WHITE PAPER

Bracing for headwinds - How APAC challenger banks can navigate disruption in 2023

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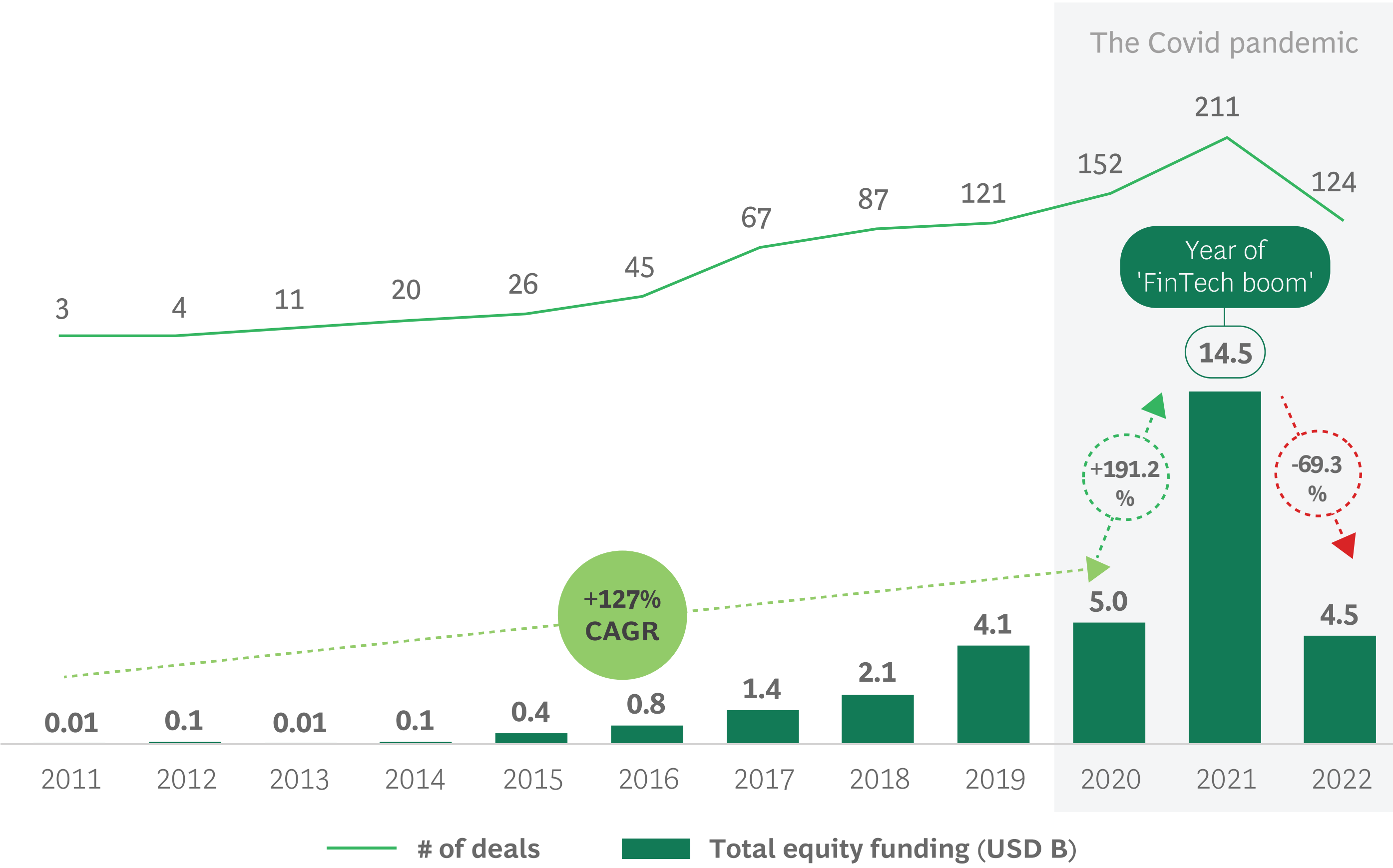
Introduction

The banking landscape has seen significant changes over the past decade, as technology continues to unlock new banking opportunities. These changes have paved the way for ambitious Digital Challenger Banks (DCBs) to gain traction across the globe. These emerging banks offer a digital-first, customer-focused banking solution which is disrupting the traditional landscape and fighting incumbent banks for market share. The rapid growth of these DCBs is largely attributed to the fact that they offer streamlined, digital-first banking solutions that are disrupting traditional banking principles.

Since the advent of Challenger Banks and neobanks, we have witnessed steady and sustained sector growth, with total equity funding growing at 127% compound annual growth rate (CAGR) from 2011 to 2020. [Exhibit 1.]

Exhibit 1 - The total amount of equity funding and the number of deals raised by challenger banks worldwide



Note: Cumulative equity funding raised by digital challenger banks, does not include Debt, M&A or IPO funding
Source: BCG FinTech Control Tower

This emerging DCB sector faced its first tough period at the beginning of 2020 when the Covid-19 pandemic struck. The short-lived Covid-19 recession (also known as The Great Lockdown) negatively impacted many DCBs' revenue streams, delayed both product launches and market expansion plans, and even lowered the valuations of some players.

The pandemic also triggered unexpected, deeper, persistent positive impacts on the banking ecosystem, accelerating the digital transformation of financial service institutions, increasing the demand for digital services, and changing long-term consumer behavior. As a result, there was an unexpected 'Fintech boom' in 2021 as more investors began pumping funds into the sector. This allowed DCBs to regain momentum and raise a record amount of funds throughout the year, with equity funding increasing by 191% in 2021, close to three-times higher than that of 2020.

Due to the negative macroenvironment in 2022, investments in tech/Fintech (including DCB) slowed, with equity funding falling 69% to its level of 2020. 2022 saw a worldwide increase in inflation and central banks raised their interest rates to curb it. As rising interest rates generally impact the business and financial performance of DCBs and other players in the Fintech ecosystem, it is likely that we will witness more evidence of its effects in financial reports for 2023.

Although DCBs arguably remain one of the most active and promising Fintech sectors, there are clear signs that 2023 will continue to be challenging, largely due to three rising headwinds:

- **Interest rate hikes**
- **Funding winter**
- **Recession**

In this paper, we will examine those emerging headwinds and analyze how they are likely to play out for DCBs if they do occur. We will also explore a list of recommendations on how DCBs in the Asia Pacific (APAC) region can prepare and navigate these trying times in order to remain resilient.

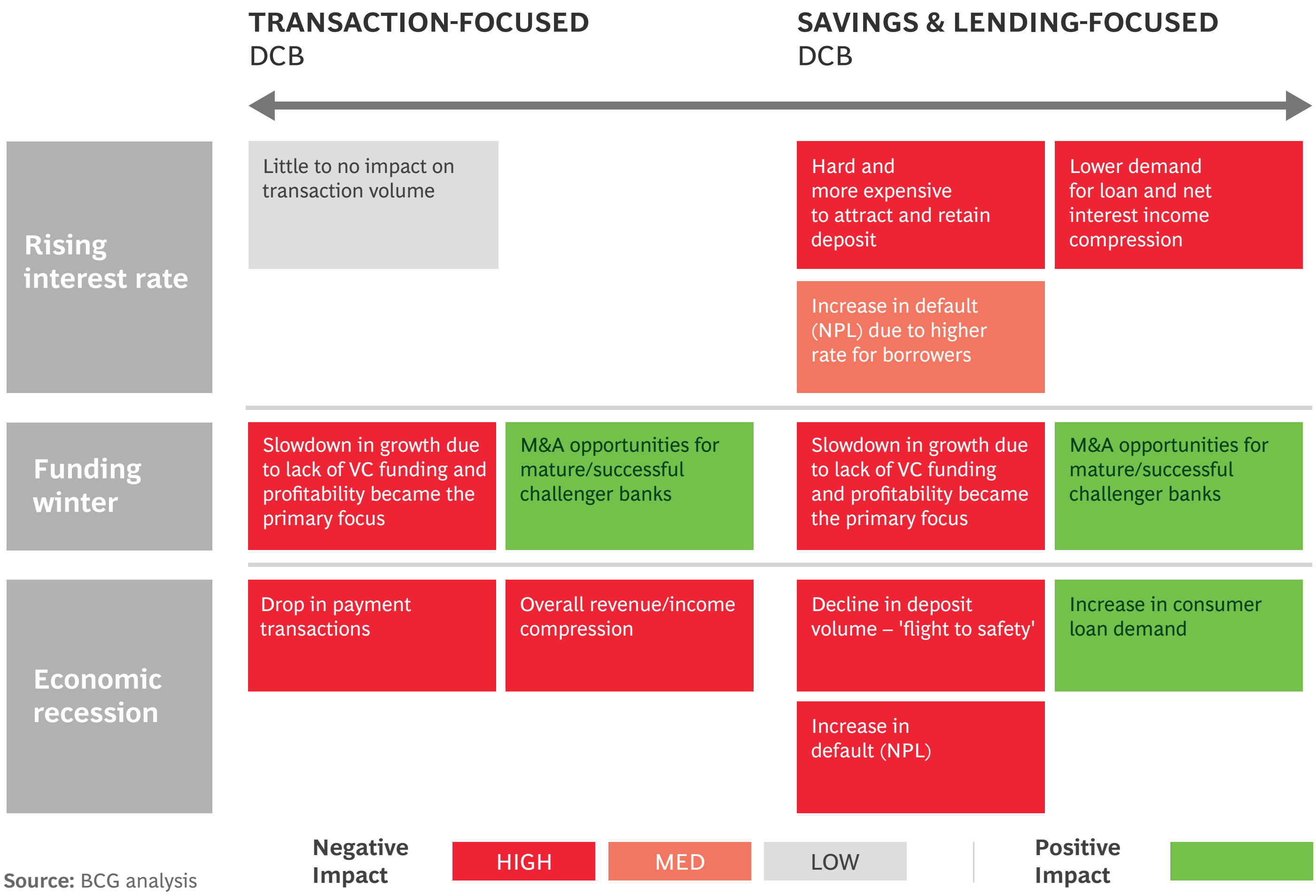
Macroeconomic Challenges for Digital Challenger Banks

DCBs are ambitious emerging challengers in an exciting Fintech ecosystem, but as they look to sustain business in 2023 they will need to address the challenges of three major headwinds which may yet dampen market prospects. [Exhibit 2.]

Each of the three identified headwinds comes with its own unique set of potential impacts and challenges that DCBs may have to overcome, with pertinent implications for industry players. Rising interest rates will have little to no impact on transaction-focused players, but could deliver significant negative impacts in areas of saving and lending, including difficulty attracting deposits and lower demand for loans.

The funding winter creates both challenges and potential opportunities for both transaction and savings/lending players, slowing down growth but unlocking potential merger and acquisition (M&A) opportunities. The broader threat of economic recession will likely slow down transaction volumes, damaging revenue for transaction-focused DCBs. Recession will also lead to declines in deposit volumes, increasing margin pressures, and create a more complex landscape for consumer loans.

Exhibit 2 - Potential impact of the 3 headwinds on challenger banks

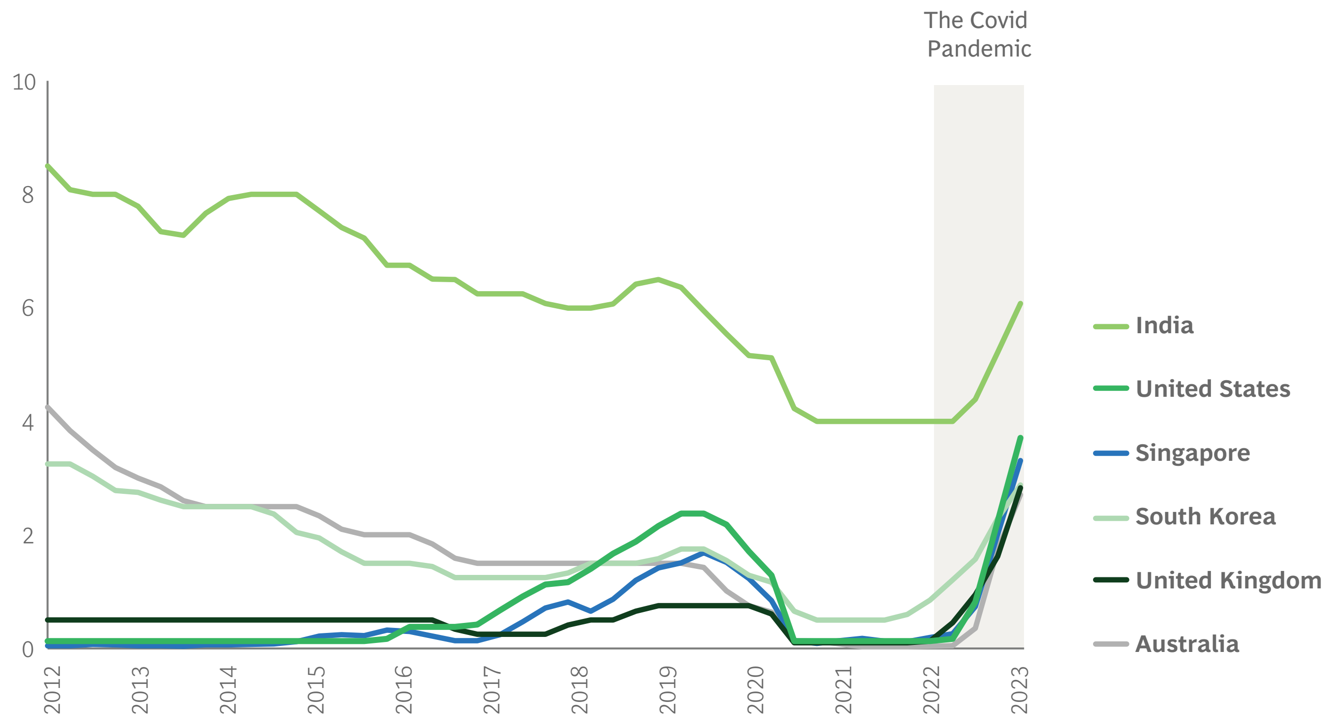


Source: BCG analysis

1. Interest rate hikes

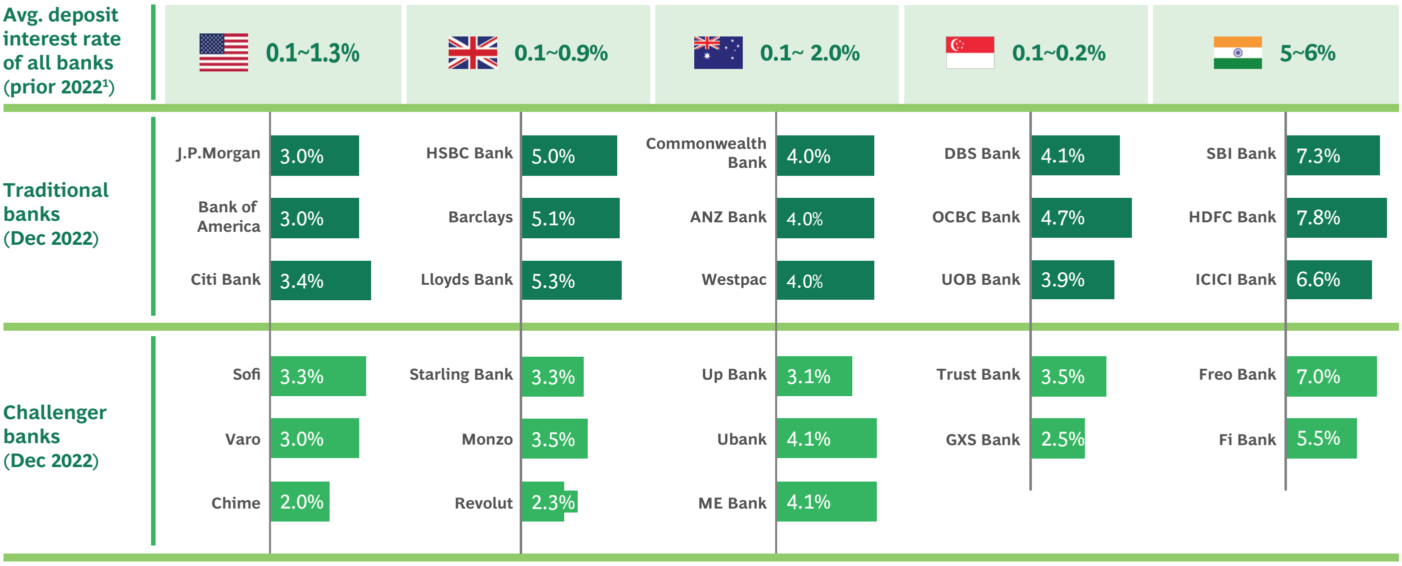
In 2022, many central banks around the world raised their interest rates (policy rates) to combat high inflation, with some markets even reaching historic highs. [Exhibit 3.] Considering many DCBs in APAC were formed in the past few years, it is the first time they have ever faced such a high-rate environment. Our research indicates that inflation and rising interest rates could present a significant obstacle for DCBs, disadvantaging them in competing against traditional large banks.

Exhibit 3 - Interest rates (policy rate) have risen rapidly in many markets since 2022, some even reaching a 10~15 years high for the first time



Source: Economist Intelligence Unit

Exhibit 4 - Traditional banks and challenger banks are competing for deposits with high savings account interest rate



1. 2017~2021
Source: desktop search, Economist Intelligence Unit

1.1. Attracting and retaining deposits is getting increasingly difficult and expensive for digital challenger banks

With interest rates (policy rates) raised sharply by central banks in 2022, traditional banks increased their savings rates to compete for depositors. [Exhibit 4.] Traditional banks generally view high interest rates as an opportunity for revenue growth. Offering a competitive savings rate helps them to capture deposits as well as acquire new clients and establish new customer relationships.

As the cost-of-living increases and loans such as mortgage rates become more expensive, banking customers will be more inclined to embrace inflation-beating interest rates for their deposits and savings. If DCBs are unable to raise their savings rates to compete with traditional banks, they may find that balances begin to drain from transaction accounts.

However, merely offering above-market savings rates to attract new customers may not result in effective monetization. DCBs should also place importance on driving daily banking and payment transactions, while maintaining lending capabilities. Without sufficient focus on these areas, DCBs could potentially be vulnerable in an era of high interest rates.

Take the example of Xinja, a DCB from Australia. [Exhibit 5.] Xinja offered the highest savings rates possible in order to attract customers. However, they were not equipped with the funds needed to deliver on that promise of high-interest returns as they had no lending products. When the Covid-19 pandemic hit, Xinja was unable to raise funds—given the challenging capital environment—and this resulted in its permanent closure of business in 2021.

Exhibit 5 - Xinja's model of "high-interest deposits" back-fired

September 2019

Xinja receives unrestricted banking licence and launches Australia's highest interest-bearing deposit with a plan to launch its loan product by H1 2020

February 2020

Xinja launched high-yield savings account 'Stash' with 2.25% p.a., making it the highest savings account interest rate on the market

March 2020

Xinja suspends Stash saving account to new customers in favour of maintaining its 2.25% rate

May 2020

Xinja fails to receive targeted funding of $433 Mn from Dubai World Investments, instead raises only $10Mn in equity

Delay in funding forces Xinja to preserve cash and further delay launch of revenue-generating loan services

July 2020

Xinja informs savers it will cut rates to 1.65%, the 2nd cut in rates within a 2 months span

November 2020

Xinja caps interest-bearing component of its deposit accounts to just $50k

Deposits plunge to $278Mn in late November

December 2020

Xinja updates investors informing of the decision to exit banking only 15 months after receiving its licence

Source: Desktop search (public information)

1.2. Rising interest rates could potentially eat into challenger banks profitability

In principle, rising interest rates can boost traditional banks' loan revenue and net interest income as traditional banks are able to pass the increased rate to borrowers. Traditional banks often take advantage of the difference between the interest they pay to depositors and the interest earned from lending and investments. However, DCBs may not have the same luxury.

In a rising interest rate environment, not all lenders benefit equally due to varying lending profiles. Ratings agency Fitch noted in June 2022 that "larger high-street banks tend to benefit the most from rising interest rates, given their large market share in current account deposits. Mid-sized banks, mortgage lenders (non-banks), and Challenger Banks will find it more difficult to widen their margins as they rely more on savings deposits, for which savers will demand higher interest rates."

As opposed to traditional banks who have access to larger funds, more diverse lending products and funding mixes, as well as a large user and borrower base—typically consisting of premium customers, rather than the unbanked and underserved segments—DCBs have relied on inexpensive deposits and economical wholesale funding (or securitization) to fund originations for a long time.

With the hike in interest rates, DCBs are now being exposed to interest rate fluctuations and capital market volatility, which could greatly increase their cost of funding. Given that their customer base often heavily focuses on unbanked and underserved individuals, DCBs may find it challenging to pass the higher deposit costs to borrowers. If they cannot do something creative on the asset side of the balance sheet beyond simply investing in portfolios of low-risk securities, the gross margin can be further compressed.

1.3. Rising interest rates could lead to 'higher adverse selection' resulting in increase of non-performing loans

Most DCBs target subprime—unbanked and underserved—customer segments, resulting in a greater number of relatively higher-risk customers than traditional banks. As such, DCBs will face higher adverse selection, especially in the unsecured lending space.

Adverse selection occurs when low-risk borrowers become reluctant to pay high interest rates, but higher-risk borrowers are willing to take out loans with higher interest rates. Given that DCBs target subprime customer segments, they tend to have more high-risk customers in comparison to traditional banks.

As interest rates rise, the quality of the average borrower begins to decline. This is due to the fact that good borrowers avoid excess spending fueled by loans, while bad borrowers continue to commit to larger loans, especially from lenders with loose criteria. This often results in higher utilization driven by bad lenders and, in turn, an increase in non-performing loans (NPL) with lower profitability. Thus, the impact of 'higher adverse selection' on DCBs tends to be greater than on traditional banks.

These effects have recently been observed on a leading DCB in one of the major economies in Southeast Asia. The delinquencies for the DCB have increased by 50% in the last six months in comparison to a year ago. This rise in late payments was mainly driven by recession with utilization levels and loan re-take rates up by 10% and 15%, respectively.

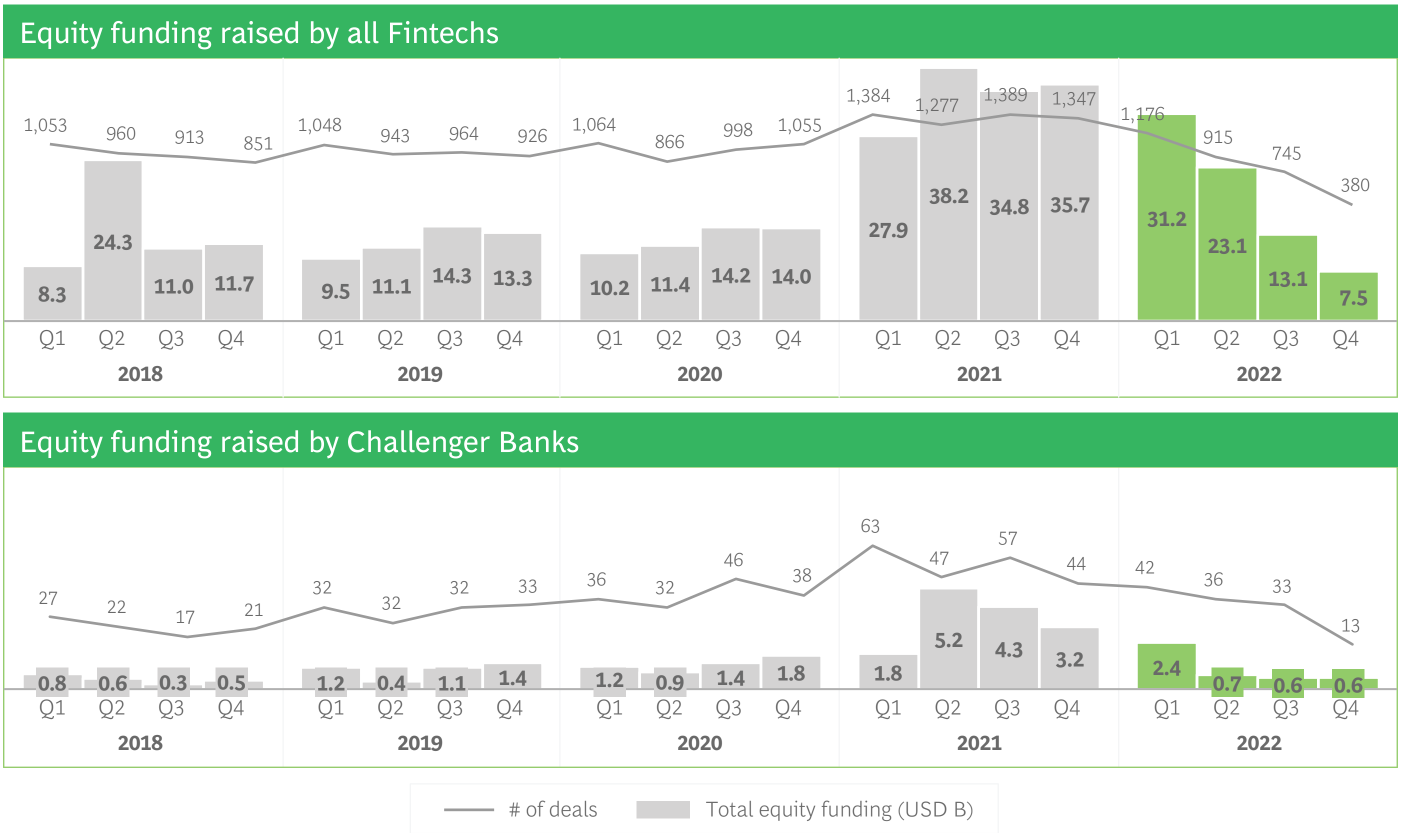
2. Funding winter

A further potential risk for DCBs is the 'funding winter', largely attributed to negative market sentiment. This period sees investors concerned about the faltering economy, with some minimizing their investments in the Fintech sector, making it difficult for startups to obtain funding.

At the end of Q4 2022, equity funding raised by Fintech companies dropped to US$7.5 billion compared to US$35.7 billion in Q4 2021. Similarly, equity funding raised by DCBs declined to US$600 million in Q4 2022 as opposed to US$3.2 billion in Q4 2021. [Exhibit 6.] This indicates that macro-pressures may have caused investors to become more discerning in 2022, creating a profound impact on the DCB ecosystem. The total number of deals has also witnessed a significant decline, falling from 1,347 for Fintech and 44 for DCBs in Q4 2021, to 380 and 13 respectively in Q4 2022, marking a seismic shift in deal volumes.

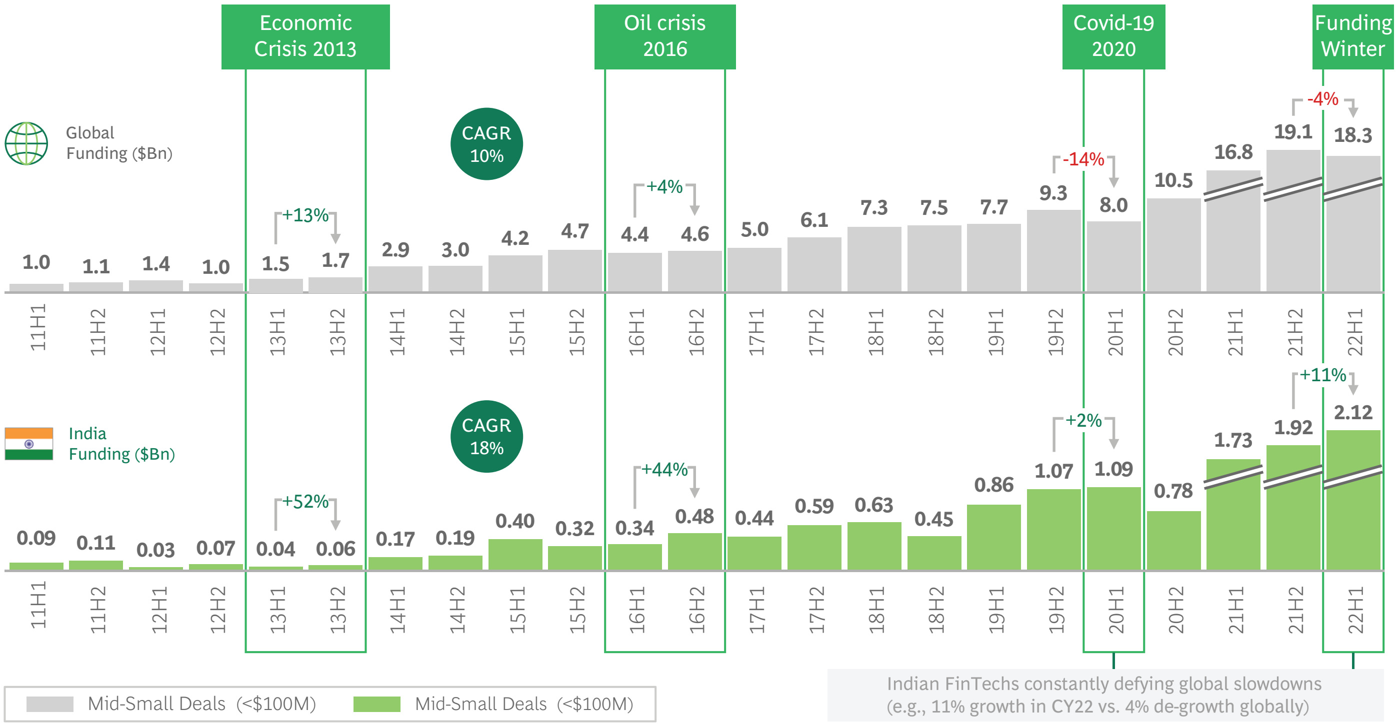
As we experience the largest Fintech funding winter of the past decade, there have also been other important, but less impactful headwinds that have contributed to a decline in funding in the past. While these have had a less sizeable impact on DCBs, they nevertheless contribute towards a more complex funding environment. As the size of the Fintech market, and total value and volume of investments grow, these downturns will have a more persistent impact, and contribute towards the overall gap between 'winners' and 'laggards'.

Exhibit 6 - The 'Funding winter' started to emerge since 2022; Total equity funding to both Fintechs and Challenger Banks reached their lowest levels



Note: Cumulative equity funding raised by digital challenger banks, does not include Debt, M&A or IPO funding
Source: BCG FinTech Control Tower

Exhibit 7 - Fintech funding trends during crisis, for mid-small sized deals (<$100M) - Global and India market examples

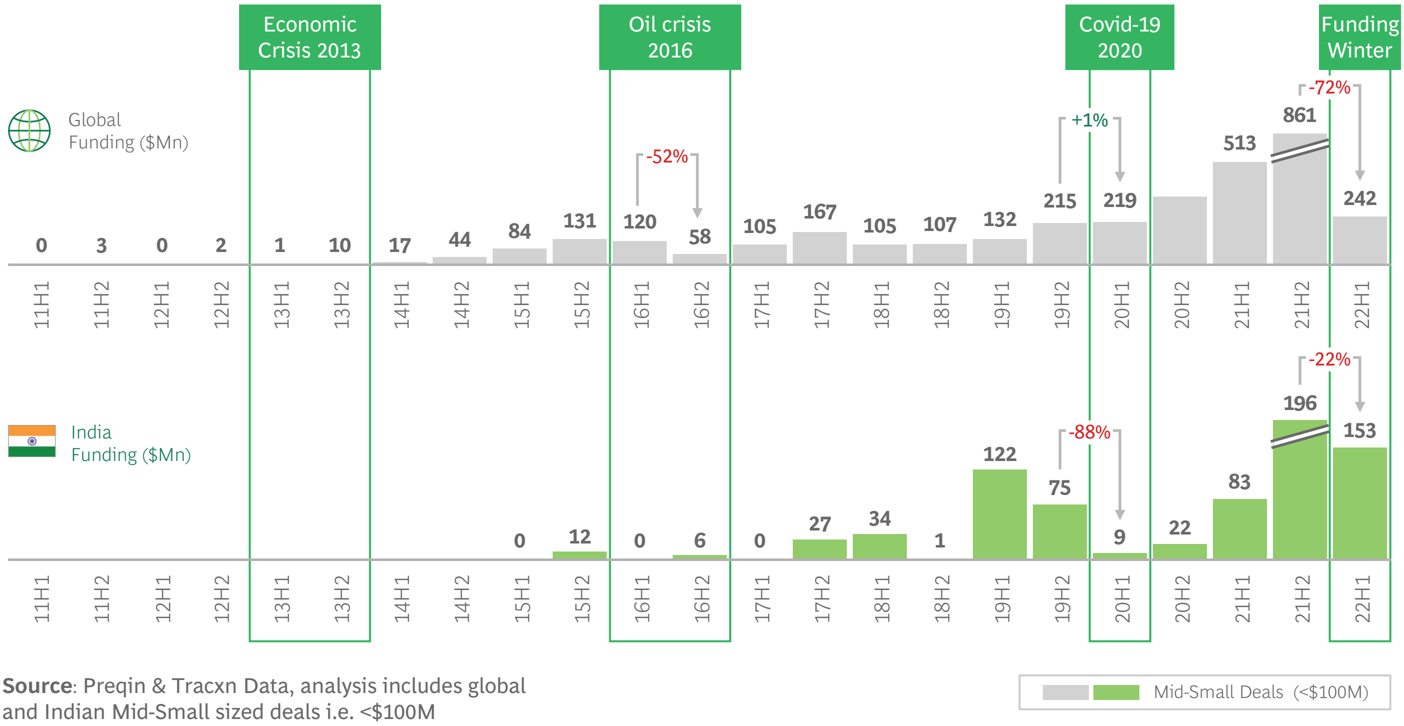


Note: Cumulative equity funding raised by FinTechs, does not include Debt, M&A or IPO funding
Source: BCG FinTech Control Tower

Experience of Fintech funding trends from previous crises has also revealed that the investor appetite for large deals has waned, and instead there is a preference for medium or small-sized ticket assets. While the overall funding amount decreases, there is a disproportionate increase in early-stage deals, driven by investors willing to take small bets across a spectrum of high-potential deals. [Exhibit 7.]

However, this overall Fintech market trend is not shown to be true for DCBs, who have seen a significant drop in both large and medium/small-sized deals during funding winters. This can be largely attributed to lower confidence in their ability to sustain the effects of a recessionary environment and high competitive pressures from large incumbent banks in the market. [Exhibit 8.]

Exhibit 8 - Small-sized funding in DCBs plummeted during downturn scenarios, contrary to overall Fintech investment trends



Source: Preqin & Tracxn Data, analysis includes global and Indian Mid-Small sized deals i.e. <$100M

2.1. The contracted funding environment exposed business model vulnerabilities of challenger banks

According to BCG Fintech Control Tower, there are a total of 431 DCBs worldwide today, and of this total only 20, or 4%, have achieved breakeven. While a few ecosystem-backed and consortium-backed DCBs in APAC achieved profitability, the majority of DCBs have suffered losses and continue to rely on funding for survival. .

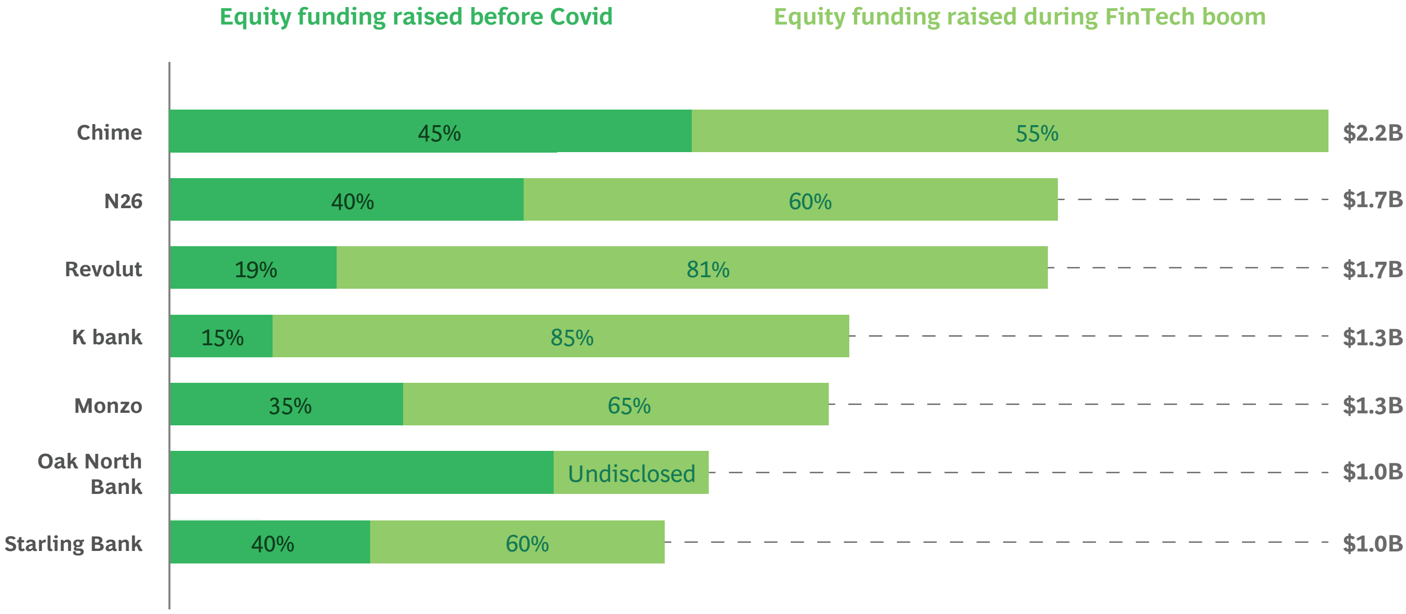
Many of these DCBs have prioritized growth over profitability with the recent cycle of exuberant growth generating a disconnect between DCB valuations and their financial metrics. Many of these DCBs have adopted the strategy of 'valuation play' by focusing on user acquisition and market expansion through leveraging venture capital funding. This is done in an attempt to maximize valuation as rapidly as possible, even if it comes at the expense of growing losses.

With the current negative market sentiment, combined with rising interest rates, some DCBs are at risk of funding and liquidity challenges. The gap between revenue and valuations is now undergoing a normalization phase as venture capital firms and other investors may no longer provide large equity injections into DCBs without a clear path to profitability. This is pushing DCBs to rethink and revamp their playbooks.

2.2. Mature and at-scale challenger banks need to accelerate profitability strategies amid growing pressure from markets to yield profits sooner rather than later

Most mature and at-scale DCBs are well capitalized and funded thanks to the 'Fintech boom'. Many of them raised more than half of their entire equity funding during this period, and these companies now claim they possess the necessary funds to sustain business without further investment over the next two years. [Exhibit 9.]

Exhibit 9 - Many mature/at-scale challenger banks are well capitalized, and majority of their funding were raised during Fintech boom (2021)



Note: Cumulative equity funding raised by digital challenger banks, does not include Debt, M&A or IPO funding. Publicly listed challenger banks are excluded here
Source: BCG FinTech Control Tower

Since investors are now valuing and investing in DCBs more rationally as a result of the negative market sentiment and market uncertainties, DCB founders and executive management teams are facing pressure to achieve breakeven or deliver on the promises laid out in their business plans.

Many DCBs had to make the most drastic changes in their pivot from growth at all costs to a profitability pursuit by establishing the long-term viability of their business model and focusing on more balanced unit economics. However, taking into account the macro-pressures, market uncertainties, and the fact that only 18 Challenger Banks in APAC have achieved breakeven, turning a profit in such a short time frame will not be an easy task for DCBs.

2.3. Funding winter shortens runway for early-stage challenger banks

DCBs lacking the scale to monetize may find growth even more difficult without adequate funding. These early-stage or smaller DCBs will have to continue seeking funding for basic operational needs, such as the funds needed to finance working capital, compared to mature or large DCBs that are looking to increase their cash reserves.

In a tightening capital market, small and new DCBs will have a difficult time acquiring and retaining new and existing customers. DCBs that relied on economical credit facilities (e.g., alternative or embedded lenders) could see their unit economics declining, forcing them to pivot into new business models that focus on near-term profits. As a result, some may choose to increase their prices on services if they want to sustain their business. However, this will weaken their value propositions and make them less competitive. Others may choose to minimize spending through layoffs, pivot to alternative funding options such as crowdfunding/debt, or even to the extent of preparing an exit plan.

We have already witnessed some DCBs in Australia and Germany collapsing after failing to raise additional funding. For example, Volt was one of the earliest DCBs in Australia to surrender its license and return approximately US$67.3 million in deposits to customers. This was caused by a failure to gain capital to support its mortgage-lending plans. Similarly, German neobank Ruuky filed for insolvency after failing to raise funds in January 2023.

2.4. Market perspective: shallow capital markets remain a persistent funding challenge

International venture capital in APAC has flourished over the last decade, led by ecosystem platforms, Fintech, gaming, e-commerce, and more. Some APAC markets, such as India and Southeast Asian (SEA) countries, are among the most attractive venture markets globally for technology and Fintech investors as these markets are bolstered by large populations, a rising middle class, and increasing technological adoption.

As a result, there have been a number of tech and Fintech unicorns that have emerged with a rapid growth rate who eventually announced an initial public offering (IPO). However, many of these unicorns have fallen well below their listing prices, causing investors to be more cautious with their funds.

These sluggish share price performances might be attributed to many macroeconomic factors (for those who listed in US stock markets) as well as lack of deep equity markets in India and SEA (for those who choose to be listed locally). As a result, the faith of limited partners in Fintech investing may decline, which may adversely affect the funding appetite for many years to come.

2.5. Learnings from the past

Fintech founders looking to secure funding must build investors' confidence along multiple dimensions. This is particularly crucial in funding winters where money is scarce.

With record levels of funding in today's global market, corrections in valuation multiples and shifting industry dynamics over recent quarters, investors are cautiously optimistic. Any concerns about valuation growth are generally offset by the potential significant payoffs for success.

Today's investors, however, are expected to be a lot more selective, focusing on companies with true underlying performance as opposed to high paper valuations. This includes facets such as strong unit economics, a sustainable 'moat' of protection, and a path to profitability. We have observed a few common traits from founders who have been 'Winter Immune' and raised money in these scenarios. [Exhibit 10.]

Exhibit 10 - Key Traits that make Fintechs 'Winter Immune'

1 Business Model	2 Revenue & Cashflow Mgmt.	3 Founder & Team Characteristics	4 Valuations
Agile by design, for a strong market fit • Pivot fast on product design, business model to create financial degrees of freedom • Innovate offerings to build higher revenue and products per customer • Clear "hero" product	**Amplify financial prudence** • Extend runway to atleast two years, for optionality • Avoid "equity dilution for valuation" • Cost-cutting without baking in additional funding rounds • Strong portfolio management - build 'self-funding' mindset	**Prudent Founder mindset** • Open-minded, resilient and cash conscious founders • Reduce salaries of senior management and stave off layoffs during recession • Proactively plan all capital to be raised – equity, debt, etc. to reach the objectives	**No Bloated Valuations** • Avoid "down-rounds", which is a possibility in the near future
Time bound road to profitability • Capital is now more discerning to quality of margins, scale, proven unit economics • Prove profitability in "shrinking" time horizons	**Restructuring financial instruments** • ESOPs to retain employees and keep the morale high • Exercising ESOPs in winters for cash inflow	**Customer obsession mindset** • Customer focus at the center of all decision making, investments	**Valuation backed by fundamentals** • Business plan and value proposition strongly backing the multiples • Clear right to win (Proprietary tech, data, customer segment reach,...)
Lock-in growth drivers • More confidence to investors by mitigating risks to revenue (e.g., Long term contracts)			**Funding Track Record** • Avoid frequent fund raisers (e.g., shareholder dilution every 3-4 months to feed expenses/growth) • Returns track record - significant vs incremental value creation

2.6. The funding winter is likely to prompt a wave of consolidation

With many small and early-stage DCBs and Fintech companies now at lower valuations, the market presents a rare opportunity for at-scale and mature DCBs with spare capital, incumbent banks, and other corporate players who wish to enter new areas or gain access to proven technology and existing user base.

It is expected that there will be consolidations of the market with merger and acquisition (M&A) deals involving DCBs. There have already been some early signs of this significant market shift:

- **Balance-sheet driven deals.** These deals are widely focused on lending plays that form such an important pillar of DCB profitability. A DCB with more capital could rapidly acquire Fintech companies involved in lending to strengthen their lending capabilities. This can be seen in Starling's acquisition of Fleet Mortgage, Tandem Bank's acquisition of personal loan specialist Oplo Group, and Bunq's acquisition of the Irish real estate lending specialist Capitalflow Group.

- **Product expansion driven deals.** DCBs are also buying Fintech companies in adjacent fields of banking to expand their product lines. This could be viewed as a strategic move or to introduce a new line of products. Examples include OakNorth acquiring Fluidly, a cashflow and forecasting tools Fintech, Bunq acquiring the expense management tool Tricount, and Solarisbank acquiring payment processor Contis Group.

- **Natural selection.** This environment also offers a window for successful and profitable DCBs to supplant competitors with targeted offers and competitive pricing.

3. Recession

The sustainability of DCBs is being threatened as the global economy contemplates the looming risk of possible recession in many markets around the world. As of late 2022 and early 2023, DCBs were facing an uphill struggle in multiple facets of their business operations, highlighted by the headwinds explored in this report. A recession will exacerbate the effects of high interest rates and a funding winter on DCBs, adding new complexities, consequences, and implications for profitability and survival.

3.1. Covid-19 lockdowns exposed challenger banks to recession impacts

There are numerous implications for Fintech industry from the Covid-19 recession, but its negative impacts are mainly reflected in three areas for DCBs:

- **Deposit.** Many consumers enjoyed the convenience of DCBs. However, during periods of economic turbulence, most consumers forgo convenience for proven safety and security such as that offered by large traditional banks. The Covid-19 pandemic induced 'flight to quality', where the market saw consumers/investors moving capital from risk toward the safety of larger incumbents. As per Federal Reserve Data, large US commercial banks saw a nearly six-fold increase in deposits compared to a three-fold increase for small US commercial banks (including DCBs) following the outbreak of the Covid-19 pandemic. This data is signaling that DCBs have to fight even harder for deposits given a protracted period of economic turbulence.

  Recently, there have also been emerging stories with negative impact on the perception of Fintech players across different segments. Examples include layoffs at several Fintechs in the US, valuation resets at various global players, and the collapse of digital asset companies FTX and BlockFi. If another recession were to occur, consumer trust in Fintech companies could decline further, particularly in regard to depositing funds on Fintech platforms.

- **Revenue.** DCBs' revenue, particularly those that rely on fee-based revenue such as merchant discount rates and interchange fees, were hit by a drop in consumer spending. This was a result of the economic uncertainty and lockdowns that led to a change in consumer spending behavior, resulting in low transaction volumes and lower revenue.

- **Credit risk.** In the early days of the Covid-19 pandemic, non-performing-loans (NPLs) and delinquencies increased for most lenders—including DCBs—and as a response to this, many tightened their credit policies and lowered origination volumes.

3.2. Further impacts of a potential downturn in 2023

The ongoing cost-of-living crisis taking place in multiple markets—as well as the wider potential for recession—may also trigger complex impacts with major implications for Fintech and DCB players.

Among the potential effects of an economic downturn in 2023 is the impact on consumer savings. As with any period of economic turbulence, a recession and the rising cost-of-living will eat into consumer savings. When times are tough, funds are often transferred from savings accounts into current accounts to help consumers weather the storm. If the upcoming recession persists, consumers will see their savings accounts decreasing at a rapid rate.

Another example is the possible shift in market dynamics. If a recession were to occur, there would be a paradigm shift in the types of loans sought out by consumers. The demand for large-ticket loans such as mortgages and car loans will decrease, while the demand for small-ticket loans such as cash loans for smaller amounts will increase, as consumers look for ways to cover their daily expenses as opposed to purchasing expensive items. The rising cost-of-living will prompt consumers to take out short-term loans, pushing unsecured products such as personal loans and credit cards to grow, as consumer 'balance sheets' become weaker, and people try to bridge their short-term income and expenses gap.

Access to talent may also be affected by an economic downturn as talent acquisition could become a major issue. Over the past decade, talent has jumped from corporates and big tech companies to Fintech startups, with some even choosing the entrepreneurial path and starting their own ventures. However, as the equity and financial stability of Fintechs is impacted by global headwinds, their attractiveness as destinations of choice for top talent will wane. Despite the recent big tech layoffs, demand for tech talent across APAC continues to remain strong, with an increased demand in non-tech industries such as traditional financial services, hospitality, logistics, retail, and others. As a result, Fintech companies in APAC are likely to struggle in the coming talent wars due to the impacts of recession.

3.3 OVERALL IMPLICATIONS: SHIFTING THE COMPETITIVE DYNAMICS OF THE CHALLENGER BANKS SECTOR

There are two key takeaways from these headwinds that DCBs should acknowledge as they look to inform their near-term strategies:

1. What worked in the past, might not be a reliable solution for the future

DCBs have historically enjoyed easy access to funding, inexpensive lending, and low deposit rates. Today, we live in a world where funding is increasingly difficult to obtain, lending is expensive, and deposits generate higher returns.

DCBs used to benefit from the abundant, low-cost equity capital that fueled rapid customer acquisition, product development, and overall growth. They were able to disrupt the banking space by focusing on digital customer experiences and product innovation—an untapped segment that traditional banks scrambled to keep up with. During this period, 'valuation play' was a popular option for many DCBs, and was widely accepted and encouraged by investors.

Now, with significant challenges for raising additional venture capital, DCBs will have to devise creative strategies and figure out how to achieve profitability and sustainable growth during uncertain and high-rate market conditions that many have not encountered before.

2. Incumbent banks may regain their advantage over Digital Challenger Banks given evolving market conditions

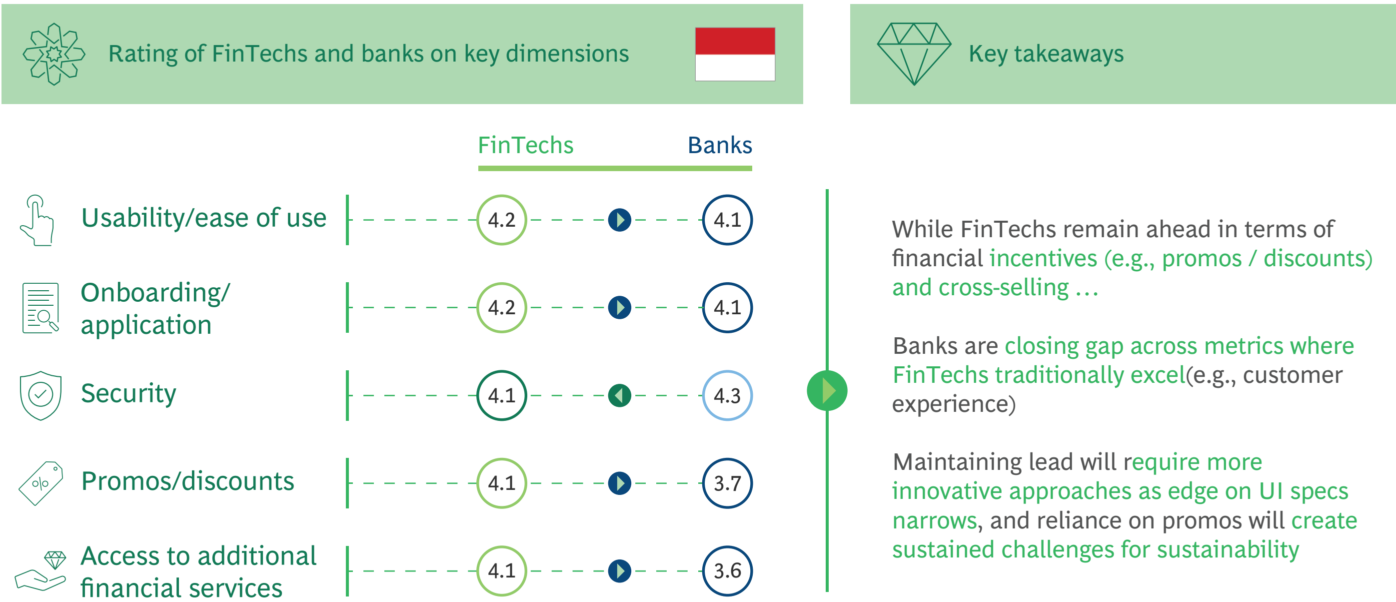
In recent years, incumbent banks have been stepping up their game and launching their own digital banks. For example, Standard Chartered launched their digital-only banks in Hong Kong and Singapore, while UOB launched digital-only banks in Thailand and Indonesia with plans to expand into more markets.

The same can be said for JP Morgan Chase, who experienced a successful launch in the UK in 2021, acquiring over 500,000 customers and US$10 billion in deposits in its first year. The company is reportedly looking to launch a new digital bank in Germany as its second international expansion effort.

These traditional banks are slowly catching up with digital trends and beginning to adopt new technologies to cater to customers' needs—user interface (UI) and user experience (UX) are no longer key differentiators between Fintech companies and incumbent banks. DCBs will need to continue to innovate to stay ahead of the UI/UX curve, while also balancing the attractive nature of promotions against the need to ensure sustainable economics.

A recent BCG survey in Indonesia found that Fintech players outperform traditional banks on overall usage. [Exhibit 11.] However, rising interest rates and the funding winter are playing in favor of traditional banks, improving the competitive position of incumbent banks. Some DCBs may be at risk of succumbing in the battle between them and traditional banks, as traditional banks have the financial muscles to withstand economic uncertainty and a potential recession.

Exhibit 11 - Fintech players outperform traditional banks on overall usage, but UI/UX arbitrage is closing



Note: Rate your primary FinTech/traditional banks on the following factors (1= Poor, 5= Excellent)
Source: BCG SOFTU Survey 22

Weathering the headwinds

Given the significant implications of rising interest rates, the funding winter, and possible recession on DCBs, BCG has identified key recommendations on how to sustain operations and navigate through this challenging period. Brazilian DCB Nubank offers a valuable case study on effective strategies to weather this storm.

Nubank case study

Nubank is a valuable example of a DCB that has successfully weathered a combination of headwinds during 2020 to 2022 in an emerging market that is similar to many parts of the APAC and SEA region.

Background. Nubank was founded in 2013, and represented one of the early DCB pioneers, growing to serve nearly 75 million users across Latin America. By 2017, Nubank's growth had seen it achieve unicorn startup status, with a valuation of US$1 billion.

During the period of 2020–2022, Brazil experienced a volatile macro-environment and economic downturn with the following effects:

- Inflation rates went up from an all-time low of 2% in 2020 to 12% in 2022.
- Brazil's central bank increased its key rates up by more than 10 percentage points, from 2% in 2020 to 13.75% in 2022.
- The Covid-19 pandemic took a heavy toll on Brazil. The economic impacts included a recession, with their gross domestic product (GDP) dropping 4.1% YoY in 2020. The economy bounced back in 2021 but has yet to fully recover.
- Nubank's market capitalization fell from US$43 billion during its IPO in December 2021, to US$19 billion in December 2022, heavily influenced by macroeconomic conditions which included US interest rate hikes and resulting pricing adjustment to technology stocks.

Despite these growing economic challenges, Nubank found a way to thrive during this economic downturn, managing to cultivate explosive growth. It masterfully navigated this challenging environment from 2020 to 2022 and achieved profitability by moving from a loss of US$107.1 million in Q4 2020 to a net income of US$58.0 million in Q4 2022. Its more mature Brazilian operations are already among the most profitable financial businesses in the country with ROE levels above 30%.

Nubank's strategy for growth. Nubank continues to expand its customer base, growing it from 33.3 million in Q4 2020 to 74.6 million in Q4 2022 (including its recent entry into two new markets, Mexico and Colombia). Nubank's monthly active users (MAU) also grew from 66% in Q4 2020 to 82% in Q4 2022. Its strategy includes maintaining a low, stable cost-per-client and strong engagement rate, and the model has demonstrated consistent increasing revenue per client across time based on cohort maturation.

Nubank's lending and credit portfolio. Nubank successfully positioned its lending and credit portfolio as its key component and driver of revenue growth. Nubank's interest earning portfolio has consistently grown with its share of interest income in total revenue increasing from 44% in Q4 2020 to 76% in Q4 2022. In spite of its rapid growth, the credit portfolio continued to exhibit strong resilience with Nubank consistently outperforming the industry in terms of asset quality—its 90+ NPL has been ~25% lower than that of the industry throughout the period of 2020-2022, although the dynamic impacts of Covid-19 have created a complex landscape during this period.

Deposits. With a focus on building a robust deposit franchise, Nubank continuously expanded its deposit base to maintain a strong capital position and keep funding costs below the central bank interest rate. In order to support these plans, Nubank adapted its product offerings to changing business needs and macroeconomic conditions, for example:

- Launching Money Boxes, an award-winning innovation in Brazilian banking. The tool is a simple and customizable in-app experience allowing clients to organize their checking and savings deposits into investment portfolios according to specific goals with different income options. For starter clients, Caixinhas offers Bank Deposit Receipt (RDB) which is insured and yields at 100% of the interbank rate (CDI). This feature helped attract deposits and improve the stickiness of depositors.

- Prior to that, Nubank had a deposit product where customers could earn interest rates for both current and savings accounts that yielded 100% of the CDI on a daily basis. With the launch of Money Boxes as a simple and easy alternative offering the same yield, the rule for the deposit account changed to discontinue the 100% CDI yield for deposits withdrawn before 30 days. As a result, Nubank enjoys an extensive amount of free funding since a large part of deposits turn before the 30 days are complete.

Nubank also leveraged deposits to fund loan originations. This allowed them to decrease reliance on external funding or securitization which are more sensitive to a volatile macro-environment. Nubank maintained a loan-to-deposit ratio at ~25%, one of the lowest in the industry, which rewarded them with a strong liquidity position. The bank also capitalized on the rising interest rate by investing unused deposits and company cash into liquid financial instruments, which resulted in a large amount of additional interest income.

> **In our 9-year history as a company we have already seen a lot: we saw a GDP contraction of 7% during the years of 2015-2016, the largest recession in Brazilian history; we saw a presidential impeachment; we saw right-leaning governments and left-leaning governments coming and going across the three countries we operate. And today we see a slightly more volatile environment than we saw in 2021, which brings a bit more caution, but that also creates opportunities**

David Vélez, CEO and co-founder of Nubank

Six actions challengers banks in APAC should consider when adjusting their playbooks

The majority of markets in APAC are experiencing the complex pressures of the trends highlighted above. While China and Japan enjoy relatively low interest rates, and India is enjoying sustained GDP growth, the reality is that many DCBs are operating in markets that are battling some—if not all—of these global headwinds.

With 81 DCBs operating in markets across the region, APAC is home to 19% of global DCBs. In recent years, more regulators are starting to issue digital-only bank licenses in markets such as Hong Kong, Singapore, Korea, Taiwan, Australia, Malaysia, Philippines, and more, opening up the region for a new wave of these aspiring, digital-first banking players.

Many of these DCBs are new to their respective market(s) and will experience difficulty in achieving financial viability given current global conditions. One key difficulty lies in the fact that most DCBs—both new and established—target unbanked and underserved segments in APAC. However, with a softer economy, lending to these predominantly low-income individuals with limited credit history poses a higher risk.

As such, both mature and new DCBs will have to review and adjust their playbooks if they want to remain competitive and become profitable. To help these DCBs, we have identified six key factors to consider:

1 Refocus on the power of the traditional bank balance-sheet business model

In the current economic environment—where funding is costly and deposits yield higher returns—established DCBs should not only maintain a focus on lending, but also prioritize building a stronger base of deposits.

Many DCBs in the APAC region are supported by a large ecosystem of consortiums and conglomerates. Thus, they should leverage and utilize existing assets—strong brand recognition, rich pool of data, personalized offerings, an ecosystem of users—to develop innovative deposit products and features to attract funding and lower funding costs.

2 Pay close attention to credit risk

In terms of asset management, DCBs should focus on enhancing their credit scoring capabilities and adapt credit risk models to reflect the latest market conditions. With a looming economic downturn, DCBs should still be able to outperform incumbent banks with effective use of data for credit underwriting if they act strategically.

3 Review and define clear roles for each product offering

Many DCBs are under pressure to achieve near-term profitability. This means that there is likely to be a limited runway for experimentation. DCBs must carefully orient their business models towards value creation and profitability. They must look to review their existing product offerings to ensure focus on monetization. Consequently, as funding depletes, founders should shift their focus more towards their ‘hero product’ as this will become their main source of revenue.

4 Strengthen finance strategies and focus on the right metrics (unit economics)

Chief financial officers of DCBs will need to closely monitor growth and unit economics across product lines, strategize ways to achieve a balance between prioritizing product lines and a stronger profitability metrics for short-term usage, while maintaining healthy medium- and long-term positions, and optimal cash burn.

As market liquidity tightens, DCBs will need to dedicate more focus on strengthening their unit economics. In essence, this means that they need to place a higher importance on lifetime-value-per-customer, customer acquisition cost, marketing ROI, driving upsell/x-sell, retention rates, and other key elements of unit economics, as opposed to merely focusing on rapid user acquisition.

5 Review pricing strategy using the best-in-class approach

During periods of high inflation and economic uncertainty, customers become more price sensitive. As such, DCBs need to perform an in-depth pricing study to determine customers’ needs and preferences and then leverage this data to inform product launch strategies, for example choosing between loss-leader versus profitable product.

6 Fueling growth through opportunistic M&A deals

Fintech companies have the opportunity to accelerate their growth through M&A deals to launch new features, build new capabilities, or pivot to new revenue streams and segments. The emerging period of uncertainty—or lower valuations—and the funding winter might be beneficial to larger players as smaller players with advantageous business elements such as technology, a presence in key locations, access to niche or high-value customer segments may become available for acquisition at attractive valuations.

Charting the course ahead

> **The Chinese used two brush strokes to write the word 'crisis.' One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger, but recognize the opportunity**

John F. Kennedy

Times of crisis inevitably create times of significant opportunity. DCBs looking to excel in this landscape should take a considered approach, looking at learnings from the past, the landscape of the present, and the opportunities of the future.

The past. The rise of DCBs emerges as a crucial aspect of the expanding Fintech industry as a result of the previous global financial crisis. The emergence of DCBs was driven by a need to address key market conditions and innovation within the banking sector, where traditional banks and financial institutions lacked the means to do so due to their reliance on outdated systems and lack of competition in the industry.

The present. The current headwinds—rise in interest rates, the funding winter, and possibility for a recession—may present an opportunity for DCBs to adapt and grow, anticipating a repeat of the Fintech innovation on display in the years following the previous global financial crisis. As before, Fintech companies must be able to respond nimbly to changing market conditions and leverage their agility to identify new market opportunities and develop innovative business models.

The future. Despite near-term headwinds, the DCB sector is expected to have a positive long-term outlook, as several favorable trends continue to fuel growth. The ongoing digital transformation is a key driver that will increase in scope across various regions, providing DCBs with a strong foundation for existing and new business models. This is framed in a market where a significant portion of the APAC population still lacks access to adequate financial services. These two driving forces offer a long-term opportunity for DCBs and Fintech companies to grow their offerings of user-friendly, digital-first solutions that meet the needs of the unbanked and underserved segments, ultimately driving financial inclusion across APAC.

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