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Beyond banking: How banks can use ecosystems to win in the SME market

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Small and medium-sized enterprises (SMEs) form the backbone of many economies around the world. Representing one-fifth of global banking revenues, SMEs generate around $850 billion of annual revenue for banks--a pool expected to grow by approximately 7 percent annually over the next seven years.

As a customer segment, SMEs offer vast potential. However, the profits of SME-focused banks have traditionally lagged those that specialize in other customers, often because of highly varied credit quality in the portfolio. Finding the optimal balance between providing a great customer experience and managing cost-to-serve has also proven to be difficult. As a result, many banks have not prioritized SMEs, forsaking the vast potential value, and leaving many SMEs feeling that their needs are ignored.

But now, new customer propositions and better service models enabled by technology are creating opportunities for much more lucrative returns. Fintechs are entering the business, as are the “big tech” firms, with innovative service models that reduce costs and increase revenue. Their offerings include traditional banking products, and also many other business services such as invoicing, payroll, tax preparation, and inventory management. Such “beyond-banking” ecosystem offerings target customers’ fundamental needs in a single easy-to-use service. Even better, they answer the primary challenge of SMEs, as identified by our survey of more than 500 business owners: giving entrepreneurs more time to focus on their core business activities.

Ecosystems are not just for tech companies. They also offer banks a unique and scalable solution to the competitive challenge. Banks have great advantages, including rich data and customers’ trust, to expand beyond their traditional limits into adjacent businesses. Already, some banks are succeeding at offering these services. But most banks are not.

In this article, we outline how banks can win a significant share of SME revenue pools and maximize returns using an innovative ecosystem proposition that addresses the needs of SMEs. Using several case studies and insights from our extensive research and ecosystem work, we describe what it takes to succeed in an SME ecosystem.

What's at stake: How valuable is the SME opportunity?

The scale of SME banking

Almost all businesses are small or medium in size. Ninety-nine percent have fewer than 50 employees, and 97.5 percent have fewer than 10. In many countries, SMEs account for over 60 percent of total employment. Worldwide, SMEs produce about $850 billion of annual revenue for banks, through deposits, lending, overdrafts, and payments. That is about 20 percent of all banking revenues.[1] The global market is expected to grow by around 7 percent annually over the next seven years.

Despite its size, the SME segment has typically appeared unattractive because of its relatively low return on equity (ROE), about 7 to 8 percent for traditional players. Serving SMEs is relatively costly, as they typically generate lower revenue opportunities per head than do commercial clients, yet with comparable costs to serve. Also, credit profiles and data for SMEs are more difficult to find, and in an economic downturn, poorly designed credit models can lead to substantial loan losses.

The underserved middle

Small-business owners find that their relatively low turnover means they are not a priority for most traditional banks. As a result, SMEs often find themselves stranded between large corporates and retail customers, saddled with products and services that fall short of their expectations–the "underserved middle." For example, many SMEs struggle to access adequate financing; and lending products are often unable to meet their needs, such as quick and seamless application.

In the UK, the Competition and Markets Authority's investigation into the SME banking market found that satisfaction levels of SMEs with business current accounts offered by the "big 4" banks are just about 60 percent. Only 25 percent of owners feel supported by their bank. The report concluded that SMEs are not getting the best bank accounts for their needs and suggests that the banking industry is not as innovative or competitive as it should be.[2]

This opportunity to better serve SMEs has opened the segment to a new wave of attackers with interesting customer-led propositions (Exhibit 1).

These include technology giants such as Amazon, which recently entered SME lending with the ambition to lend to two million SMEs in the UK, US, and Japan. An increasing number of fintechs such as Coconut, which serves freelancers with business bank accounts and personal financial management services, are entering this sector. Around 30 percent of all fintechs are currently focusing on SME solutions, according to research by Panorama, a McKinsey Solution.

Change is coming

Three changes are now making SMEs a more attractive segment.

First, customers—including business owners—are becoming used to convenient and tailored services in their personal lives. This is shaping their expectations about how they want to interact with financial services. Many customers are increasingly demanding real-time personalized and convenient cross-sectoral service—including the kind of immediate availability provided by the likes of Apple, Amazon, Google, and Alibaba.

Next, more cost-efficient models for serving SMEs are emerging, and helping to lift margins. Digitization

1 McKinsey Global Banking Pools database. For Western Europe, SMEs are below €250 million annual turnover. For other regions we have used local definitions.
2 "Retail banking market investigation," Competition and Markets Authority, August 9, 2016.

Exhibit 1

A new wave of attackers is focused on the SME market.

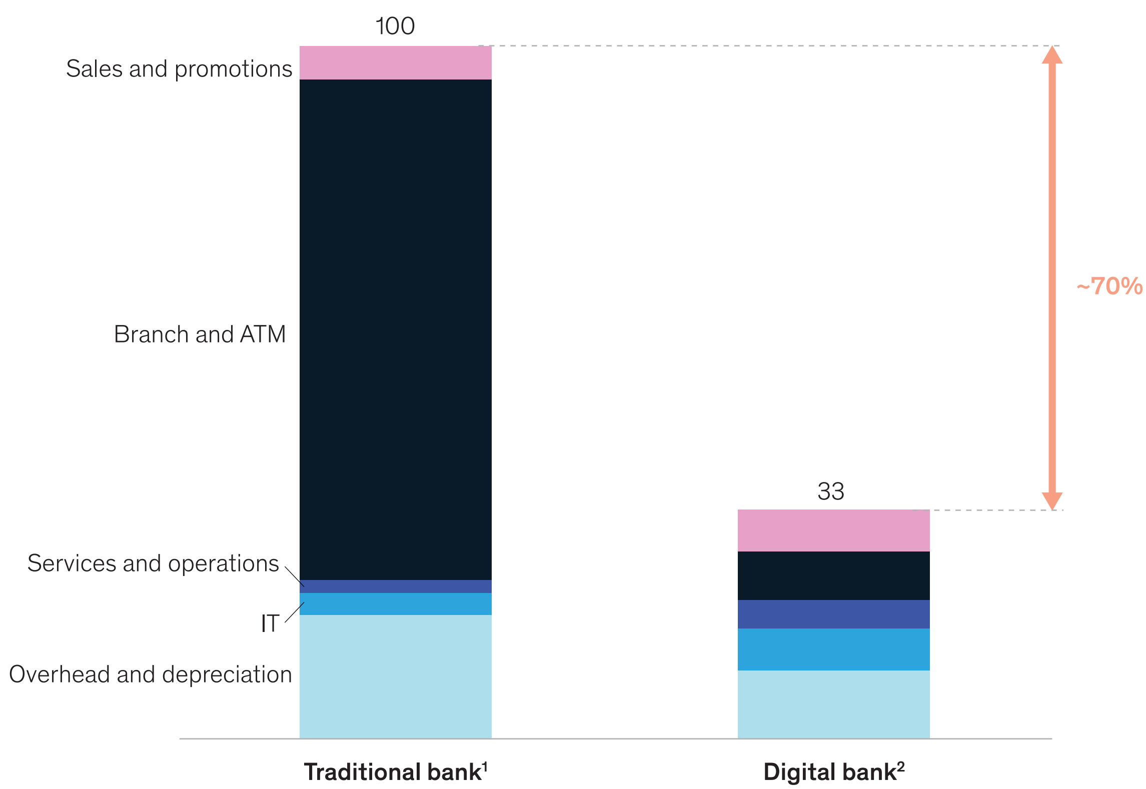
Amazon (global)	Lending to SMEs in UK, US, and Japan
PayPal (global)	Short-term business financing
Cumplo (Chile)	Business bank accounts and personal financial management for freelancers
Holvi (Finland)	One-stop account that helps SMEs manage and view their finances
Ayden (Netherlands)	Global provider offering end-to-end frictionless payments
Klarna (Sweden)	Innovative e-commerce payments solutions for businesses and merchants
Coconut (UK)	P2P lending platform with alternative financing

Source: McKinsey analysis

Exhibit 2

Digital SME banks enjoy significantly lower cost to serve than their traditional peers

Operating expenses/deposit balance, Indexed



[1] Estimate of a comparably size retail bank serving same size segment (2 million customers).
[2] Year-5 projections at steady state operations (not growth mode); no transaction subsidies, minimum branch network and no out-of-branch RM
Source: McKinsey analysis

makes processing cheaper and the growth of APIs are making it easier to serve SMEs. Several traditional banks planning to enter the SME market have chosen to set up standalone SME digital banks—with cost-to-income ratios between 30 and 40 percent (Exhibit 2). Access to more data and advanced analytics as well as improvements in risk management enables better segmentation and risk selection, at lower cost. An abundance of new data from previously unavailable sources (such as online shopping) is improving the predictive power of credit models. So too is the advent of robust technologies (including deep-learning models, improved optical character recognition capabilities, and location verification tools to prevent fraud). As a result, financial services can be offered cost-effectively to currently underpenetrated segments, including millions of SMEs.

Finally, P&L and regulatory pressures are encouraging banks to explore new revenue streams. Low margins and tighter capital requirements pose significant challenges for the banking sector, whose valuations remain below those of other industries. Regulatory shifts including open banking and PSD2 are pushing banks to fundamentally rethink business models. And in turn, more open regulation is enabling a wave of new entrants into the market. A recent McKinsey Open Banking survey[3] found that several types of SME, especially tech-savvy firms, are interested in and likely to use offerings from non-banks that rely on open-banking regulations.

[3] McKinsey Open Banking Survey Research, UK, October 2018, completed by 950 small enterprises (1-50 employees) and freelancers.

Why ecosystems can give SMEs what they want

What SMEs really want

We surveyed 500 small-business owners in North America to understand their day-to-day operations and challenges.[4] The survey also covered the online solutions they use and the importance of different services. The survey findings confirmed what we've learned from helping large companies around the world serve SMEs. Small-business owners want to spend more time running their business and minimize their administrative duties.

The research suggests that entrepreneurs' daily tasks fall into two categories (Exhibit 3). One is, obviously, building the core business: finding and approaching prospective clients, managing the delivery of products and services, and maintaining client relationships to generate further business. These activities are the true drivers of growth and profits.

The other category includes administrative activities such as accounting and bookkeeping, payroll management, following up on payables and receivables, financing, tax planning, and managing payments and bank accounts. These are all essential tasks without which a company cannot function properly. But they do not create profits.

Unsurprisingly, our research showed that entrepreneurs would prefer to maximize the time spent on core business activities, and minimize the time spent on administration. As one entrepreneur put it: "I would like to arrange all my admin tasks in 15-20 [minutes] every morning at my dining table so I can free up time for more important business to dos."

Businesses also tell us they lack adequate support at some critical tasks in both core and non-core activities. Owners spend more time on these areas than is necessary, resulting in "pain points." These points vary across sectors and each phase of an SME's lifecycle, but there a number of common issues (Exhibit 4).

Our work with SME banks also suggests another important customer need: convenience. Entrepreneurs—like most individuals—seek a simple, intuitive, and personalized experience. They do not want a set of products, but rather an integrated service designed to meet their needs in an easily accessible channel—just like their online experience with world-class digital firms.

Why ecosystems offer SMEs a winning proposition

Given SMEs' significant unmet needs, it's easy to understand the attraction of ecosystems. The ecosystem idea is to offer a broad range of services SMEs need, including but not limited to banking, in a single integrated platform. This provides the convenience SMEs seek, and reduces the amount of time spent searching for and accessing other products and services. And an ecosystem makes new and better services possible for SME owners. For example, access to an entrepreneurs' transaction data and invoice history will allow banks to make more informed decisions (about credit limits, say), recommend more suitable financial solutions, and even nudge business owners to act ahead and avoid potential problems (for example, by comparing payment due dates for supplier invoices against the current account balance, business owners can be warned about potential lack of funds).

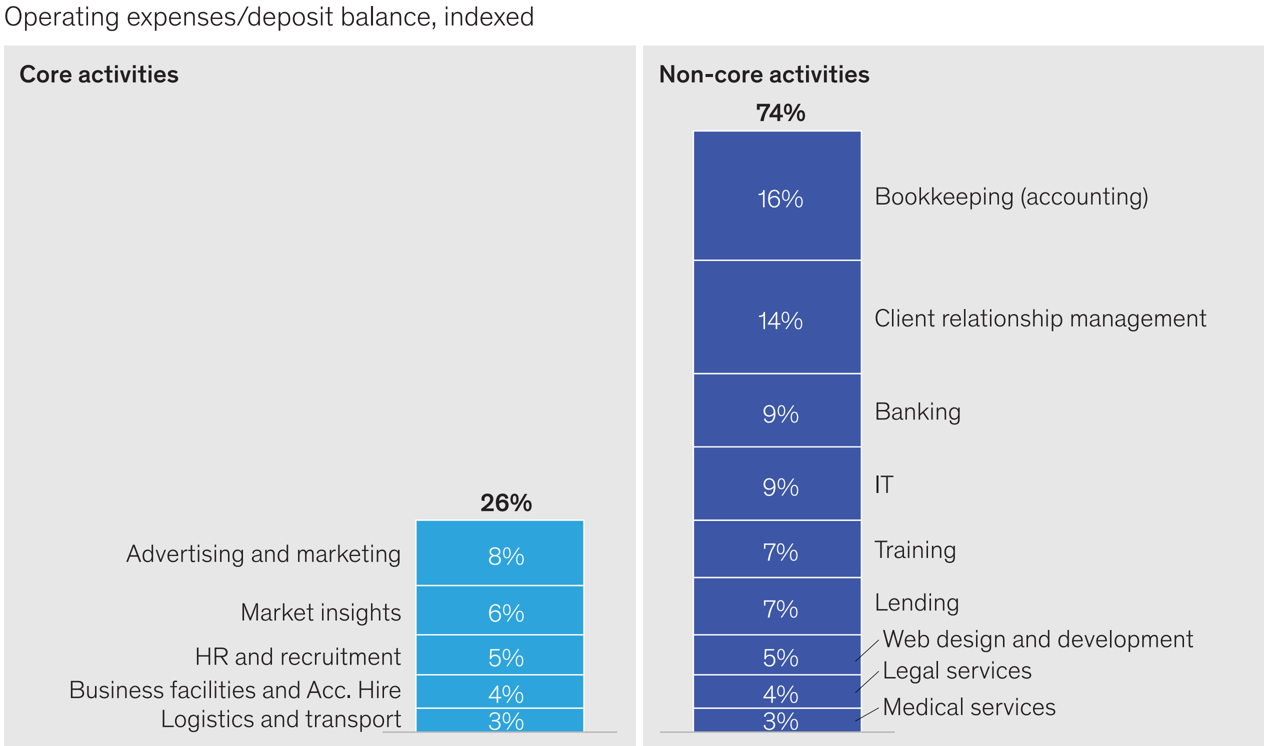
Players that offer such solutions also stand to gain, for example by generating new revenue streams, increasing customer satisfaction by easing their customers' daily operations, and collecting more customer data (such as accounting information) that can be used in several ways (including credit scoring and product recommendation).

For instance, Recruit Holdings has emerged from publishing and advertising to orchestrate several ecosystems and provide one-stop-shop SME business tools. Globally, it provides

[4] McKinsey SME Survey, Canada, November 2016, completed by 500 SMEs.

Exhibit 3

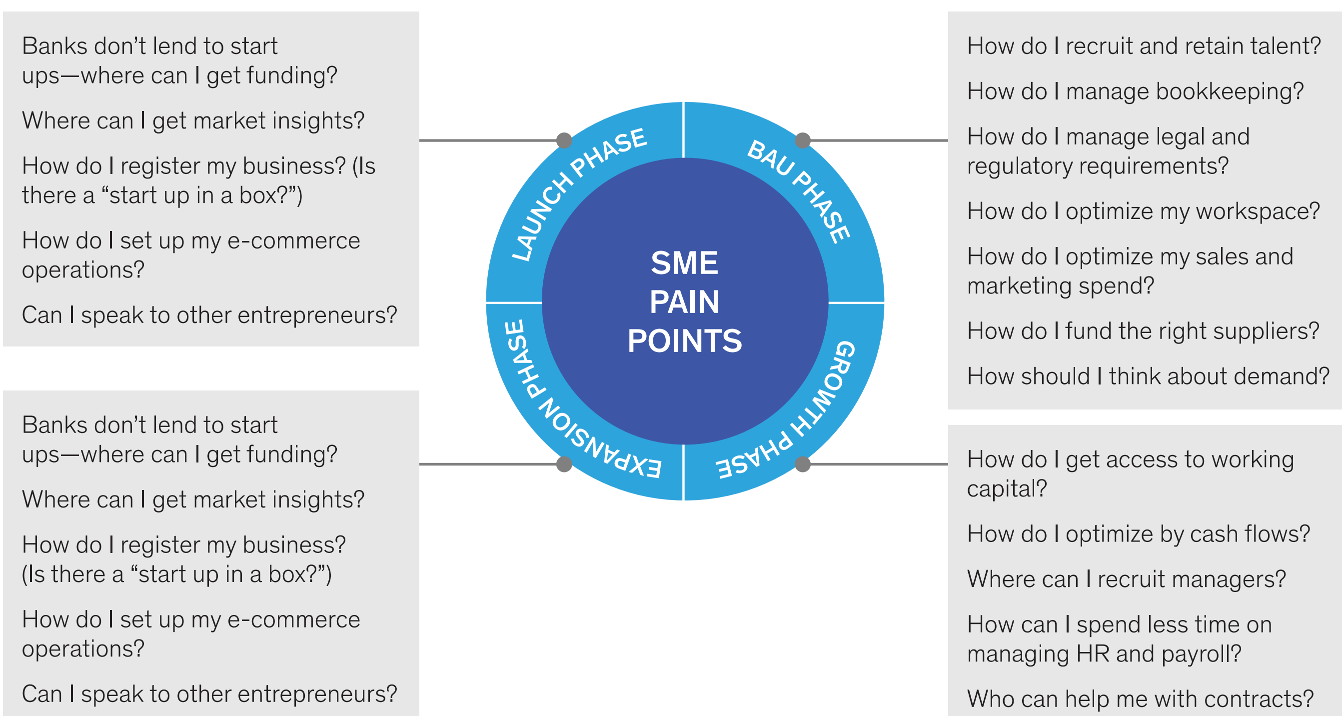
SMEs spend a significant amount of time on non-core business activities.



Source: McKinsey Canadian SME Survey, 2016

Exhibit 4

The landscape of SME pain points.



Source: McKinsey analysis

Exhibit 5

SME ecosystems are emerging across the globe.

Uber (US) Uber partnered with GoBank to offer US drivers current accounts; and partnered with Holvi in Finland to offer easy finance to drivers.	**Alipay** (China) The rapidly growing online and mobile payments provider recently entered European markets with the goal of having two billion worldwide users in the next decade.
Stripe Atlas (US) Offers a “company-in-a-box” toolkit that automates incorporating a company, setting up a bank account with a tax ID number, discounts with accountants, legal and tax advisors, and a Stripe account for online payments.	**Knopka** (Russia) A remote support service offering non-banking services, including legal, accounting, and business travel.
Inuit QuickBooks (US) One-stop shop for SMEs offers a paperless real-time accounting solution providing multi-user experience. Is accessible anytime and anywhere, and automatically backs up and secures data.	**RBC** (Canada) RBC’s Ownr is an end-to-end online platform offering a comprehensive set of services that assists in setting up and managing a new business. It also helps with the most burdensome administrative and regulatory requirements.
Gusto (US) An integrated platform with comprehensive services for payroll and HR management. It automates all payroll tax calculations, tax filings, reporting, and payments, and enables businesses to provide direct deposits to employees.	**Xero** (New Zealand) Offers SME support services with free APIs, and integrated with AI for customer augmentation. App Marketplace supports CRM, invoicing, jobs, payroll, HR, point of sale, reporting, financial services, and debtor tracking, among others.

Source: McKinsey analysis

outsourced HR services and maintains several job search websites. It helps businesses streamline operations with cloud-based CRM platforms and offers mobile and alternative point-of-sale/service payments. It also offers staffing, recruitment, and integrated HR services, even in highly specialized niches such as industrial staffing. Recruit has capitalized on its ecosystem strategy: in 2018 it achieved roughly $18.85 billion net sales with $2.32 billion EBITDA. Its job searching platform, Indeed, is the most visited job site worldwide, with 100 million resumes uploaded and 18 million employer reviews.

In Singapore, UOB BizSmart offers digital applications that help SMEs run their business more efficiently. It conducted market research to understand the typical services SMEs require, then partnered with various digital B2B providers (in accounting, payroll, sales, employee management, and information security). All these features are integrated seamlessly with UOB bank accounts, allowing SMEs to reconcile transactions with their bank statement in one simple click. UOB benefits from this solution in several ways. It brings additional customers to digital providers in exchange for a commission. UOB also gains access to customers’ real-time data as the financial transactions are integrated automatically with UOB’s system. Data can be used to offer customers other relevant financial products.

Such ecosystem offerings provide true additional value for everyone: primarily the entrepreneurs themselves, but also for the platform provider, which can widen its proposition and revenue streams. Solution providers also benefit as they get access to customers through the platform, which helps them build scale. And ultimately, simplifying the life of SMEs contributes to improving productivity and hence, economic growth.

Already, several digital companies have started to build SME banking ecosystems to capture the opportunity (Exhibit 5).

Why banks can win: How financial institutions can capture this opportunity through ecosystems

Digital firms are staking a claim on the opportunity. But ecosystems are an attractive play for any service business that can claim ownership of the primary customer relationship. Those that have the strongest relationship with the customer enjoy the highest profit margins in ecosystems, and thus the most sustainable and lucrative business model. Participating in an ecosystem, or organizing one, provides the opportunity to boost otherwise shrinking banking returns.

Banks enjoy competitive advantages compared to other relevant players such as tech giants and telco firms. As banks contemplate an ecosystem play, they should consider three strategic roles they might assume, and five primary principles for avoiding pitfalls and ensuring successful implementation.

Why banks have a competitive advantage

Banks are in a favorable position to build SME ecosystems because of the number of their trust-based customer relationships; the data on customers that they gather and own, with customers' consent; their starting position, including their ability to invest; and the type of services they can offer business owners.

While some other players—such as technology giants and telco companies—share some of these characteristics, to a degree, it is transactional data that truly makes a difference. Banks have access to a vast amount of transactional data that sheds light on many aspects of companies' behaviors and activities. That is a profound advantage in the race to offer ecosystem services.

Further, business owners consider financial services to be closely aligned with other non-core services. That positions banks well to play a primary role in addressing SMEs' needs at every stage of their development (Exhibit 6).

However, some of banks' advantages could be eroded over time. New fintech and "big tech" entrants offering truly digital and low-cost services have started outperforming banks on technology, image, and trust. Furthermore, open banking will eat away at banks' proprietary data, opening up customers to even more competitors. For a bank to succeed it must deliver an exceptional proposition that is more compelling than those of competitors.

What strategic roles can financial institutions play?

Banks can take three different strategic roles in SME ecosystems, distinguished by the degree of involvement:

1. **Participate**

Banks can provide financial services to at-scale competitors that are building ecosystems from a base in other industries. This strategic play can bring in revenue by reaping spill-over benefits, as banks add new customers from other business systems. While this role grants the lowest financial opportunity overall, it helps banks monetize their product portfolio with minimal additional investments. A typical example is GoBank in the US, which teamed up with Uber to offer certain banking services to the entrepreneurs on the ride-sharing platform. In this set up, the bank gains access to a vast customer base, while the platform operator earns revenues from connecting the parties.

2. Orchestrate

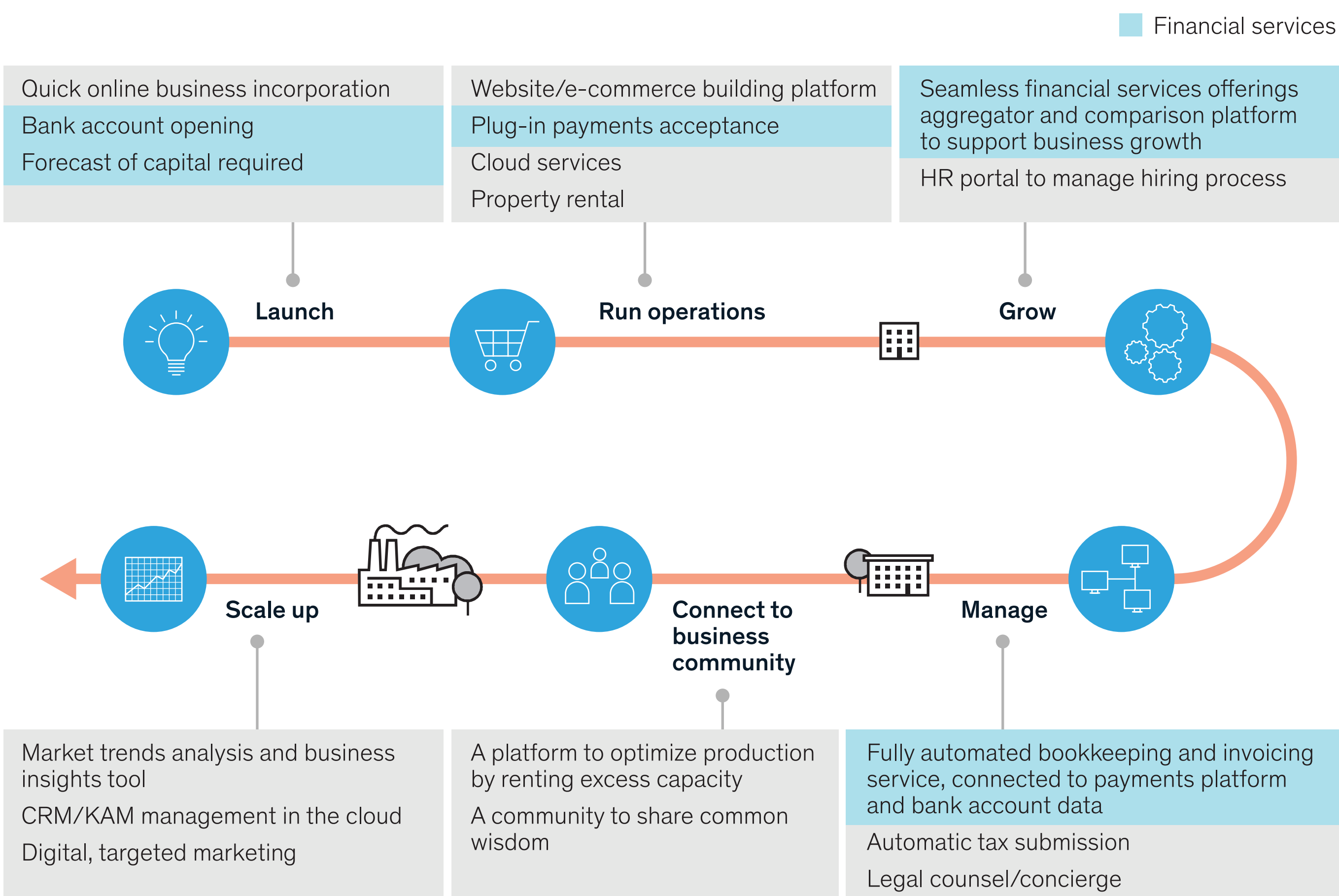
Banks can also become the primary integrator of partnerships, and thus reduce the scale of investment and complexity of execution. In this case the bank becomes the primary and ideally the only provider of financial services. One example is Idea Bank in Poland, which was founded in 2015 and provides end-to-end financial and business services support for SMEs and start-ups through a cloud-based platform. Beyond-banking services offered by Idea include concierge support in dealing with the state, accounting services through a subsidiary company, cash-flow analytics tools, and promotion support. As part of this ecosystem, in 2017 the bank launched a bookkeeping application for Uber partner-drivers, offering lower costs and higher security than rival services.

3. Build

Finally, banks can build new businesses within and across ecosystems. This role provides the most significant financial and non-financial benefits; however, it is also the hardest to pull off. OTP Bank in Central and Eastern Europe launched a state-of-the-art solution called eBiz which is essentially an online financial management tool for SMEs. In Canada, RBC introduced a cutting-edge end-to-end online platform called Ownr which offers a comprehensive set of services that assist in setting up and managing a new business in Canada. Ownr helps with tasks such as registering a business as a sole proprietorship or incorporation, building a logo and brand, and bringing together information

Exhibit 6

Many of the professional services SMEs require are related to financial services.



Source: McKinsey analysis

from marketing campaigns, website traffic, and sales activity to get a better understanding of the business.

How can financial institutions successfully build ecosystem platforms?

Partnerships are an important component of all three roles. But for banks that choose to compete with a beyond banking ecosystem, partnership is only the first step. Orchestrating or building a successful ecosystem platform requires banks to fundamentally rethink their value proposition and develop an operating model that is different from their traditional business. In our review of several ecosystem efforts recently tested by global firms, we identified five key principles to consider when building an ecosystem platform:

1. Focus on customers' biggest challenges

Across markets, we have seen pain points for entrepreneurs vary from basic lending needs to office and factory space to access to marketplaces. Hence, before embarking on the ecosystem journey, banks must research the pain points specific to the market and assess their own ability to offer services to allay those pain points. In some markets, we have found that issuing invoices and tracking incoming invoices by financial institutions can be the most significant way to create value for SMEs. Addressing any other needs at this stage in the cycle could unnecessarily increase the complexity of building such a platform.

Several firms are offering SME services that address customer needs for core and non-core related activities (Exhibit 7).

2. Start with an MVP and scale rapidly

Starting with a minimum viable product, or MVP, is straight out of the start-up playbook, but not an obvious choice for banks. Most product launches in banks have historically been mass marketed from inception. Further, most new products have been variations on current products, rather than totally new products. But with an ecosystem offering, we suggest starting with an MVP tested on a small segment of customers, getting feedback, and then building a full proposition in an agile way. MVPs help in debugging and incorporating feedback and accelerate the speed to market.

Once the MVP has been tested with real customers, banks have two main paths to scale the solution. With larger, established SMEs, one feature such as invoice tracking can serve as a "hook" product to establish a relationship. For newer companies, banks should offer a comprehensive beyond-banking solution built around three to four key features (as Ownr did in Canada).

3. Make key IT design choices early

In parallel to designing the prototype, it is critical to start thinking through IT implications at the outset. The design choices will significantly affect the speed of development, and the potential reach of the new solution. A design based on integration with an existing banking app might command a larger audience than a new standalone application—yet the latter typically offers more flexibility. The choice of a platform should be wedded to the monetization approach (see below). If the bank wants to retain the option of spinning off an ecosystem platform in the future, or listing it separately, its IT should not be enmeshed with the bank's legacy systems. Nor can it be completely divorced: efficient transfer of information between the two systems is needed to maximize value for both banking and non-banking offerings.

IT is a key driver of costs and of the ecosystem design and business model. For instance, a Western European bank decided to integrate its ecosystem solution to its mobile banking platform. This caused substantial implementation complexity and delayed the launch, but opened up the solution immediately to hundreds of thousands of SMEs.

4. Think early about monetization

Organizations considering a beyond-banking ecosystem run the risk of offering additional products and services and increasing complexity without necessarily realizing material benefits. An ecosystem should be viewed as means to add new forms of value, and not just a pure customer-acquisition/retention vehicle. Ecosystems can generate platform revenues in the form of lead generation, recurring fees such as registration, listing or subscription fee, and data monetization. If successful, a beyond-banking entity could significantly surpass the valuation of the institution that hatched it, as shown by the likes of Ping An (see sidebar).

While proper monetization of a beyond-banking offering is difficult, pioneer banks have typically succeeded by building the following revenue streams:

Exhibit 7

Banks and fintechs are addressing both core and non-core SME needs.

	Features	Examples
Relationship building and due diligence	Automatic importing and categorization of transactions Automatic and prompt invoice issuance	Billingo Wells Fargo/Intuit QuickBooks
Managing expenses	Scheduling supplier payments Digitizing expenses with OCR image processing	Bill.com, UBS/bexio FreeAgent, Standard Chartered
Collection management	Reminders and repayment solutions for debtors	Cashflower, Bodetree, RBS Chase, PNC-CFO, vistr
Payroll services	Live overview of the financial health of the company Generating customized reports Easier decision making on different projects based on forecasted cash flows	ADP Bank of America/Intuit Gusto
Tax administration services	On-demand tax consultation Sales tax automation	Avalara Davo
Complex administrative service offers	One-stop-shop beyond-banking services offered to SMEs	Holvi Knopka
Complex administrative service offers	Centralized inventory, order, and product information management across multiple sales channels	TradeGecko Stitch Labs
Relationship building and due diligence	Insights on the financial health of trading partners Single collaboration hub	Tradeshift CreditHQ

Source: McKinsey Panorama Fintech

— Subscription fees: SMEs that use the platform pay a monthly fee for the services. Typically, there are two to three bundles with a varying number of transactions included in the fee. Fees are often set in comparison to similar solutions on the market (for instance, one European bank charges between 6 and 15 euros per month). To attract users, most banks offer a free trial of three months or so.

— Commissions: If a bank is an orchestrator but not a builder of the ecosystem, the actual services will be provided by third parties. In such cases the bank is entitled to a share of the fees that the providers receive from clients. As billing is done through the platform, the bank administers all financial flows.

— Data for better decisions: All banks we have worked with plan to leverage the data and insights they gather about their customers to provide more relevant and tailored offers to recommend products (financial and non-financial as well), optimize pricing, or prevent customer attrition. Yet, it is important to note that few firms build their business case on this lever.

— Data monetization: Certain ecosystem orchestrators aim to share the customer data insights with external parties to generate value. Most banks do not quantify the impact of this lever. Any sales of data will need to abide by relevant regulations, such as the European Union's General Data Protection Regulation.

The key factor behind the revenue streams is the number of customers. Hence, the go-to-market strategy should focus at first on building a critical mass of clients. Banks will need a clear perspective on how the ecosystem progresses versus the business case.

Ping An – A holistic case study on successfully building an SME ecosystem

Ping An, the Chinese personal financial services firm, provides an interesting example of ecosystem building. Ping An offers an open platform and marketplace for about 377 million online customers (Exhibit 8).

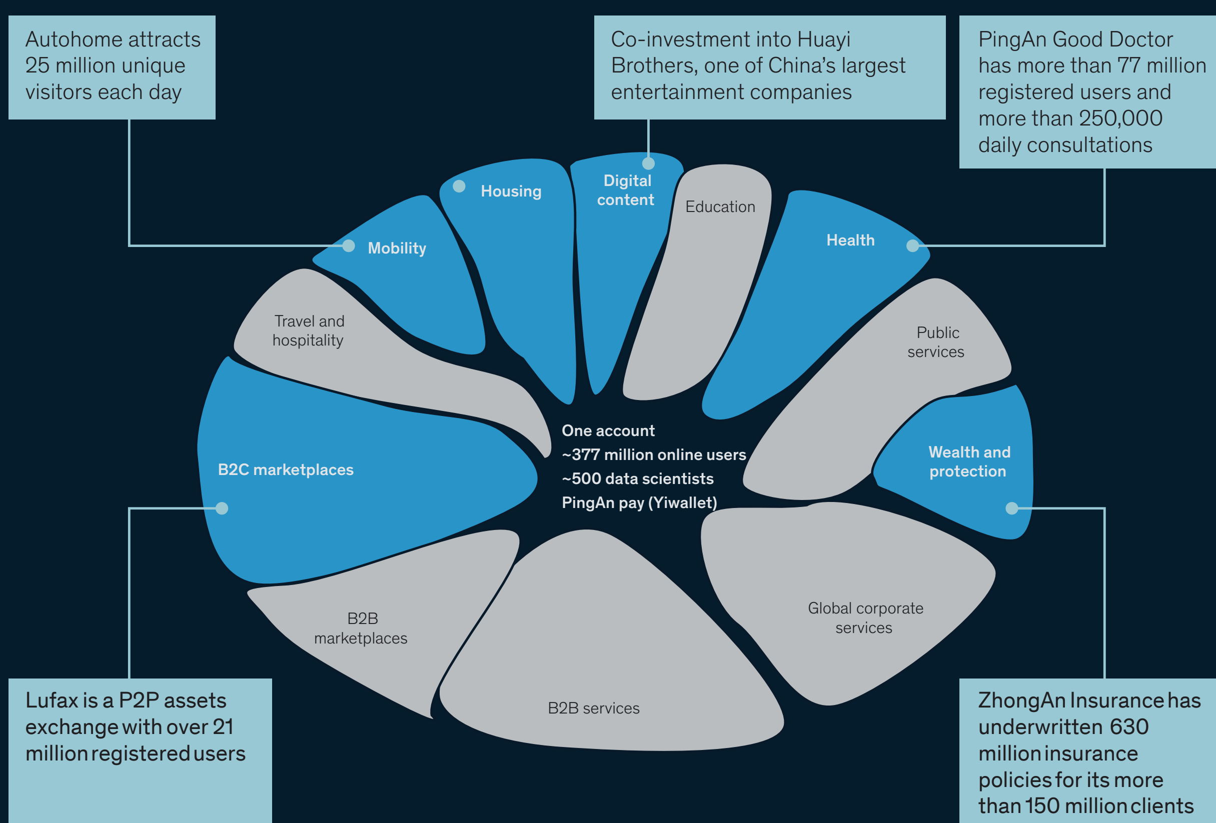
Ping An aggressively expanded beyond traditional finance by following a three-layer approach. First, it developed platforms to acquire digital users as they go about their everyday tasks. For example, Ping An acquired an online used-car business (autohome.com.cn). Second, it converted users to banking customers by offering easy-to-use open platforms of bridge products (such as a digital wallet, and SMS payments), and a financial-products "supermarket" with unbiased recommendations. Third, it created pull for its offerings in this supermarket through a distinctive user experience and clear benefits such as seamless multichannel integration, simplified transactions within three clicks, and customizable apps and views.

Traditional insurance products still generate most of the company's revenues, but Ping An's new platforms are generating traffic and making increasingly larger contributions (19 percent of revenues in 2016, up from 0.3 percent in 2010).

The company applies various principles while building its ecosystem. First, it typically uses a new and independent brand wherever transparency is important (such as for the financial supermarket) but its own brand for elements that require trust (the payments network).

Exhibit 8

Ping An has built digital ecosystems around all essential living scenarios.



Source: McKinsey analysis

Investment need is also a critical driver of the business case. The ambition level defines the investment need. Some banks have spent between €5 million and €20 million to build their MVP, depending on the breadth of services offered.

5. Build a separate digital organization

One pitfall is to house the ecosystem initiative within the bank, typically by giving additional responsibility to the SME product team. This unit usually lacks the focus required in a start-up, the right governance structure to ensure top management attention, and the relevant skills needed to execute.

On these grounds too, banks need to establish a separate entity with clear governance for interaction with the parent. Once established, the new digital organization must develop a new talent proposition. Our experience suggests that the bulk of new management will likely be sourced externally. Key industries from which to source platform talent include ecommerce and other technology companies.

Creating an ecosystem offering for SMEs is a high-risk, high-reward bet. Getting it right will not be a simple task. Yet, done right, it offers immense value for business owners—and banks. Those who can find the right recipe for their markets will be able to establish a far-reaching competitive edge and solidify their standing with their small-business customers—both in financial services and beyond. Banks that invest early have a strong starting point to unlock the potential.

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