The Economist INTELLIGENCE UNIT

# A WHOLE NEW WORLD:

## How technology is driving the evolution of intelligent banking in Latin America

**The race to cash in on financial inclusion sees fintech firms flourish. Traditional banks face a dual imperative of cutting costs and investing in new technology to keep up.**

Banking in Latin America (LatAm) is too often the preserve of those who can afford it or are willing to trust it. Historical hyperinflation, economic volatility and poor credit infrastructure means banks often overprice risk. To compensate, charges and interest rates can be high, pushing millions of potential clients out of the market.

Indeed, according to World Bank figures, two in every five Latin American workers have no bank or savings account.[1] Of the unbanked in Brazil, Colombia and Peru, nearly 60% say excessive cost is the reason why they have no accounts.

As mobile money operators have had far less impact than in underbanked areas of Africa, few Latin Americans have their wages paid electronically and many have to pay in cash for goods they buy online.

### Cost and competition

This untapped market has attracted entrepreneurs and venture capitalists hoping to make a strong return on financial inclusion, helping customers manage their money better through low-cost, mobile financial products.

Respondents from LatAm to The Economist Intelligence Unit's global retail banking survey have their concerns about this new source of competition. With e-commerce growing fast, partnerships between the tech giants and fintechs rank second (cited by 31% for the 2020 time horizon) to payment players (44% for 2020) as the biggest, immediate non-traditional competitive threat to their business.

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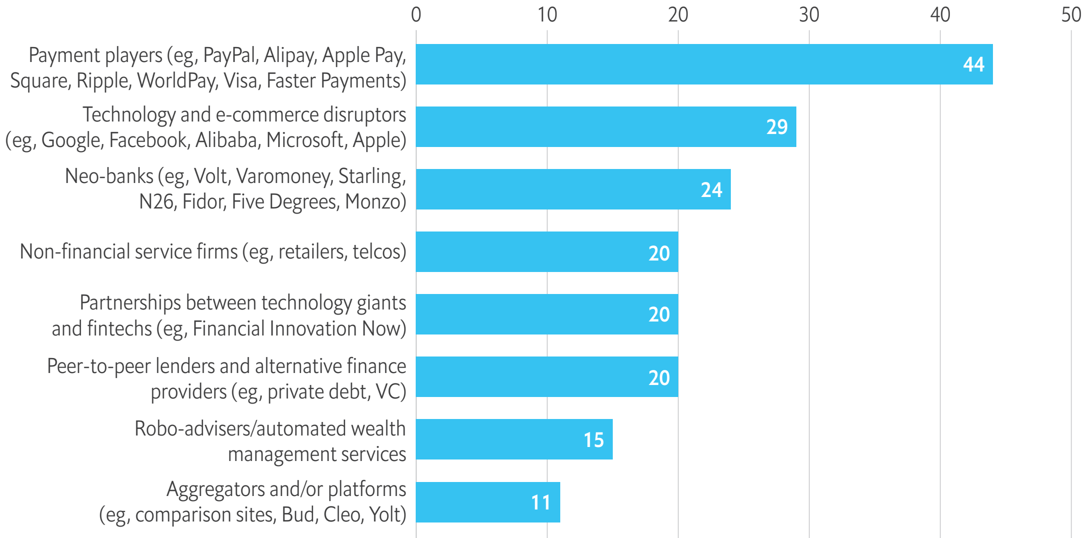
[1] The Global Findex Database 2017, World Bank
https://globalfindex.worldbank.org/

TEMENOS THE BANKING SOFTWARE COMPANY

**Chart 1: Which non-traditional entrants to the retail banking industry will be your company's biggest competitors by 2020?** Select up to two
(% of respondents)




Source: The Economist Intelligence Unit.

It is not just transactional businesses such as payment processing that are feeling the heat. Other product lines are also under competitive pressure. According to the survey, 30% of LatAm respondents expect new entrants to gain market share in retail lending and leasing, higher than the global average (22%). Nearly seven in ten (68%) also expect peer-to-peer lending to be available on banking platforms by 2025.

According to trade association LAVCA, the fintech sector attracted 25% of the US$2bn of venture capital invested in LatAm last year.

"An inclusive economy, empowerment and wide digitisation have made the market propitious to any new digital financial initiative, making it a great business opportunity, especially for the new 100% digital banks," says Jeferson Garcia Honorato, director of Next, the app-based bank from Bradesco, one of Brazil's largest incumbents. "The emergence of digital banking in recent years is directly linked to a cycle of opportunities and demands generated by the hyper-connected audience."

The market is substantial: Mr Garcia Honorato says there are 60m potential digital banking customers aged between 18 and 35 in Brazil alone.

## A new model

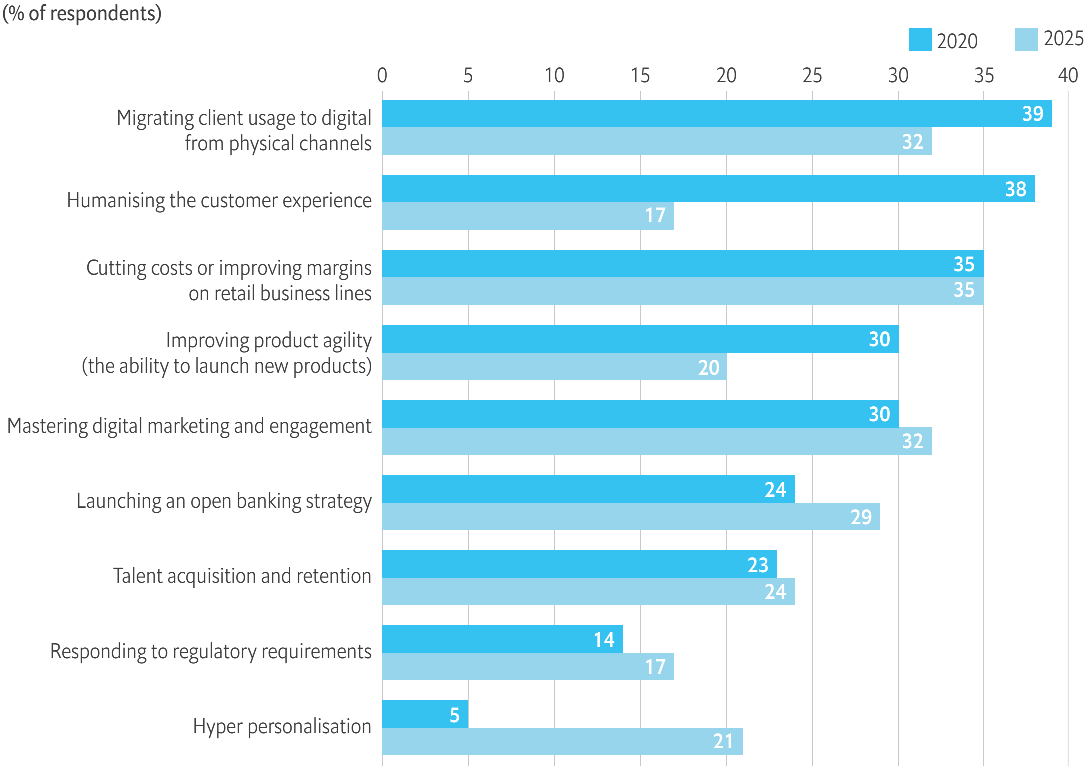
Politicians and regulators are taking action to make the banking system more competitive, and tackle the high cost of credit and transaction charges. The Brazilian central bank Banco Central do Brasil, for example, has introduced legislation on card fees in 2018[2].

The Conselho Administrativo de Defesa Econômica, the country's competition authority, is also clamping down on poor practices that stifle the ability of competitors to offer new services at lower prices.

Challengers, such as Mexican neo-bank albo, think traditional banks may struggle to adapt to models with no or very low charges for retail transactions.

"Fifty percent of bank revenues come from fees, so this is huge," says Ángel Sahagún, albo's founder. He also believes that banks will find it hard to price new competitors out of the market and remain profitable in the long term.

**Chart 2: What are your top strategic priorities by 2020 and 2025?** Select up to three
(% of respondents)




Source: The Economist Intelligence Unit.

[2] https://www.reuters.com/article/us-brazil-cenbank-regulation/brazil-caps-debit-card-fees-may-limit-them-further-idUSKBN1H22XL

“The innovation is not only the front, the app and user interface. At albo, we have a completely different cost structure, with no branches and without thousands of staff. The banks also have a different mindset and approach to innovation and risk,” he says.

As competition and regulatory initiatives erode their margins, banks are focusing their efforts on stripping out unnecessary costs (cited as a priority by 35% for both 2020 and 2025). Other immediate concerns include migrating existing clients to digital channels (39%) and humanising the customer experience (38%). Priorities for the medium term are mastering digital marketing and engagement (32%) and launching an open banking strategy (29%). (See chart 2.)

As a result, banks are having to invest significantly in new technologies (cited by 40% for 2020 and 42% for 2025), an action that outranks changing customer behaviour (36% for 2020, 29% for 2025) as the trend with the biggest impact on retail banks currently and over the next five years.

### Why even digital challengers cannot ignore cash

Customer numbers are rising 30% each month at Mexican challenger bank albo, which offers a free bank account and Mastercard as well as fee-free transactions. “We are focused on a very specific niche: under-banked people with a bank account but limited access to other financial products,” says founder and CEO Ángel Sahagún.

Of albo’s 100,000 active users, one-fifth had no previous bank account before signing up, he says. The typical albo customer is aged between 20 and 40 years old, with a stable income, but a limited credit history. Budgeting tools are an important app feature, and a first step to building a nest egg for the future for those who currently live from one pay cheque to another.

In the meantime, Mr Sahagún must also account for Mexico’s dependence on cash. “Right now, you have to provide cash-in/cash-out because it is impossible to live in Mexico without cash,” he admits, adding that albo users can add funds to their card at over 17,000 OXXO convenience stores across the country.

The payment landscape is changing fast, however. Merchants in smaller towns and cities are beginning to realise the security benefits of lower cost point of sale solutions from the likes of Clip and Sr. Pago. Until the country reaches a payments tipping point, challenger banks will still have to build cumbersome ATM access and cash-in facilities into their expansion plans.

## Digital synergies

Bradesco has sought to develop synergies between its existing operations and Next, its standalone digital app.

"The starting point was to create a new way of designing solutions, changing the mindset, that was focused on products, to journeys," says Mr Garcia Honorato. "We created new agile work methods, new operational processes, DevSecOps [merging software development, security and operations] and new technology solutions to support the rising of a new concept of financial experience."

Before the Next project was launched (see box), Bradesco adapted its own processes for open banking. Four hundred new application programming interfaces would allow its platforms to support proprietary and third-party products, even before open banking regulation was introduced.

The bank also developed its artificial intelligence (AI) capabilities, Bradesco Inteligência Artificial, used for customer service interactions via banking apps, WhatsApp and Google Assistant.

### Bradesco: The banking giant fights back

New competition in Brazil has forced traditional banking incumbents to think differently.

Just two years old, Bradesco's Next app seems to have found its place in the new digital banking market, facing off a giant fintech, Nubank. There is even talk that Next, with 1.2m active accounts, may eventually spin off from its 76-year old parent.[4]

Next is firmly targeted at the younger generation. Eighty-five percent of its customers are aged 18 to 35. They have been attracted by a sleek app, no or low charges, free transactions and special offers on purchases.

Importantly, Next has succeeded without cannibalising the main brand: 78% of its customers did not have Bradesco accounts before signing up, and primary usage is on the rise.

"Approximately 40% of clients use Next as their main bank and 10% use [it] as their salary account. These numbers are increasing monthly," says Jeferson Garcia Honorato, director of Next.

Over 50 versions of the Next app have been released since its soft launch, tweaking services such as personal financial management and savings goals.

Monetising the business may be difficult, however. Next offers various fee-charging accounts, but most customers have opted for the "Na Faixa" free version, which offers them a free international credit card, cash withdrawals and payments. Next even pays their mobile data fees for in-app transactions and offers discounts from 300 partner brands, worth up to R$4,000 (around US$1,000) per year.

Once young customers get used to free banking, it may be difficult for Next to upsell them with a platinum credit card costing R$50 per month.

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[3] http://www.dof.gob.mx/nota_detalle.php?codigo=5515623&fecha=09/03/2018
[4] Next, do Bradesco, vai ganhar vida própria, Valor Econômico, 16 April 2019 https://www.valor.com.br/financas/6214735/next-do-bradesco-vai-ganhar-vida-propria

## Getting stakeholders on board

To make the banking system more inclusive and competitive, collaboration may be required. New regulations such as Mexico's Ley Fintech aim to open up the market[3], but this can be achieved only if individuals and small businesses have the means to access it.

The Mexican central bank Banco de México is piloting CoDi (short for Cobro Digital), a digital payment system designed to encourage shoppers and small businesses to make free digital payments from their accounts via QR codes. This allows them to circumvent the high cost of cards and merchant payment charges.

Nevertheless, for CoDi and other digital payment services to work efficiently, the banks and fintech firms will first need to get customers and small businesses on board.

They will need to educate new client bases that are unfamiliar with accounts and the concept of credit, as well as their own staff. Indeed, when it comes to open banking, respondents are most concerned about low levels of customer awareness (42%) and staff education on data security (32%). Banks may also need to change perceptions. By region, LatAm bankers are the most concerned about cloud computing security issues (47% compared with 39% globally). More than half of local respondents (53%) believe customers view AI as a security threat to their personal financial information.

## Experimental apps

HSBC has decided against setting up local greenfield mobile banks to compete with the challengers. As Juan Carlos Espinosa Ortega, the bank's head of digital banking and innovation in Mexico, explains, he wants to offer the full experience to every HSBC customer with its banking app.

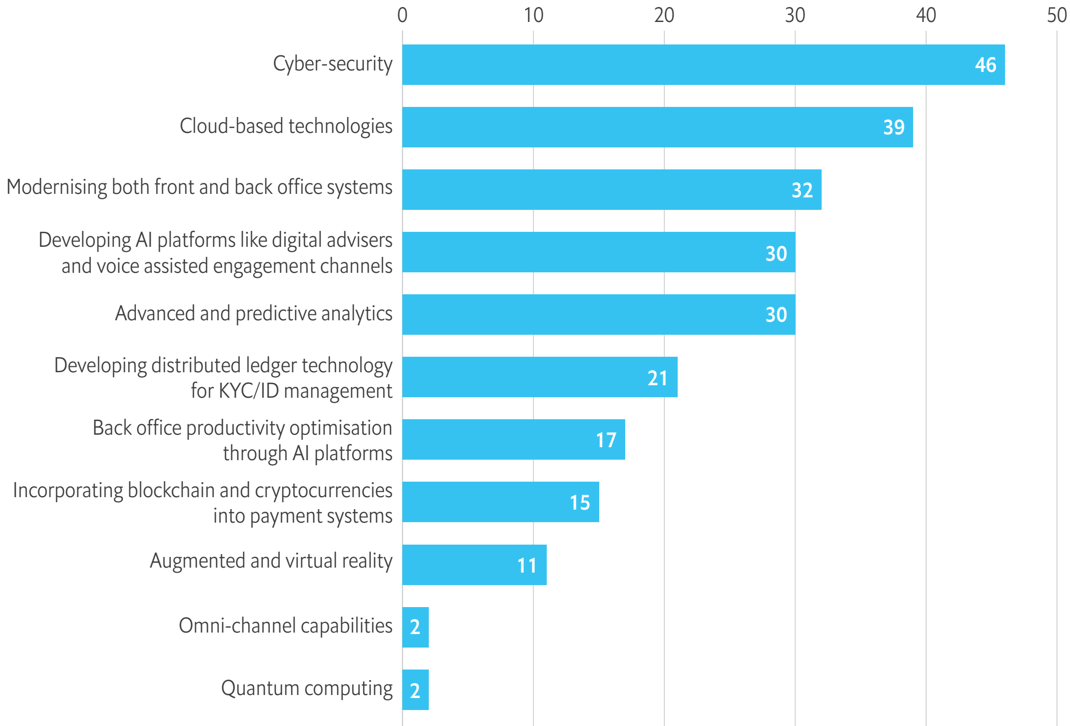
"The cost of managing, launching and maintaining separate brands has trade-offs," he says.

But the bank is experimenting with separate apps to engage with different customers. If features of those apps prove popular and useful, they may find a way back into the main banking app.

"In Mexico, many customers have credit cards but not full bank accounts with us," explains Mr Espinosa Ortega. "So we launched a card app where customers can control their debit and credit cards."

This app, named Control Total, was developed in collaboration with OnDot, a large fintech firm that works with other card issuers and processors around the world to give cardholders more functionality. HSBC is also piloting QR payments with Dapp, a local start-up wallet provider, and experimenting with credit scoring applicants' email data with a US start-up.

**Chart 3: Where is your company focussing its digital investment?** Select up to three
(% of respondents)




Source: The Economist Intelligence Unit.

As the region's banks focus their digital investment on cyber-security (46%), cloud-based technologies (39%), and modernising front and back office systems (32%), millions more Latin Americans may finally be drawn to abandon physical money for digital accounts, payment apps and intelligent, data-led services.