



Taking on the world

The rise of the challenger banks

By Judd Caplain

Over the past year, so-called challenger banks and neobanks have been making headlines by attracting big venture capital investments. Britain's Monzo raised US\$93 million in November 2017,¹ building on a US\$27.5 million financing round during the first quarter. Earlier in the year, Atom Bank, a fellow UK challenger, pulled in a total of US\$140 million.² A third British startup, digital-only Starling Bank, announced in September that it was raising US\$54 million in fresh funding.³

Challenger banks can be established firms — most likely midsize or specialist — that seek to compete with larger institutions. Neobanks tend to be newer, completely digital mobile outfits, but there's some overlap. One common thread: these banks don't carry the weight of legacy technology, so they can leapfrog over traditional infrastructure and disrupt the status quo.

A global movement

Most challenger banks and neobanks are in the UK, for two reasons. First, Britain isn't as saturated with big banks and their branches as a nation like the US, creating an opportunity for non-traditional financial institutions. Second, the UK was an early adopter of digital banking, dating back to the dotcom era of the late 1990s and early 2000s. That head start has probably helped it lead the shift toward challenger banks and other alternative models.

However, there's a misconception that challengers and neobanks are just a British phenomenon. In fact, they're popping up worldwide. Challenger banks now number

more than 100, everywhere from South America to continental Europe to Asia. Brazil has Banco Original and Nubank. Germany is home to SolarisBank and N26; in 2017 the former announced plans to expand into Asia, while the latter is preparing for a 2018 launch in the US, where growth of challengers has been sluggish to date.

Asian players include China's MyBank, backed by e-commerce titan Alibaba Group, and WeBank, launched by conglomerate Tencent Holding; Digibank of India; Vietnam's Timo; Japanese outfit Jibun Bank; and South Korea's K Bank and Kakao Bank.

Unlike their traditional counterparts, challenger banks and neobanks aren't burdened by legacy systems and cumbersome organizational structures such as major branch operations. Because most don't offer a full suite of services, they're also less hampered by regulatory requirements. All of this means that challengers and neobanks are moving ahead faster in developing countries such as China and India, where established brick-and-mortar banks are relatively rare.

So far, most challenger banks have focused on niche products rather than the entire retail banking value chain.

¹ <https://www.reuters.com/article/us-monzo-fundraising/british-app-only-bank-monzo-attracts-93-million-in-fresh-funding-idUSKBN1D711S>

² <https://www.crunchbase.com/organization/atom-bank>

³ <https://www.cnn.com/2017/09/22/fintech-startup-starling-bank-to-raise-millions-for-global-expansion.html>

Customers can open a checking account with a relatively high rate of return, and may also be able to borrow, but they have to go elsewhere for services such as credit cards, mortgages and wealth management. These outfits use a variety of business models, but the majority have banking licenses, so clients get the benefit of deposit insurance.

Beating the challengers at their own game

Traditional financial institutions aren't asleep at the switch when it comes to these new kinds of banks. A couple of years ago, there was concern that fintechs and digital startups would replace blue-chip names, but that hasn't happened. Instead, mindful that millennials have no interest in visiting a bank branch, some legacy firms are launching nimble digital banks of their own that could pose a threat to independent challenger startups.

Take Goldman Sachs, the ultra-traditional high-end investment bank, which in 2016 rolled out a digital retail offering called Marcus by Goldman Sachs. Because Goldman is so established, this venture fits the description of a challenger bank. JPMorgan recently unveiled Finn by Chase, a completely digital play targeting younger customers and areas of the US with a shortage of brick-and-mortar banks. With their eye on millennials, who will become more lucrative

clients over time, traditional banks are also working to launch digital operations whose branding doesn't include their name.

The incumbent advantage

Neobanks and challenger banks are on the rise, but don't look for them to supplant traditional financial institutions anytime soon. In addition to big client bases, traditional financial institutions have a brand advantage that connotes trust. Right now, the established players enjoy the best of both worlds, having augmented their full-service models with digital banking. They've created innovation and fintech groups — consisting of young employees often located outside the orbit of their mainstream culture — whose ideas get embedded into the traditional business models.

Still, established banks are paying close attention to the challengers and neobanks, with the understanding that within 10 years, millennials will drive the delivery of banking services. They have much to learn from these digital game changers.

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