Xinja's Response to the Productivity Commission's Consultation Paper on Competition in the Australian Financial System

Submitted via the Productivity Commission portal

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Introduction

Xinja welcomes the opportunity to respond to the 'Inquiry into Competition in the Australian financial system'. Xinja commends the Productivity Commissioner for meeting with a number of industry stakeholders, including Xinja and the open nature of those initial conversations.

Xinja is building Australia's first neobank, designed to be 100% digital and made entirely for mobile, from the ground up with customer interests at heart. We are not a bank yet, but we want to be. Xinja is working in partnership with APRA and ASIC to become a bank and obtain an AFSL and ACL. This will enable Xinja to provide a full range of retail banking products and services (eg. transaction accounts, savings accounts and home loans). Having recently completed our Seed Funding Round and now in our Series B funding round, we are keen to share our experience of becoming a new entrant to the Australian banking system.

Xinja was created with the belief that it's time for Australians to enjoy the benefits of banking competition, innovation and quality of service already enjoyed by customers in other parts of the world. Despite Australia's high level of mobile technology adoption, we haven't been able to fully embrace the possibilities of innovations such as real time payments, digital wallets, big data, open APIs, artificial intelligence and machine learning. While consumers in the US and UK are already benefiting from new capabilities brought by neobanks and digital challenger banks, Australian customers have told us they still struggle with even the simplest of banking needs, such as recognising each merchant and transaction on their bank statement. It is our hope that a more competitive banking sector will encourage investment in new entrants and make much more possible for Australian consumers and businesses when it comes to dealing with their banking and their money.

The current competitive landscape for new banking entrants

Australia's major banks currently benefit from a historic accumulation of capital meaning that regulatory capital requirements have become barriers to entry for new players. These barriers not only impact smaller ADIs, they also impact the commercial realities of being a startup bank seeking funding in Australia. It is not surprising that the growth in innovation and competition in Australia's financial services sector has not been in banking, but in specific niche areas of financial services with lower capital and regulatory hurdles to be able to offer a service in the market: peer to peer lending, investing, mortgages, and small business lending are good examples. None of these specific areas require a $50m capital hurdle to simply offer a product to market. However, when an organisation is seeking to take deposits, and wishes to call itself a bank, the $50m hurdle applies. As a result, we have seen at best limited innovation and competition in the form of the rebranding of existing ADIs, acquisitions of 'online only' banks, traditional banks 'digitising' their services and offerings and slowly improving their mobile distribution channels. What Australians have not seen yet is a genuinely new, full service retail bank entering the market, as has happened in most other developed banking markets. Xinja and Neo banks in general are focussed on providing new digital customer experiences accessible anytime, anywhere a customer has a mobile handset - with the security consumers have come to expect from banks.

Building a startup bank in Australia has its unique challenges. In the principles of lean startup, the fastest least risky path to growth is to be able to start with a minimum viable product (MVP) on a small scale to validate the product - market fit, and to learn and iterate from that until you are ready to scale. In the context of banking in Australia, there is no real opportunity to start lean with a MVP in market as you require authorisation before you can offer a banking service, so your first banking customer will already cost you in excess of $50m. This leaves only two other alternatives for those wishing to enter the banking sector in Australia, outside of applying for your own authorisation as an ADI. The second option is to partner with an existing ADI, which in and of itself creates complexity in terms of commercial arrangements, how funds are reported, how customers are managed and how innovation and competitive offers can be brought to market. The third option is to buy a smaller ADI, however that in and of itself does not enable a startup to call itself a 'bank', which again limits how you can engage with customers. The pathways to starting a new bank in Australia are therefore a choice of three problems:

1. Raise over $50m in capital,
2. Be dependent on and constrained by your competitors, or
3. Raise less capital and operate like a bank without calling yourself a bank.

None of these are particularly commercially attractive, market competitive, or market attractive. In fact, a branch of a foreign bank would most likely find it easier to enter the Australian market, than a local startup under the current regulatory framework.

In addition to these capital barriers to entry, existing major banks also enjoy competitive advantages in terms of their access to comparatively lower cost of funds and higher volume of funds, compared to their smaller counterparts and any new entrant. This makes it difficult for new entrants to be genuinely price competitive (at least in the immediate and short run), even for those who do overcome the $50m hurdle. Over and above the $50m, new entrants then need to source funds to lend out, further adding to the total amount of funds needed to start a new bank in Australia.

The landscape for raising $50m in startup funding in Australia

For those who take on the $50m challenge, the real cost of starting a bank will be well in excess of $50m. There is the cost of the licensing process itself, the cost of building the bank's core systems and processes, the cost of wholesale funding, the operating costs of running the bank, as well as the costs of customer acquisition and compliance.

The primary options for such startup funding in Australia (outside of family and friends) are accelerators, grants, business loans, and equity financing through angel investors, venture capital and early stage venture capital partnerships (crowdfunding is still yet to become available for privately held companies - yet that is how most startups begin in Australia)[1]. None of these standard pathways are straightforward in and of themselves, let alone particularly suitable for funding a startup bank. Government grants for an excess of $50m don't exist. Applying for a 'business loan' from a bank to start a bank would be akin to a startup asking it's competitor to fund it, whilst handing over your business plan for how you will compete. Then if we look at equity funding for anyone who is at pre-revenue, pre-customer traction and pre-ADI, it gets even harder. Series A funding in Australia might typically raise $3m to $7m[2]. By comparison, a startup bank in Australia would need from 8x to more than 16x this to reach the $50m capital requirement alone. The $50m hurdle also represents 10x the estimated $5m cost of a core banking platform itself, according to EY[3], and creates a disproportionate barrier to startups being being able to take full advantage of falling technology costs for core banking platforms to bring new alternatives to the market. While the cost of a core banking platform is not the only cost involved in starting a bank, by comparison, the $50m regulatory barrier significantly changes the economics and commercial proposition for starting a bank. Raising funds for a startup, and raising funds for a startup bank, are two very different challenges.

Despite the general interest in innovation in financial services, and the interest in increasing competition in the banking sector, the actual interest in funding a startup bank is a very different reality - especially if you are looking for funding from outside the major banks themselves, and looking for funding from those without existing strategic relationships with the major banks.

Comparing to the UK experience

Australia's $50m capital requirement for new banks is particularly onerous compared to lower minimum capital requirements in the UK since 2013, which have now been reduced to €1 million or £1 million[4] (whichever is higher), plus a capital planning buffer. Even though UK customers and banks suffered more than Australians from the GFC, the UK was faster to embrace banking

[1] http://www.pollenizer.com/2016/08/09/funding-options-available-startups-australia/
[2] http://mashable.com/2016/06/15/guide-startup-funding-australia/
[3] http://www.afr.com/business/banking-and-finance/financial-services/new-breed-of-uk-startup-banks-force-licensing-rethink-20170424-gvr8ah
[4] http://www.bankofengland.co.uk/pra/Documents/publications/reports/2014/barriers2014.pdf

innovation and competition[5], providing a clear roadmap for startups to 'grow up' into becoming fully authorised banks in a scaleable, commercially viable way[6]. We support initiatives such as the current proposed amendments, which we expect will open up the banking sector and create similar opportunities for Australian consumers.

Since the introduction of these regulatory changes, there has been significant growth in new startup banks in the UK including Monzo, Atom, Starling and Tandem. Many of our customers have already experienced the banking services available in the UK via these digital mobile challengers and have been asking why it isn't happening in Australia. We hope the proposed amendments to the Banking Act, in addition to the wider budget changes, will give Australians access to similar standards of innovation and competition. In line with the creation of the UK's dedicated new bank startup unit to specifically address the licensing needs for new bank startups, Xinja is pleased to be working directly with APRA's newly establish licensing unit. We look forward to continuing to work collaboratively and in partnership with regulators to ensure customer deposits are safe and secure whilst providing sufficient room to build, grow and scale in an appropriately customer centric, risk managed and commercially viable way.

Thank You

We thank the Productivity Commission for the opportunity to respond to this consultation and encourage the Productivity Commission to continue to engage both informally and formally, with the broader startup and financial services community. We would welcome the opportunity to meet to discuss our response further, especially in the broader context of opening up competition in the Australian banking sector. We believe Australia could be a global leader in innovation in banking and financial services industry and look forward to the Productivity Commission's continued leadership role in this area.

[5] http://www.bankofengland.co.uk/publications/Documents/joint/barriers.pdf
[6] http://www.bankofengland.co.uk/pra/nbsu/Pages/default.aspx

With the proposed regulations due to come into effect in late 2017 / early 2018, we hope this will provide further room for APRA to authorise new entrants to become ADIs under less restrictive capital requirements, with a phased approach to licensing that will enable new entrants to bring new banking services and experiences to Australians sooner rather than later.

We don't expect APRA to be providing unrestricted licenses in the first instance. However we do expect that new entrants should demonstrate their capacity and capabilities over time and in line with the increasing scope and scale of their customer operations and deposits. We believe it is possible to bring competition into the sector in a safe, scalable and commercially viable way, keeping customers interests at the centre of what we do. We believe it's time Australian's experienced banking as it could be, and we value the opportunity to make that happen.

Regards,

David Nichols
Chief Risk Officer

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Co-Founder & Customer Innovation Director