Can digital banks crack the code and break even?

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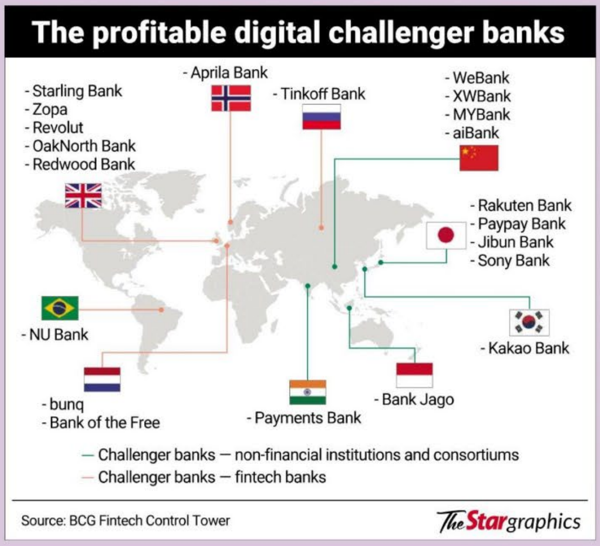

BEHIND the sleek interfaces and services within digital banks is the significant startup cost.

From establishing robust technology infrastructures to ensuring seamless operations, the initial investment in these challenger banks is undeniably substantial.

Acknowledging this, Bank Negara took a proactive approach, conducting four levels of assessment on 29 applications and narrowing it down to five consortiums, which were subsequently granted digital bank licences back in April 2022.

The evaluations conducted by the central bank did not only focus on applicant integrity and the viability of business and technology plans, but more importantly its financial resources.

When considering the timeline for reaching the break-even point of a digital bank, questions naturally arise about neobank's profitability prospects.

A joint report by Boston Consulting Group and QED Investors revealed that in 2022, only 20 out of 453 global digital challenger banks were profitable.

Notably, 11 of these profitable entities are situated in the Asia-Pacific region.

This success in Asia-Pacific was attributed to the historically underpenetrated market, where digital banks are expected to address access issues, thereby facilitating financial inclusion.

However, with conventional banks ramping up their digital offerings, it also begs the question – can digital banks secure customers, turn profitable and reach the break-even point, given the fierce competition from the incumbent banks?

An industry expert suggests that the capped asset size of digital banks over the next five years might be a barrier to their growth, and hence, it will take them quite a while to break even.

To note, Bank Negara has imposed a RM3bil asset threshold on digital banks for three to five years, referred to as the foundational phase.

Despite sharing the same perspective, KPMG Malaysia partner Kevin Foo emphasises that it is crucial to note that Bank Negara's primary goal isn't necessarily to foster direct competition between digital banks and established entities.

Instead, he, who is also the head of financial services in KPMG in Malaysia, says digital banks can thrive by strategically focusing on niche markets and addressing the distinctive needs within the underserved and unserved segments.

"For example, most customers who fall under the underserved and unserved segments would typically fall short of the conventional bank's credit criteria when financing is sought.

"Therefore, there will be a demand for 'bite-sized' products such as micro-savings or deposits, micro-financing and micro-insurance, which can effectively cater to the specific requirements of this demographic," he adds.

Similarly, the industry expert believes digital banks need to ensure that their product offerings are suitable and cater to the right niche.

"So essentially, there are two segments that digital banks should target, the lower segment of the population or unbanked population and smaller small and medium enterprises (SMEs) where I think is the underserved market," he tells *StarBizWeek*.

"Frankly speaking, that segment (smaller SMEs) are larger and more profitable. I think digital banks should target more retail SME clients rather than individual customers per se," he notes.

He opines that instead of focusing on lending, where the risks are higher, digital banks should focus on fee-based income, offering all kinds of financial products and services.

He exemplifies that digital banks can collaborate with other financial technology (fintech) companies to provide SMEs with a range of services including accounting, payroll and employee management services.

Meanwhile, RHB Research analyst Nabil Thoo Min Ren believes that due to Bank Negara's mandate for digital banks to reach the unbanked and underbanked segments, who often lack the credit history that meets the requirements of incumbent banks, competition on loans should be manageable.

The analyst, who focuses on the financial services industry, however, foresees a rise in demand for consumption-based loans, driven by digital banks' unique capabilities.

Firstly, he says digital banks are well-positioned to offer accessible and affordable financing tailored to the needs of underbanked segments.

Moreover, he emphasises that digital banks play a crucial role in enhancing financial literacy, empowering individuals to make informed decisions.

"By gradually enhancing the financial literacy and economic well-being of these individuals, digital banks contribute significantly to the increased demand for consumption-based loans as more people become informed and empowered to make sound financial decisions," Nabil notes.

Although the analyst did not explicitly state whether consumption-based loans are good or bad, he acknowledges that if not managed responsibly, these loans can lead to over indebtedness.

Nabil, on the other hand, says that at this stage, he is not overly concerned about consumption-based loans, as digital banks will be operating under a strict asset limit.

"We think it is also important to note that the digital banks will also be focusing on lending to micro-SMEs that are currently underserved by incumbent banks, and not just households.

"In any case, even if the entire asset base comprises household loans, the total RM15bil (RM3bil per bank) forms only 1% of total household loans in the banking system, which is not that substantial," he notes.

Shifting the focus, Nabil anticipates that competition will be more intense on deposits, given that a significant portion of the population already holds deposit accounts with the incumbent banks.

"We could see the digital banks offer higher rates to attract depositors, for example, GX Bank Bhd (GXBank) currently offers 3% per annum on savings accounts deposits, credited daily.

"With that said, most of the digital banks, through their consortium partners, already have access to wide ecosystems of customers that they can tap into to obtain deposits," he says.

GXBank, the Grab-led digital bank that commenced operations on Sept 1, 2023, is one of the five consortiums that obtained the licence.

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When asked how long it will take for a digital bank to break even, the industry expert says it essentially depends on the costs and how fast they launch and how well they perform.

"Going by global standards, it typically takes at least three years or more to break even," he says.

He believes that when the focus is on unbanked and underserved populations, it probably works better for countries like Indonesia, where a large portion of the population still does not have access to banking.

"Locally, however, most people already do have access to banking, hence it is more challenging for the digital banks here," he adds.

Nabil thinks the speed to profitability would depend on how quickly the digital banks are able to, for example, obtain a captive customer base – for both loans and deposits – build scale and achieve a reasonable sustainable interest margin.

"Technological expertise for the development of customer centric products, data analytics and credit assessment could also be a key driver," he highlights.

Given the high capital requirements for digital banks, will they seek to then sell stakes in consortiums to raise funds?

"I can't rule it out. At the end of the day, they need to team up with partners with a strong financial ecosystem, but the ones that already have licences are people with strong presence in the consumer market," the industry expert says.

Foo, however, believes the likelihood of engaging in share selling without adhering to the same stringent regulatory process is minimal.

Nabil, who is not sure about selling shares to recoup capital, believes sooner or later the digital banks will need fresh capital injected to sustain operations.

"This could entail the onboarding of new strategic shareholders, which could in turn dilute the stake in the digital bank of the original consortium members.

"Another avenue that the digital banks could explore to regain some capital is through the listing of the digital bank, but we also haven't heard much on this either.

"For now, we think the focus for the digital banks would be to reach profitability first," he concludes.

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