White Paper

Matchmaker, Make Me a Match

Best practices in bank-fintech partnerships

Mindy Hauptman, Nigel Morris, Juan Uribe, Deepak Goyal, Inderpreet Batra, Kamila Rakhimova

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Fintechs are maturing and are reshaping the competitive landscape for traditional banks. Partnerships between banks and fintechs can be mutually beneficial and have become increasingly common. Nevertheless, some banks have baulked at this idea, deterred by cultural and technological obstacles that can make partnerships difficult to execute. This is short-sighted. Partnering with fintechs can help banks meet their operational objectives, enhance products and improve customer experience. To maximize the chances of success in these partnerships, banks should pursue certain best practices. They need to:

- Treat partnerships as a strategic priority, with proper C-suite attention devoted to them
- Select the right partnership mechanism
- Create a culture and capabilities that will attract fintech partners
- Organize themselves in the right way to accelerate speed to market
- Ensure alignment in areas where disputes can arise

The unstoppable march of fintechs

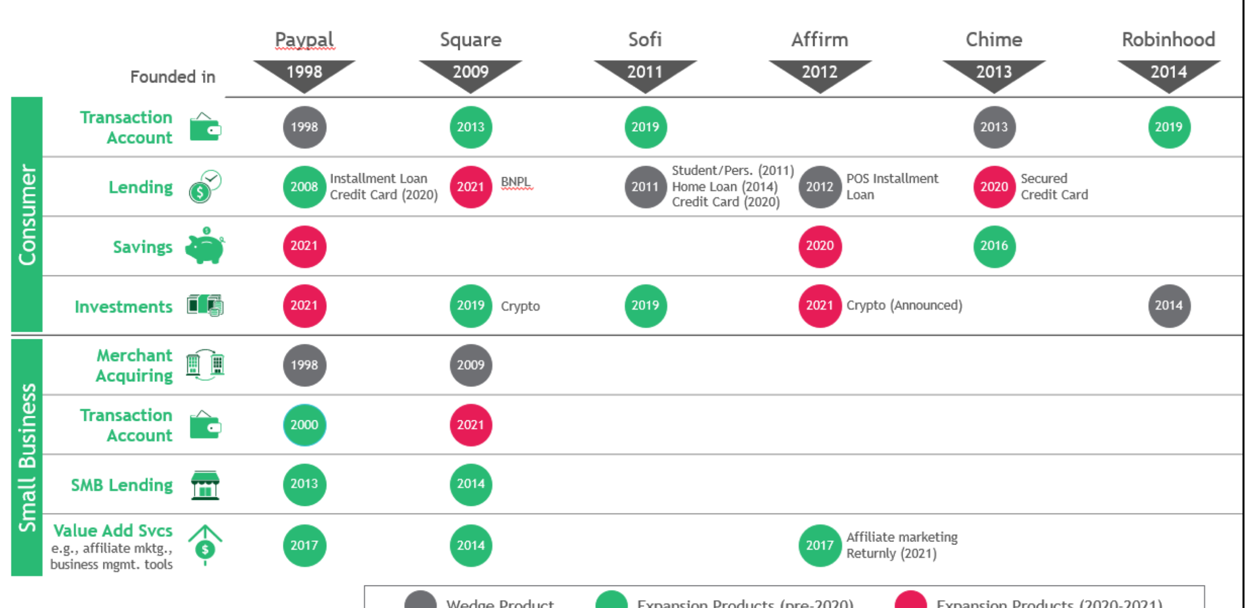
There has been a step change in the status of fintechs. These disruptors no longer operate at the periphery and are now a significant force in the financial industry. Adoption of fintech services has accelerated and is no longer confined to young consumers. Paypal's 200 million US customer base surpasses even the largest banks'; users over age 55 represent over 20% of their base and is their fastest growing segment.[1] Credit Karma has 110 million users.[2] Chime has roughly 12 million customers, more than the largest regional banks; while they target Gen Zs and Millennials, about a third of their customers are over age 40.[3] Buy Now Pay Later usage has skyrocketed across younger consumers (36% of Gen Zs and 41% of Millennials) but has made inroads among older consumers as well (30% of Gen Zs and 18% of Boomers).[4]

[1] Paypal press reports
[2] Credit Karma press reports
[3] Cornerstone Advisors
[4] Cornerstone Advisors

Fintech disruptors are achieving primacy with their customers. Digital banks hold 11% of primary checking accounts, while 30% of consumers cite a fintech as their primary financial institution.[5] Chime estimates that two in three of its customers regard it as their primary bank.[6] A slim majority of consumers, 53%, still define their primary financial institution as the one in which their pay is deposited, but 31% believe it to be the institution where they conduct most of their day-to-day transactions, opening the door for payment processors to displace banks as consumers' primary financial providers.[7]

Most fintechs started out as monolines, establishing a customer base with a single product. Many are now expanding their offerings to become full-service providers (see Exhibit 1). So far, the expansion has been largely organic, but we anticipate that fintech mergers will soon play a significant role in this process.

Exhibit 1: Fintech Product Line Expansion



Source: Company disclosures, BCG Analysis

[5] Coop Financial Services
[6] Press reports
[7] Financial Brand

Fintechs are outgrowing their start-up status and gaining credibility. Twenty percent of fintech unicorns are publicly traded.[8] Several challenger banks have received bank licenses directly or through acquisition and are ready to meet the concomitant regulatory requirements. Data aggregators are preparing for increased regulations and have joined forces to create data security standards so that they can help to shape them. Disruptors are building awareness beyond early adopters with increased media advertising. And many currently unprofitable fintechs have identified paths to profitability as they scale.

Despite their lack of profits, valuations have soared. Approximately 250 global fintechs are valued at more than $1 billion.[9] The top ten U.S. fintechs have a combined valuation of almost $500 billion, representing an increase of 620% over the past five years.[10] These valuations are feeding a virtuous cycle, enabling fintechs to invest in technology, talent, product expansion and marketing, all of which will fuel further growth.

Conversely, traditional banks face a persistent low-growth, low-profit environment. New relationship formation is set to remain sluggish for two reasons. Underlying population growth is expected to slow down to only .7% annually,[11] while we are also witnessing a historically low percentage of unbanked individuals who can be brought into the banking system.[12] The returns of most banks have not met hurdle rates since the financial crisis, and revenue will continue to be constrained by ongoing low interest rates and by competitive and regulatory pressures on fees.

Regional banks are encountering a particularly difficult environment, as they must compete against both the disruptors and against larger national banks. Over the past three years, their share of new checking accounts has fallen from 26% to 21%.[13] Their year-over-

[8] Fintechlabs.com
[9] Fintechlabs.com
[10] Fintechlabs.com, as of April 13, 2022
[11] US Census Bureau
[12] FDIC How America Banks: Household Use of Banking and Financial Services
[13] Cornerstone Advisors

year consumer deposit growth has lagged that of national banks by 18%.[14] Moreover, they are faced with an aging customer base that is, on average, four years older than for national banks, and seven years older than for digital banks.[15] Customer satisfaction is often poor; net promoter scores of the six largest regional banks range from a high of 39 to a low of -63.[16]

Breaking down the fintech landscape

There are many different types of fintechs. They include technology providers, payment processors, neobanks, roboadvisors, online trading platforms, digital lenders, and affiliate marketing sites. Some are business-to-consumer (B2C) companies, others are business-to-business (B2B), and still others are business-to-business-to-consumer (B2B2C). To think about them as a single entity is simplistic.

We have developed a framework that helps to understand the fintech landscape, based on the nature and magnitude of the threat they pose to banks (see Exhibit 2):

- **Direct Competitors** provide the same services as banks. These fintechs generally compete on price, customer experience, and value propositions that alleviate specific (and sometimes niche) pain points. Most of them target young, mass-market customers who are just beginning to establish financial relationships and behaviors. By eroding transaction and balance share and by exerting pricing pressure, Direct Competitors can put pressure on bank performance even if they do not capture entire customer relationships.

- **Adjacent Competitors** provide services that banks could, but generally have not, offered. They provide additional value beyond traditional bank products, often expanding the list of "jobs to be done" or embedding finance into an extended

[14] Q.2 2021 vs. Q2 2020; nationals include Bank of America, Chase, Wells Fargo, Citi and Capital One. Regionals include PNC, US Bank, Truist, TD Bank, Fifth Third, Citizens, Key Bank, Huntington Bank and Regions Bank
[15] BCG Research on Customer Primacy
[16] Comparably (PNC, US Bank, Truist, TD Bank, Fifth Third, Citizens)

value chain. They compete based on user experience and on the value delivered. Their revenue can be viewed as an opportunity cost to banks - the incremental revenue that banks could have earned if they had been responsible for similar innovations. As Banking as a Service (BaaS) enables Adjacent Competitors to bolster the integration of traditional bank offerings, they could potentially disintermediate banks and raise customer expectations for integrated, value-added offerings.

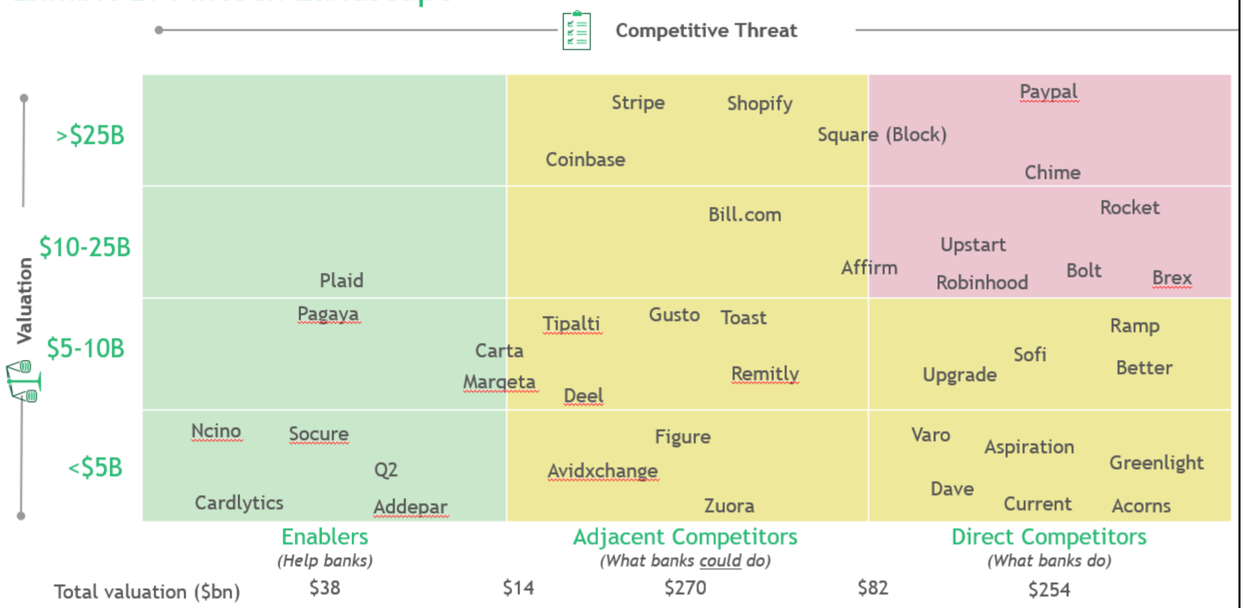
- **Enablers** provide services that help banks, such as marketing support, data and analytics, risk management, or other technology. These Enablers are, by definition, the allies of banks.

A map of the highest-valued fintechs (Exhibit 2) reveals that Adjacent Competitors are enjoying most of the value creation. Only 12 of the top 40 are Adjacent Competitors, but they account for 41% of the top 40's total valuation, not least because three of them have broken from the pack and are valued at more than $10 billion each. In addition, those fintechs providing some services that compete directly and others that are adjacent constitute a further 12% of the top 40's total valuation. On the other hand, Enablers and Enabler/Adjacent Competitors make up just 18% of the top 40's total market valuation, presumably because they do not own end user relationships and are viewed as akin to utilities.

A still more notable finding is that payment processors comprise 73% of the top 40's valuation. These extraordinary valuations reflect two factors:

- Payment processors are uniquely positioned to create two-sided ecosystems, enabling them to deliver real value to merchants (increased sales, faster receipt of payment) and create seamless payment experiences for consumers, while also collecting a treasure trove of data that powers a self-sustaining momentum.
- As we have already seen, consumers have come increasingly to view these payment providers as their primary financial institution, laying the foundations for them to expand their offerings into super-apps that can satisfy a broad range of financial needs.

Exhibit 2: Fintech Landscape



Note: Top 40 North American public and private fintechs by valuation shown; as of 4/13/22
Source: Fintech Unicorns of the 21st Century, Google Finance, BCG Analysis

The case for partnerships

There is already a history of bank and fintech partnerships, most frequently between banks and Enabler fintechs. While extremely valuable, such partnerships are not revolutionary. While Enabler fintechs are culturally different and may be more agile and perhaps embrace more risk than traditional vendors, these relationships are in essence simply a contemporary twist on traditional business relationships.

Partnerships with Adjacent Competitors may be even more valuable and can take several forms. Banks can offer a fintech's services to bank customers through white label or referral arrangements. By making use of fintech capabilities - modern, flexible technology; lean operating models; best-in-class user experiences; engineering and product design talent; data and analytics expertise; digital marketing skills; customer centricity, and a focus on unit economics and customer lifetime value - banks may be able to improve customer engagement and identify incremental revenue sources more quickly and with a higher success rate than they could accomplish on their own. Partnerships could have advantages from a defensive point of view too, discouraging the Adjacent Competitor from branching out to become a Direct Competitor.

Bank partnerships are essential to many Adjacent Competitors, who need access to the banking system to embed payments, lending or deposits into their offering. To date, relatively few banks are participating as BaaS partners to fintechs, but the opportunity to provide operational capabilities to fintechs could be substantial. While many banks reflexively reject this notion, fearing that they will end up cannibalizing their own business or that they will risk being reduced to dumb pipes, these fears are often unfounded. The extreme fragmentation of banking limits the danger of cannibalization for all but the largest banks. Indeed, for most banks, the number of customers served under the BaaS arrangement would be incremental. Moreover, while BaaS arrangements preclude a direct customer relationship, it is wrong to think of them as dumb pipes. In reality, it is quite difficult to build agile, scalable systems. Banks who do it well have a valuable, differentiated capability to sell.

Partnerships can be especially beneficial to regional banks who are often perceived as undifferentiated and have been losing share to the national megabanks, whose resources allow more effective competition with fintechs. Strategic use of fintech partnerships can strengthen the internal technology, product development, and marketing capabilities of regional banks. BaaS arrangements could be especially beneficial to regional players seeking to penetrate revenue pools that lie outside of their traditional footprint.

At the same time, fintech leaders are realizing that they cannot accomplish all their goals alone, especially as they try to expand from being monoline to multi-product businesses. We therefore expect to see a wave of fintech mergers, leading to "superfintechs" that are even tougher competitors for banks. The closer cultural fit may make these fintech-to-fintech partnerships easier to manage than bank-fintech partnerships.

However, banks can bring significant assets to a partnership that fintechs lack: existing customers, brand awareness, long-standing consumer trust, licenses, proprietary data, regulatory and compliance know-how, credit risk management, and low-cost deposits. Moreover, despite digital's meteoric growth, the physical distribution, human touch, and advisory capabilities of traditional banks continue to appeal to a large swath of customers, creating an advantage over digital-only players. These assets make banks attractive partners, and smart bank leaders will turn such strengths to their advantage as competition for partners heats up.

Barriers to partnering

Bank-fintech partnerships present challenges as well as advantages, and fewer partnerships come to fruition than the potential benefits might imply. There are various practical and cultural barriers:

- **Lack of visibility into the fintech community** - Fintech activity is often concentrated in a few geographies. Banks that do not operate in these territories must be proactive, outwardly focused, and vigorously engaged with the fintech community to identify potential matches.

- **Fear of cannibalization** - The adage that it is better to disrupt yourself than be disrupted by others is not easy to accept. Bank managers at all levels may oppose partnerships that will divert sales or resources from their established businesses.

- **Time-consuming and frustrating process of vetting and integrating technology** - Fintech technology is often less mature than commonly thought. APIs may be unreliable or poorly documented, and bank scale can place stress on the fintech's capacity. Customized technology integration requires API and cloud-based technology experience that many banks lack and diverts resources that fintechs would prefer to deploy toward growth and development.

- **Poor cultural fit** - Cultural issues are perhaps the most significant barrier to partnering. Banks and fintechs may use the same words, but often talk past each other. Banks move slowly and deliberately as they gain internal consensus; fintechs move quickly. Banks are risk-averse; fintechs are mavericks. Banks expect short-term profitability; fintechs value growth over profits. Banks value talent with banking experience; fintechs prioritize talent with an innovation mindset. Banks want fintech partners to adapt to their existing processes; fintechs eschew customization which diverts resources that they believe could be used more productively elsewhere.

<u>What makes partnerships succeed?</u>

Despite these barriers, banks and fintechs are regularly forming partnerships. To maximize their chances of success, banks should follow several best practices:

- **Treat partnerships as a strategic initiative demanding C-suite sponsorship and attention** - Articulate how your bank plans to create competitive advantage and how fintech partnerships will support that plan. Create a team that immerses itself in the fintech ecosystem, charged with identifying strong fintechs, deciding whether partner candidates align closely with the bank strategy, and recognizing when the moment to act has arrived.

- **Select the right partnering mechanism** - Banks often prefer to acquire fintechs so they can retain full control and offer differentiated services exclusively to their customers. However, it is hard to know when the time is right to acquire a fintech. A fintech's early days, when they are experimenting with their product-market fit, their operating model and their path to profitability, are characterized by a high level of risk. However, once it achieves stability and clear market traction, its valuation often soars, leading to earnings dilution for a bank acquirer. Furthermore, the bank may not be able to maintain the fintech's greatest strengths – talent, agility, simplicity – after the acquisition. For their part, fintech founders may not view bank acquisition as the ideal exit strategy. While typically it may be faster than an IPO, it offers few benefits when compared to other opportunities, such as a private equity sale.

  Other partnership mechanisms may deliver ample benefits but involve lower risk. By participating in venture funds or incubator programs, banks can hedge their bets, gain deep knowledge of the fintech landscape, and identify potential fintech winners early in their lifecycle. Through licensing agreements or white labeling, they can expand service offerings while retaining control of the customer relationship. Those who fear potential reputational risks associated with offering a third-party product as their own or who want to minimize integration requirements may prefer a referral model.

- **Create a culture and capabilities that will attract fintech partners** - Just as banks are evaluating which fintechs to partner with, fintechs are also assessing banks for possible partnership. They seek partners who are committed to the new business's success and who are easy to work with, as demonstrated by:
  - Relatively fast and easy contracting processes
  - Clearly identified executives who have the knowledge and authority to bring the partnership to fruition
  - Commitment to fostering the initiative through sufficient marketing investment and leadership attention
  - A track record for launching new businesses and generating customer engagement
  - Willingness to meet the compensation expectations of fintech leadership and key talent
  - Good technology infrastructure.

  Larger banks may be appealing because they bring a great number of customers with them. However, their complexity, the sheer number of decision-makers and the frequently protracted timelines may make them less attractive to fintechs than smaller, leaner, simpler organizations.

- **Organize to accelerate speed to market** - Completing the required risk and compliance, contracting, and technology tasks is inherently time consuming. Banks should strive to streamline decision making and execution by assigning a dedicated team that spans product, design, legal, risk, contracting and engineering. This team would promote integration across all touchpoints in the organization. Ideally, the team would be able to expedite implementation by using a development sandbox that identifies technology issues *before* the contractual work is completed.

- **Ensure alignment in areas where disputes can arise** - For example, banks should decide on appropriate uses of data, approaches to compliance and communications, and how to balance quality with speed to market.

- **Pay attention to the soft factors –** While mutual trust and credibility between parties are critical, they are frequently lacking due to the vastly different respective experiences and world views of the bank and fintech leaders. However, we are now beginning to see executives move between banks and fintechs. This barrier will begin to diminish in size as such convergence progresses.

Success Stories

Wildfire

Wildfire is an Enabler fintech that allows partner banks to introduce embedded white-label shopping experiences similar to Honey or Capital One Shopping, including a rewards program, shopping comparisons, and offer directories, in a matter of weeks. In addition to delivering value to bank customers, the service creates economic value for bank partners through merchant-funded offers that generate substantial revenue on top of the interchange generated by purchases.

Wildfire's business is being propelled by banks who recognize, to an increasing degree, that they need new value propositions to thrive. These banks believe that finding ways to become more central to their customers' lives will lead to success; remaining in the background will result in failure. Consequently, they feel that fintechs whose value propositions generate customer engagement will be the most potent partners.

Wildfire seeks to work with banks who share its vision on the evolution of banks' value propositions, and who view the partnership as a new business, as opposed to a one-off project. It looks for marketing and executive support.

Treasury Prime

Treasury Prime is an Enabler fintech that facilitates bank-fintech partnerships. It makes identifying and implementing bank-fintech partnerships easier by delivering APIs that embed a broad range of bank processes, including seamless account onboarding, real-time account management, connection to payment rails, risk and compliance management, and the design of a tailored debit card experience.

As a BaaS platform, Treasury Prime aims to support, not to disintermediate banks. In its view, industry consolidation will create a dynamic that leaves small and mid-sized banks with no choice but to partner with fintechs to remain competitive. Its value proposition is clear: the company identifies the most suitable fintechs for banks to work with and accelerates speed to market.

Treasury Prime stresses that a bank's technical maturity and engineering skills are less critical to success than leadership commitment, inter-functional support, and alignment on governance and compliance.

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Banks have come to recognize that fintechs are neither a passing fad nor a mortal enemy. They must now determine what form their relationships will take: competitor, partner, or some of both. Those who successfully select and integrate fintech offerings to fill product gaps, improve customer engagement, drive operational efficiencies, and generate incremental revenue, will have a potent advantage over those who opt simply to coexist alongside fintechs.

Mindy Hauptman
Nigel Morris
Juan Uribe
Deepak Goyal
Inderpreet Batra
Kamila Rakhimova

Mindy Hauptman *is a partner and associate director in the Philadelphia office of Boston Consulting Group (BCG).* ***Nigel Morris*** *is a Managing Partner with QED Investors.* ***Juan Uribe*** *is Managing Director and Partner in BCG's New York office.* ***Deepak Goyal*** *is a Managing Director and Senior Partner in the firm's New York office.* ***Inderpreet Batra*** *is a Managing Director and Partner in BCG's New York office.* ***Kamila Rakhimova*** *is a Managing Director and Partner in the firm's San Francisco office.*

You may contact the authors by e-mail at:
hauptman.mindy@bcg.com
nigel@QEDInvestors.com
uribe.juan@bcg.com
goyal.deepak@bcg.com
batra.inderpreet@bcg.com
rakhimova.kamila@bcg.com

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