The challenge facing the challengers
Challenger banks (non-bank owned fintechs providing banking products with or without a banking license) have been a growth story in banking in the last decade. Today there are ~450 challenger banks globally worth $300B in 2022 compared to 100 in 2017 worth 161B.

Globally, the UK with high-profile successes like Starling, Monzo, Revolut, Tandem and Tide, and the US with challengers like Chime, Dave, Acorns and Varo, have seen the highest proportion of challenger banks coming to market: the former because of a permissive regulatory regime open to fintech innovation and indeed liberal with issuing banking licenses and the latter for opposite reasons – a banking license is extremely difficult, expensive and time-consuming to obtain leading to largely non-licensed challengers forming partnerships with licensed banks in order to operate. Varo and Greendot are exceptions. Asia has seen the rise of the platform giants and their challenger offshoots such as Grab, WeBank, Tencent and PayTM whilst markets like Brazil (Nubank, C6), Australia (Judo) and South Africa (TymeBank) have also seen reasonable challenger activity.

Typically, challenger banks have doubled their customer base every 18 months. The platform giant or telco owned challenger banks like WeBank, Kakaobank, Rakuten and PayTM have grown the fastest with customers in excess of 10M. But some independent challengers like Brazil’s Nubank (75M), UK’s Revolut (25M) and US’s Chime (13M) have also seen stellar growth. Others such as Europe’s N26 (7M across 24 markets), UK’s Monzo (7.5M) and South Africa’s Tyme bank (5M) are sizeable entities as well.

1. Note: includes now failed challenger banks
Sources: Capital IQ, Pitchbook, Company’s investor presentations, BCG analysis, Statista, Exton Consulting, The Financial Brand, Neobank Tracker
The challenger value proposition: all about the customer

The challengers entering banking in the past few years share certain characteristics – they are all consumer-oriented technology-driven companies that are leveraging disruptive technologies to develop compelling propositions for their customers. They have modern technology stacks built on cloud-native, microservices and API architectures that offer full plug and play capabilities to integrate with eco-system partners and allow them to deploy next generation analytics and AI across the enterprise, all the way from customer experience to fraud to operations.

Modern Technology Stack

Innovative Uses of Open Data

Analytics & AI

These critical capabilities have allowed challengers a competitive advantage over incumbents with regards to the high quality service-focused customer experience they are able to offer and the opportunity to innovate and grow with the lowest cost of operations and infrastructure. 100% digital operating models across onboarding, origination and servicing as well as zero legacy debt allows challengers to have 50-75% lower operational costs, whilst offering rapid and hyperpersonalized product innovations to open up sizeable target addressable market segments like SMEs or freelancers or low-income individuals, that have been historically underserved by the incumbent banks.

Challengers have been able to ease the points of friction that customers have with incumbents as well as fulfil changing customer expectations that incumbents struggle with. Retail customers expect a banking experience similar to what they get in other aspects of their lives such as Uber or Amazon: they are demanding more convenience, greater relevance and higher responsiveness from their banks while at the same time becoming more values-driven around environmental and social issues. They are less loyal and happy to shop around for a better quality of user experience, better value for money and closer alignment to their values and belief systems. Today’s corporate users too are millennials who want the same experience from their corporate banking relationships as they get in their daily lives. SMEs expect an experience at par with retail and products at par with corporate. Finally, wealth customers want digitally augmented high touch experiences combined with new and complex products.
One important consideration for challenger banks to help them compete and create their unique value proposition is specialization around a niche—an underserved or highly specialized customer segment or a geography or around a specific painpoint. Globally, there is a huge potential for financial inclusion in the retail and SME segments. According to the World Bank, 27% of adults do not have a bank account, another 50% are underbanked and 67% of regulators have a mandate for inclusion. SMEs are universally acknowledged as underserved as they seem to have fallen through the cracks between retail and corporate. Incumbent banks did not consider this segment attractive or profitable enough – credit risk and cost of servicing were deemed to be too high.

Challengers have seized upon these gaps in the market to focus their offerings. SME focused challengers like Tide, Stash or Grasshopper are improving access to funds, providing accounting, tax and payroll support to SMEs. They are also targeting microsegments within SMEs such as sole traders and freelancers (Coconut in the UK), or industry verticals like Founders Bank in the EU that targets emerging tech companies, Toast in the US focused on restaurants or Oxbury in UK on farmers. Niche retail segments based on shared lifestyle or shared beliefs include students (Sofi in the US), immigrants (Monese in UK), climate activists (Tandem in the UK) or LGBT communities (Pride in Brazil). Within retail, there are also industry focused segments such as doctors (BankMD in US).

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The ambition

From rapidly launching and growing their customer base around their unique value propositions usually starting with a single product, challengers aspire to recoup the heavy initial costs of customer acquisition, mostly branding and marketing.

The obvious way to monetise the customer base is through product expansion beyond the initial product. In the US, revenue came mainly from transaction fees and debit interchange fees where challengers had a regulatory advantage due to the Durbin amendment. In the UK, Starling launched with a current account whilst Revolut and Monzo started with prepaid cards to gain their customer base. Generating cross-sell revenue and adding ancillary products such as wealth, trading, BNPL or crypto wallets, and where they have acquired a banking license, entering regulated products is the logical next step. Some start charging subscription fees. Scaling the business either through embedded finance or Banking-as-a-service (BaaS) models or to create super apps with other ecosystem providers in Banking-as-a-Platform (BaaP) models, or to enter lending, in order to generate healthy NIMs are all various growth strategies.
Profitability – the holy grail

Despite low operational costs, the average cost income ratio of challengers is 130% compared to 62% for incumbents. Profitable challengers are generally platform or telco owned, mostly in Asia. There are few exceptions in the rest of the world - independent profitable challengers include Greendot in the US, Nubank in Brazil, Bunq and Tinkoff in Europe and a good handful in the UK (Starling, Revolut, OakNorth, Redwood and Zopa). Interestingly, all of these acquired a banking license on their growth trajectory.

However, the reality is that only 5% of the 450 challenger banks in the world have become profitable.
Profitability – why not?

1. **Banking license**: Obtaining a banking license is so expensive and time-consuming to obtain that only a handful of challengers have been able to. This is because otherwise, they have to rely on expensive wholesale debt or private funding in order to diversify and grow. A license provides the deposits to originate loans and hence raise NIM. In the US, where challengers are reliant on BaaS partnerships and where 70% of their revenues come from debit interchange fees due to the Durbin exception, a license allows for revenue diversification beyond the debit interchange fee model.

2. **Customer base**: By their very nature, the customers that challengers have spent so much money to acquire are also less credit worthy and less profitable. They tend to be either underserved or unserved segments and hence financially struggling or younger demographics who are several decades away from the banking revenue peak. Typically, the average challenger bank age bracket is 20-30 years which is 40 years away from the revenue peak of 60-70 years. Also, despite rapid growth, most independent challengers still remain sub-scale when compared to incumbents or the platform giants in an industry with significant margin pressures.

3. **Primary relationship**: Only a handful of challenger banks’ customers are true transacting customers where their primary relationship is with the challenger. 70% of accounts with challenger banks are not used on a monthly basis. Only 23% of 7.8M customers at the US challenger bank, Dave are active. These customers with low activity and low blended balances (only 5-7% those of incumbents) are difficult to cross-sell additional products to (lending, wealth, credit cards). Acquiring customers without a rise in transactional volumes is hurting these banks.

4. **Incumbent advantage**: Through the rise of the challengers, incumbents have continued to hold the primary relationship with clients and have been able to meet the holistic needs of their customers across a broad product portfolio, dominating profitable products such as lending where challengers typically struggle – they lack the skills for risk-based data driven loan underwriting and servicing and pricing scenario stress tests, and typically have above average charge off rates compared to incumbents. Above all, regulation-native business models and culture have proved to be formidable strengths. Challengers continue to lag incumbents in risk and compliance, KYC and onboarding. A review by the UK’s Financial Conduct Authority has found that challenger banks need to improve how they assess financial crime risk, with some failing to adequately check their customers’ income and occupation. In some instances, challenger banks did not have financial crime risk assessments in place for their customers. Last year, it was revealed that Monzo is being investigated by the FCA for possible AML breaches, and the German financial regulator BaFin slapped N26 with a €4.25m fine for delayed reports of suspicious activity in 2019 and 2020.

Temenos
The turning tide

The climate has changed for fintechs and challengers this year. They are entering unchartered territory in a rising interest rate and recessionary environment with tightening funding and incumbent fightback. Their competitive edge around niche propositions, superior customer experience and rapid growth is being eroded by a number of factors.

1. **Funding**: Challenger banks are no longer able to comfortably attract funding on the basis of their large target addressable markets alone. Funding has declined by nearly 80% since the 2021 peak levels across all categories with banking and lending more impacted than say wealth tech or payments. This was true across the world except Africa. As a consequence, since April 2022 fintech valuations dropped across all segments and geographies by an average of 60% although revenue has continued to grow. Investor scrutiny has shifted from growth and customer acquisition to the underlying drivers of profitability and cashflow like margins, customer retention, customer credit quality, share of wallet and operational costs.

2. **Incumbent fightback**: With their diversified product portfolios, sizeable lending business lines and large IT budgets, incumbents are better able to withstand the adverse macroeconomic environment. They have been rapidly closing the gap on digital and technology with compelling digital propositions on a wider range of products post-Covid. They are moving to public cloud and have IT budgets that dwarf the VC funding available for neobanks (up to 11X in 2022), and are also using M&A to close gaps in digital functionality. Bank of America is spending billions on core modernization and digitization and already reaping the benefits - 82% of their wealth management clients are digitally active. JPMC, Capital One and PNC are all investing in cloud native technology. Many are also starting to focus on many of the challengers' niche segments such as Citi’s focus on SME, Natwest's acquisition of Rooster Money to focus on financial education for children or PNC Bank's acquisition of POS firm Linga to target restaurants. Many continue to invest in their digital subsidiaries to directly compete with neobanks such as Standard Chartered’s Mox in Hongkong, Natwest’s Mettle and JPMC’s Chase in the UK.
3. **Competition**: Apart from incumbents, competition is intensifying for challengers across the board. The target segments are getting saturated with the number of challengers entering the market. Those aspiring to become superapps lack the scale or ubiquity to attract customers in the face of payment, e-commerce and technology platform giants. In the ancillary product areas, they face competition from specialized vertical fintechs such as Robinhood in wealth, Klarna and Affirm in BNPL or Coinbase in crypto-wallets. In the US, they face competition from digital wallets, embedded finance and other forms of account to account payments.

4. **Regulatory headwinds**: The regulatory arbitrage that challengers successfully capitalized on in many jurisdictions is also closing. In the US, for instance, products like wallets are coming under regulatory scrutiny with deposit insurance and regulatory capital required. Reg Z or Truth in Lending and Reg W which regulates non-bank transactions between depository institutes and affiliates are all creating a level playing field between regulated and unregulated entities. Also, the lucrative interchange fee model is under threat. In any event, challengers forego the advantage once they scale and increase their accounts and assets beyond the $10M Durbin limit.
1. **Shut Down.** Of ~630 launches since 2010, ~180 challenger banks have ceased operations due to lack of sustainable revenues and hence failure to attract funding, or due to compliance issues. In 2020, Moven, one of the world’s first digital challengers set up in 2011, closed its banking operations to refocus its efforts on becoming a digital banking and financial technology provider to banks and fintechs. Other examples of banks running out of cash include Dozens (UK), Xinja (Australia), Volt (Australia) and Glorifi (US). The challengers, Beam and Ahead in the US, had to close down due to regulatory non-compliance.

2. **Merge.** Consolidation is not off the cards either. Successful growing challenger banks will acquire or merge with counterparts to grow internationally or to consolidate in saturated niche segments. UK’s well known but as yet unprofitable Monzo bank (7.4M customers) is looking to expand its footprint into Europe through acquisitions – it is considering acquiring the Nordic lender, Lunar (0.65M customers Denmark). Greenwood, the digital banking startup for Black and Latino people and business owners, has acquired fellow neobank Kinly, bringing the two largest fintechs focused on the Black community together.

3. **Get acquired.** There are fewer examples of incumbents buying out challengers for their modern technology and digital expertise or for entry into niche segments. After the early acquisition of Simple in the US by BBVA in 2014, there have been few cases. The Australian challenger, 86400 set up by the founder of Atom Bank in the UK, was bought by National Australia Bank in 2021 for its digital platform in order to strengthen and merge with its own digital subsidiary, UBank. Societe General bought out Shine to focus on the micro SME segment. Incumbents are tending to form technology partnerships and embarking on their own digital initiatives including setting up own-brand challenger subsidiaries rather than outright acquisition of a successful challenger.

4. **Grow.** Therefore, only those challenger banks that demonstrate the ability to maintain a strong and engaged user base and can scale, will ride out the current storm. A pre-requisite is to build digital trust and demonstrate transparency in data handling and privacy, managing cybersecurity and adhering to the highest regulatory standards. Securing a banking license helps in the journey to growth, making it easier to secure funding from the debt and private markets whilst those without a license could attract BaaS partnerships with license holding banks.

**What next?**

Challengers face an uncertain future. Some will run out of cash, some will get acquired by incumbents or even the more successful challengers, and then there are those that will succeed independently.
The technology enabling success

Having a technology platform that is designed for scalability from day one enables challengers to embark on and continue with their steep growth trajectory to success. Whilst a small minority have built their own proprietary platforms, most have chosen to form strategic partnerships with banking technology providers offering pay-as-you SaaS models to kickstart the business and scale with their business growth. This has allowed them to achieve the extremely fast times to market needed to achieve market traction, and to focus their efforts on the superior customer value proposition and compliance they need for success. Examples include Varo, the first challenger in the US to get a federal charter, PayPal which launched its BNPL product in 2020, Welab in Hongkong and Albaco in Europe.

The Temenos Open Platform for Composable Banking has the breadth and depth of functionality from product engines to financial crime, payments and origination, localised for different markets, that offers challengers the agility and time to market to rapidly launch and then scale their businesses. The platform offers scalable and adaptable APIs focused on building best-in-class digital experiences. Low-code extensibility and developer portals with advanced API documentation and ease of use as well as pre-integration to an eco-system of third-party technology providers offer the ability to hyperpersonalize products. Challengers can select the products they need for their business model from the modular platform which elastically scales to their growth. A payments platform giant launched their “Buy Now Pay later” embedded lending product on the Temenos platform, reaching 200M loans across multiple countries in just over 3 years. The moment economy in the world of embedded finance is all about being available 24x7 and successful challengers require best-in-class security and resilience with near zero risk of outages. With continuous updates or evergreening, they can consume new features as they become available to develop their customer-centric specific propositions at their own pace and desired frequency.
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Kanika has nearly 30 years experience in banking technology and operations and has held senior roles within SAP, McKinsey and General Electric. Kanika holds an MBA from the Indian Institute of Management, Bangalore.
About Temenos

Temenos (SIX: TEMN) is the world’s leading open platform for composable banking, creating opportunities for over 1.2 billion people around the world every day. We serve two-thirds of the world’s top 1,000 banks and 70+ challenger banks in 150+ countries by helping them build new banking services and state-of-the-art customer experiences. The Temenos open platform helps our top-performing clients achieve return on equity three times the industry average and cost-to-income ratios half the industry average.

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