Digital Banks

Disrupting the Financial Landscape

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With Bank Negara due to award up to five digital banking licenses in 1QCY22, we recently hosted a knowledge sharing session with regards to the nature of Digital Banks (DBs) and what it means to the industry going forward. The session was helmed by Kenanga Investment Bank's Dr.Sekar Jaganathan, Director of Digital Strategy, Sarah Lim Fern Chieh, Head of Digital Strategy & Business Development, and Ian Lloyd, resident Fintech Specialist. We gleaned from the in-depth session a clearer distinction of what set DBs apart from traditional banks, particularly with regards to the possible outreach and various product offerings made seamless, enabled by data analytics. In this piece, we also share the lessons and strategies from the various global examples in what is unchartered territory for us. At least for the near term, we believe local DBs will have to heavily depend on partnerships and collaborations to build a sizeable customer base. While the near-term focus will likely be to fulfil Bank Negara's aspirations to better serve the un(der)banked and un(der)served markets in the rural and lower income groups, their long-term presence could contend with larger traditional banks in attracting customers with flexible offerings that could stir the dynamics of the market.

Embracing technology. The idea of digital banks (DBs) revolves beyond the concept of "branchless banking", but further explores technological applications including customer on-boarding, risk management and control, developing products, solutions and many more. We have seen that traditional banks are progressively incorporating more digital capabilities into their ecosystem to reach out to customers (more commonly, through mobile apps) and to improve the efficiency of back-end processes. However, physical intervention is still core within its operations, reflective in the cost structure of banks where manpower is the largest component of operating cost (c.55%-70%). Additionally, the absence of manpower and physical establishments translate to a much leaner cost structure for DBs as opposed to traditional banks.

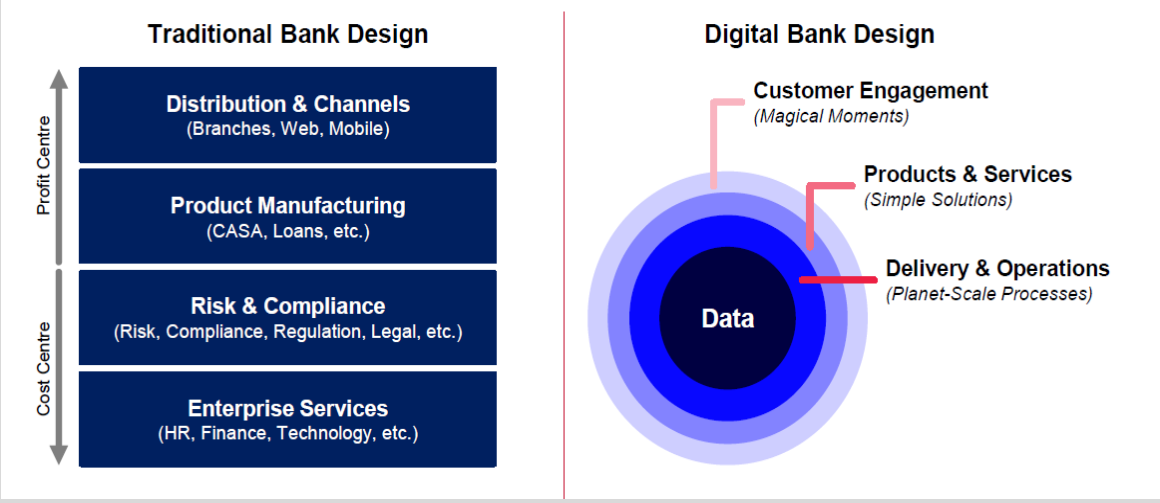
Conventionally, banking activities are initiated and conducted with the presence of a physical office/branch. This also plays into the penetrative ability of the banks where some players are dominant in certain regions due to the absence of competition and ease of doing business. However, the decision to establish a new branch is often due to strategic or economic reasons, such as if it would be best to focus on a more populous, higher income region to achieve a stronger turnover and economies of scale of operations to be profitable. This often means the population of lower income groups in certain sub-urban and rural areas could have less access to basic banking facilities (i.e. savings deposits), which also stems from low financial literacy. Hereby arises the definition of an un(der)banked market. Adding to this, un(der)served customers could exist whereby while basic banking facilities are accessible, the limitations of conventional evaluations and loan assessment criteria could a customer's access to financing.

Our speakers offer that this term should also encompass consumers and targeted micro-SMEs that require only smaller sized borrowings as opposed to that offered by conventional personal business loans. Possibly, banks have avoided providing these products due to lack-of-scale inefficiency, granted they consume similar man-hours and resources needed to process loans of higher value. Further, there is a greater risk is usually attached to these lower ticket size accounts as cash flows and repayment capabilities are highly uncertain. Alternatives available in the market are through credit cards and financing instalments offered by non-banking institutions or seek funding from personal means. We are beginning to see the emergence of such products in the form of "Pay Later" programs offered by e-commerce platforms but these usually only extend to retail goods and purchases, not available for business transactions.

Building the foundation. A digital framework could also enable a crucial component, being an automated end-to-end with data analytics to process request, transactions and deliver the required results. In context, a customer could apply for a loan via a DB's website or mobile app, provide the necessary data and documentations to be processed and reviewed via built-in software and contingencies with minimal human intervention. This result in three crucial developments:-

(i) dynamic products and services that provide highly personalised offerings based on customer information and needs;
(ii) highly scalable interface developed to accommodate large volumes of orders and instructions; and
(iii) low human involvement (especially on highly administrative functions i.e. compliance, document processing) to keep operating cost lean.

A Comparison Between Traditional and Digital Bank Concepts (1)



Source: Kenanga Digital Strategy Team

Having these, DBs are theoretically able to solve the economies of scale problem with micro-loans. Additionally, low operating costs could allow for more wiggle room on interest charges on "higher risk" accounts. Traditional banks would typically penalise riskier endeavours of which DBs may have a bigger appetite for thanks to their inherently lean structure. On the flipside, DBs could incentivise better saving habits with better deposit rates if savings goals are met, keeping cash reserves healthy and customers sticky.

Additionally, big data could also bring about the introduction of personalised products. Beyond micro-loans, DBs could offer more flexible conditions (i.e. tenure, repayment terms, and purpose of loans) based on the needs of the customer. Expanding on this, our speakers opine that data analytics could introduce a new means of dynamically reviewing credit-worthiness via past spending habits and use of cash within the DBs ecosystem.

A Comparison Between Traditional and Digital Bank Concepts (2)

Comparison	Digital Banks	Traditional Banks
Platform	Digital but may be supported by agent banking	Physical bank branches located across Malaysia
Customer focus	Un(der)served segments - reach rural areas and low income segments denied loans over lack of credit history	Customers with access to the nearest physical branch and credit track record
Transaction costs	Lower expected due to data analytics facilitated by alternative credit scoring system	Higher due to relatively manual processes with longer turnaround time
Physical branches	Not allowed but may participate in the Shared ATM Network or enter into arrangements with traditional banks	Physical branches to facilitate customer transactions
Minimum capital funds	Foundational phase: RM100 million Post-foundational phase: RM300 million	Locally incorporated: RM300 million Not locally incorporated: RM2 billion Investment banks: RM500 million
Asset size	Foundational phase: RM3 billion Post-foundational phase: No limitation	In comparison, Malaysia's smallest bank, Alliance Bank Malaysia Berhad has an asset size RM60 billion

Source: Kenanga Digital Strategy Team, The Edge, Bank Negara Malaysia

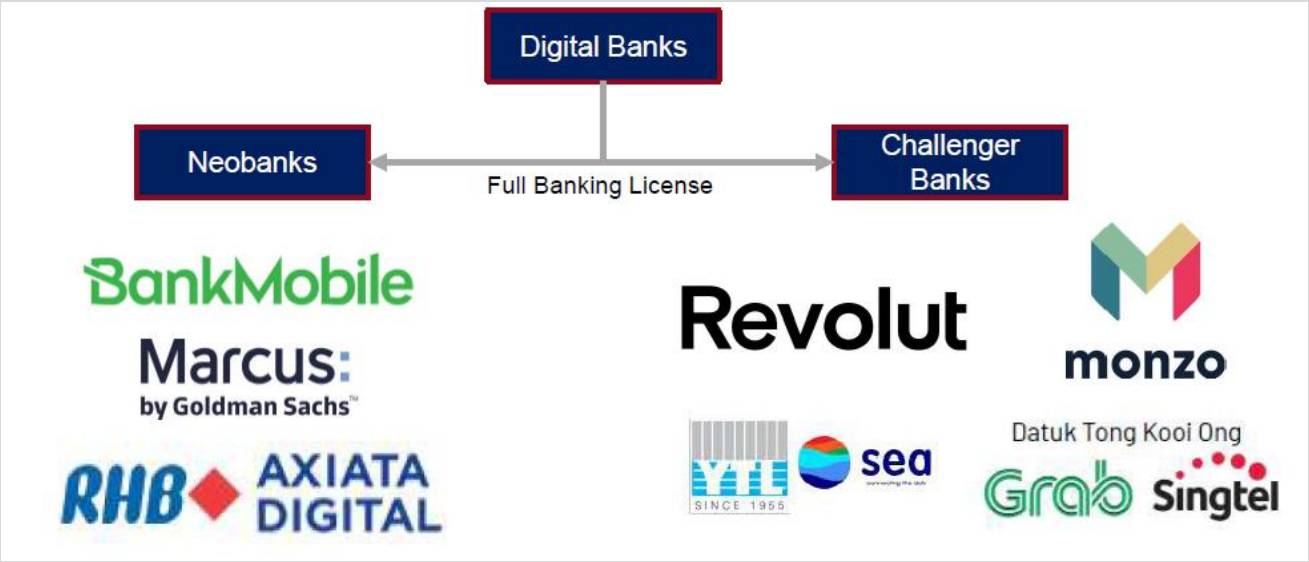
Essence of a Digital Bank

Source: Kenanga Digital Strategy Team, Neofinancial.com

The Global Landscape

Our speakers highlight two distinctions of DBs, namely: (i) Neobanks, and (ii) Challenger Banks. Neobanks are bank-backed Fintechs that utilises its banking license and could serve as an extension of its existing bank but with a different branding proposition. Meanwhile, Challenger Banks are pure Fintech or tech driven companies that are not bank-backed.

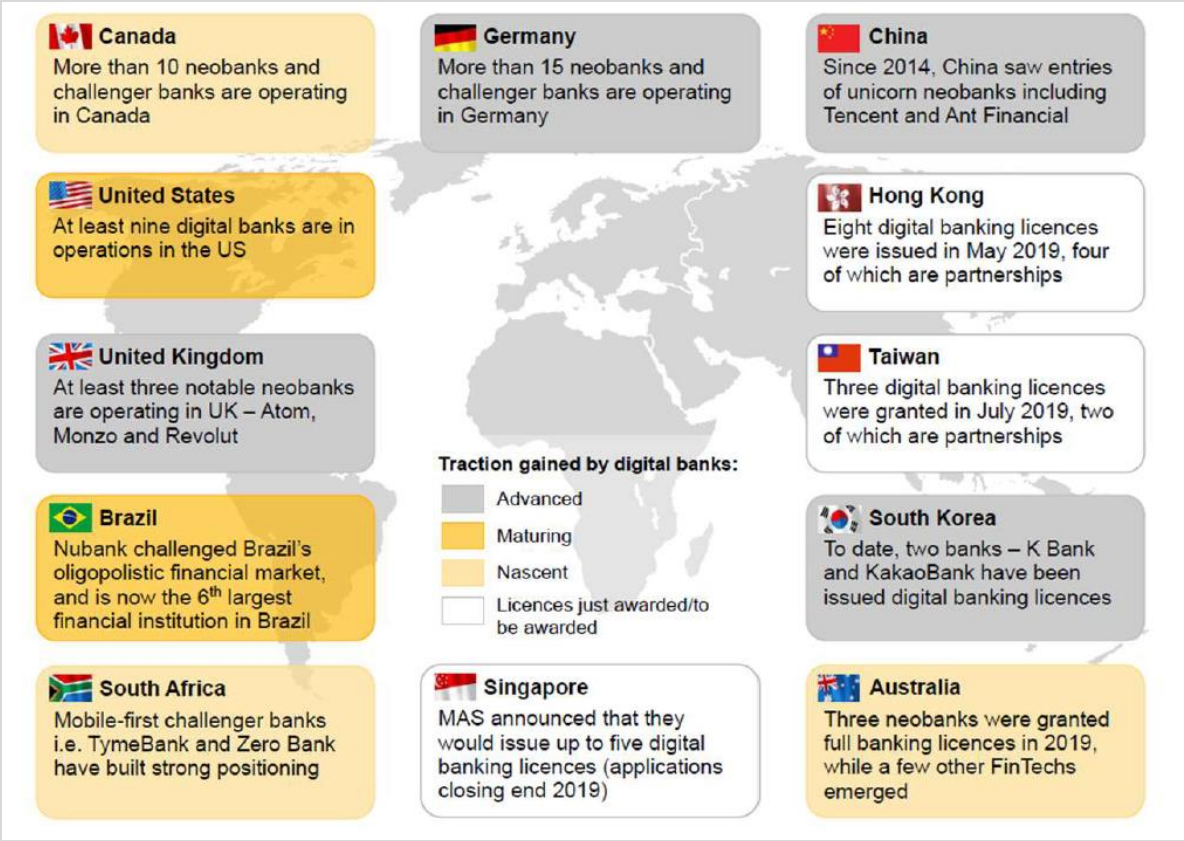
Types of DBs



Source: Kenanga Digital Strategy Team, BCG

Internationally, Germany houses the most DBs with over 15 institutions in this space. It is interesting to note that Brazil runs the largest DB through Nubank, said to have raised up to USD1.3b in funding with a total active user base of 33m customers. This demonstrates the strong penetrative capabilities of DBs especially with the likes of Brazil which faces various demographic and geographic challenges within an economy.

International Initiatives



Source: Kenanga Digital Strategy Team, PWC

Notable Global Digital Banks

Source: Kenanga Digital Strategy Team, topmobilebanks.com

Within the Asia Pacific region, Hong Kong's new entrants such as Mox Bank (Standard Chartered Bank-backed) will likely serve as a specimen for our Malaysian DBs, having just launched in September 2020 in the middle of the Covid-19 pandemic. In 6 months, Mox Bank is said to have gained 90,000 new customers and expects to breakeven in 2024. This is in spite of surprisingly modest deposit rates of 0.65%, indicating how successful a DB could be with the right product and strategies in place. ZA Bank, Hong Kong's first DB, could also be a notable precedent, having launched in March 2020 but now commands the largest share of over 300,000 accounts within a year and has begun offering insurance products on top of its usual banking facilities to SMEs.

Lessons to learn

With any new innovation or business models, an incubation phase is bound to occur where the institutions focus on proving product viability, capturing as much market share as possible and work towards profitability when arriving at a desired scale. This will be a constant in the DB business but what could be alarming is that based on findings by BCG, only 13 out of the 249 global DBs in 2020 have broken even (5%). Interesting to note that 10 of these 13 BDs belong in Asia Pacific markets which includes the likes of China's Webank, South Korea's Kakaobank, Japan's Rakuten Group's DB consortium and India's PayTM.

An interesting case study can be observed with Revolut and Monzo, the largest UK-based DBs which were both being established in 2016. While being the frontrunners in the market, these DBs struggle to turn a profit and are instead seeing greater increments in their operating cost as opposed to their customer base. Constant capital injection has been called upon for the DBs to sustain operating cash flows and we believe it could a matter of time before investors could pull the plug. This **strongly drives the point that growing a strong loans base is paramount for a DB**, especially during its early days when the iron is hot and its identity is exciting to consumers. Failure to capitalise on its scalable business model could cause an unfortunate pivot to lead a cost-driven business.

Beyond the abovementioned, we present other the key similarities from the findings of our speakers, between the successful DBs and what our prospective local players could take from it:

- **Capitalise on big data.** In a highly digital environment, data is the greatest resource in understanding the needs and wants of your customers effectively and efficiently. Successful DBs understand that it is difficult to bring to market a "one-size-fits-all" product where consumer requirements are subject to many variables. Data interpretation also progressively evolves as more information materialises to update to changes in consumer behaviour which can lead to wins or losses in market demand.

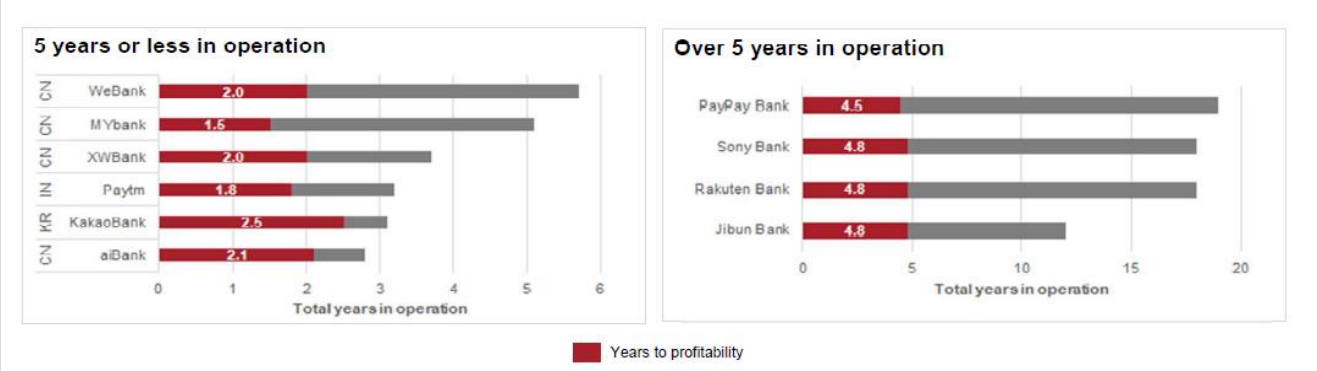
- **Early traction pays dividends.** Especially given the newness of DBs in the market, strong brand awareness and customer acquisition efforts need to take place. Early gains in customers also play well in the first point where a DB will obtain valuable data which can lead to churning more favoured products in the market. Additionally, like with traditional financing, there is no telling on the frequency or recurrence by specific customers to undertake loans in the future. Hence, latecomers could possibly have an even harder time to gain footing and sustain in the high stakes market.

- **Operate in a highly scalable manner.** Traditional banks had typically focused on larger sized loans as they yield the greatest value in returns and earnings to the bank. Digital financing products, however, are more likely the complete opposite in proportion, being micro-loans. Hence, DBs need to establish a self-sustaining, linear cost structure that does not inflate in conjunction with the rise of product sales. Building an intelligent and automated framework also means that operating budgets can be invested elsewhere to boost the DBs presence.

- **Form strong partnerships.** Like with any business model, companies with strong collaborative eco-systems typically stand a better chance of survival with the sharing of expertise, know-how and resources. With DBs, partnerships could potential yield a sizeable captive market which would otherwise be costly and arduous to tap into and therefore easing the process of gaining brand awareness. Additionally, cross-selling of products could also be the cherry on top to win more customers over, especially with existing brands that they already have a strong affiliation.

It is crucial for DBs to achieve sustainability as quickly as possible for them to remain a viable business. Our speakers gathered that the DBs in the Asia Pacific region took an average of two years to achieve profitability. Other profitable players took close to five years in operation to achieve sustainability, but it is likely we will be benchmarked against our regional peers. We believe that having just one locally bred name to arrive at profit would instil great confidence in the Malaysian financial market in the global arena, which could spill over exponentially into other economic sectors.

Years to Profitability for Selected Digital Banks

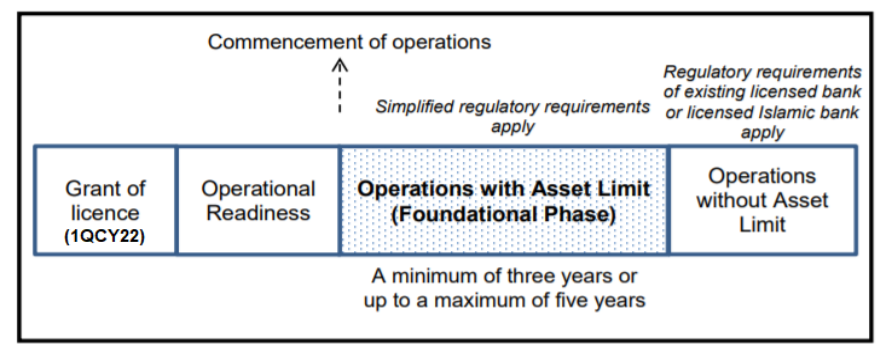


Source: Kenanga Digital Strategy Team, The Asian Banker

Our Local Front

Bank Negara released its first "Licensing Framework for Digital Banks" on 30 December 2020, spelling out its key requirements for participation within this new space. Bank Negara also expressed with the challenges arising from the current global pandemic, there is a need to ensure user interests remain safeguarded and that the stability of the financial system is not undermined.

Operational Progression



i) During the foundational phase, a licensed DB shall:
- maintain at all times a minimum amount of capital funds of RM100m unimpaired by losses;
- be subject to the business limitation of not exceeding a total asset size of RM3b at all times during the foundational phase; and
- other regulatory framework as described in the "Licensing Framework for Digital Banks"

ii) From the minimum of 3 years to the maximum of 5 years of operations, a licensed DB will apply to end its foundational phase to uplift its business limitations. Bank Negara's approval depends on the DB:
- complied with all applicable laws and regulatory requirements;
- achieved a minimum amount of capital funds of RM300 million unimpaired by losses; and
- shown satisfactory progress in achieving the committed value propositions as described in its business plan.

iii) Failure to graduate from its foundational phase in the fifth year, a licensed DB will have to implement an exit plan which could lead to the revocation of its license

Source:Bank Negara Malaysia

During the 6-month application period as of June 2021, Bank Negara has received a total of 29 applicants with a healthy mix of fintech institutions, e-commerce providers and even conglomerates vying for one of the five DB licenses on the table. As we had expected, a fair share of bidders come in the form of consortiums to pool expertise and resources into a new business venture.

Digital Banking Bidders

Note: The complete list of applicants is not disclosed by Bank Negara and existing information on applicants are based on public announcements

Source:Fintech News Malaysia

Personally, we believe that the winners would be players that fulfilled well the following conditions:-

- Have a large existing customer base (hopefully within the target markets) for faster penetration and adoption;
- Huge capital funds reserve (largely beyond Bank Negara's required RM300m minimum) for longer runway;
- Possess strong IT capabilities to build necessary banking infrastructure and tools; and
- Preferably, already has a mature involvement in Fintech services.

While there are many more considerations that Bank Negara will be taking into account, we opine that candidates with the above attributes would greatly improve the survivability over the new DB players. Understandably, this narrows down to most e-wallet players which to us makes sense as they not only have a strong foothold in financial services, but the brand awareness already ingrained into consumers could build greater confidence and trust especially with matters of personal finances. Whereas we believe that players outside this space would have to offer cut-throat rates to incentivise on-boarding which could hurt the sustainability of the business.

We were surprised that Touch N Go did not choose to participate in the bidding, as we believe they could be a strong contender with already a large captive market from their TnG ecosystem. These are advantages that we expect Axiata Digital (via Boost) and Grab to fully capitalise should they be awarded a license. Not to mention TnG's affiliation with the CIMB Group that could lead to many collaborative opportunities.

Closing Remarks

The debate over whether traditional banks should bid for a digital banking license has been long standing, to which most banking representatives pointed out that most consumer banking transactions are already performed digitally and technological investments are a periodic norm to enhance operating efficiency. However, it still stands that conventional products and risk management approach, while tried and test, could be outdated if digital banking methods prove more favoured by the public.

In our opinion, **heightened competition from DBs could lead to possible consolidation within traditional players.** In the near-term, the target markets of DBs of micro-loans are beyond the radar of most banks. However, it is possible that as their presence matures in the long-term, they could aim towards targeting larger sized conventional products such as personal loans and even hire purchases. There has always been talk that there are "too many" banks in Malaysia and the entry of DBs could possibly be the catalyst as the demand for greater efficiency and competitive edge will weed out redundancies.

Hence, we anticipate traditional banks to have to further evolve into a pseudo-digital business model where conventional platforms (i.e. bank branches, ATMs, client servicing) could serve as a more complementary role. This can be observed as a natural transition for organisations to be more technologically dependent with a streamlined workforce, as demonstrated in other sectors such as: (i) robotics and automation in manufacturing sectors, (ii) digital advertising and brand marketing of consumer goods, and (iii) AI and machine learning for large scale data processing. It is likely that efforts could be painful early on as traditional banks attempt to balance profitability, underhanded by legacy cost structure while ensuring the stickiness of their customers.

Whether the five DBs will prosper within the next a few years, that remains to be proven. However, their injection into the financial markets cannot be ignored as market forces will always be competitive and consumers will always align to providers which cater best to their needs. Investors and corporations alike will observe the developments with great interest.

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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