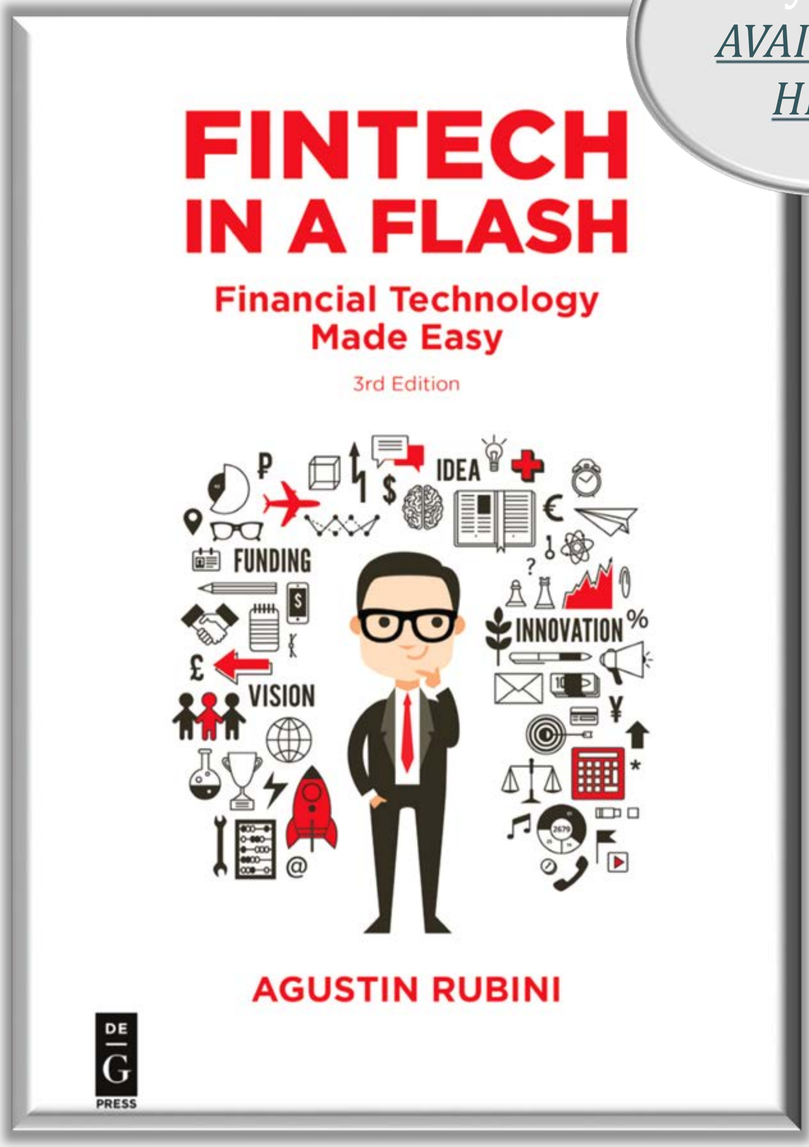

SAMPLE CHAPTER

Chapter 5: Commercial Banking Transformation

Agustín Rubini

Fintech in a Flash

Financial Technology Made Easy

Third Edition

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About the Author

Financial savant, author, and advocate, **Agustín Rubini** has many interests and is devoted to excelling in these fields. With many years of experience as a financial industry strategist, Agustín is passionate about the world of finance and the future of financial services. He spends much of his time speaking and writing about fintech and advising businesses on innovation and digital transformation.

He has a strong background in developing digital strategy, driving innovation in the financial services industry, and is well-versed in the disruptive effect of technology on the industry. As a means of helping others understand the complexities of the financial services industry, Agustín wrote and published *Fintech in a Flash*, a comprehensive guide to financial technology. A resident of London, Agustín's love of the UK led to the release of his first book, a novel about a young Latin American's first trip to London. An advocate of child welfare, arts and culture, and a proponent of education, Agustín combines his love of science and technology, knowledge, and compassion to effect positive change and offer a better understanding of our complex world.

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Chapter 5
Commercial Banking Transformation

Commercial Banking Transformation in a Flash

Commercial banks have realized that profitability is strongly dependent on innovation. New entrants are forcing commercial banks to quickly adapt to change and offer innovative solutions to SMEs and larger enterprises. Although it is hard to accurately estimate the exact market size of SMEs, it is certain that they are the backbone of most economies across the world. Therefore, new "sharing economy" players are developing business banking platforms to inherently link fintech start-ups, payment service providers, and SMEs.

Fintech start-ups are acquiring a larger market share due to their customer-centric approaches. Currently, the main areas of commercial banking that fintechs are helping to improve include the introduction of specialized platforms, the improvement of pricing and customer selection, cost reduction, and the optimization of processes. Other services offered by fintechs include payroll, online accounting, expense management, and benefits management.

In some cases, partnerships between banks and fintechs are an effective way for banks to gain an insight into the world of digital innovation and position themselves at the core of the fintech industry. Nevertheless, banks have the competitive advantage of being more familiar with regulatory requirements.

How Commercial Banking Works

The traditional commercial banking model covers business banking, which caters to the needs of small and medium enterprises (SMEs); and corporate banking, which provides corporations with custom banking and financing services. In both cases, their customers are depositors and borrowers. Commercial banks accept deposits from trusted customers and lend them to borrowers at a higher interest rate. They also offer fund transfers, credit creation, and other general services.

Commercial banks' profits come mainly from their net interest income, that is, the interest income on loans, minus interest expenses on deposits and other funding sources. For example, a loan portfolio of $2 billion which earns 6% interest generates an interest income of $120 million. If the expenses of a customer deposit portfolio of $1.3 billion, earning 2% are $26 million, the net interest income is $94 million. At the same time, banks diversify their income sources and ensure higher liquidity through non-interest income, which includes income from areas outside their lending operations, such as deposit fees, transaction fees, annual fees, and so on.

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SME Market Size

Although it is hard to put a number on the exact market size of SMEs, according to McKinsey and the International Finance Corporation (IFC), there are approximately 365 to 445 million SMEs globally, of which between 55 to 70 million are formally established as micro-businesses and between 25 to 30 million are formally established as SMEs. The remaining 285 to 345 million are informal enterprises.[100] In 2012, SMEs accounted for 99.8% of all enterprises in the European Union, employed almost 67% of the total workforce, and contributed 58% of gross value added (GVA).[101] Additionally, it is estimated that of the 5.5 million private sector businesses in the UK, 99.9% are SMEs, employing nearly 60% of the private sector workforce.[102] EU SME employment has picked up recently at a 5.2 % growth between 2013 to 2016, almost 50% faster than overall employment in the EU-28 economy over the same period.[103] In China, SMEs contribute around 80% of GDP and 60% of national employment.

A report by BBVA shows that 80% of European banks see the SME Market as an important growth area, and loan balances in the region are over £120 billion. 63% of SMEs appear satisfied with the banking service they are getting; however, they would welcome a decrease in their fees.[104]

The Impact of Fintech on Business Banking

Fintech start-ups are acquiring a larger market share due to their customer-centric banking propositions. Overall equity investment in fintech start-ups has grown from $4 billion in 2013 to $12 billion in 2014,[105] $19 billion in 2015,[106] and almost $20 billion in 2016.[107]

Five main areas exist where fintechs can provide improvements in business banking: introducing specialized platforms, servicing underserved sectors, improving pricing and customer selection, reducing costs, and optimizing processes.

Introduction of Specialized Platforms

The creation of full-fledged service banks can be a big challenge, especially if a bank wants to cater to specialized lending opportunities. However, if fintechs focus on specific services, they can be successful, offering better portals than the ones offered by incumbents. Advanced offerings such as foreign exchange and supply chain finance are obvious examples, but improved day-to-day services such as payments are also redefining business banking.

More than 70% of fintech companies are focusing on banks' most profitable services—personal and SME banking accounts—which account for nearly 50% of the banking industry's profits.[108] Focusing on individual services and products offered by traditional banks allows fintech companies to provide cost-effective services with new technologies, such as artificial intelligence, that can better identify the individual needs of consumers and SMEs.

Business lending is a big opportunity. Today, almost 60% of income for banks comes from granting loans to retail customers and SMEs. The biggest fintech lender in the United States, Lending Club, has offered nearly $9 billion in loans since 2007, and it accepts higher default rates because it capitalizes on efficiencies.[109] The main areas of business lending that are being invested in are marketplace lending, merchant and e-commerce finance, invoice finance, supply chain finance and trade finance—we cover these in the lending chapter.

Apart from the lending opportunities, electronic payments solutions can also be lucrative. The evolution of fintech has led to the circulation of virtual money, which beats the time-consuming processes of traditional business banking and facilitates the seamless payment of expenses. Although these amounts may be relatively small compared to corporate banking, people are starting to use these services en masse, because they are convenient and efficient.

Servicing Underserved Segments

Established banks commonly exclude a significant amount of the population. Based on IFC data, 45–55% of SMEs globally don't have an overdraft allowance but would benefit from one. While 21–24% have accessed loans, they are still severely limited. Worldwide, another $2.4 trillion in demand for credit exists, according to IFC data. In the US, 44% of SMEs' requests for lending were rejected. In the United Kingdom, there is a funding gap as large as £59 billion. On top of this, about 30% of British SMEs did not manage to get the funding they attempted to obtain.

By offering alternative lending services, fintech companies provide innovative approaches to segments, such as subprime loans, which are not served by traditional corporate banking. Funding Circle, Kabbage, Lendio, OnDeck, and Swift Capital are some of the players that have capitalized on the 20% decline in bank lending to SMEs since 2007. Lending to larger businesses has risen by about 4% during the same period.[110]

Improvements in Pricing and Customer Selection

The data that banks hold is as valuable as gold—especially all of the transactional data. By combining this data source with other external ones, commercial banks can improve their pricing strategies, which can sometimes be very complex in the corporate space.

This wealth of information can also be used to decide how to categorize customers and what products to make available for each different type of business. A company that has a good solution in this space is PrimeRevenue. Data processing can also help with underwriting practices. Some of the new fintechs in the US use more than 2000 different data points from more than 100 sources to make their credit decisions.

Enabling Cost Reductions

Fintech can create services, platforms, and products on a budget. As they start from a clean slate, there are no legacy issues to be resolved. Legacy issues are mainly connected with the IT systems that support an operation, but other concerns such as culture and workforce character carry legacy issues, too.

Different innovations can be used to reduce costs in banking. For example, in the servicing space, virtual assistants can enhance customer service while simultaneously reducing costs. When looking at back office processes, several tools are being introduced, including robotic process automation, which can replace human intervention by using algorithms, electronic identification solutions, and optical character recognition.

Optimizing Processes

The use of technology is automating transactions, and customers can make payments using mobile phones and tablets. Therefore, bank staff are now required to play more of an advisory role rather than actively carrying out transactions. According to Citigroup, numbers of US bank staff are expected to shrink by 30% between 2015 and 2025, from 2.6 million to 1.8 million people. In Europe, bank branch employment is expected to decline by 38% from 2.9 million to 1.8 million.[111]

Fintechs provide digital features that can improve these processes. For example, advanced decision-making engines such as the ones developed by Kabbage allow for quick credit approval. Platforms such as the one developed by Earthport can allow international payments to be settled in real time. Finally, a platform such as Ripple can encourage live international payments, cutting costs significantly.

How Traditional Banks Can Catch Up

The use of ground-breaking technologies that accelerate business banking transactions is forcing business banking to quickly adapt to change. Some business banks have already started partnering with fintech players, but doing so involves risk that needs to be managed.

Another strategic course of action is that of investing in strategic development and gaining a better understanding of what fintech start-ups really do. Either way, traditional business banking needs to reshape its model to accommodate change. Otherwise, their customer portfolios are likely to be taken by companies making better use of technology.

The Impact of Fintech on Corporate Banking

Fintech hasn't been seen to be a big threat to corporate banking so far, perhaps because of the more complex needs of corporate clients. Sophisticated corporate portals have already been built, with advanced functionality such as treasury management, cash pooling, and the ability to check balances and sweep from different banking institutions. They exist both locally and internationally, using the SWIFT payments system—a vast messaging network used by banks and other financial institutions to quickly, accurately, and securely send and receive information, such as instructions for money transfers. Additionally, large corporations have gained and still retain sizable economic and customer relationship advantages. They know their customers and how they like to do business.

This doesn't mean that corporate banks can rest on their laurels. The biggest threat for corporate banking comes from other banks already present in the corporate sector. Fast-movers that have integrated fintech innovations into their business models may become game changers. Specialized customer service and efficiency improvements can change the value chain and offer corporate clients a superior customer experience. Also, given that the fintech services remain largely unregulated, they may deliver sizable revenues along with customer insights, based on big data analytics and refined risk modelling practices.

A recent study by McKinsey finds that growth in the developed markets of Australia and New Zealand, Hong Kong, and Singapore is mainly driven by the mobile channel. In these markets, customers are shifting to mobile banking, seeking a seamless and swift banking experience. Growth in emerging markets is driven both by secure site and mobile banking.[112] To improve customer relationships and anticipate the increasing threat of fintech players, corporate banking needs to accelerate its digitization. Strategic alliances with fintech companies have already taken place: BBVA with Holvi Bank,[113] CIBC with NAB and Leumi,[114] and Santander UK with Kalixa Payments and Monitise,[115] with the aim of achieving higher profits and improved risk management.

In developed markets, banks should improve their digital sales, thereby expanding their customer base. The integration of diverse technology platforms, the use of big data analytics across multiple channels, and the analysis of customer behavior can help corporate banking identify customer needs and provide suitable services. In emerging markets, corporate banking should capitalize on the opportunity that arises from high smartphone penetration, especially in Southeast Asia. Fast movers that adopt digital technologies are more likely to increase their customer base. However, corporate banking should maintain personal contact with customers.

Key SME Banks to Watch

Cogni, originally known as Bizbaze, is one of the promising players in the fintech field, providing PSD (Payment Services Directive) business banking to European SMEs.[116] The Dublin-based i-banking platform targets SMEs, micro-businesses, and start-up entrepreneurs involved in the sharing economy and provides them with low-cost, customized financial services. The data-driven bank offers multi-currency business accounts linked to artificial intelligence financial tools and assists SMEs in automating their tax and savings, receiving salary payments, or making money transfers without overdraft fees. Cogni is classified as a "High Potential Startup" by the Irish government.

HOLVI®

Holvi is a Helsinki-based online-only business bank for entrepreneurs and SMBs.[117] The bank enables entrepreneurs to manage their businesses efficiently by opening digital business accounts and transferring money between accounts. The service also provides built-in invoicing and paperless bookkeeping options. Holvi was acquired by BBVA, the multinational Spanish banking group, for approximately $100 million on March 7, 2016, as part of BBVA's digital transformation process. It operates in Austria, Germany, Estonia and Finland.

Using Revolut for Business, SMEs in Europe and the UK can manage international payments, payroll, and corporate travel.[118] Seeking to cut back on banking fees and normalize interbank exchange rates, Revolut features an innovative mobile app covering international payments, corporate cards, merchant accounts, and business travel. In June 2017, Revolut for Business launched business accounts in the UK and Europe, enabling businesses to hold and transfer money across 25 supported currencies.[119] It also added fintech partnerships and cryptocurrencies to the platform. The company expanded into the US market in September 2017.[120] Revolut are working hard to create a new acquiring product that will be more effective for merchants.

Business banking start-up Tide offers automated bookkeeping, integrated invoicing, business banking, and banking assistance services.[121] SMEs can open a bank account in less than three minutes with no initiation, monthly, or annual fees and can capitalize on a range of value-added services, including money-saving tools, APIs to build apps or integrate them with Tide, auto-categorization of transactions, integration with Xero and FreeAgent online accounting, 24/7 banking assistance, and secure banking transactions.

In July 2017, Tide raised $14 million in one of the largest Series A funding rounds of the year. The funding seeks to enable small- and medium-sized businesses to find their balance in the wake of Brexit.[122]

The Russian bank Tochka offers an online finance bot for SME customers. By selecting "income for business" from the bank's dashboard, SMEs can keep funds at the point of transaction and run their businesses online via Facebook.[123] The social media network, which has 2.23 billion active users per month, has opened its messenger platform for business, thereby enabling SME customers, both legal entities and private customers, to pay their bills, check their account balances, ask financial questions or apply for a mortgage loan.

UK based CountingUp provides a business bank account that combines book keeping. Founded in 2017 by Tim Fouracre, who also founded Clear Books cloud accountancy, it has raised £2.3 million in seed funding in 2018. CountingUp claims to be able to open an account in less than five minutes and its accountancy integration includes profit and loss reports, book keeping categorization and ability to attach receipts to transactions.

Online Accounting for SMEs and Integration with Business Banking

As mentioned above, recent studies reveal that 63% of SMEs in the UK are satisfied or relatively satisfied with their banks regarding quality of services and cost, but 45% claim that they would be more satisfied if their bank reduced costs. Evidently, the remaining 37% are totally dissatisfied, which provides fintech with significant opportunities.[124]

Fintech can offer SMEs the added value services they need and are willing to adopt. The use of cloud accounting can help SMEs save time and money through automation and simplified financial reporting. This is an untapped opportunity for banks as well. By offering differentiated, digitized service in a heavily commoditized market, they can drive more growth and re-establish customer relationships.

Tools for SMEs

Payroll

For small businesses, payroll can be an intricate task because it includes hiring new employees, providing them with contracts, managing their vacation requests, and processing their expenses claims. Some business owners do not like the idea of outsourcing these tasks, considering in-house processing to be more cost-effective than outsourcing and because they want to protect the wage information.

In fact, outsourcing payroll tasks with the use of suitable software can save an SME money because it does not involve employee training, software, hardware, and IT support. Instead, the CEO or the HR manager just needs to ensure that all the paperwork generated by the software is compliant with legal requirements. After all, outsourcing payroll tasks allows SMEs to invest in developing greater value-added products and services that can offer higher profit margins.

Online Accounting

The growing involvement of the fintech sector in providing low cost, less time-consuming, and more customized services puts banks under pressure. Individual customers are seeking to manage their finances on the go, whereas SMEs look at mobile-oriented services to manage their businesses efficiently. Hence, fintech start-ups are taking aspects of traditional banking and offering customers user-friendly solutions.

Online accounting is very important for SMEs since they need to handle invoicing, accounts receivable, accounts payable, and employee expenses. Great cloud-based software has been created for this purpose, such as Freshbooks, Quickbooks, Xero, and Wave. They offer SMEs the tools to record their payroll entries and outsource their accounting, invoicing, and receipt tasks.

Having realized the great potential of the fintech sector and seeking to smooth out the impact on traditional banking, banks are forming alliances with online accounting providers. For example, NatWest has partnered with Edinburgh-based fintech FreeAgent to offer SMEs an innovative sharing-economy capability.[125] With FreeAgent, SMEs can perform accounting tasks online, saving both time and money.

Given the fact that online accounting firms have a lot of information on their customers, it wouldn't be surprising if they tried to take over traditional banking in the short term. To do so, they would need to learn how to deal with the subtleties of banking, such as complex regulatory requirements and risk management.

Expense Management

Expense management is one of the biggest challenges for SMEs. The use of the digital and mobile channels offered by fintech provides SMEs with cashless, paperless, and mobile handling of their expenses, leading to better cost control, increased productivity, and a greater chance for success. It is refreshing to see that expense management is starting to be consolidated in SME bank propositions, for example in Holvi and US Bank.

Benefits Management

Benefits management is important for SMEs as it facilitates the way they manage their resources. Fintech offers competitive benefits management software by equipping SMEs with the tools they need to track demographic data and analyze employee segments to optimize healthcare coverage. SMEs can take care of employee benefits by collecting all the information on the composition and size of a workforce, and then deciding on appropriate group plans and individual coverage. Consequently, they lower the costs associated with recruitment, increase employee loyalty, and achieve a higher rate of productivity.

Key SME Tool Players

Founded in 2009, FinancialForce.com is a San-Francisco-based company offering cloud business ERP (enterprise resource planning) apps for effective resource and talent management, benefits management, sales engagement, project management, financial management, and accounting. Built on SalesForce architecture, FinancialForce.com enables SMEs to share customer records, reporting tools, and revenue recognition analytics by syncing their transactions across one system. FinancialForce.com also has EMEA (Europe, the Middle East, and Africa) offices in Harrogate, UK, and Sydney, Australia, as well as in Chicago, IL, Manchester, NH, Burlington, Ontario, and Granada, Spain. It has been named to the Forbes 2018 Cloud 100, the list of top private cloud companies in the world.

Founded in 2013, Zenefits is an HR platform suited to the needs of start-ups and SMEs. The platform offers broker services, HR advisory services, and tech support, while its online software automates health insurance, payroll, and other key business perks.[126] Zenefits got to a valuation of $4.5 billion in 2015, but two years later it had to lay off almost half of its staff. This was due to aiming to achieve growth targets that were too aggressive. Zenefit's vision is to simplify how organizations with less than 500 employees connect with people to get the right heath, wellness and benefits solutions.

Gusto, formerly known as ZenPayroll, offers cloud-based payroll and employee benefits solutions to SMEs. Founded in 2011, the California-based company integrates with FreshBooks, QuickBooks, and Xero to provide specialized online accounting, including payroll automation, benefits management, and payroll taxes.[127] In December 2015, Gusto raised $50 million in fundraising, thereby reaching a valuation of $1 billion and directly competing with Zenefits.[128] Their partnership with Capital One Spark Business offers SMEs online banking solutions with no transaction limits, monthly fees, or minimum balances and a 1.00% APY (annual percentage yield) for a Spark Business Savings account.

Gusto is part of the unicorns club, with a valuation of over $2 billion. It received $140 million in Series C funding. The funds will be invested to create new direct-to-employee benefits that allow employees to choose how they want to get paid.

bob

Addressing the needs of HR managers, CEOs, and accountants, Hibob features an HR and Benefits platform for SMEs.[129] The Israeli-British start-up was founded in 2015, and in June 2016 it raised $7.5 million from a group of VCs and angel investors to launch an innovative HR platform to meet the needs of SMEs.[130] Hibob offers people management, employee benefits, employee engagement, and pension auto-enrollment solutions. Additionally, it features a very efficient Help Center section, where interested parties can find lots of useful information on using Hibob and getting the best customer experience.

In April 2017, Hibob raised $17.5 million in Series A funding led by US VC firm Battery Ventures, with participation from Arbor Ventures, and Fidelity's Eight Roads Ventures. The firm's total funding reached $25 million.[131]

sproutsocial

With more than 17,000 brands in its portfolio, Sprout Social is a promising fintech in the area of social media management. Founded in 2010, the Chicago-based company offers a range of business solutions for SMEs, including social media management, social media marketing, social customer service, and social media analytics. Sprout Social has official partnerships with LinkedIn, Facebook, Twitter, Instagram, and Google+, and integrates with Feedly, Zendesk, Bitly, Google Analytics, and UserVoice.[132] In 2016, the company was voted the most innovative social media platform[133] and #2 in Crain's Chicago Business List.[134]

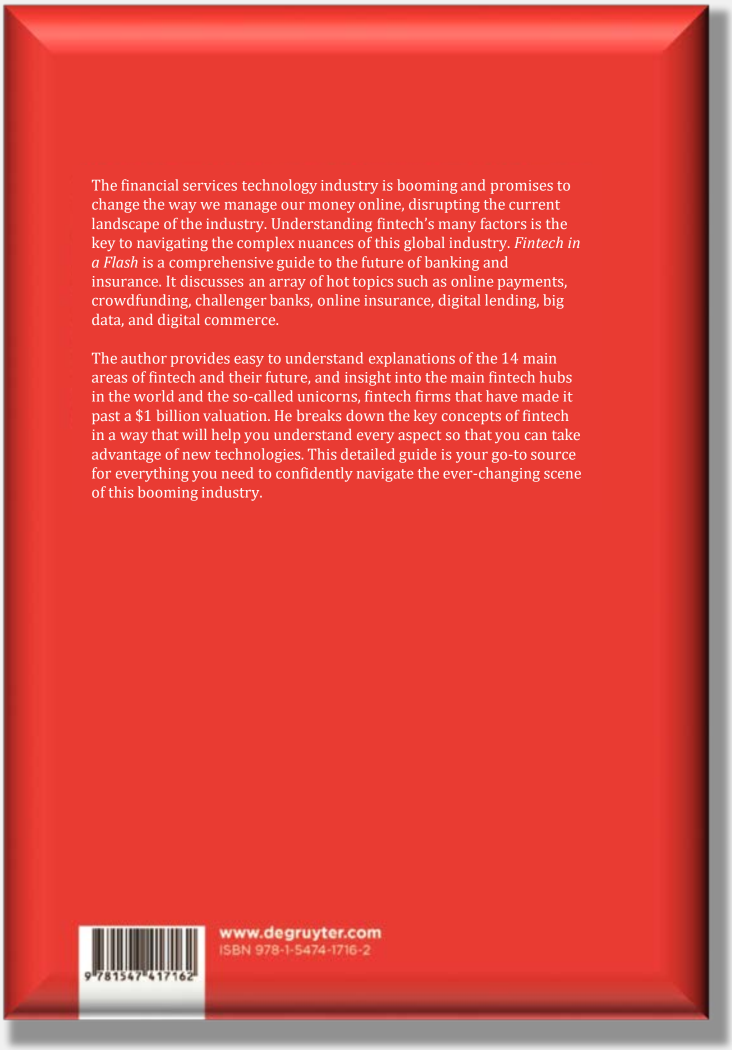
Founded in 2006, Xero is widely used by more than 16,000 accounting firms around the globe with a subscriber base of more than 1.2 million people and used by 8800 accounting firms in more than 180 countries. In 2015, the company was ranked #1 in Forbes' Most Innovative Growth Companies List,[135] and in 2016, it generated an operating revenue growth of 67% and subscriber growth of 51%.[136] The New Zealand-based cloud accounting software company leads the New Zealand, Australian, and UK markets by offering online accounting, sales tax, invoicing, bank reconciliation, payroll, and inventory services to SMEs. Through the years it has raised more than $325 million in funding.

The Future in a Flash

Business banking will embrace fintech much more quickly than corporate banking, since the barriers to entry into this area are lower. However, looking at the medium term, all of commercial banking will be impacted by technology.

We can expect to see a massive improvement in account opening and account servicing processes, which can currently be very painful, due to the amount of paperwork and due diligence required. Opening bank accounts and managing them will become easy. It will also be easy and relatively cheap to get the right software to manage all of the mandatory reporting requirements that small businesses have, mainly around tax and accounting. We can expect that the divide between bank accounts and peripheral services such as accountancy and ecommerce will be highly integrated, creating customer centric products that are yet to be imagined.

Only the companies that understand technology properly and invest in it regularly will survive in a new environment with new rules.



The financial services technology industry is booming and promises to change the way we manage our money online, disrupting the current landscape of the industry. Understanding fintech's many factors is the key to navigating the complex nuances of this global industry. *Fintech in a Flash* is a comprehensive guide to the future of banking and insurance. It discusses an array of hot topics such as online payments, crowdfunding, challenger banks, online insurance, digital lending, big data, and digital commerce.

The author provides easy to understand explanations of the 14 main areas of fintech and their future, and insight into the main fintech hubs in the world and the so-called unicorns, fintech firms that have made it past a $1 billion valuation. He breaks down the key concepts of fintech in a way that will help you understand every aspect so that you can take advantage of new technologies. This detailed guide is your go-to source for everything you need to confidently navigate the ever-changing scene of this booming industry.

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