PwC's Top Trends
Financial Services

02

Specialty Finance Challenger Banks in Italy: reshaping the lending landscape?

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Foreword

Following major market and regulatory turmoil in the last decade, **structural changes of the banking and financial system** start to be actual and visible: **technology, customer behaviour and regulation are driving a "paradigm shift"**.

Key dynamics are well-known on an individual basis, but a comprehensive picture of the on-going major **transformation process** emerges if indicators are considered all together:

- The number of individual banks have decreased by 24% over the five years period 2012-2017 (from #706 to #538);
- #8 well-known Institutions (with a total of c. €120bn of asset and c. #1,900 branches) have gone under resolution or restructuring process in the latest 12-18 months and merged with high street Banking Groups;
- Banking branches have decreased by 17% from 2012 (from #32,881 to #27,374);
- Banking customers, that are active on digital channels, are ~#19m;
- Following the new "Intermediario Unico" regulatory framework, the number of financial companies have reduced from #530 (companies ex art. 106 and 107) to around #150.

The dynamics related to the recent regulatory reforms (credito cooperativo, popolari, fondazioni bancarie) and profitability issues of the traditional- branches based commercial banking model will push for **further consolidation in the banking sector, in particular for small regional banks**.

Nevertheless, **building scale is no longer the only answer: technology is shaping the new market landscape and business model innovation can generate alternative value creation options**.

Customers are looking for additional choices in terms of products-services, channels and providers; new digital technology and open banking platforms enable modularization and integration of systems, within and across companies.

New players **are driving innovation and providing customers with more choice**: specialized banks and financial companies but also emerging players, with digital business model.

Competitors from other industries are joining; unexpected alliances and partnerships will innovate the industry landscape and foreign players are entering into the market, leveraging on EU passporting; the role of Big Tech could be disruptive.

Profitable market niches, underserved by traditional banks, exist. Specialization can be a key competitive factor to capture the opportunity.

Specialty finance is one of the most profitable segments in the banking and financial landscape, with intense competitive dynamics and innovation, new players and business models, M&A activity and Investors.

"Challenger banks" has been recently used, with a broader definition, to identify the group of new banking players that pursue differentiating strategies with respect to high-street banks in terms of product/customer specialization and/or technological innovation.

In this paper, we will focus on **Specialty Finance Challenger Banks** as banking players with a **strong potential for superior performance**, as they operate in the high yield and/or low risk segments of specialty finance, with distribution models based on alternative channels, digital technology and flexible operating models.

This working paper has its origins in the **extensive projects experiences of our teams** in this area. It has the ambition to become an **ongoing observatory**, able to capture the key market and competitive dynamics, collecting hints and points of view of the different players in the Industry.

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Strategy& Italy since 2016 developed his positioning in strategy consulting for **Financial Services with a dedicated team of professionals** and vertical capabilities on key topics and main industry sectors: retail and corporate banking, insurance, asset management and specialty finance. Our integrated team draws from corporate & business strategy, large-scale transformation, new business models and innovation, strategic deal services to help clients with speed and certainty and unlock value from their business.

Key messages

Technology, customer behaviour and regulation are driving a "paradigm shift" in the banking industry

The need for scale, to enable both cost efficiency and digital transformation, **will push for further consolidation** …

… **but building scale is no longer the only answer**: technology is shaping the new market landscape and business model innovation can generate alternative value creation options

Profitable market niches, underserved by traditional banks exist. Specialization can be a key competitive factor to capture the opportunity

Specialty finance is one of the most profitable segments in the banking and financial landscape

Specialty Finance Challenger Banks have a strong potential for superior performance and competitive advantage. Based on our analysis, in 2018 specialty finance specialists and challenger banks overwhelmed the traditional banks on the base of all key performance indicators

Leveraging the distinctive elements of this model **could represent an opportunity for both incumbents and new entrants ...**

… organic growth could be too slow: it's time for an acceleration in **business combinations and strategic partnership**

1 Challenger banking model in specialty finance

Definition and business models

Introduction

In order to provide a **framework** that could help analysing the different strategies we suggest the following **segmentation approach**.

Specialty finance players

Specialty banks have propositions typically anchored around **specialist lending** for customers underserved by others in the market, such as certain types of small and medium-sized enterprises and the consumer market (for a specific definition of specialty finance segments, refer to the following chapter). They generally have very **limited physical presence**, placing more emphasis on call centres, **third-party distribution channels**, some regional offices and, increasingly, **digital channels**. They often work with intermediaries to source new business. They still see potential for growth in their target markets, but are agile and confident in their ability to adapt when the time comes to broaden their areas of focus.

Digital-only banks

Digital-only banks recognise the megatrend of **customers shifting to digital channels** and are building their business to serve both digital natives and converts. They pride themselves on **innovative technology platforms that promise exceptional customer experience and engagement**, primarily through mobile apps. The majority have been founded very recently. They are positioning themselves to lead in the forthcoming era of **Open Banking**, which will require banks to share specific data securely through open APIs, the technological tools that will deliver this change.

Source: PwC UK "What are you calling a "challenger"? How competition is improving customer choice and driving innovation in the UK banking market"

Often, the most innovative ventures start as **financial companies or payments institutions** and leverage wholesale funding strategies (securitization or non-recourse disposal); **banking transformation** is a must-do when direct/ retail funding becomes a competitive factor.

Specialty finance challenger banks

According to our definition:

Specialty Finance Challenger Banks represent a specific group of banking players that operate in the high yield and/or low risk segments of specialty finance with alternative channels, digital technology and flexible operation models

Definition and business models

Digital +

Specialty finance *	**Specialty finance specialists** / **Specialty finance challenger Banks**	
Transactional services	**Pure digital players**	
Other segments / asset gathering	**Other specialised banks**	

Differentiating factors:

- Focus on **high yield segments**
- Distribution models based on **alternative channels, mainly digital / network of specialist**
- **Digital technology** and **flexible operation models**

* Many specialty finance players operate without a full banking licence, mainly as financial companies (106)

Specialty finance segments

In our definition, **Specialty Finance** includes **financing activities and players that operate in specific credit segments**: both **consumer** (households financing: personal loans, salary/ pension-backed loans-CQ, auto financing) and **commercial lending** (leasing, factoring, specialized SME lending).

In a **broader definition**, we also include **credit management services**: players that operate as banking institutions can leverage on **regulatory and funding platforms to develop comprehensive and "sophisticated" approaches in NPLs and UTP**, both in financial (from purchase to refinancing) and industrial terms (from special to master servicing). Finally, we include **specialised B2B banking models focused on corporate finance and fund services**.

Specialty finance segments

	Consumer credit	WC Management (Factoring / Leasing)	SME Lending	NPL / UTP	Corporate finance
Activities	• Personal loans • PoS loans • **Salary-backed loans** • **Innovative products (e.g. TFS advances)** • Pawn loans	• **Public Government Debt acquisition** • Small Business factoring • Tax claims • Leasing (Equipment / Auto / Agriculture) • Niche financing (e.g. gold)	• Small Business Enterprise **(SME) and Micro Enterprise medium / long term lending** (leverage on the central government fund's warranty)	• **Debt purchasing NPL / UTP** • **Senior Financing** • Sponsorship (in NPL transactions)	• **Syndicated loans trading** • Club deals • **M&A, IPO, Debt advisory services**
Distribution models	• Third party networks (credit advisors) • Digital Marketplace • Distribution agreements with banks	• **Physical network of "field bankers" or financial advisors** • Digital Marketplace to acquire potential customers • Agreements with third parties offices	• **Agreement with digital originators** to speed up the growth and customer acquisition • Physical network of "**field bankers**" or credit advisors • Digital Marketplace	• **Product specialists** (also with Due Diligence capabilities)	• **Product specialists** able to work on B2B side with funds to be part of specific deals financing needs • **Trading desk** • **Corporate finance experts**

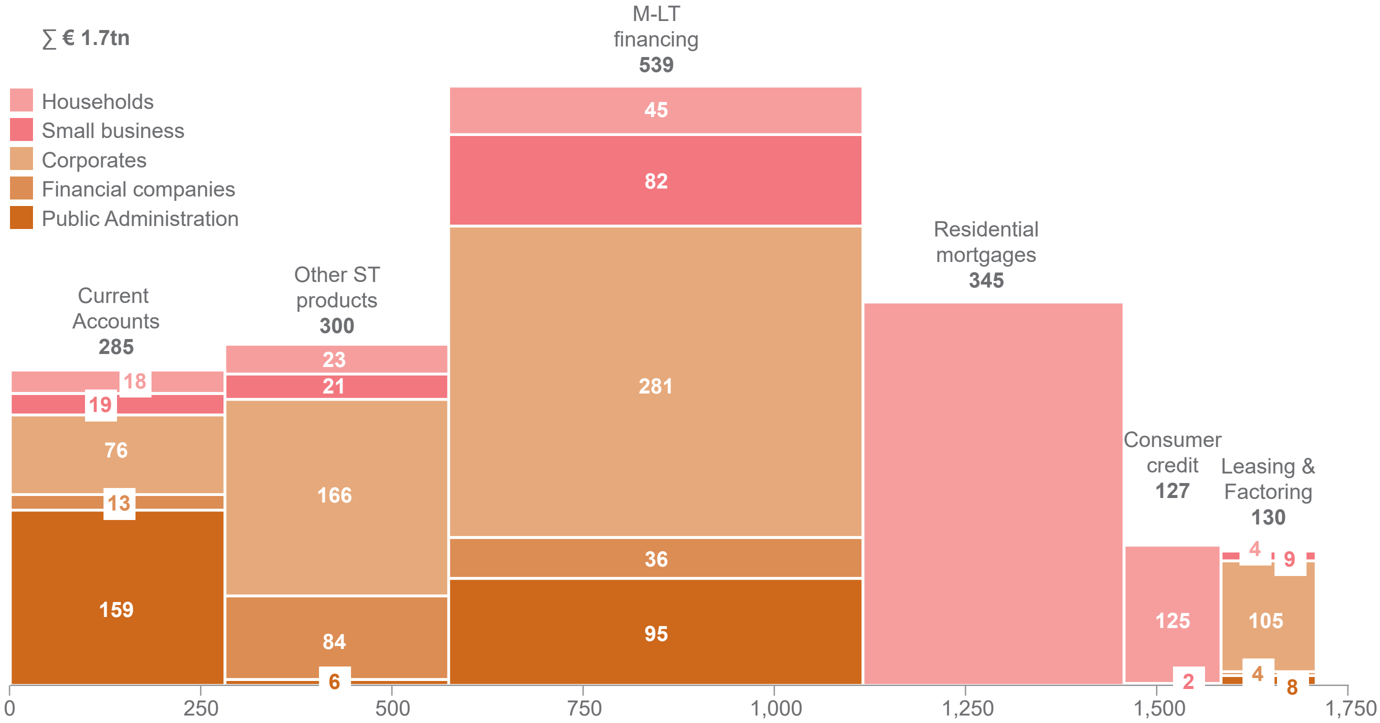
Italian lending business and specialty finance

Italian banks' and 106 intermediaries' loans stock at December 2018 was equal to over €1.7tn excluding bad loans. **Over €250 bn (approx. 15% of the total) are represented by specialist products** like consumer credit, leasing and factoring.

Also within more traditional banking products (e.g. current accounts, overdrafts, medium-long term financing), **there is demand and room for specialization and alternative products** (e.g. subsidized loans, pre-UTP loans refinancing, SME-tailored finance).

Traditional lending is losing ground in favour of specialty finance. In addition to widely known speciality finance areas (i.e. consumer finance, leasing and factoring) new specialised products are «attacking" business areas of more traditional players

Italian Loans stock by product and counterpart sector - 4Q 2018, € bn – excluding Bad Loans



Source: PwC Strategy& analysis on Bank of Italy data

Specialty finance competitive arena

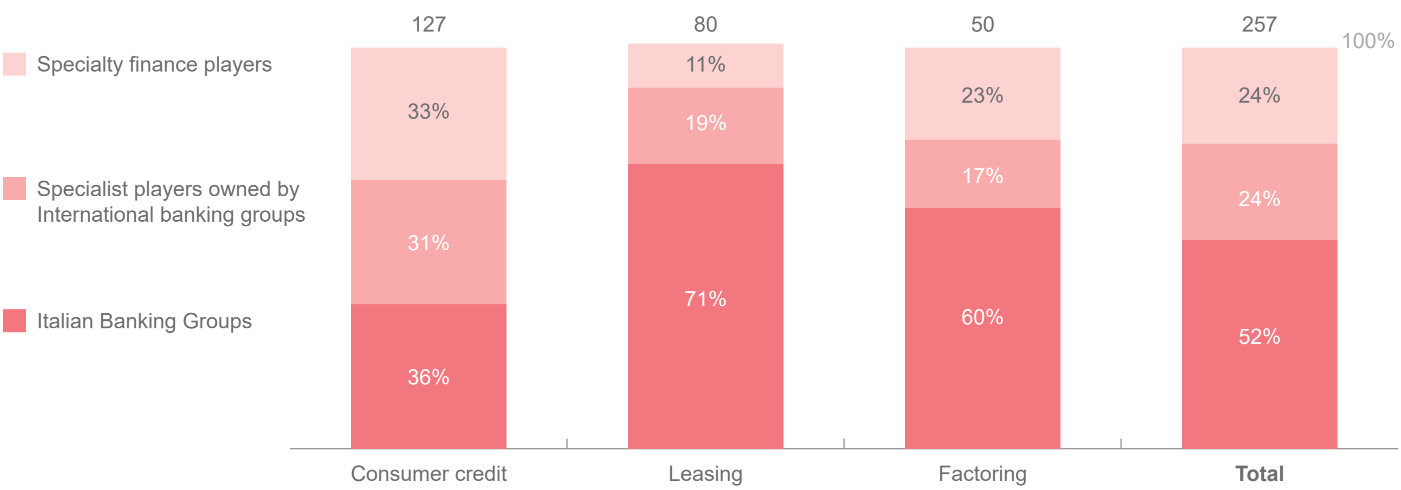
Traditional banking groups share specialty finance competitive arena with other specialist players. In particular, Italy counts approx. **#100 financial companies ex art. 106 independent from Italian traditional banking groups and mainly active in consumer finance, leasing and factoring and NPL purchasing** (refer to Appendix for further details).

Both specialist players owned by large international banking groups (like Crédit Agricole, Sociéte Generale, BNP Paribas, ING, Santander) and several independent specialty finance players (Compass, Banca IFIS, Banca Farmafactoring, IBL Banca, Banca Sistema) gained important market shares in specific segments.

In addition to pure financial players, captive finance companies owned by industrial players (mainly car and equipment manufacturers) have a distinctive positioning in consumer credit and leasing.

Specialty finance competitive landscapes show the presence of specialist players (both international and local) accounting for 50% of the market which were able to better innovate and meet customers' needs

Italian Specialty Finance stock by lender type - 4Q 2018, € bn and %



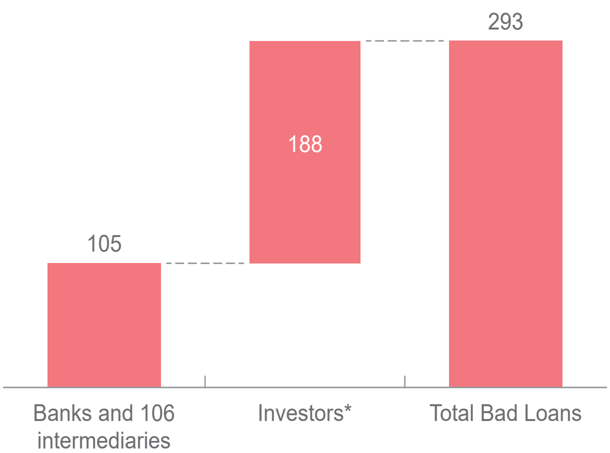
Source: PwC Strategy& analysis on last available data from ASSOFIN, ASSIFACT, ASSILEA and company reports

Italian Gross Bad Loan stock is equal to over €290bn at December 2018, of which only 36% is still on traditional banks' books. Approx. €190bn of Bad Loans are owned by investors or banking/ 106 debt purchasers.

Based on the shift from banks to investors, the management of Bad Loans moved towards specialist players, which at the same time increased their role in the management of bad loans that are still on banking books: we estimate over €240bn of bad loans are today managed by specialist players (including also €50+ bn of banking bad loans).

Bad Loans management is definitively dominated by specialist players. The UtP market, yet in an early stage and quite limited in terms of volumes and number of transactions, will be the next challenge and opportunity for specialty finance challenger banks

Italian Bad Loans stock by owner - 4Q 2018, € bn



* Including also banks and 106 intermediaries specialized in debt purchasing and servicing (e.g. Banca IFIS, Credito Fondiario, Guber Banca, MB Credit Solution, SGA)

Specialty finance main players

Based on the above defined criteria, we have identified a **list of players that operate in the specialty finance competitive landscape with a banking license**.

In the same competitive space, but with a different history and strategic/ organizational model, **Mediobanca developed a distinctive business model focused on highly specialized banking businesses**, starting from investment banking and subsequently entering consumer credit, debt purchasing and servicing, factoring and wealth management.

Players classified as specialty finance banks based on our definition

	Core business areas				
	Consumer credit	Factoring / Leasing	SMEs and corporate	NPL and UTP	Corporate finance
Banca Ifis	■	■	■	■	
Banca Farmafactoring		■	■		
IBL Banca	■			■	
DoBank				■	
Banca Sistema	■	■	■		
Credito Fondiario		■	■	■	■
Guber Banca				■	
illimity			■	■	■
Banca Progetto	■	■			
Credito di Romagna (SC Lowy)			■	■	■
Banca Privata Leasing	■	■	■		
Banca Finint			■	■	■
Vivibanca	■				
GBM Banca		■	■		

* In terms of Total assets (AuM for NPL servicers)

Specialty finance challenger banks:key differentiating factors

The **competitive strategy of challenger banks in specialty finance** is based on the following pillars:

- **Specialization in high yield segments**: players have been focusing on products and/ or segments not covered comprehensively by traditional banks due to the lack of specialization, with in general **higher pricing** (commercial spreads in a range between 200 and 500bps vs an average market level of approx. 130bps) able to offset the risk associated to the counterparts (mostly SME segment). Moreover some players focused their value proposition in the acquisition of existing debt towards the Public Administration (ex. commercial invoices discounting) and the setup of dedicated recovery units.

- **Distribution model based on alternative channels**: specialty finance players do not develop their business through traditional channels (i.e. retail branches), rather leveraging on **dedicated, specialized channels, such as relationship specialists, direct channels, third party agreements**. This business model is reflected in better efficiency indicators (i.e. cost/ income lower than 50% on average) vs traditional banking players (≈60% on average).

- **Digital technology and flexible operating models**: many challengers use technology to create flexibility in their operations and control infrastructure costs (e.g. cloud services, open APIs, AI). In addition, players tend to adopt flexible approach to the market (e.g. leveraging on partnerships and outsourcing).

Specialty Finance Challenger Banks: core elements

Higher profitability based on lower cost/income structures and better returns on absorbed capital.

Performance vs traditional banking players

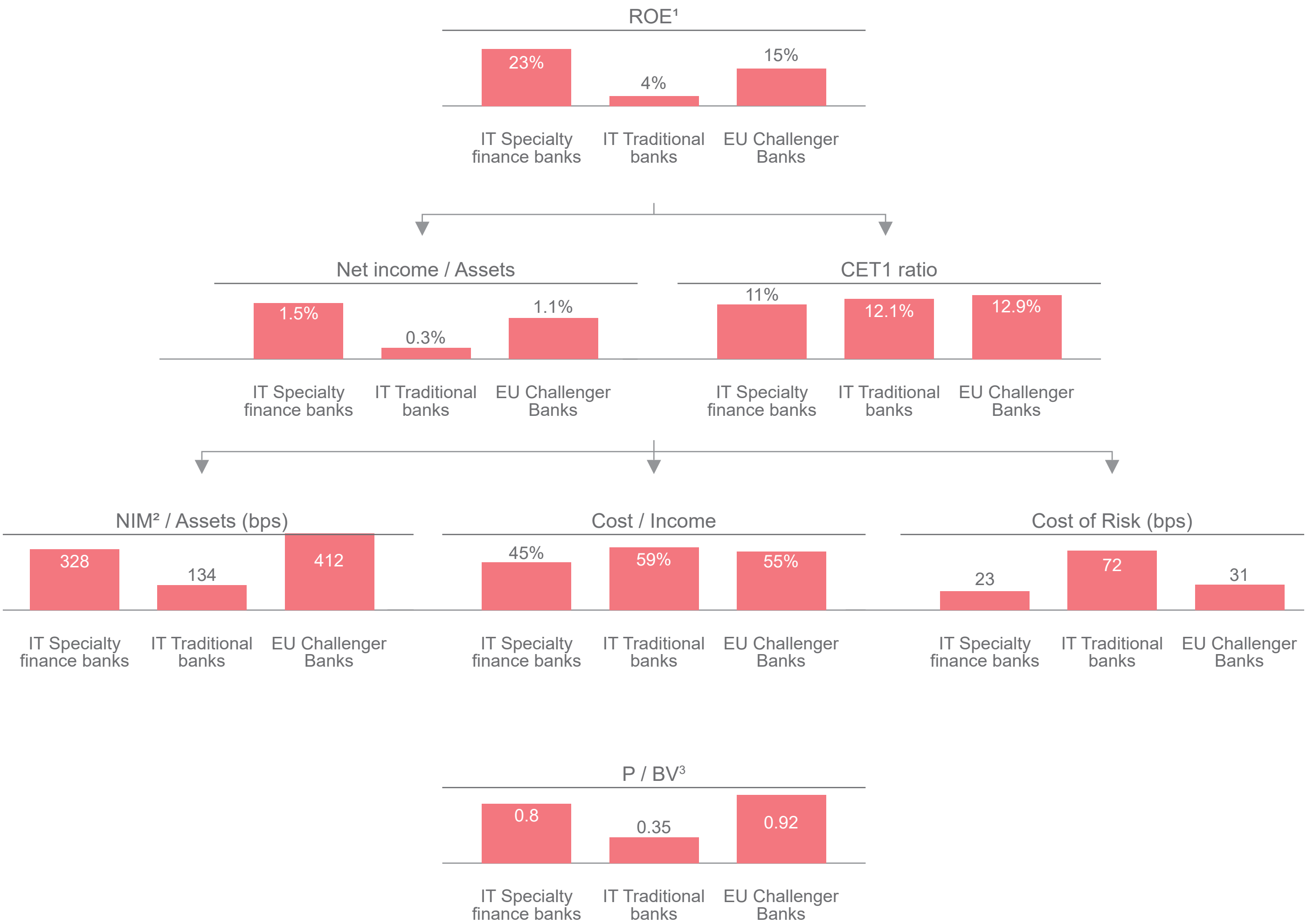
Based on our analysis, **in 2018 specialty finance specialists and challenger banks overwhelmed the traditional banks on the base of all key performance indicators**. We analysed the KPI of:

- Top specialty finance players in Italy;
- Top Italian banking groups;
- A cluster of European specialty finance challenger banks.

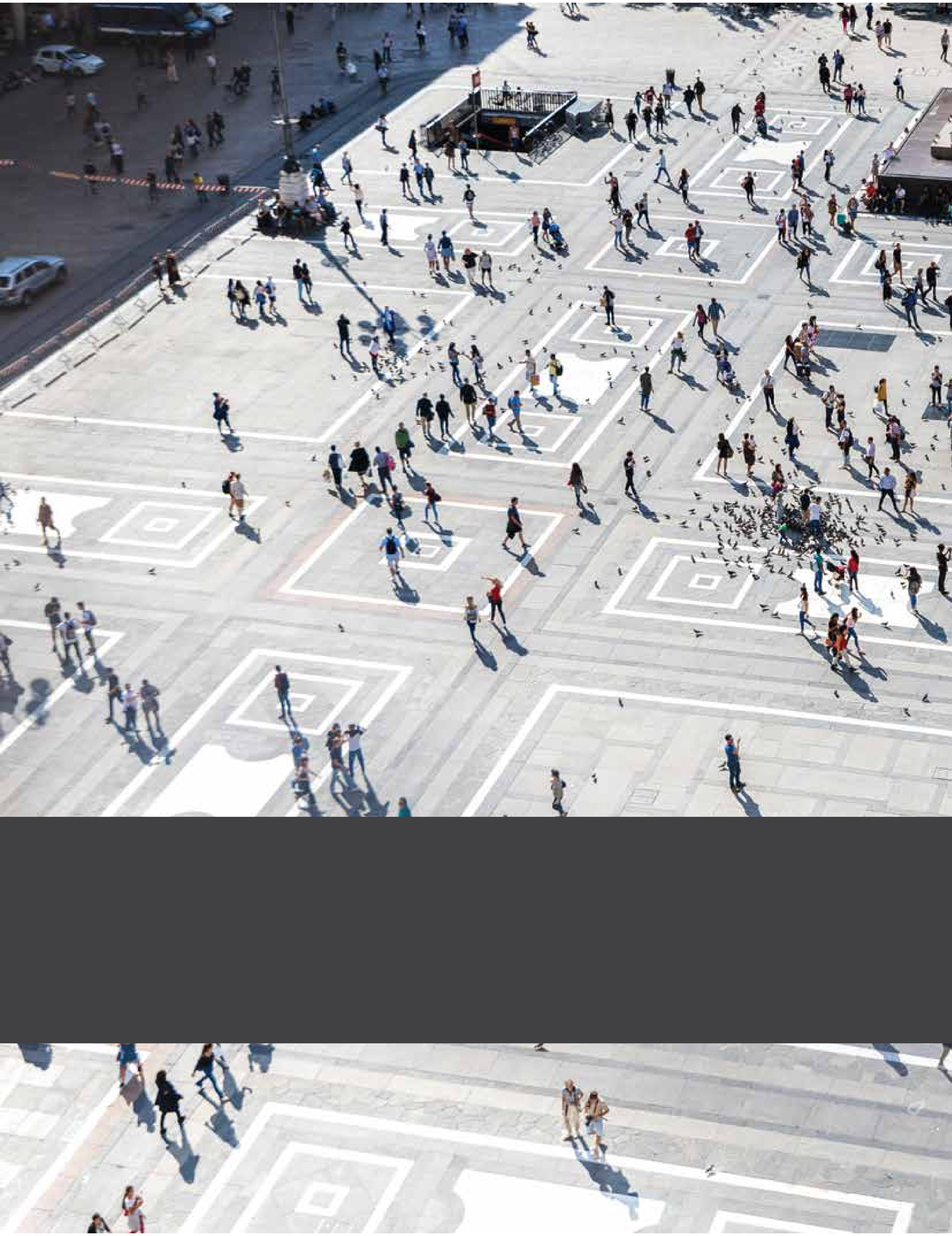
Specialists' higher profitability is mainly connected to better pricing/cost of risk and lower cost/income structures, thanks to flexible distribution models and operating platforms.

Specialist banks are on average demonstrating better performance expressed majorly in higher profitability (ROE), lower cost to income ratio, lower cost of risk and higher market multiples in comparison with traditional banks

Challenger banks vs. Traditional banks ROE – based on 2018 data



Note (1): ROE calculated as Net Income (T) / [Net Equity (T) – Net Income (T)]. "T" defined as the last period with available data
(2) Net Interest Margin
(3) P as of 15/03/19 and BV as of 31Dec18



2 SME Special Situations challenger banks

Italian SME landscape

During the last decade, credit access to Small and Medium Enterprises (SME) has represented a marginal topic within the financial revolution which has been disrupting traditional banking models. **SMEs have been largely (under)served by banks, but fintech players are about to untap their potential**.

The Italian SME landscape: facts and figures

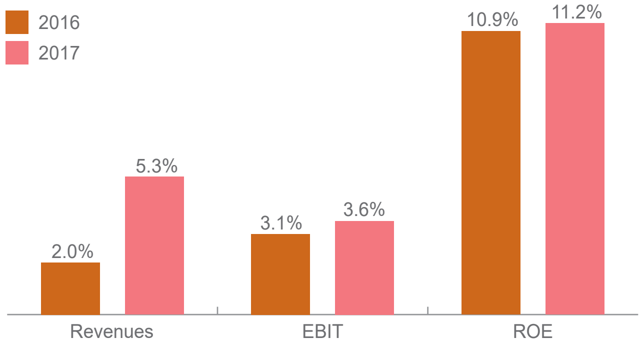
Italian SMEs constitute the nation's economic backbone: as of 2017 they have grown to #148.5k (of which 83% are small size and 17% medium size).

They **employ more than #4m workers** and generate a **+€886bn turnover** (with an added value of €212 bn, close to 12.6% of the total GDP).

Growth was a key pattern for 2018: **SME size increased by 2.9%** (almost #3k new enterprises). This trend has shown healthy traits: sustainable financials and increasing investment rates.

Source: Cerved Rapporto PMI 2018

The evolution of SME financial KPIs (% change YoY)



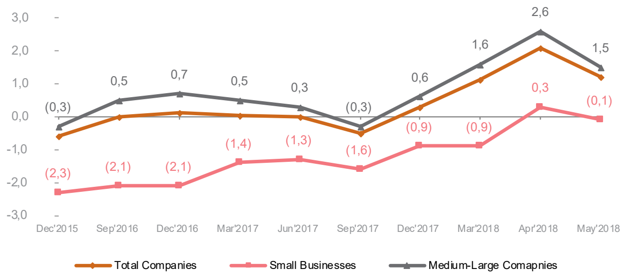
Source: Cerved Rapporto PMI 2018

Lending trends and opportunities

The Italian SME funding, comprised of bank loans and bonds, is more than €180bn (about €50 bn are small tickets for SMEs).

Traditional **credit supply to SMEs is dominated by medium-sized companies**, while small/micro companies have shown stagnant growth in financing.

Trend of lending stock to Italian SMEs (% change YoY)



Source: PwC analysis on Ufficio Studi Confartigianato su dati Banca d'Italia

>150 k SME

>€886 bn Turnover

>#4 m Workforce

>€180 bn funding

Role of specialty financing players in the SMEs turnaround

The SME lending revolution

The traditional banking service model struggles to serve small profitable businesses (typically credit deals < €50k are not profitable for a bank); the credit stock trends and banks' results confirm this statement.

Historically Italian SMEs were able to finance their activities through banking loans since accessing the capital markets has usually been difficult for smaller enterprises. However over the last couple of years, we have seen a new trend in the market where **niche segments' specialty finance players, new challenger banks, and fintechs were able to develop new ecosystems, focused on SMEs and new financing**; the degree of dependence between SMEs and traditional banks is decreasing: out of #140k SMEs, 40.8% completely self-finance their business by not using bank debt, as of 2017[1].

Capability to afford SMEs lending requires a low cost to income ratio and short response time (time to Yes is less than 2 days)

In terms of the marginality SME lending could produce a yield of 6-7%

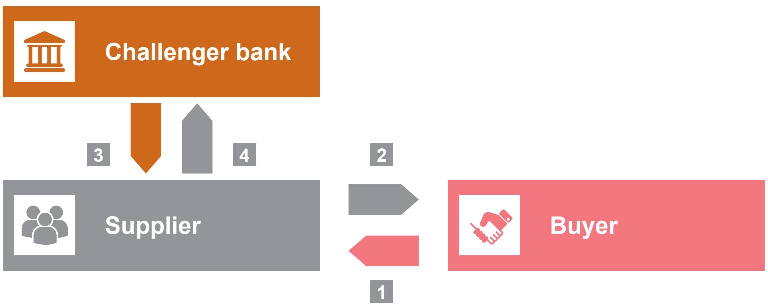
From the status quo…

- Obsolete and slow credit processes, not suitable for SME firms;
- Inefficient and poor exploitation of credit enhancement opportunities;
- Credit origination still based on traditional channels: no digital experiences for SME;
- Difficulties to leverage on new models for risk management: high risk profile for banks.

… To specialty finance players for SME

- Semi-automatic underwriting workflow (time to yes: 24 hours);
- Active exploitation of credit enhancement opportunities;
- Credit origination based on Digital processes (digital signature, remote identity identification, etc.);
- Technology driven innovation (Online origination platforms, advanced matching engine, credit scores leveraging on social big data).

Example of invoice financing through Challenger banks



1. Buyer acquires services from Supplier.
2. Suppliers sends invoice to Buyer for the services rendered.
3. Challenger bank steps in and finances the 100% of Supplier's invoice.
4. Once the Buyer repays the amount due to the Supplier at a specified date, supplier repays back the loan to a Challenger bank.

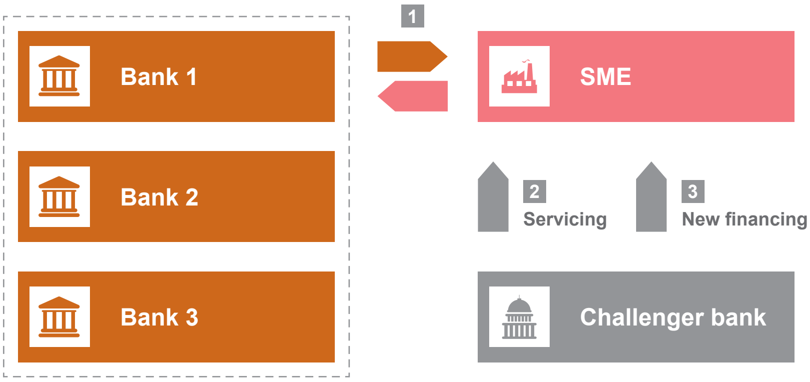
Note: (1) Cerved Rapporto PMI 2018 (Cerved SME report 2018)

Market opportunities for specialty finance players in the UtP

In the UtP management, specialty finance players may efficiently drive the restructuring process due to zero legacy with traditional banking system, option to use new financing facilities, and availability of vertical competence centres.

Challenger banks perform the role of the recognition mechanism that either carries out the UTP servicing or provides a new financing for SMEs restructuring

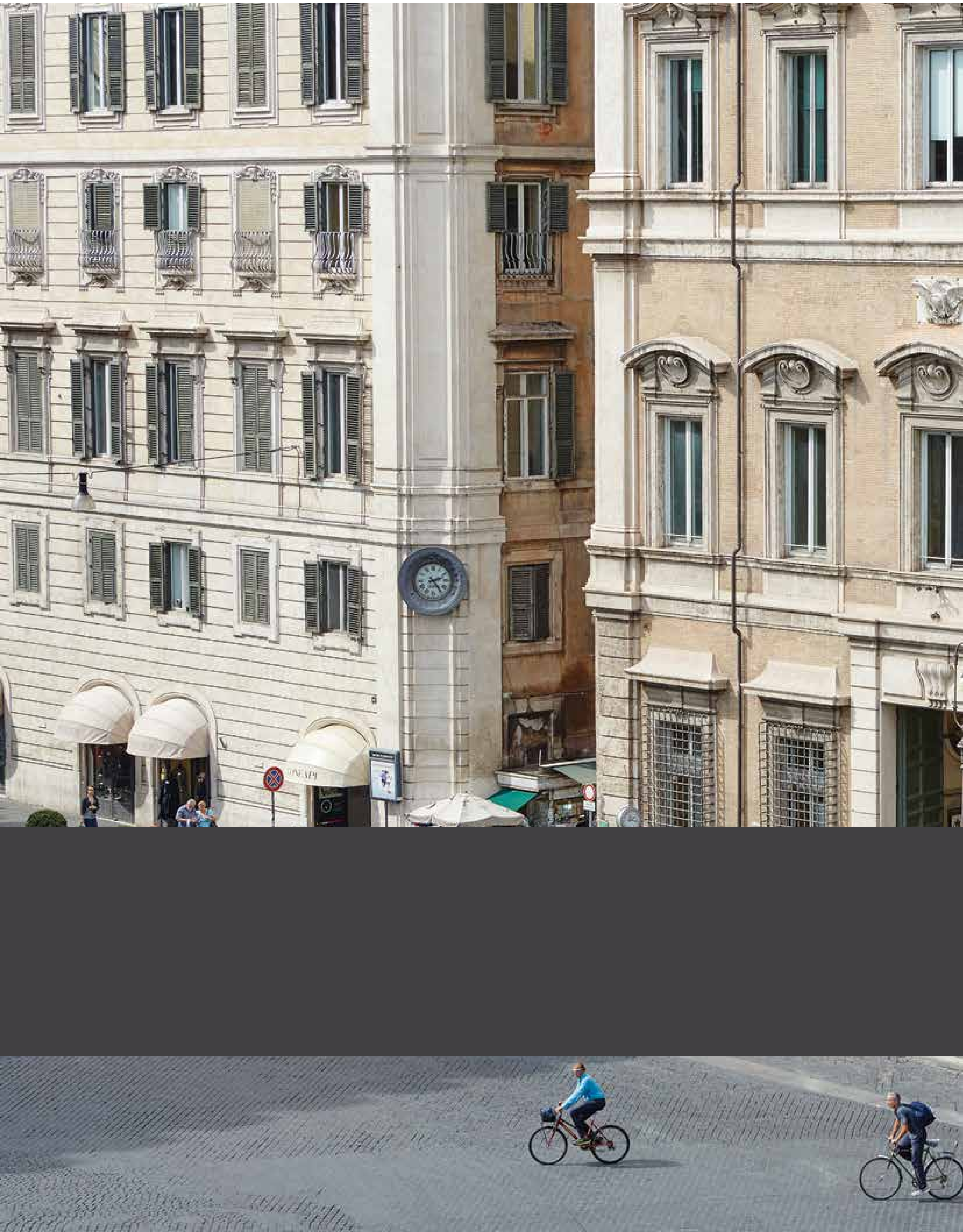
Example of challenger banks model application in the UTP



1. UTP contribution in a securitization vehicle. According to IFRS 9 requirements, the transaction will be structured to allow the originator banks to achieve loans' accounting derecognition (under certain conditions) and to recognize in their balance sheet the notes issued by SPV subscribed by the banks. Moreover, on the basis of certain assumption regarding the structure of the transaction, this will allow the originator banks to achieve the non consolidation of SPV according to IFRS 10 requirements.

2. Set up of a Servicing Agreement.

3. New Financing will be provided to Portfolio companies by Challenger Bank in order to restore financial position. Available cash flows deriving from the portfolios will be used to repay SPV 130 notes.



3 Specialised models in consumer lending

Specialised models in consumer credit

Market structure and trends-highlights

The Italian consumer finance market, after a contraction phase during the period 2008-2013, has been **growing since 2014**, reaching over €60bn financed in 2018 (not including automotive captive subsidiaries and other companies not associated to Assofin, except for CQ). The growth rate is slowing down: after a peak of +16.3% in 2016; data in 2018 indicates +6.2% versus the previous year.

The recent growth path is common among the various segments, which have all experienced a relevant growth between 2013 and 2018: CAGR +10% personal loans; +9% PoS loans (including car); +10% cards; + 6% CQ.

Industry structure and business models-highlights

The consumer finance competitive landscape is characterised by the presence of **different types of players in the specific product areas**:

- **Personal loan** segment is dominated by traditional banks, distributed mainly by traditional banking branches;
- **Car loans** present a significant market share of captive players;
- **CQ loans** segment is characterized by the presence of specialized players, with strong leverage of specialized branches and intermediaries (mainly credit agents).

Banking groups adopted **different strategies in consumer finance, in terms of strategic role and organizational/operational models**:

- Internal divisions/units;
- Specialised subsidiaries;
- Commercial agreements with third parties.

In the latest period, a **specialization trend seems to prevail in the industry**, with many initiatives aimed at developing **specialized consumer credit units through both acquisitions, spin-offs and/or NewCo**. Ability to attract and retain skilled resources, flexibility in multichannel distribution strategies, increasing level of independence in developing dedicated credit risk policies and scoring methodologies are main drivers.

Concentration and M&A dynamics-highlights

Consumer credit market is highly **concentrated** (with the exception of CQ), with top 10 players generating ca. 80% of total new financed loans in 2016, and dominated by big specialized players and captive companies of top banking groups. **M&A activity has been pretty intense** in the last period: many deals related to concentration dynamics and new entrants in the salary-backed loans segment.

The smallest among the consumer credit clusters - cessione del quinto - has been probably the most dynamic in terms of business-operational model evolution and industry trends. A focus on CQ is presented in the following chapter.

Consumer credit is currently one of the most attractive areas in the banking business. Specialization is a key competitive factor. The recent evolution of business and organizational models confirm it

Consumer credit business / organizational models for banking groups

1

"In-house"
(division or business unit of the Bank)

2

Specialised subsidiary

3

Commercial agreement with third party

Some banks adopt "hybrid" models: CQ loans in specialised companies; personal loans in-house

Recent trend towards specialization, via acquisition or spin-offs

A focus on salary/pension-backed financing

CQS represents 10-12% of the consumer credit market, nevertheless it's considered **one of the most attractive asset classes and industry sub-segments in the lending landscape**.

Two main reasons: it's **regulated by law** and **attractive in terms of credit risk**. In the past, distribution and operational malpractices led to relevant **operational risk**; nowadays, the sector is **much more stable, thanks to a comprehensive regulatory framework** and robust industry structure, with **an "eco-system" of specialists, with strong track record, along the value chain: distributors, lenders, insurance companies, service providers, and securitisation specialists**.

On the **demand side**, it's an attractive product for customers, with "embedded" features in terms of financial education: the limit of 1/5th helps managing the risk of overindebtedness; the **mandatory insurance coverages** face life and unemployment risks. Customer perception towards the product is changing: from a "near-prime" product for almost "unbankable" customers to a **"main street banking" retail credit service**.

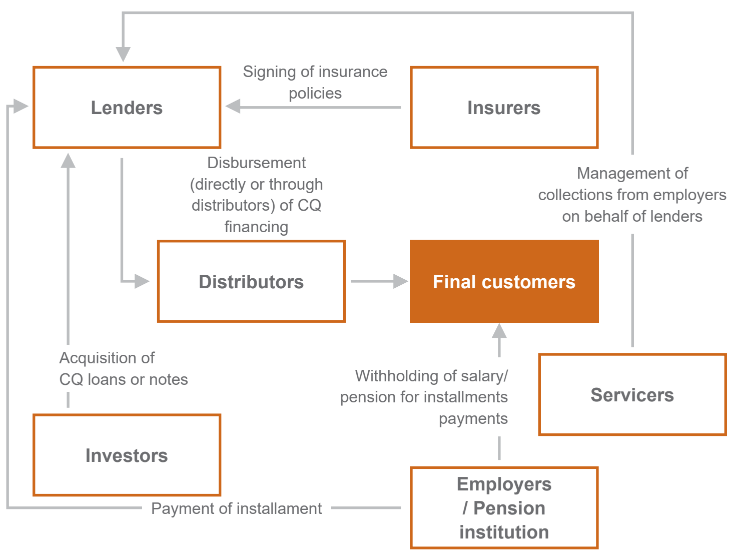
On the **offer side**, the CQ industry has been dominated by **specialists**, both banks and financial companies. The latest period has been characterized by **consolidation and increasing role of commercial banks; strong specialization remains a key success factor** to operate in this market, due to the specific underwriting-distributive-administrative- credit management peculiarities.

The recent introduction or **more favourable prudential treatment for CQS/CQP** is an important acknowledgement of the distinctive features of the product.

Innovation in technology and customer interaction will shape the competitive ground in the next future.

Salary-backed loans – the path from a "near-prime" to a "flagship" consumer credit product. The recent stabilization of the regulatory framework has further reinforced the distinctive elements that make CQ "unique" in the international retail lending landscape and an attractive ground for specialised business models and challenger banks

The CQ «ecosystem»



Product features and the evolution of the regulatory landscape

Salary-backed loans (CQS – cessione del quinto dello stipendio) and Pension-backed loans (CQP- cessione del quinto della pensione) peculiar features are mainly related to the **repayment process** (installments are paid directly by the employer or by the pension institution – ATC amministrazione terza ceduta) and **a number of product-embedded guarantees** (i.e. compulsory insurance coverage for unemployment and death).

These elements **mitigate CQ's credit risk**, with a considerably lower default probability and a correspondingly low loss given default. As a consequence, **a more favourable prudential treatment with respect to alternative forms of consumer credit has been recently introduced**: under current CRR rules (Capital Requirement Regulations) salary-backed loans carry a risk weighting of 75%; the new amendments are expected to bring the risk down to 35%. Considering total CQ outstanding asset of around €20bn (of which public employees and pensioners for €17bn) in 2018, the new rules might reduce up to €0.6-0.7bn the capital currently required.

The new regulation should come into force at the end of the legislative procedure involving three main European public bodies – Parliament, Commission and Council. The new capital requirement rules for CQ are the latter of a series of initiatives that have been **stabilizing the regulatory framework** of CQS/CQP for all the players active in the different phases of the value chain, both lenders, distributors and servicers.

Market size and customer dynamics

Based on official data from Assofin (the consumer industry association), the total CQ financed amount in 2018 was equal to €5.3bn (ca 10% of total consumer credit), growing 5% vs previous year; a similar growth rate is estimated for 2019. A relevant part of the market is not included in these features, as a number of banks and financial companies are not associated to Assofin: based on our estimate, it amounts to €1.5bn-leading to a total of €6.8bn CQ amount. Stock of over €20bn, #1.3m clients.

So far, most of the market has been based on renewals of lending on **existing clients** (around 60-70%); **the next challenge is on new clients**: more competitive product and pricing feature, new customer interaction facilities and lighter administrative processes will create conditions for additional penetration on PA employees and pensioners.

The most relevant opportunity is on **private employees** (today ca 18% of total market), with large spaces for innovation in business-operational model: combined value propositions SME-consumer, joint approaches of banks-insurance to specific sectors/industries/ geographies, integration within employees benefit/ welfare platforms.

Industry and channel structure

Many players are active in the market, with different origin, strategy and legal structure. We segment the sector in the following clusters:

- **Traditional banking groups**, operating directly with their banking licence/ brand/branches or through specialized subsidiaries ("106");
- **Specialized banking groups or Investors**, operating through banks or specialized subsidiaries ("106");
- **Family-owned financial companies**: in many cases, they have no independent financing capabilities and operate as "mandatarie", selling credits to specialized institutions with "wholesale approach" ("mandanti").

There are ~ **#30 players active in the market**:
- #8 with banking licence, #22 financial companies (106);
- Half of the players are associated with Assofin;
- #10 players independent 106 and family-owned.

M&A activity in CQ has been intense in the latest period. The concentration level is lower than other consumer credit segments and other banking/financial businesses: leader - 12%, top five -43%, top ten - 70%. We **expect increasing concentration** in the next period.

In terms of channels, the role of intermediaries in CQ segment is relevant. Looking forward:

- Increasing role of **hybrid models** (i.e. agents working in strict relationships or even within banking branches);
- Increasing role of **third party channels** (in particular Poste Italiane);
- Direct channel remains limited as end-to-end interaction, but **online lead generation and multi/ omnichannel** approach will increase.

Minimum scale for full operations may increase and therefore there may be space for **new business models**: small banks or players could operate as agents or **under "advanced" outsourcing models**.

Financial structure

CQ players are leveraging various funding sources, depending on their regulatory status: deposits, bonds, ECB funding, credit sales without recourse and/ or securitizations.

The **securitization market is particularly active**; considering the low interest environment and the attractive risk-return profile of the product, banks/ investors have a **high appetite on financing transactions backed by this asset class**.

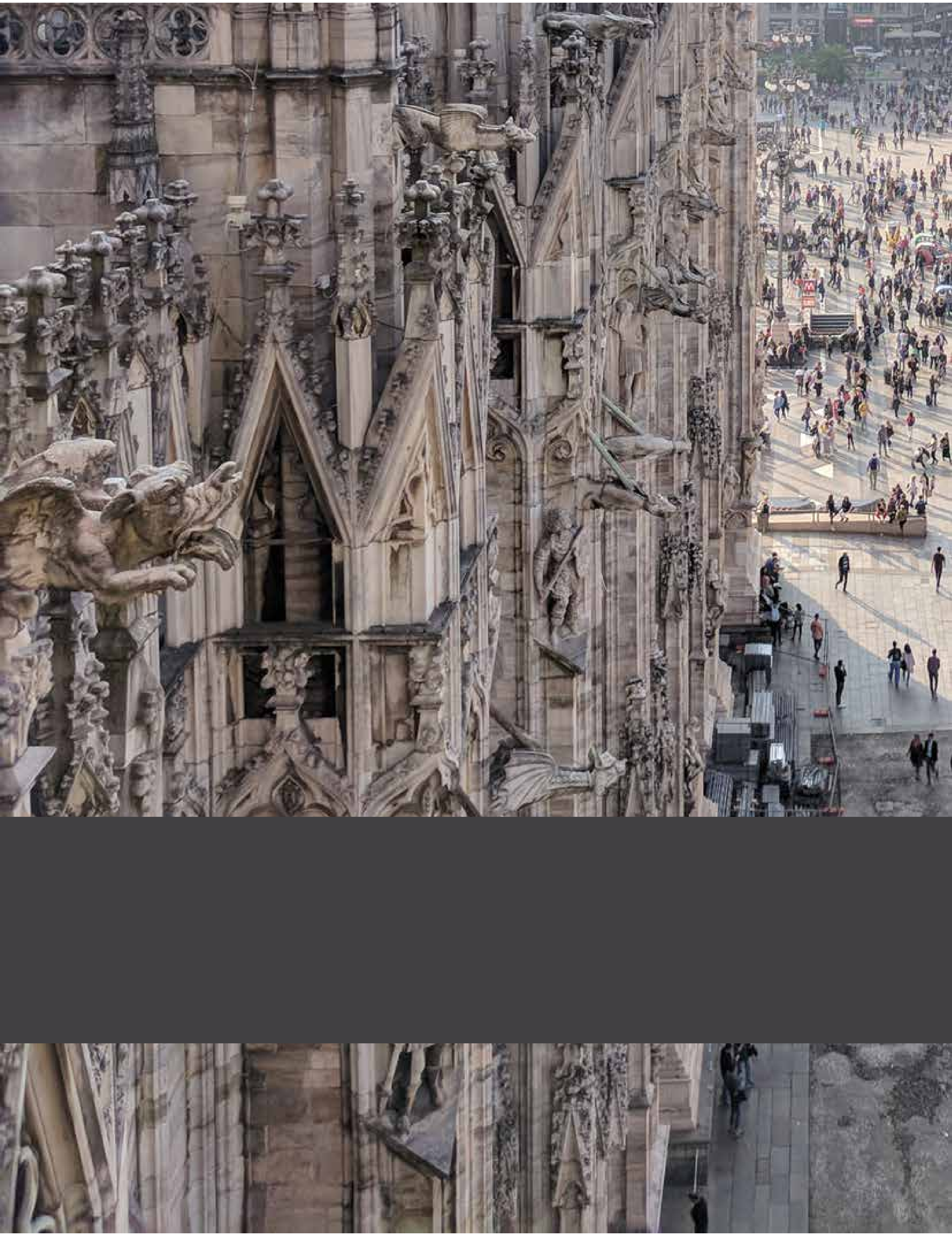
Technological innovation

Due to the number of players involved in the CQ "eco-system" and heavy administrative processes, the opportunity related to **digital innovation** in the sector is high: initiatives leveraging **blockchain**, **RPA** (robotic process automation) and **AI** (artificial intelligence) have recently started.

Expected trends and business opportunities

The segment presents a **positive outlook**: growth opportunities and new clients are likely to compensate price competition. **Distribution capabilities will be key**: players with **strong distribution franchise and powerful customer management capabilities will be winners**.

CQ is likely to be one of the key segments for retail specialty finance strategies in the Italian market and one of the potential entry points for new challenger banking models



4 Digital Banking: new paradigm or enabling factor?

Financial innovation impact on the market structure

Introduction

Technology innovation is slowly affecting financial stability by **changing the market structure in financial** services through application programming interfaces (APIs) over the internet, cloud computing and changes in consumer behaviour driven by smart phone technology. The utility of certain technological applications has increased dramatically with **big data and greater computing power**.

PSD2, Open Banking and use of APIs

PSD2 enables bank customers, both consumers and businesses, **to use third-party providers (TPP)**, AISP[1] and PISP[2], to manage their finances. While **AISP provides access to the pool of transactional data** of bank customers, **PISP in turn is the payment service provider** that enables an efficient payment data exchange in between the customer and the retail service provider. **With the consent of customers, banks are obliged to provide AISP / PISP access to their customers' accounts through open APIs** (application program interface). Otherwise, **banks may select themselves to develop a function of AIS or PIS**, that will allow it to open a wide range of opportunities in the market. It is reported that the programmable web (a public directory of web APIs) has grown the size of its records from just #1 in 2005 to more than #17,000 in 2017.

Another regulation that supports preservation of personal data is the GDPR. With the PSD2, that creates access to a large amount of customer's transactional data, banks and TPPs will have to be compliant with the GDPR, that requires protection of the data.

Mobile banking and smart phones

Consumer expectations have risen with **greater convenience** of a range of services, including financial services. Smart phones have become a platform for third-party developers to develop new products. Combined with APIs, smart phones increasingly have payments capabilities built into their operating systems, thus capturing a 'client interface' through the purchase of a phone.

Note: (1)Account information service provider
(2) Payment initiation service provider

Cloud computing

Cloud computing refers to the practice of using a network of remote servers, typically accessed over the internet, for the provision of IT services. Cloud computing offers advantages such as economies of scale, flexibility, operational efficiencies and cost effectiveness.

Presently, financial institutions mainly use the cloud for such operations as customer relationship management, human resources, and financial accounting. However, we expect that by 2020 institutions will use cloud to also run such services as **consumer payments, credit scoring, statements and billings** for asset managers' basic current account functions. Customers expect more convenient experiences across the services that they use.

There are also **demographic factors driving demand**, such as the growing financial influence of the millennials. These younger generations may be more likely to adopt FinTech. In particular, these consumers may have greater trust in the services of lending market entrants. There may be a more general perception among some consumers that FinTech credit, and especially peer-to-peer (P2P) lending, which directly matches lenders and borrowers, is more socially responsible and of greater social value than conventional banking.

Finally, there are also economic development and convergence factors, such as the rapid adoption of digital technology in some emerging market and developing economies.

Financial services market is based on information sharing and big data analytics

International overview and best practices

Situation today

Digital-only banks are defined as retail banks, offering innovation, digital technology and data as the key means of providing new products and services to the market. Over the past 5 years, **digital-only banks developed rapidly to the point to be considered a valid alternative to the traditional banking players**. Unlike traditional banks, digital banks often **lean on fintech business model, with digital distribution channels that enable faster velocity of the customer assistance and better users' experience**. As a result of mentioned factors, as well as lower charging fees, more and more customers tend to drive away from the traditional players to challenger banks.

European digital-only banks

- Monzo
- Revolut
- Nimbl
- Urve
- Raisin
- Atom bank
- N26
- OakNorth
- B
- Starling bank
- Tandem
- Tide
- Loot

Source: Moneysupermarket «The rise of Digital banks»

According to a study of "atm marketplace", 40% of traditional banks have already initiated to pro-actively invest in new technologies, while 34% are updating the existing legacy IT systems in 2019. As stated by banks, **the largest barriers to compete with challenger banks and digital companies remain to be the legacy systems and high capital expenditures into new technologies**, necessary for AI and machine learning and to meet regulatory requirements.

For example, HSBC has launched the creation of its own challenger bank in UK in line with the industrial plan for £15-£17bn investment in new technologies.

Another example is BBVA, that launched a BBVA Open platform in US, targeting to maximize the potential for open API platform banking.

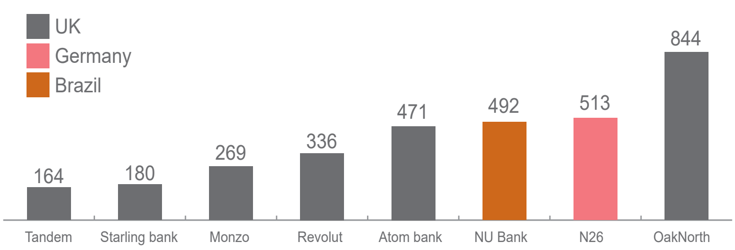
Related to fintechs, German fintech company Raisin enhanced partnership with MHB bank, fully licensed fronting and service bank, through its recent 100% acquisition.

In Italy, Banca Sella launched Fabrick, a B2B2C ecosystem of competences, technologies and services to banks, companies and fintechs to empower them all to collaborate, create and discover customized financial solutions leveraging an open, collaborative, API-based technological platform.

Rising interest in fintechs

In 2018, fintechs (including challenger banks) raised \$39.6bn of financing globally (#1,707 deals), of which \$3.6bn were raised in Europe, representing a record increase of 120% compared to 2017. Such rapid jump has been mainly associated with the venture capital funding from investors, who aimed to gain a market share through offering cheaper and efficient digital financial services.

New European fintech fundraising record (€m)



Source: CB insights

Fintechs perform the role of new intermediaries that are capable of handling large amount of data processing (Big Data), through new delivery channels

New era for Challenger banks

In the short period of time, the largest digital banks have managed to rise the record number of users and even outweigh the traditional banks in terms of financing issued.

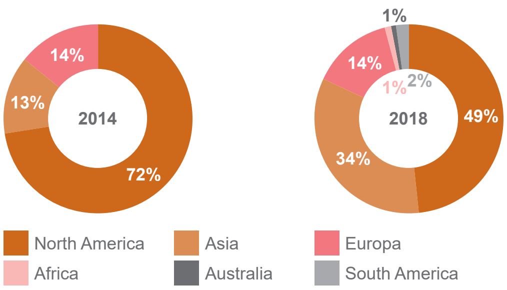
The **market oversees more partnerships involving fintechs in the future** as the demand for APIs grows, while integrations are cheaper in terms of introduction of new products and gaining customers.

Starling is one of the examples of challenger banks, that established a partnership with fintech (Moneybox) to use its API marketplace. The other challenger banks, alongside, are chasing opportunities to create financial services marketplace with banking operations.

Focus on emerging markets

In terms of geographical focus, since 2014 global **investors' attention** gradually has switched towards **challenger banks and fintechs in Asia-Pacific and Latin America regions**, where the growing supply of wealth and a desire for higher returns in the face of low yields has provided challenger banks and Fintech platforms with a larger investor base. Europe did not witness changes in investors' demand, remaining as one of the leading and most attractive markets.

Challenger banks and fintech companies fund-raising by regions



Regulatory support and barriers to entry

In the last year, **traditional banks** had to **confront the barriers in the form of new regulations** that support the challenger banks' access to the market.

German N26, after managing to receive the banking licence from ECB in 2016, has expanded its operations abroad to UK. The most recent valuation demonstrated that the company is worth €2.6bn with over 1 million of customers across the Europe. In 2019, the bank oversees expansion to US through collaboration with a partner bank, which might contribute in obtaining full banking licenses.

- **Open banking standards**-standards for application programming interfaces (APIs), that enable banks to sustain revenues, with reduced time to market and costs, facilitate new partnerships between the banks and non-bank service providers.
- **EU's Revised Payments Services Directive (PSD2)**- enables the customers to connect 3rd party services to their payment accounts allowing for faster and simpler payment performance.
- **Revised GDPR**-customers' provision of approval to organisations before they can use customers' personal data.

Digital Banking: new paradigm

Business Cases comparison: the birth of digital-only banks

1. Traditional Approach

Atom Bank, Tandem Bank, and Starling Bank, the leading digital challenger banks registered in UK, started to fully operate as banks after obtaining the bank chapter, once the regulatory restrictions were lifted, that in general took 2 years. Thus, Atom Bank launched its savings account and SME lending after regulatory approval. The launch of current accounts is also expected, but at the moment is delayed.

Despite leading positions of the banks, the approach selected by them have not been a win-win. Having prioritized regulatory protection and authorization for the launch of wider set of services to customers, they went behind their market peers who used the time lag (after registering with the Financial Conduct Authority) to get their products to the market and gain the customer base.

Tandem's banking charter has been suspended in 2016 after failing to secure funding. In 2018, it acquired Harrods bank to receive back the full banking license following with acquisition of money management app Pariti.

- Monzo
- Revolut
- DBS
- Atom bank
- N26
- Zopa
- Starling bank
- Tandem

2. 'Fast Lane' Approach

Revolut challenged the traditional go-to market strategy through obtaining an e-money license, which embed an easier process, and targeting currency exchange rather than current accounts. Through establishing of digital currency exchange app, allowing customers to exchange money across countries, facilitated in concurring the leading position across the challenger banks. The product has been launched after registering with the FCA before obtaining the banking chapter, enabling the bank to gain access to a larger base of clients for a broader banking offering.

Moreover, Revolut leveraged on the European Economic Area "passporting" to expand its operations across Europe and partnered with other fintechs to grow quickly.

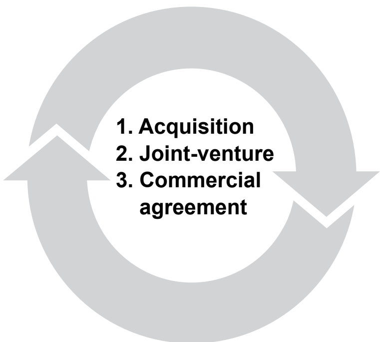
Zopa, before receiving the UK banking license from FCA in 2018, has been able to facilitate to over £3.7bn of loans to nearly #0.5m customers as a peer-to-peer lending platform since 2005. With the banking license, the company is planning to introduce new financial products (fixed-term savings account, credit card, etc).

DBS bank, leading financial services group in Asia, specialized in corporate, SME and consumer banking was recognised the "World's Best digital bank" in 2018, due to the digital transformation strategy adopted back in 2009. After 10 years in the market, DPS has managed to become the leader that leverages on big data technology, ensuring management of the transactional trends based on analysis of customers' behaviour.

Example of traditional bank partnership with fintech company (digital enabler)

Thanks to Fintech even traditional banks can be transformed into successful story to cover new niche segments, such as P2P lending, crowdfunding, cross-border payments and, thus, bring closer their business model to the ones of challenger banks.

Traditional Bank
Through the partnership, banks obtain an access to the innovative technologies and products



Fintechs
• Credimi • WI • BorsadelCredito.it

Fintechs obtain access to the customer base of banks, while having less regulatory pressure on them

Please see the next page for examples of business model

Integration of fintech platform with traditional bank's «state of art» IT system

The partnership enables traditional bank to accelerate in the services delivered to the customers

Illustrative

Factoring services	**Acquisition finance**	**Peer-to-peer Lending**	**Other financial services**	**Invoice trading**

1. **Factoring services** – for companies that need financing of working capital to maintain the supply chain.
2. **Peer-to-peer lending** – debt financing enabling retail clients mainly to obtain the funds in the form of loans from private investors, companies or institutional investors without the use of financial intermediary.
3. **Acquisition finance** – assistance to financial investors and / or companies in implementation of their external development programs.
4. **Invoice trading**-intermediary of loans against invoices to be cashed.
5. **Other financial services** – acquisition of individual Unlikely-To-Pay corporate loans positions, offering advisory and restructuring services, new financing, etc.

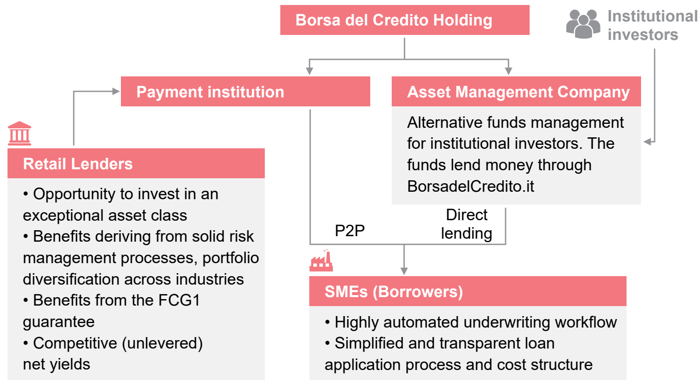
- **Fintech platforms** provide an **access to online processing of client operations, new data sources and methodologies**, putting a large burden on the banks and enforcing them to reconsider underwriting processes and deploy more efficient data analytics systems.
- Fintech platforms are **attractive also to private equities and institutional lenders** to enter the alternative financing market independently from traditional banking model.

Overview of fintechs' business models in Italy

Borsa del Credito

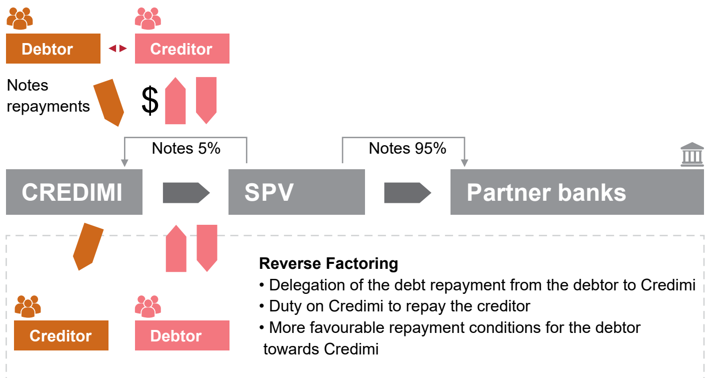
BorsadelCredito.it is the first Italian fintech alternative lender for SMEs: it offers competitive marketplace lending landscape where SMEs can rapidly find a credit solution or an investment opportunity. The Group is composed by 2 companies:

- an asset management company for alternative funds;
- A payment institution for P2P lending.



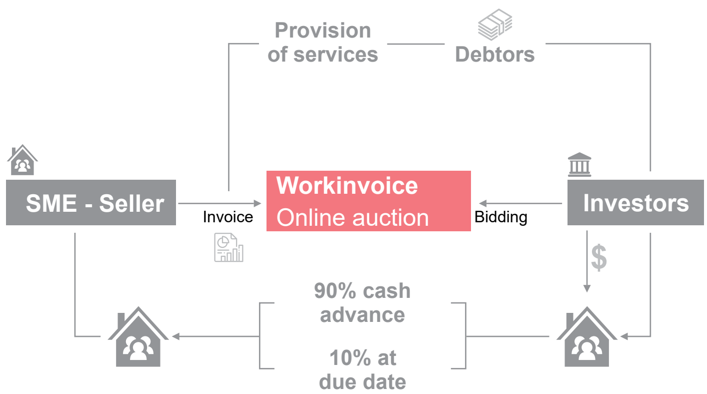
Credimi

Credimi is a digital financial intermediary, in the form of a 106 TUB, dedicated to Italian companies, which helps businesses to manage their cash flow. Quickly and easily, it is the solution to traditional banking and factoring alternatives, making access to credit more transparent, with no fixed costs, bureaucracy and paperwork.



Workinvoice

Workinvoice is the first P2P platform in Italy to provide SMEs and investors with a digital marketplace where they may trade efficiently and transparently commercial invoices. It provides an alternative channel for in-advance invoice payments, putting in direct contact the financial resources and the productive sector.



Note: (1) Italian Credit enhancement facility for SME lending, that guarantees up to 80% of the recovery rate

Cooperation models between banks and fintechs

Specialty finance players may **collaborate with fintechs in 3 ways** as represented below:

Integration and Control

1 Build

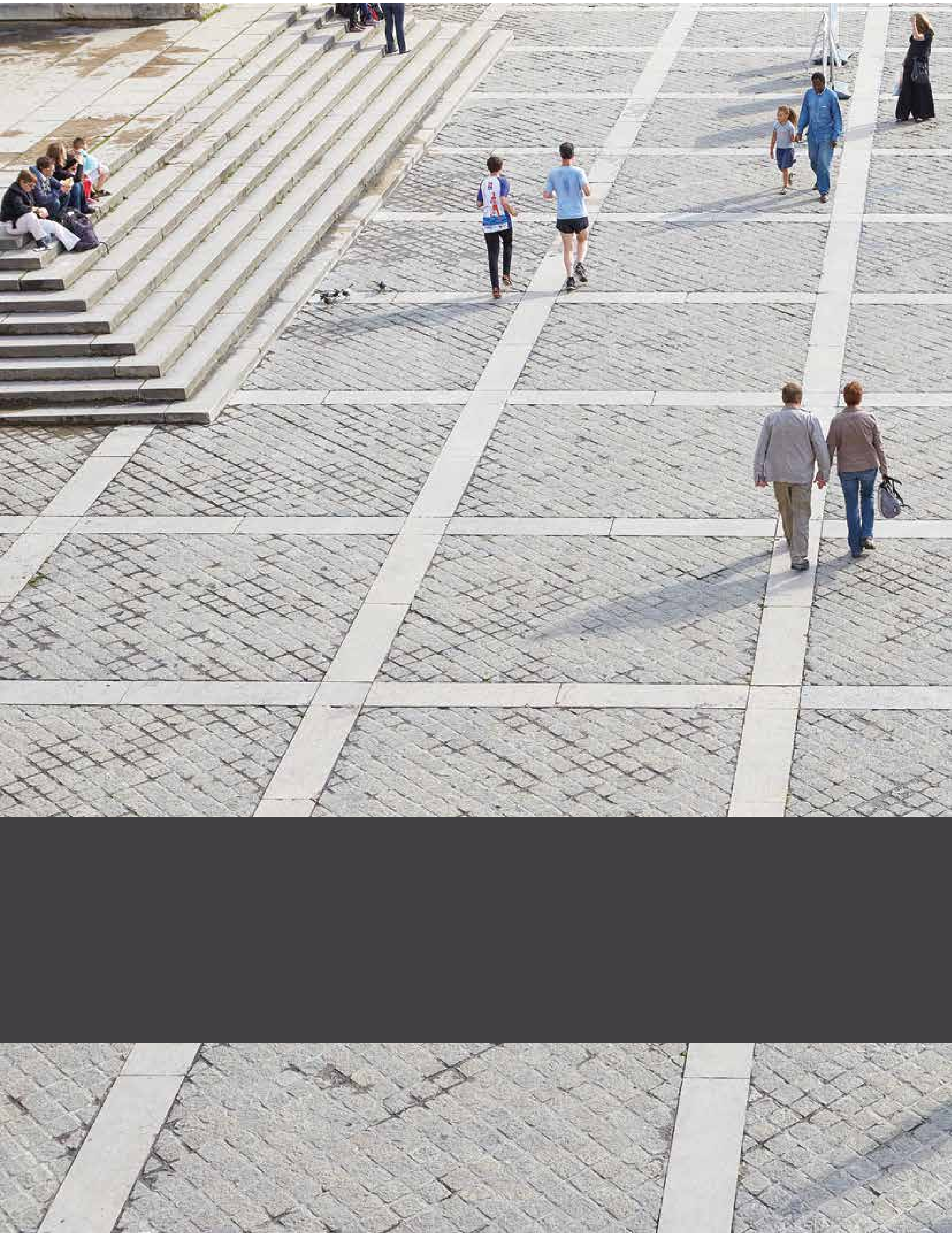
Digital Unit	Internal unit dedicated to innovation from within the company.	Establishment of **trust upon the capability of companies**, given their scale and resources.
Subsidiary	Independent entity to a certain extent, but showing relevant connections with the mother company.	

2 Buy

Full Acquisition	Complete acquisition meant to incorporate Target business.	Financial services players **(Private equity funds, Venture capital funds and new M&A teams) oriented towards investments in digital innovation**.
Majority Stake	Majority stake aimed to create collaboration and provide a clear business direction.	

3 Co-operate

Minority Stake	Minority stake aimed to create collaboration and provide a clear business direction.	Traditional banks **assist startups to optimize business models and competences**, often looking for equity stakes in exchange for their support, expertise and assets, such as access to the technological platform, and hoping to identify potential disruptors. Other **companies tend to form alliances with Fintechs** which could help them serving new client segments or offering new value sources to existing ones.
Acceleration	Identification and support of startups which could generate value once fully developed.	
White label	Sourcing of a single Fintech product to be integrated in the traditional banking business.	
Co-branding	Joint development of a solution aimed to support the business, without direct control.	
Referral	Relation aimed to maintain client contact without serving their needs directly.	



5 M&A and capital market activity in specialty finance

M&A and capital market activity in specialty finance

After many years of few deals, characterized by uncertainty from important regulatory framework changes (i.e. introduction of a single register – Albo Unico 106 – for financial intermediaries), since 2017 **M&A activity in specialty finance has decisively restarted and is expected to continue in 2019**.

M&A activity is being driven by different factors:

- **Challenger banks or international investors that are looking for profitable lending segments**. In this context, the market is showing growing interest towards niche segments (such as CQ, pawn loans) which offer good returns and are not dominated by traditional banks;

- **International investors which are looking for light-asset banking licenses to be used as platform for developing specialist banking models.**

In 2019 important dossiers are expected to go to the market: additional opportunities may come from banks interested in carving-out their specialty finance businesses or independent financial intermediaries looking for financial and/or industrial partners to stabilize their business and continue the path of growth.

Organic growth in specialty finance could be too slow: it's time for an acceleration in business combinations and strategic partnerships

Specialty Finance - recent deal activity

2015 - 2014

- **Seer Capital** Acquisition of Mediocredito Europeo
- **Banca CR Asti** Acquisition of 65% of Pitagora
- **JZ international** Acquisition of Fincontinuo
- **Oaktree** Acquisition of 100% of Banca Lecchese (now Banca Progetto)

2016

- **Banca IFIS** Acquisition of 100% of GE leasing and factoring companies
- **Santander Consumer Bank** Acquisition of agency network of Accedo/ Intesa Sanpaolo
- **Terfinance** Acquisition of 100% of Credito Salernitano (now Vivibanca)

2017

- **Banca Mediolanum** Acquisition of 100% of EuroCQS
- **Alchemy** Acquisition of 100% of Sigla
- **Cre.Val.** Acquisition of 47% of General Finance
- **Cre.Val.** Acquisition of 100% of Claris Factor
- **SC Lowy** Acquisition of 90% of Credito di Romagna
- **Dorotheum** Acquisition of pawn loan business of UniCredit
- **Banca Sistema** Acquisition of 20% of ADV Finance
- **Banca IFIS** Acquisition of a controlling stake of Cap. Ital.Fin.
- **Chenavari** Acquisition of 80% of Creditis
- **Banca Popolare di Sondrio** Acquisition of 100% of Prestinuova

2018

- **Banca Sistema** Acquisition of 100% of Atlantide
- **Cofidis** Acquisition of 100% of Libra
- **CR Cento** Acquisition of 100% of I.FI.VE.R
- **Imprebanca** Acquisition of 20% of Siriofin
- **SPAXS** Acquisition of 100% Banca Interprovinciale (now illimity)
- **IBL Banca** Acquisition of 70% of Finanziaria Familiare
- **Cassa Centrale Banca** Acquisition of 100% of Claris Leasing
- **AGOS** Acquisition of 100% of ProFamily, after carve-out of extracaptive business

LEGEND (target activity)

- CQ only
- Consumer lending
- Pawn loans
- Leasing & Factoring
- Asset-light banks

6 Which opportunities ...and challenges... for challenger banks?

What are the opportunities for challenger banks?

- **Specializing the business model**, with a focus on niche segments, such as e.g. salary-backed consumer loans, is a **strategic option for small-medium size commercial bank** on the way to improve profitability.

- **«Distribution is king»**
  Omni-channel management will make the difference. **Third party networks** could be a lever to reach cost flexibility and improve customer experience in specialty finance.

- **The UTP market**, yet in an early stage and quite limited in terms of transactions, should **be the next challenge** and opportunity for Italian banks: room for innovative models leveraging a combination of lending, servicing and restructuring capabilities; challenger banks could play a leading role.

- **PSD2- open banking- AI**
  Connecting people-data-systems will change current competitive boundaries and create new business opportunities.

- **EU passport in order to gain access to** operations in **other European markets** based on domestic authorisation, easing up cross border transactions, payments and investments.

- **Specialised does not necessarily mean small**: scale could be relevant in niches, as well. Challenger Banks can be **business aggregators** of different players along the value chain i.e. **strategic combinations of banking platforms with product specialists/fintech** could present significant **value creation** potential.

What are the challenges for challenger banks?

- **A minimum scale is necessary** to compete even in specialty niches: organic or inorganic growth?
- Does **IT operating strategy** allow to **sustain scalable business model** with a low cost base?
- **Is wholesale funding scalable enough** to sustain growth or a **retail funding strategy is always necessary**?
- A **diversification** / **multi-niches strategy in specialty finance** could increase the risk to **weaken the competitive advantage** of the «truly-specialised» model?
- **The higher cost of funding guaranteed to the customers** compared to the traditional banks, in the medium run **may adversely impact profitability**?
- Does provided **service quality and customer experience ensure acquisition and retention of the customer base**?
- Does the challenger bank have the **proper technology to handle the customers on-boarding process**, i.e. APIs, KYC , etc.?
- **Increasing competition** among the challenger banks leads to **lower yields for the financing** issued?

Appendix: ... not only banks – the evolution of financial intermediaries (106)

Appendix: ... not only banks: the evolution of financial intermediaries (106)

In addition to specialist banks, many financial intermediaries operate in the Specialty Finance marketspace.

According to Bank of Italy regulation, financial intermediaries are entities other than Banks allowed by Italian law to provide credit in the Italian territory: lending companies, loan guarantee consortia, securitization servicers and pawnbrokers are included.

Until 2015, according to the size, the Regulator made a distinction between players under general register (106) and those in special register (107), subject to prudential supervision.

At the end of 2015 #530 intermediaries were present in the registers, #424 ex 106 and 106 ex 107.

Their regulatory framework has recently changed: based on the reform of the Title V of the TUB (Testo Unico Bancario), as amended by Legislative Decree 141/2010, which came into effect in July 2015, financial intermediaries need to be authorized by Bank of Italy in a single register (Albo Unico 106).

New and tighter requirements have been introduced in terms of capital (they are subject to a prudential supervisory regime equivalent to banks), governance, organization and operations.

The strategic goal of the reform, aimed at having only well capitalized and organized players operating in the market, seems achieved: after a transition period, a relevant rationalization of the industry is underway.

At the end of February 2019, the number of financial companies has reduced from #530 to #147, of which #7 new intermediaries.

#390 unsubscriptions were registered due to restructuring, mergers, transformation into non regulated distributors (agents or credit brokers), transfers to other regulated registers (IP-Istituti di Pagamento, IMEL- Istituti di Moneta Elettronica, Società 115 for debt collection agencies, …).

A clustering analysis of the #147 new intermediaries lets us understand their nature in terms of business model:

- #39 are mainly active in the consumer credit market
- #24 in factoring
- #38 in leasing
- #21 in NPL purchasing and servicing
- #6 in master servicing
- #19 in other business areas

In terms of ownership structure #54 are controlled by traditional banking groups.

Our publications

**The Italian NPL Market:
Entering a New Era**

https://pwc.to/2CS9ho0

**Open banking…
so what?**

https://pwc.to/2V9HhmR

**Robotic Process Automation
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The €1 trillion challenge in European banking

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The dating game in European banking

https://pwc.to/2VrEhm6

2017 Financial Services Trends

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