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Disruption in European consumer finance: Lessons from Sweden

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Introduction

Consumer finance is a standout performer in the European financial services sector. Average annual shareholder returns for listed institutions between 2012 and 2017 were about 11.5 percent, compared with retail banking's 9.1 percent and corporate banking's 7.4 percent. Privately held (often private equity backed) consumer finance firms performed even better, routinely achieving returns on equity of more than 20 percent.

The strong earnings have drawn the interest of specialist providers including challenger banks, large retailers, and fintechs, which are using digital technology to make significant gains in consumer finance. Sweden, with its high rates of digital adoption and well-developed infrastructure for credit scoring and recoveries, has been the focal point for this activity: Specialists accounted for around 60 percent of the country's consumer finance market in 2016, compared with 20 percent in 2001.

Sweden's specialists have thrived through a mix of innovation and experimentation, usually incorporating at least one of three elements: investment in the digital customer journey, an aggressive (typically online-led) acquisition strategy, and a focused and agile data-driven operating model.

In other European countries, universal banks retain a larger slice of the consumer finance pie; major UK banks, for example, cede less than 30 percent share to specialists, according to McKinsey estimates. However, the drivers of competition, including expanding digital banking infrastructures and increased availability of scoring data, are becoming more pervasive.

Given retail banking's recent performance in Europe (return on equity in 2016 was below its cost for the seventh straight year), the industry can ill-afford to let the profitable consumer finance segment slip away. No bank should ignore the shifts that have played out in digitally advanced Sweden, or the lessons learned.

An attractive market slipping away from banks

Western European banks generated €56 billion of consumer finance revenues (after risk costs) in 2016, equal to 18 percent of retail lending revenues, and compared with just €41 billion in 2012. The segment has outperformed almost all other Western European financial services segments, with total returns to shareholders ranking second only to payments over the recent period (Exhibit 1).

Strong performance in consumer finance resulted from solid fundamentals, including:

- **Volume growth in line with GDP over the cycle.** Performance in the consumer finance sector has been boosted by growing consumer confidence and higher spending. However, penetration as a proportion of disposable income across the European Union has remained steady (rather than rising), in part because of regulatory scrutiny of consumer lending.

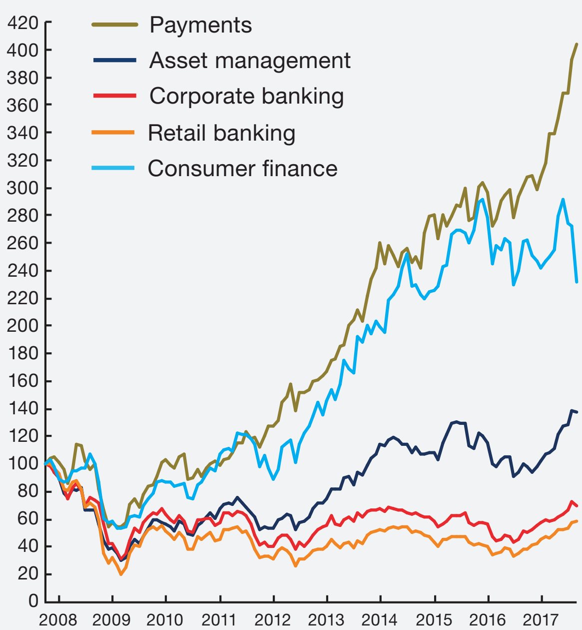
- **Improving net interest margins on loan books.** A persistently low interest rate

Exhibit 1

Consumer finance has outperformed most other financial services sectors in Western Europe.

TRS performance in Western Europe

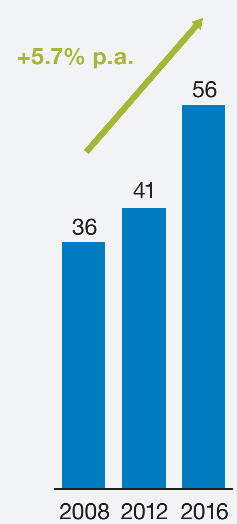
Index 100=October 2007



CAGR 2012-17 %	CAGR 2007-17 %
20.3	15.0
11.5	8.8
15.3	3.3
7.4	-3.5
9.1	-5.3

Revenues after risk costs in Western Europe

€ billion



Share of total retail lending %	13		18

NOTE: N= payments (27), retail banking (20), asset management (20), corporate banking (5), consumer finance (33).

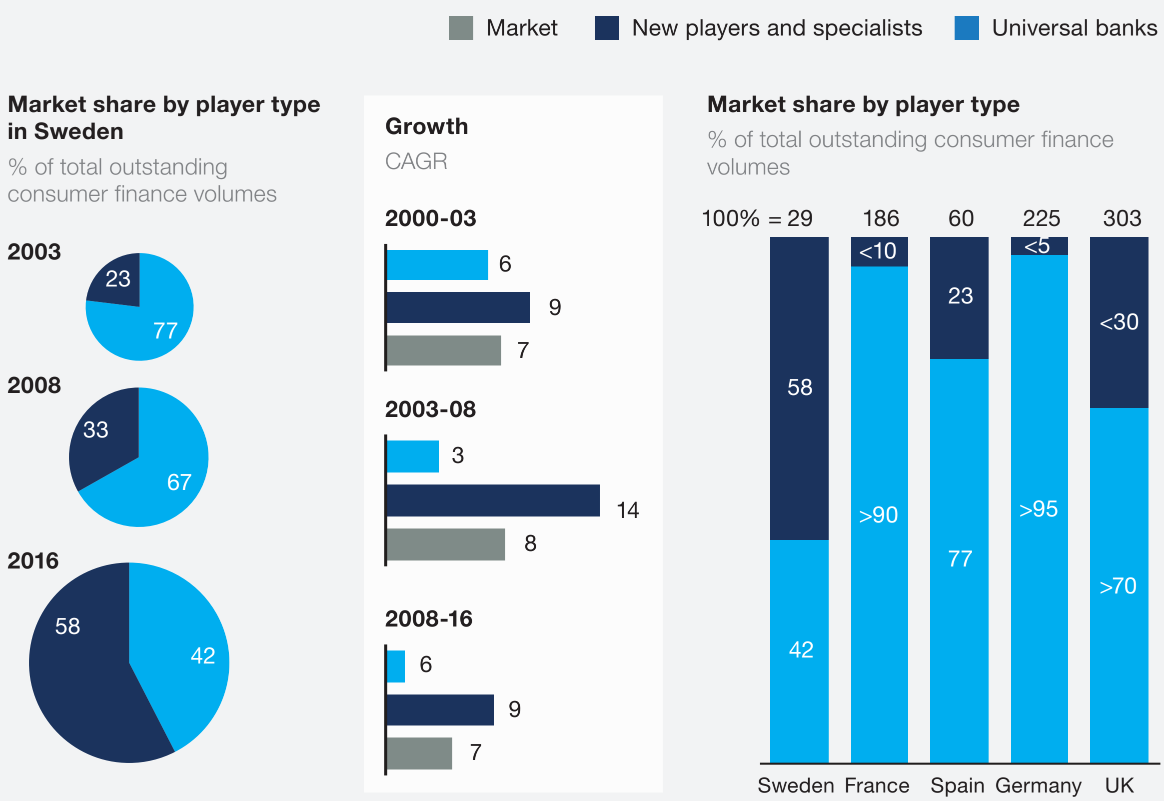
Source: S&P Capital IQ; McKinsey Global Banking Pools; McKinsey analysis environment has bolstered consumer finance performance.

- **Significant reduction in loan loss impairments.** At 130 basis points across Western Europe in 2017—compared with 210 to 220 basis points during the financial crisis—loan loss impairments have enabled stronger performance for consumer finance.

In market share terms, incumbents have fared better in some markets than in others. German universal lenders still control more than 95 percent of consumer finance volumes, while French universal banks retain more than 90 percent, according to McKinsey estimates (Exhibit 2). Swedish universal banks, by contrast, have lost 35 percent of consumer finance volumes in the past 15 years, capturing just over 40 percent in 2016. Swedish specialists, meanwhile, have taken a dominant hold of some niches, for example accounting for 70 percent of the unsecured cash loan market in 2016.

Exhibit 2

Specialists have taken significant market share in Sweden.



NOTE: Universal banks include direct consumer finance activities of traditional retail banks, and consumer finance divisions of domestic universal banks. New players and specialists include nonbank-owned consumer finance specialists ("challenger banks"), pan-European consumer finance monoliners, balance aggregators, online credit providers as well as peer-to-peer lenders.

Source: National statistics and company filings; McKinsey analysis

What happened in Sweden?

From the turn of the century, new providers of consumer finance have targeted the Swedish market, taking advantage of technological change (including simplified sign-up processes through BankID, launched domestically in 2003) and continued reliance on manual and branch-based processes at incumbents, seen as increasingly inconvenient by digitally enabled consumers. Specialists such as Bank Norwegian, Nordax Group, Klarna, Resurs Bank, and the financing arms of large retailers (ICA Banken, Ikano Bank) have built market share, often focusing on specific products, segments, or channels. Consistent strengths include their ability to leverage analytics to build data-driven operating models, proactively target new business, and streamline the customer journey.

Initially, the emergence of specialists expanded the market. Up to 2010, Swedish consumer finance volumes as a share of GDP rose from 3.5 to around 6 percent. In recent years, penetration rates have remained steady, putting more emphasis on the battle for market share (Exhibit 3).

Exhibit 3

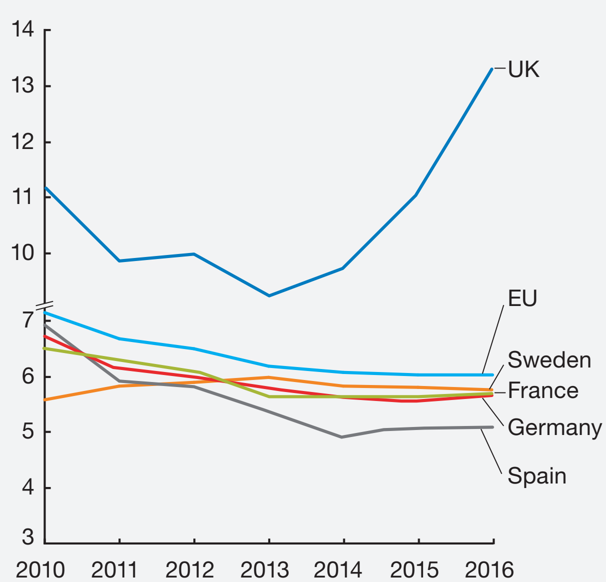
Specialists initially expanded Sweden's consumer finance market, but penetration has remained flat in recent years.

Penetration rate, Sweden

Total consumer finance outstanding balances as % of GDP,[1] %

Penetration rate

Total consumer finance outstanding balances as % of GDP,[1] %



[1] Based on nominal GDP.

Source: National statistics; McKinsey Global Banking Pools

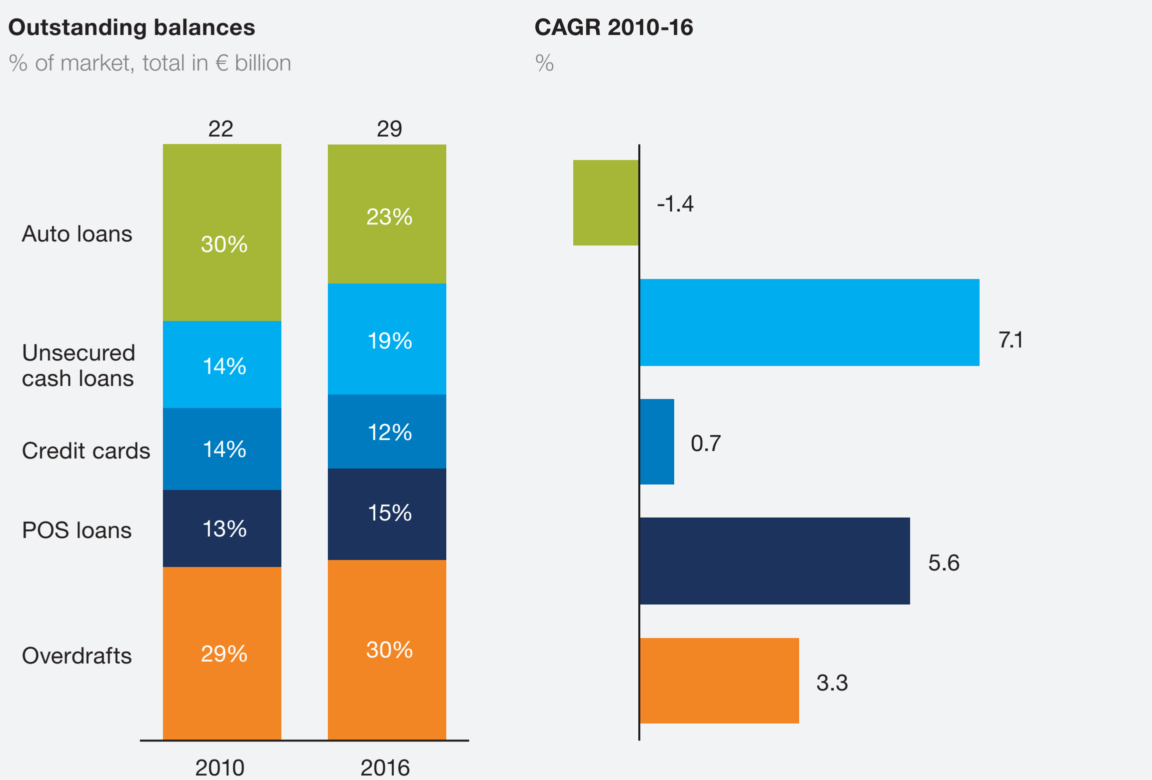
As specialists thrived, universal banks were relatively slow to innovate, often because of strategic deficits such as a lack of focus, agility, and capability. Some were also uneasy over promoting a product segment that was seen to carry significant credit and reputational risk.

Still, the gains made by specialists would not have been possible without technological change, and a surge in innovation that led to new products and channels. These have prompted a shift away from traditional account-based overdraft lines, branch-distributed offerings, and credit cards for point-of-sale (POS) distribution and toward a higher share of cash loans (partly driven by debt consolidation) and non-card-based POS credit (Exhibit 4).

Exhibit 4

Sweden has seen a shift towards cash lending and noncard-based POS solutions.

Sweden product mix development



Source: National statistics; McKinsey Global Banking Pools; McKinsey analysis

The habits of successful specialists

Specialists in the Swedish consumer finance market have gained share on the strength of their product features and service offerings. In POS loans, unsecured cash loans, and credit cards, these firms share the following traits:

- A focused business model, targeting specific products, customer segments, and channels.
- A speedy, convenient, almost exclusively digital customer proposition, backed by flexible and tailored offerings.
- An aggressive, proactive customer acquisition strategy, powered by advanced analytics.
- A highly-focused, agile, and data-driven operating model, enabling short-cycle testing and fast decisions.

The dominant consumer finance product categories—cash loans, non-card-based point of sale loans, and credit cards—have seen significant disruption, with distinct lessons emanating from each:

- **Cash loans.** In Sweden, cash loans were traditionally offered by retail banks on a responsive basis in branch. In the early to mid-2000s, specialized players entered the market, building share with proactive marketing, new channels, and convenient, digital application processes. Traditional banks did not respond effectively. Proactive marketing was regarded as a reputational risk, and the segment was small, and not a priority. After 2010, once brokers and aggregators emerged, providing transparency for consumers and distribution for small specialists, market share started to shift more quickly. Speed of response became an increasingly important differentiator, with specialists leading the way through the use of automated decision engines. The disintermediation process was accelerated through consumer debt consolidation offers, in which revolving credits were folded into installment cash loans at lower rates. Finally, specialists such as Bank Norwegian and Lendify invested in digital marketing, emphasizing the growing importance of the direct online channel for customer acquisition, already used extensively by online brokers. By 2016, traditional banks held just 35 to 45 percent of the cash lending market.

- **Non-card-based POS loans.** Sweden's market for non-card-based POS loans (including online and physical store offerings) was traditionally dominated by banks, thanks to synergies with their merchant cash management and financing offerings. Often, however, the products did not meet the needs of either customers (in terms of convenience) or merchants (low conversion rates and insufficient merchant support). In the 1990s and early 2000s, some merchants started their own financing companies, which were later spun off to become specialized POS financing firms (e.g., Resurs Bank and Qliro). In 2002, Klarna entered the market, offering consumers more online convenience and security by allowing them to pay via invoice when receiving merchandise, and in due course launching check-out solutions for merchants, leading to a significant improvement in conversion rates (from basket to payment). Klarna later introduced new consumer finance solutions, such as installment loans, winning market share from credit cards in the online space. In some Swedish retail segments (e.g., consumer electronics), the majority of leading firms are now served by specialists, particularly in online sales.

Two priorities currently dominate POS financing specialists' agendas. They are integrating their offerings into the online and offline shopping experience, often working alongside merchant sales teams. They are also focused on offering a consistent financing proposition and customer journey across channels, a response to rising demand from retailers for omnichannel solutions.

- **Credit cards.** As non-card-based solutions have gained ground with merchants in Sweden, brand-linked credit cards, often backed by traditional banks, have lost market share. In addition, differentiated credit card value propositions (e.g., loyalty, rewards, insurance benefits) have been difficult to sustain as regulation, such as interchange fee caps, and competition (fueled by price comparison websites) have pressured core income streams. Traditional banks remain the most important players in general purpose cards, but specialists are gaining share with no-frills propositions (no fee, high reward) offered to all segments. A proactive, multichannel approach is a critical element of their success. Bank Norwegian, for example, acquires customers through both direct and broker channels (digital and nondigital) and invests significantly in digital marketing.

Swedish lessons

Consumer finance specialists found fertile ground for disruption in Sweden, thanks to its high rate of digital adoption (in both banking and e-commerce), accessible credit scoring data, and efficient recoveries. Specialists have also been adept in adopting new electronic identification technologies (e-ID), creating efficiencies in compliance, and introducing convenient functionality such as the ability to accept e-signatures.

Similar enablers are now pervasive across Europe, with digital banking growing fast, and regulation and technology innovation leveling the playing field. Several countries, for example, are launching their own e-ID schemes. Specialists are likely to aggressively pursue consumer finance profit pools in markets ripe for disruption.

As competitive threats intensify, retail banking leaders in Europe need to take action. They must become more focused and customer centric, and embrace the end-to-end transformation of operating models. McKinsey has set out four strategic steps for banks to protect and grow their consumer finance franchise:

1. Develop a focused strategy and proposition

To compete with consumer finance specialists, banks must leverage their significant data resources, customer knowledge, and market experience to focus on products, segments, and channels in which they can offer the strongest proposition. Any repositioning should be backed by a strategic analysis of the consumer finance pool, and estimates of potential value by product, segment, and channel for each geography. Banks should leverage their data and marketing resources to develop sharper insights into consumer needs, the competition, and potential new entrants (local and international), and develop a clearly defined go-to-market model.

Sweden provides a number of examples of successful go-to-market models: Resurs Bank built a merchant POS-focused customer acquisition engine through which it cross-sells cash loans and cards. SevenDay Finance focuses on cash lending for highly-rated customers through a digital broker channel and uses a strong API solution to seamlessly link with brokers. Nordax Bank also focuses on cash lending, but for a broader spectrum of customers, and backed by direct marketing. Bank Norwegian has a mass credit card- and cash-lending offering, acquiring customers across the Nordics, primarily through digital marketing.

There is no single preferred model, but leaders share a clear product category focus and exceptional execution capabilities leveraging specific unique selling propositions.

2. Revitalize the customer proposition with strong execution

The key to a successful customer-focused strategy is a customer proposition defined by strong execution across the journey, including loan applications (relevant offerings, tailored marketing, seamless application process), converting applications into paid out loans (effective and accurate credit engine automated to enable a speedy response), and management of customer lifetime value (cross-selling, churn management, and collection/recoveries). Successful specialists execute at a high level, creating distinctive brands and operational cultures. Klarna, for example, employs advanced analytics to deliver seamless customer journeys and innovative credit scoring (Exhibit 5).

3. Adopt agile operating models and build capabilities

Consumer finance at Swedish banks has often been organized into product silos, separating cash lending, POS, and credit card businesses. IT organizations are often run separately from the core business, and digital marketing and risk are routinely located in their own units. With consumer finance rarely at the top of the strategic agenda, innovation has bled away.

Successful specialists by contrast create structures with clear leadership (e.g., CMO, CRO, COO, CTO) and distinct accountabilities, but with cross-functional teams to develop the business. Leaders tend be guided by two key principles:

- Business development grounded in the voice of the customer, leading to fast innovation and "test and learn" set-ups, and supported by cross-functional task forces. Successful specialists harness real-time customer

Exhibit 5

Specialists offer distinctive features across the customer journey.

Distinctive features	Example firms	Example elements
Marketing analytics and digital marketing	Bank Norwegian, Lendify, Nordax Bank	Leading-edge digital marketing capabilities and performance; search engine marketing; search engine optimization; social media and display. Tailored and proactive marketing with follow-up on conversion rates.
Customer relationship management	Klarna	Prompting customer via SMS or customer portal/mobile app to make payment or offer extended repayment period. Machine learning to identify cross sell/activation triggers or churn predictors.
Support consumption decision at merchant	Resurs Bank, Klarna	Integrating financing offers into product browsing experience (upstream customer journey integrations), flexibly based on retailer/merchant needs. Integrating financing know-how into merchants' sales campaigns to drive sales. Offering merchants opportunity to leverage financing provider's customer portal as marketing channel or source of data.
Simpler user interface and digital customer processes	Bank Norwegian, Klarna	Streamlining application process to minimum number of steps and "one click" experience; approving customers quickly, and focusing on a mobile first experience.
Credit scoring and processing	SevenDay, Klarna, Bank Norwegian	Advanced self-learning algorithms leveraging unconventional sources of credit- rating information, e.g., online shopping history, social network information, etc. Instant credit approvals.

Source: McKinsey analysis

feedback on new offerings, generating insights into what works. They learn fast, for example by obtaining real-time analysis of conversion performance across the sales funnel following a marketing campaign.

- Powerful management information systems, enabling a clear view and data-driven decision making. Successful specialists use powerful management information systems to track markets, segments, and channels at each step in the customer engagement journey (from awareness to loyalty). The systems generate granular insights into performance and momentum—all linked to financials. When conditions change, for example when a competitor updates its offering, managers can quantify the impact and respond in a timely way.

4. Develop next-generation consumer finance solutions

As technology continues to evolve, innovation will lead to new opportunities to offer consumer credit. Payments apps are one area of potential. Financial institutions across Europe have launched a new generation of mobile payment apps, including MobilePay, from Denmark's Danske Bank, Sweden-focused Swish, owned by a group of banks, and TWINT, offered by financial institutions in Switzerland. With their high levels of consumer trust, these are powerful tools for incumbents in the battle for share. They may also help banks expand into consumer finance at point of sale, leveraging flexible in-app solutions at the point of purchase or after. However, banks must act urgently; Klarna, for example, recently launched mobile payments and lending solutions with retailers including fashion brand KappAhl. Other opportunities could stem from integration of consumer finance offerings into personal finance management solutions, for example by providing flexible credit lines based on a consumer's spending or balance status. Finally, European banks could partner with large non-banking platforms such as Facebook to generate new leads or gain access to non-traditional credit scoring information (e.g., social media activity)..

■ ■ ■

In most European countries, high street banks dominate the consumer finance market. The Swedish experience shows, however, that with the right formula new entrants can quickly win significant share. It is imperative for banks in other European markets to learn from the Swedish experience.

Banks possess strong advantages, including customer trust, vast stores of data, and market position. To defend and grow their share in consumer finance, they can build on this foundation by developing a focused strategy, and by revitalizing the customer proposition and execution engine, backed by strong digital and analytics capabilities. By taking an attacker mindset, and adopting the best practices of winning consumer finance firms, European banks stand to achieve double-digit growth and strong ROEs.

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