ALBRIGHT STONEBRIDGE GROUP

ASG Analysis: Covid-19 Spurs Global Growth in Digital Finance

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Key Trends and Takeaways

- The Covid-19 pandemic has broadened worldwide demand for digital financial services, as governments move aggressively to incorporate digital finance and payments reforms as part of economic recovery initiatives.

- Changes in consumer behavior and embrace of digital finance – including increased use of e-commerce and on-demand delivery services requiring cashless payments – suggests the pandemic marks a turning point for large-scale adoption of fintech services.

- Outside the U.S., European companies and governments occupy the cutting edge of global development of the fintech sector. In emerging markets, the pace of the sector's growth – and the variety and scale of products available – varies widely from region to region and among nations.

- The broader demand for digital financial services has accelerated efforts by governments to adopt regulations that can protect institutional and individual financial security, prevent cybercrime, and increase access to legitimate services across populations. Some governments are protecting traditional banking players while others are promoting new actors such as entrepreneurial hubs.

- The pandemic has slowed venture capital investment and opportunities for market consolidation in fintech and digital payments. Investors should seek out emerging players around the globe with incumbent potential, strong management, and scalable models for partnership.

- Digital finance providers interested in capturing new and growing opportunities should adopt market-specific approaches, identify alignment with regulatory and political change, and form strong strategic alliances with only the most credible partners.

Europe

The past decade has shaped Europe into a global leader in digital finance, with banks embracing the industry with open arms and the presence of firms like Revolut and Monzo in the U.K. and N26 in Germany creating an environment attractive to investors. Digital transactions are projected to reach USD $708.3 billion in 2020, driven primarily by the U.K., where more than half of all payments are now made by card or contactless methods. Across the 27-nation bloc, two-thirds of retailers accept some form of contactless payments.

The European Payment Services Directive (PSD2) – which regulates payment services providers throughout the EU – has helped create a stable regulatory environment, sparking the introduction of open banking and encouraging the use of open APIs that enable third-party access to data held by the traditional banking giants. This unbundling of payments from top-heavy banks has opened the market to firms seeking to innovate processes, including those using biometric verification for data protection and improving the ease of peer-to-peer payments and contactless payments via NFC on smartphones.

Impact of Covid-19

Contactless and cashless payments have increased 69 percent in Europe since January, driven by the Covid-19 pandemic and consumers' hyper-consciousness of shared-touch surfaces. An increase in online shopping and use of food delivery services that do not accept cash payments has also contributed to this rise. There is no reason to think this trend will disappear once the pandemic is controlled -- consumers are clearly embracing the efficiency and security of digital payments.

The Road Ahead

Germany's European Commission Presidency has announced that its priorities will include creating a digital financial markets union; connecting disparate European financial hubs to better facilitate cross-border transactions; and rolling out the EC's Digital Finance Strategy, which includes proposed regulatory frameworks for new fintech firms and crypto assets. The U.K. remains far and away the leader in this industry and is expected to remain so for the foreseeable future, although Brexit will certainly take its toll. Germany will reach more than USD $100 billion in transactions in 2020, while France, Spain, and Italy are poised to see extensive growth over the next four years, potentially reaching combined transactions of more than USD $560 billion by 2024.

The EU has emphasized the need for inclusion and increased access to public financial support for both businesses and private citizens through digital transfers and modern banking systems, especially during the pandemic. Brussels has also stressed the need to ensure equity for the digitally excluded, including the elderly and people who are homeless, who tend to be *de facto* excluded from digital finance products due to lack of digital access or health issues.

As the industry continues to grow in Europe, we expect investors to be increasingly bullish. The European Commission's agenda and reaction to Covid-19 will be the driving factors in shaping this industry as consumer preferences and outsized benefits continue to usher in digital finance as the norm.

Middle East & North Africa

The digital finance sector in the Middle East and North Africa (MENA) is nascent but fast-growing, spurred by government investment in fintech sandboxes and accelerators; the adoption of modern regulations; increased investment by local and global venture capital; and broader digital transformation across the region. The region has strong fundamentals for fintech, with a young population (more than half under age 25), high rates of mobile phone penetration and internet use, and the potential to serve as a gateway to markets in Africa and South Asia.

The UAE and Bahrain have emerged as regional hubs for digital finance, with the UAE alone accounting for nearly half of all fintech startups and deals in the region in 2019. In the UAE, the growth of the sector has occurred in the absence of holistic digital finance regulations, with regulators introducing fintech sandboxes and taking a case-by-case approach to crypto-assets. In contrast, Bahrain has emerged as a hub thanks in large part to a comprehensive regulatory regime spanning open banking, payment services, crypto-assets, AI, so-called "robo-advising," and other areas.

Other countries across the region are now beginning to follow suit in enacting digital finance regulations and building fintech hubs. Saudi Arabia has launched its own hub, FintechSaudi, but it is home to fewer than 50 startups, compared to 2,300 in the Dubai International Financial Center. Egypt is considering a draft fintech regulation with a focus on non-banking financial activities, such as collective financing, robo-advising, micro-financing, and insurance technology, but parliamentary elections scheduled for the fall make it unclear if and when regulations will be enacted.

Venture capital funding for fintech companies in MENA is growing rapidly. Although the region currently represents only one percent of global fintech investment, funding for MENA fintechs has been growing at a compound annual growth rate of roughly 30 percent, on track to reach $2 billion by 2022. The Covid-19 pandemic and related downturn in global oil demand have hit Gulf countries like the UAE and Bahrain especially hard, which will likely limit digital finance funding in the near-term – especially by local and regional VCs, which have accounted for most investment in the sector. This may increase competition among regional fintechs, potentially weeding out less-established players.

Looking Ahead

Longer term growth opportunities for digital finance across the region are strong. The pandemic has softened traditional reliance on cash payments in MENA, with more than 80 percent of Middle East banking customers now reporting that they are willing to use fintech solutions. It has also underscored the broader urgency of digital transformation both to ensure government and business continuity and diversify the economy. All of the Gulf Cooperation Council (GCC) countries have announced major long-term plans to transition their economies away from oil, but have struggled to make these a reality. The most prominent is Saudi Vision 2030, which includes a strong focus on developing the Saudi tech sector and a pillar specifically devoted to fintech. The pandemic may light a fire under these efforts, accelerating the adoption of new digital finance regulations and spurring greater government investment in fintech initiatives, digital infrastructure, and human capital.

The opportunities for fintech in the region vary by country. In less developed digital finance markets such as Lebanon, Jordan, and Kuwait, the greatest opportunity is in peer-to-peer payments, while more developed fintech markets like the UAE, Bahrain, and Saudi Arabia present opportunities for higher-value solutions, including account aggregation and robo-advising. Across the region, there is an opportunity at the intersection of fintech and Islamic finance, with the UAE and Saudi Arabia increasingly challenging Malaysia and the U.K. in the race to become global hubs for Sharia-compliant digital finance.

South Asia

Digital finance opportunities in South Asia prior to 2000 were largely limited by the cash-based nature of financial transactions, onerous regulatory regimes, and limited card penetration and acceptance. In the twenty years since, the sector has grown exponentially due to a combination of the proliferation of smartphones and mobile telephony; the rise of consumerism and the service sector; the progression of digital payment backbones (such as POS infrastructure and digital wallets); greater competition amongst card services companies; and leaner fee structures for merchants and consumers.

Covid-19 has further underscored the importance and centrality of e-commerce and digital payments across the region amid national lockdowns, limited mobility, and strict social distancing norms. The governments of India, Pakistan, Bangladesh, and Sri Lanka have all stressed the need for rapid digital adoption to help citizens access essential services and receive aid. In Pakistan, for instance, the government has expanded its assistance program – the Ehsaas Emergency Cash Transfer Program – and has partnered with banks to deliver funds to those with and without access to biometric verification.

India's fintech ecosystem has boomed over the past five years to become the second-largest in the world. Investments in India's fintech sector totaled $3.7 billion in 2019, nearly doubling the $1.9 billion invested in 2018. The fintech market still shows significant potential for future growth in India, with digital lending topping the list of investment deals in 2019, while digital payments attracted the most funding by value. Elsewhere, Pakistan, Bangladesh and Sri Lanka have growing fintech sectors as well. The Central Bank of Sri Lanka named 2020 as the "Year of Digital Transactions," and Bangladeshi authorities are actively considering placing greater emphasis on the sector as the government plans to launch a multi-use national digital identity card.

Government Action

While the digital payments market in South Asia has seen the introduction of several disruptive technologies and exciting new companies, some of the biggest disrupters have been the governments themselves. The government of India's decision to launch its own card services platform, the National Payments Corporation of India (NPCI), and card, RuPay, which today is the mandated product for use across most public sector issuing banks, has changed the market landscape in India. The Indian government is keen on offering the NPCI platform to several regional governments as well, which could introduce a new era of digital payments diplomacy in South Asia.

Another key factor for the fintech industry in the region is the emerging approach of regional governments to the treatment of Sensitive Personal Data, which includes financial data, amid concerns over data localization and cross-border transfer. Personal data protection legislation passed by India and Pakistan will require companies to make significant investments in order to keep financial data located within those countries. Earlier arguments by companies around the cost implications of data localization have not found resonance with governments. However, given the impact of Covid-19 on businesses, governments may now be more responsive to these arguments.

Sub-Saharan Africa

By 2019, Sub-Saharan Africa's (SSA) fintech sector had grown to more than 500 firms, attracted USD $678 million in global yearly funding, and launched the sector's first unicorn, Nigeria's Interswitch. Since then, the pandemic's significant economic toll across Africa has resulted in sharp declines in two major drivers of the sector: consumer spending and informal economies.

Over the medium to long term, however, the pandemic could act as a major fintech accelerator in SSA. ASG expects to see increasing demand for digital payment offerings, improved interoperability for Africa's underbanked, and increased access for the 676 million unbanked.

Although governments may look to boost squeezed revenues by regulating and taxing incumbents, payment service providers (PSPs) and investors can capitalize on shifts in regulator attitudes toward cashless economies. In Ethiopia and Ghana, local governments have encouraged the adoption of contactless payments and enacted reforms to open the financial sector to new actors. In Senegal, Covid-19 has spurred rapid adoption of mobile money, for transactions ranging from crucial money transfers to everyday expenses such as taxi fares. Across the continent, governments are looking to leverage electronic payments and mobile money systems to deploy stimulus funds.

Convergence in the Struggle between Bank-Led and Mobile-Led Models

The payments landscape remains divided between countries with bank-led payments ecosystems (Nigeria, South Africa) and those with mobile-led payments infrastructure (Kenya, Rwanda). This variation is a result of differing regulatory approaches over the past two decades. M-Pesa – developed in Kenya and arguably the biggest mobile money success story of the past decade – benefited from a positive regulatory environment in the platform's early days. In contrast, the Central Bank of Nigeria has taken a more heavy-handed and nationalistic approach, protecting the interests of traditional banking players.

The next decade in SSA will most likely be characterized by a move towards hybrid and integrated systems aimed at improving customer service, coverage, and interoperability. Global PSPs can accelerate this convergence and reap benefits by opening their platforms to, and forming partnerships with, Africa-focused mobile money providers and fintechs with existing market share, reach, and recognition.

Payments as Catalyst for Development

African governments have always been aware of the importance of financial inclusion and access for national and human capital development. But they have not always made these initiatives a priority. Covid-19 has shifted their approach, as SSA governments scramble to preserve the economic and social gains made over the past decade. Payment solutions are proving crucial for government financial inclusion initiatives and to implement Covid-19 relief efforts across SSA.

Since the pandemic began, multiple African governments, central banks, and payment firms have moved to limit fees and regulations on mobile money transactions, opening the payment medium to a broader socioeconomic user base. In Ghana, for example, mobile phone subscribers can open a mobile wallet and conduct up to USD $170 in daily transactions without submitting additional registration documents. These measures can be particularly powerful for women, as well as small and medium-sized enterprises (SMEs), which mainly exist in the informal economy outside of official government response efforts.

PSPs can also help Africa's efforts to rebuild post-Covid by facilitating remittance payments to the region, which reached $48 billion in 2019 – an amount greater than all Foreign Direct Investment. SSA provides opportunities for PSPs to partner with governments, international financial institutions, global foundations, and local sectoral partners on social impact initiatives and economic reconstruction that facilitate and accelerate inclusive growth across the continent.

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