

A framework to guide fintech partner opportunities

By Shahin Khalessi



Highly targeted technology companies are scrambling the evolutionary order in financial services much like the asteroid that smashed into the Yucatan Peninsula 65 million years ago. The impact of digital technology is creating a new climate in financial services favorable to those who can rapidly sense the direction of the market and adapt to new trends. And those who can't are consigned to suffer a fate similar to that of the dinosaurs.

The emergence of fintechs is a predictable result of a dynamic market that is evolving rapidly and rewards agility. The fast-moving, unencumbered startups offer institutions the kind of innovation they find hard to spark internally. Fintechs offer smart solutions that can help banks operate more efficiently and at a lower cost, and they serve markets in radically new ways that sometimes turn the idea of banking on its head.

In this period of rapid reinvention, new startups appear weekly — if not sometimes daily — addressing everything from blockchain and platforms to apps and APIs. Some fintechs appear poised to take market share from existing firms with disruptive new offerings, while other startups are more interested in supplying enabling solutions to existing banks. Others don't care. They'll take business wherever they can find it.

It's this kind of environment that makes working with fintechs both an opportunity and a risk. If a bank makes a major investment, will that new startup survive to see the launch of a finished product? Or will its technology fizzle out, leaving the institution with nothing to show for its time and money? Will a newer player with better options show up in the market tomorrow?

Moreover, is the institution ready to make risky, large investments in technology? Financial institutions have always leaned forward into new technologies, but after decades of piling on new layers of equipment and code, many find themselves enmeshed in legacy solutions that cannot be easily unwound without massive expense and operational risk. Today's rapidly escalating regulatory environment has further complicated matters by requiring institutions to spend time and money to adapt systems to meet new compliance and reporting requirements.

Large firms also seem to have difficulty developing a unifying vision in the digital era. Many feel they have their hands full just keeping existing systems running and complying with regulations. But the geological record and what happened after the asteroid crashed remind us that adaptation is essential to survival. The ability to successfully partner with fintechs represents an evolutionary path forward for financial institutions. The framework described in this paper — based on an in-depth study of 70 fintechs — can help you make the right choices.

Understanding the nature of disruption

Three main factors set the context for mutations that are occurring in the capital markets industry: cost reduction; new sources of revenue; and digitization, optimization and automation. Determining what mixture of these forces is at work in an institution is a key element in establishing a vision and determining where fintechs may be able to help the company advance its strategy.

- **Cost reduction.** Capital markets institutions have long relied on technology to take out costs, but this strategy is reaching its limits. Some clear areas remain where expense reduction can be a priority, such as lowering data management expenses and mitigating the cost of regulatory compliance. But overall, the impact of successive waves of technology investment has begun making cost reductions harder to achieve. Costs are escalating as legacy systems consume a larger share of the IT budget to maintain and become even costlier to extend and enhance. This further reduces an institution's ability to adapt to change.
- **New sources of revenue.** New competitors from within the industry (and soon, from the outside) are forcing companies to seek new sources of revenue. The foreign exchange (FX) transaction market, for instance, was historically the exclusive prerogative of big financial institutions able to apply hefty margins on noninstitutional clients. Today new entrants, such as Revolut and Kantox, offer services ranging from cheaper FX transactions to international transfers. This puts banks in the unenviable position of spending more money to chase markets where margins are growing thinner. As a result, institutions need to seek new revenue sources based on innovative offerings.
- **Digitization, optimization and automation.** As clients demand more flexibility and access to services through mobile devices and other channels, major banks and asset managers are considering the innovation path of digitization, optimization and automation. Various players in the capital markets industry are already investing in artificial intelligence (AI) and machine learning for pre-trade and execution activities, as well as in robotic process automation (RPA) and distributed ledger technology (DLT) — the technology supporting blockchain — for post-trade activities. This trend toward innovation, however, is not widespread across the industry or necessarily implemented at a groupwide level.

An objective model for evaluating fintechs

Partnering with fintechs offers capital markets institutions an opportunity to break the business-as-usual cycle and jump-start innovation. But where to begin? In a market brimming with new ideas and startups, developing a vision and trying to identify the right fintech partners can be paralyzing.

To help make matters clearer, DXC Technology conducted a systematic study of the fintech space using an innovative, in-depth analysis that can help institutions untangle the world of fintechs and choose the right group of companies to partner with. DXC's initial review focused on startups in the United States, United Kingdom and continental Europe. Any relationships with DXC (or an absence thereof) had no bearing on selection or evaluation. Companies selected met three simple criteria: They offered innovative solutions, focused on capital markets and were less than 10 years old.

The study does not cover the entire scope of capital markets. For instance, it omits listed securities trading, which is already mature in terms of revenue generation, cost efficiency and digitization. However, since fintech startups are highly dependent on funding from market participants, they can be considered indicators of the direction the entire capital markets industry is headed.

What the study reveals

Our bottom-up analysis of 70 fintechs helped us construct a functional landscape of the capital markets of tomorrow and in the process revealed two primary building blocks — data analytics (what we’ve called “datalytics” in the study) and platform. This same type of segmentation can be seen in the tech and retail industries, where large players such as Google and Amazon use both datalytics and platforms to drive their businesses. In the financial services sector, even conventional industries — banking and insurance — are starting to shift toward new operating models in which they turn insights into action by exploiting their large amounts of data on new powerful and flexible platforms.

Based on the startups’ innovative activities, we grouped all 70 startups into 11 essential functional categories, which fall into four large families, split between the two main macro groups. For definition, each startup was assigned to only one functional category that corresponds to its main business solution. If a fintech works across a spectrum of solutions, it would be classified separately in a 12th functional category we named end-to-end (E2E). In such cases, the functional category, family and macro group are the same.

The outcome of this bottom-up approach resulted in the functional landscape shown in **Figure 1**. In this, we have randomly selected 13 of the 70 fintechs and are representing their position in the functional landscape.

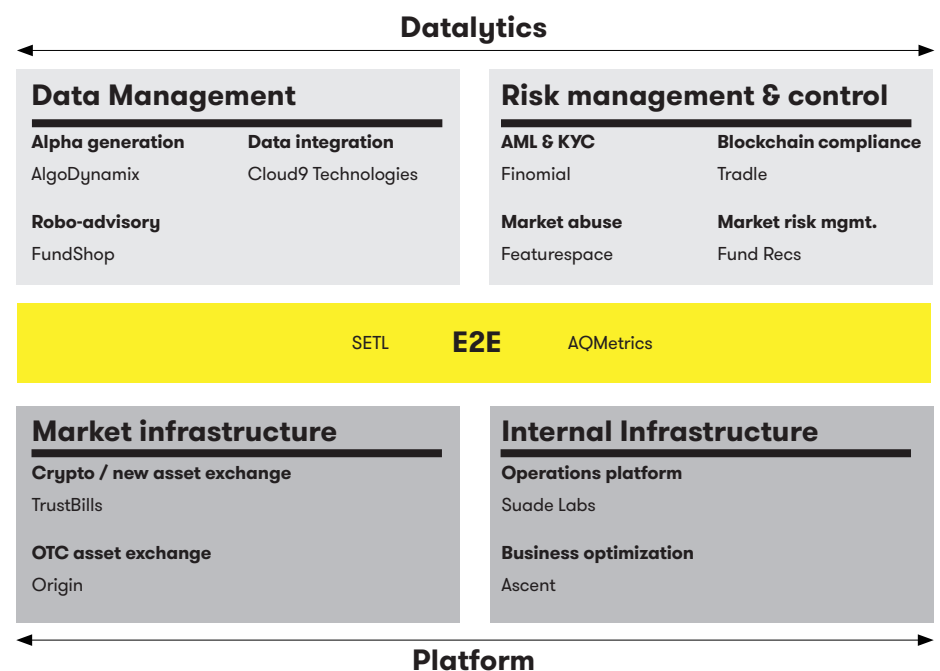


Figure 1. Functional landscape of the capital markets of tomorrow

Identifying a fintech's DNA

The bottom-up approach gave us a functional view as to what characterizes fintechs. By delving deeper into the analysis of the 70 selected startups, seven variables emerged that consistently defined the DNA of each startup: partnerships, customers, workforce, innovation, scope of solution, ease of deployment and maturity.

All the chosen criteria are quantifiable through direct or indirect methodologies. The variables tend to coalesce around two categories crucially important in early-stage companies: the potential and the level of development. Customers, workforce, partnership and maturity are proxies for the startup's stage of development. Innovation, scope of solution and ease of deployment were chosen for their tendency to reflect a company's potential. For this study, we decided to omit more qualitative variables, such as board members, management profiles and team technical skills.

Providing a visual landscape of fintechs

There are numerous ways in which one can exploit and present complex data. For our study we decided to choose a visually impacting option by applying a principal component analysis (PCA) algorithm and a hierarchical clustering (HC) algorithm to the data, with the result visible in **Figure 2**.

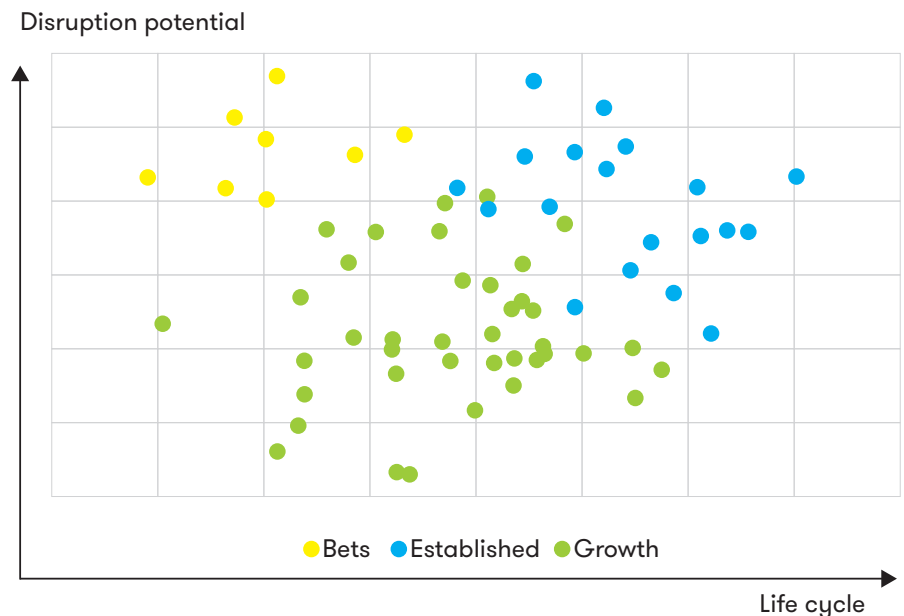


Figure 2. Relative strength fintech map

Each cluster of startups — determined as bets, established and growth clusters — has very specific characteristics as described in **Figure 3**. Financial institutions (as well as systems integrators and consulting companies) need to look at the features separately and/or comparatively to define which attributes best correspond to their business requirements.

Three clusters*

Bets (9)	Established (20)	Growth (41)
<ul style="list-style-type: none"> • High disruption potential • Architecture overhaul • Early stage maturity • Large scope of application 	<ul style="list-style-type: none"> • Strong potential • Plug and play • Mature solutions • Broad scope of application 	<ul style="list-style-type: none"> • Moderate disruption potential • Narrow scope of solutions • Varied life cycle stage

* Total number of fintechs studied: 70, numbers represent how many line up with those characteristics

Figure 3. Cluster attributes

The attractiveness of each cluster varies depending on an organization's time horizon, available resources, objectives and the nature of the desired relationship. Institutions that value fast time to market and quick return on investment may find the startups in the “established” cluster more interesting. Companies looking for fintechs with high disruptive potential may want to focus on fintechs in the “bets” cluster.

JPMorgan Chase launched a partnership in April 2016 with fintech OnDeck Capital that enabled the bank to offer online loans to small and midsize enterprises. This was a quick win for both companies, with low levels of risk associated. In the process, JPMorgan offered new services to clients and gained good insight into the startup operations, with low impact on its market share. In mid-2019, after 3 years of collaboration, JPMorgan Chase decided to **end the relationship** and go it alone, noting that the fintech helped it create and launch a new process that the bank could then continue on its own platform.

An example of another type of relationship is the **acquisition of Simple by BBVA**. In this case, BBVA helps Simple disrupt the digital banking space and maximize its potential with economies of scale while letting it develop (with a certain degree of independence) under its own brand.

How to move forward

Startups are in a strong position to help financial institutions attain their goals, whether through proofs of concept, partnerships, accelerator/incubator projects, investments and/or acquisitions. Determining exactly how to do that may require help. Can an institution find one fintech to work with, or will it require an ecosystem of companies to accomplish its vision? And is its vision the correct one to begin with?

DXC's innovative approach to analyzing capital markets views the startup ecosystem from multiple angles, so it can present a clear view of fintech startups' characteristics and DNA. Such an analysis helps capital markets institutions determine which

companies can best meet their needs without those institutions having to conduct excessive evaluations.

Our analysis of 70 innovative and specialized fintechs paints a clearer picture of the capital markets landscape lying ahead of us. The compelling outcome was the emergence of two macro groups at the heart of the industry: dataanalytics and platform. But the analysis can tell us more. Using the specific requirements of a client, our methodology can be adapted and tailored to study fintechs more broadly or focus more narrowly on a specific function.

New companies are bubbling up as technologies evolve and our understanding and use of them advances. Now, the framework exists for evaluating these exciting sources of innovation and improving the chances institutions small and large can successfully adapt and thrive in this hothouse climate of innovation and change. No institution needs to suffer the same fate as the dinosaurs, but it's a choice they'll have to make for themselves.

Learn more about how DXC can help you find and partner with the fintechs that will best serve your company.

About the author

Shahin Khalessi is a senior consultant for DXC Technology Banking and Capital Markets, working in Paris. Following a career as a derivatives trader in London and Paris covering European and U.S. markets, Shahin now provides expertise and support in financial services to DXC clients on their organizational and strategic transformation journey.

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