Digital Finance 2.0

Unlocking Latin America's
economic growth potential

A new wave of digital innovation is set to give 200 million people in Latin America access to low-cost financial services for the first time

Executive Summary

Improving access to finance for the 1.7 billion people across the world who find themselves excluded from the mainstream banking system will have significant economic and social benefits.

Santander has an aim to financially empower 10 million people by 2025.

It will do this through improving access to basic services while supporting low-income families and vulnerable groups, principally in Brazil, Argentina, Mexico, Chile and Uruguay. There are also programmes to improve people's financial knowledge and decision-making across Europe and the Americas.

• Innovations in digital banking could unlock at least $49bn of new loans and other financial services for the 200 million people without access to banks in Latin America.

• Santander believes technology will play a large part in the empowerment of this disenfranchised group and has already seen the positive impact of several initiatives such as its Superdigital service – simple, digital access to financial services specifically addressing the needs of the unbanked and underbanked.

• The digitally-enabled growth of microfinance – tiny loans that can make a big impact – means greater prosperity for community-based businesses and the people who own and work in them.

• Partnered with financial education, individuals will build up their own financial resilience, ensuring they have access to enough money and sources of credit to improve their standard of living, both now and in the future.

A digital transformation

As Latin America strives to cast off the economic turmoil of the past, a fascinating ecosystem has evolved teeming with new ideas and innovative technology to embrace millions of people previously excluded from the financial system.

It is estimated that innovations in digital banking could unlock at least $49bn of new loans and other financial services for the 200 million people without access to banks in Latin America.

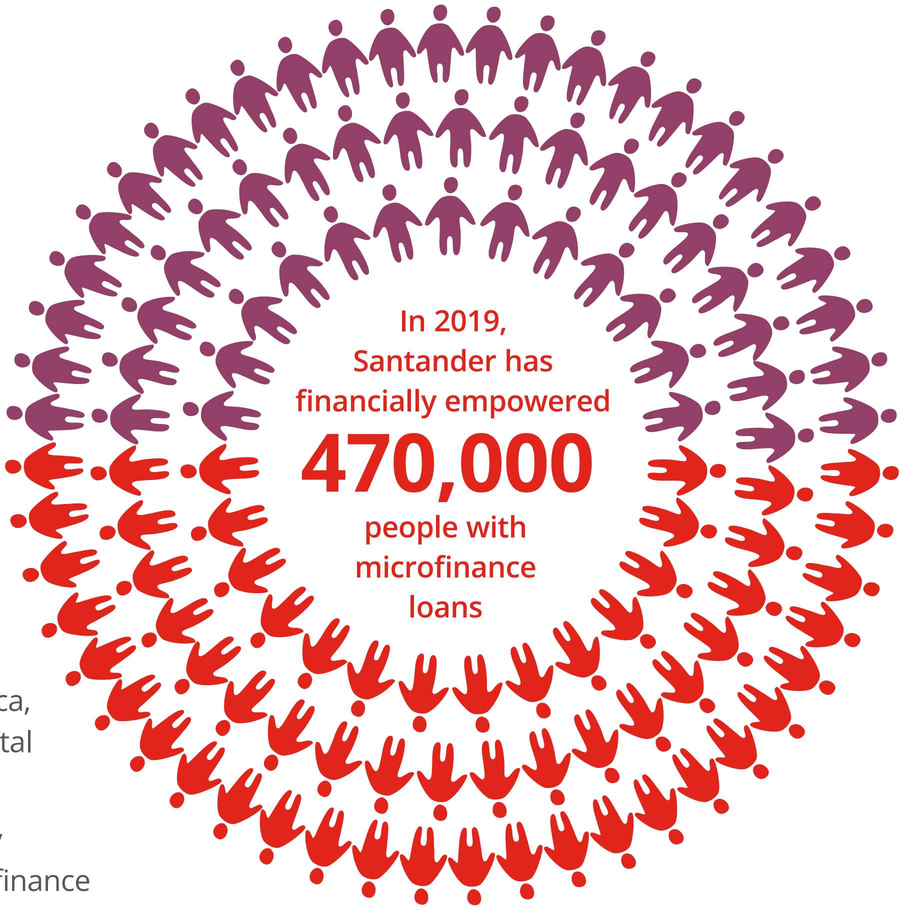
Santander has set a target of empowering 10 million people by 2025 through improving access to basic services while supporting low-income families and vulnerable groups, principally in Brazil, Argentina, Mexico, Chile and Uruguay. There are also programmes to improve people's financial knowledge and decision-making across Europe and the Americas.

Living standards are rising across the socio-economic spectrum. A new middle class has emerged with greater aspirations than previous generations and its members are impatient for further advancement. Meanwhile, in the favelas of large conurbations and remote rural areas, 'micro-entrepreneurs' have built thriving businesses that serve the very specific needs of their local communities, funded by tiny loans with short maturity periods – called microfinance.

Digital Finance 2.0 could increase bank lending by

$49bn

Source: EY



Microfinance has emerged as one of the most successful and reliable ways of bringing the unbanked into the system.

It is a growing sector now worth almost $114 billion globally and has been conspicuously successful in Latin America, which accounts for almost half of the total loan book.

So far in 2019, Santander has financially empowered 470,000 people with microfinance loans.

Hugely successful so far, further growth using traditional means will be harder to achieve as it requires very high levels of face-to-face contact while the lack of background checks – so essential to its success – limits the risks banks can afford to take.

The high level of account servicing required adds to the cost base of banks at a time when they are under pressure from regulators and politicians to develop far lower-cost product lines.

This is where technology will play a decisive role. Almost 1,200 financial software companies, or fintechs, were launched in 2018 – almost as many as in the previous two years – according to a study by consultancy IDB and Finnovista, an organisation that promotes technological innovation in finance.

Innovation in financial technology can...

Reduce transaction and services costs and foster financial inclusion and development

Enhance competition and improve intermediation, vital to increasing lending activity

Support growth and reduce poverty across the region

Source: International Monetary Fund

Around one-quarter of these ventures are focused on digital payments and transfer services. That has been identified as a huge potential market as just over 40% of online shoppers in Latin America paid cash on delivery last year for their goods, while around one in ten workers still received their wages in cash.

"We are working towards a more digital model because you can reach more people and offer them better services with easier access and lower operating costs," says Federico Gomez Sanchez, Head of Sustainability for Grupo Santander. "The big question for all banks is how you combine going digital with staying in touch with clients because, with microfinance, that personal relationship is vital."

Change is happening fast: almost seven out of ten banks surveyed by The Economist Intelligence Unit believe cash will represent less than 5% of retail transactions by 2020. A similar proportion feel customers would be willing to forego human contact if services are cheap or free.

The shift from cash

Digital payments will have huge inclusion benefits for Latin America.

7% Send or receive domestic remittances in cash

8% Receive government wages or transfers in cash

15% Receive private sector wages in cash

Source: Economist Intelligence Unit

As well as these regulatory pressures and the need for banks to drive down costs, the digital revolution is also being driven by opportunity. According to the World Bank: 55% of Latin Americans have a bank account; 45% made or received digital payments in the last year; 21% borrowed or used a credit card and only 12% put their savings in a financial institution.

A paper earlier this year from the International Monetary Fund made clear that innovation in financial technology can:

• reduce transaction and services costs and foster financial inclusion and development;

• enhance financial sector competition and improve intermediation, vital to increasing lending activity;

• support growth and reduce poverty across the region.

At the macroeconomic level, technology-enabled microfinance has a crucial role to play in nurturing an entrepreneurial culture by financing start-ups and growth-minded businesses. These, in turn, will foster domestic demand and generate wealth and employment beyond the labour-intensive processing and manufacturing industries that currently dominate the region's largest economies.

However, the benefits are perhaps even more profound at street level. New digital initiatives are offering opportunities to people who have never had access to money (other than what they could scrape together themselves) to open bank accounts, save for their future, and apply for credit cards and mortgages – as well as education on how to spend and invest wisely.

It is, then, time for a full system upgrade to Digital Finance 2.0.

Santander

Digital Finance 2.0: A reset for banking

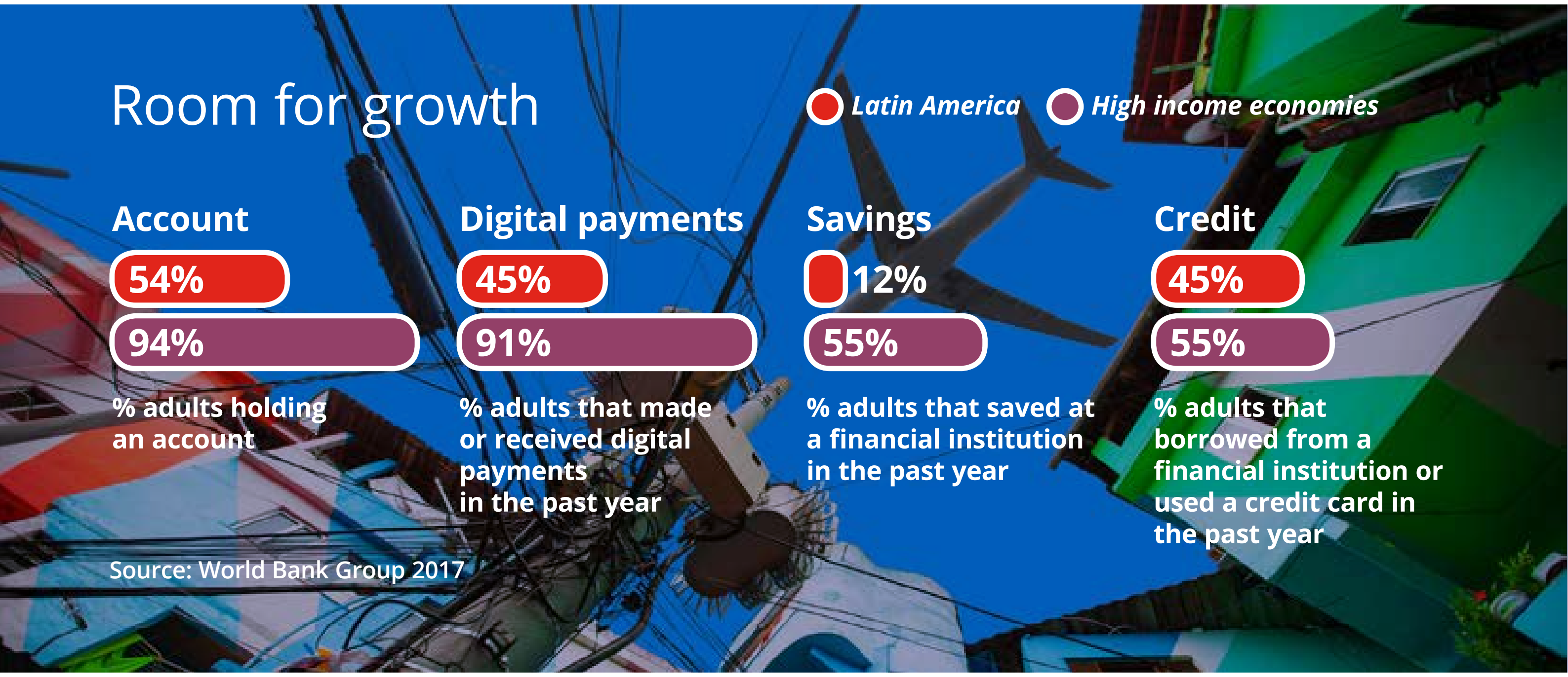
Banks in Latin America must redefine their value proposition in the move to Digital Finance 2.0, learning to customise product offerings, find innovative ways of interacting with customers and take a creative approach to risk mitigation.

An internal review by Santander concluded banks would have to actively move towards:

• simplified, affordable solutions tailored to specific target audiences. Ideas include group savings accounts, micro-insurance and credit only for women;

• a twin-track approach using digital channels to complement face-to-face customer service. Community-based agents and wifi-connected mobile branches have all shown promise and should all be in the mix;

• finding alternative sources of data to assess credit worthiness, such as interrogating customers' social media profile footprint, psychological testing and conversations with their fellow villagers.



Financial companies have accumulated a great deal of data about the new customers they have acquired at the periphery of the system so can take a much broader and more informed view of their circumstances.

Microfinance customers are excellent risks with an average default rate of only 5%, according to Santander – and such is the hyper-local nature of the lending that communities encourage repayment.

Banks are investing in new risk profiling and vetting procedures, in conjunction with budgeting tools to help customers keep their finances in order. Typically, banks' agents have to go out every week to meet customers to take money in and carry out risk assessments.

Online is more effective

Comparative costs of serving customers via different channels

Mobile: 10₵ **ATM: 65₵** **Branch: $3**

Source: Value Partners

If clients are using financial technology, or fintech, agents can greatly reduce the frequency of those visits – maintaining personal contact but making day-to-day transactions more efficient for everyone.

"Low income and emerging market economies can benefit disproportionally from fintech innovation," was the conclusion of an International Monetary Fund paper on financial technology in Latin America. "They provide opportunities for many, including for the least financially developed countries, since it allows technological leapfrogging."

However, the study authors also sounded a note of caution: as financial technologies develop at an accelerating pace in the region, little is known about how they will affect financial market structures and how policymakers can and should respond.

The business case for financial inclusion

Latin America is witnessing a huge upsurge in the number of financial software companies, or fintechs, setting up and expanding to react to the new digital landscape. Almost 1,200 launched last year and it is estimated that 60% of all the young fintech start-ups currently operating were established between 2014 and 2016.

More than 50% of those fledgling enterprises are focused on payments and alternative financial platforms. Remittance is a huge part of the financial ecosystem, with millions of migrants keen to find cheaper and faster ways to send money home. Family remittances to Latin America and the Caribbean experienced nearly 10% growth in 2018, one of the largest growth rates in the past 10 years.

And it is easy to see why. Numbers of adults in Latin America holding bank accounts, making and receiving digital payments, borrowing and using credit cards are around half the level of high income economies. The percentage saving money is only 12%, compared to 55%.

A study by professional services firm EY, *Innovation in financial inclusion,* calculated that banks in Latin America could generate incremental income of $49 billion: $11 billion from personal customers and £38 billion from businesses by better serving the financially excluded.

The EY report, which looked at the situation in key markets across the world, concludes: "Institutions that act now to increase financial inclusion will be well-placed to dominate retail and SME banking in emerging markets for years to come."

Fintechs focus on alternative finance platforms

24% Payments

18% Lending

8% Personal finance management

Source: IDB/Finnovista 2018

Empowering 10 million people

Santander has made tackling social and financial inclusion one of its main strategic priorities, with a particular focus on Latin America because it is a region in which the group feels it can make the biggest difference in the shortest timescale.

It has announced a target of helping 10 million financially excluded people into the mainstream banking and savings system. There are three main initiatives through which it intends to achieve this aim:

• guaranteeing access to quality financial products and services;

• adapting those products and services to the needs of diverse communities and groups;

• promoting financial education so that people can make better use of their financial resources.

Santander's financial education programmes have been central to its financial empowerment plans. Digital Finance 2.0 means that microfinance can now play a more tangible role in bringing financial empowerment at the same time as growing business in those regions: in short, it is profit with purpose.

The Group invests in numerous social programmes to support communities and, since 2015, has assisted around 5 million people.

Initiatives in other parts of the world include running branches in sparsely-populated parts of Spain, affordable housing programmes in the USA and a specialist support team for vulnerable customers in the UK.

In Latin America, Santander is currently engaged in developing new digital products to meet the day-to-day needs of communities across a wide social spectrum. It is also heavily involved in training people how to use money and financial services – more than 360,000 people benefited from its financial education programmes in 2018 alone.

There are basic and advanced business courses for small and medium-sized companies, as well as lectures and masterclasses both online and face-to-face. They are designed to boost their financial management skills and teach them how to use financial tools to promote and grow their businesses in a sustainable way.

It is one of the major players in microfinance in Latin America and the largest private provider of microcredit in Brazil. Apart from the focus on the continent's largest country, there are also significant initiatives underway in Mexico, Argentina, Chile and Uruguay.

A Superdigital solution

Superdigital is a mobile platform for making deposits, withdrawals and payments that does not require users to have a bank account.

Developed with Santander's own technology, it was conceived as a mobile-first app and has become the main financial services channel for many customers.

It now has more than 500,000 customers.

"Superdigital provides people with a totally different experience from the one on offer in the traditional financial market," explains Fernando Oliveira, the software development manager.

For example, users are able to chat among themselves, just like a messaging app.

Another practical piece of functionality is being able to split expenses among groups.

Our main initiatives

Brazil

Since 2002 its Prospera subsidiary has been providing loans from $130 to $16,000 to assist the growth of small businesses. About 70% of the income generated by the enterprises supported circulates within local communities.

Today, Prospera has around 430,000 active customers and $250 million active in its portfolio. The money is often offered with financial and general business advice and much of that training is undertaken by Prospera's agents, who are themselves members of the communities they serve. The agents are critical to the success of the micro lending programme – they know the streets and people to whom they lend.

For example, credit analysis is often based on face-to-face discussions and local knowledge about the applicant's ability to pay. By their proximity, the agents can also keep a friendly eye on customers to spot problems early and, conversely, opportunities to lend more.

- **$700** Average credit
- **7 months** Average term
- **65%** Women

Mexico

Launched in October 2017, Tuiio is a financial inclusion programme for people on low incomes offering a range of interconnected products from microcredits to microinsurance, payments and other services. It is supported by its own branches, agents, ATMs, point-of-sale terminals and electronic banking. The initiative includes a programme of training and financial education for its customers, with the aim of maximising their skills, developing their potential and optimising their use of resources. In Mexico, Santander allows customers to carry out basic transactions through more than 19,000 stores such as Oxxo and 7-Eleven.

With more than 3,000 microfinance institutions in Mexico alone, Santander stands out as being the only one to provide a savings account alongside credit, so customers can save in the bank instead of 'under the mattress'.

This is helping to change habits. In the first phase of Tuiio, customers withdrew money as soon as it was received, now customers are beginning to generate deposits and build savings in their accounts. This is a matter of trust – not just for Santander but for banking in general.

- **$300** Average credit
- **91%** Women
- **46%** Never used an ATM but do today

Argentina

Santander has offered microcredits to customers of its financial inclusion branches since 2015 in underprivileged regions where Santander Río opened its 'financial inclusion branches'.

Micro-entrepreneurs are granted loans providing they have prior experience with microcredits and a robust project. It is important they are backed by well regarded figures in the local community.

- **$700** Average credit
- **9 months** Average term

Microfinance is funding ambition

Microfinance, is both a driver of growth and a highly practical way of unlocking the potential of the 200 million people in Latin America who do not have access to the most basic financial services.

What we now call microfinance emerged in the 1970s when Grameen Bank in Bangladesh started providing small loans to poor people without the need for collateral. These advances were known as microcredit, or 'grameencredit'.

The leading figure in the movement was not a banker but an academic, Muhammad Yunus of the University of Chittagong, who loaned $27 to a group of 42 women so they could make items for sale during the Bangladesh famine of 1974.

Though born out of compassion, microfinance was also a financial success and proved that small loans could have a disproportionately positive impact on the lives of the poor.

"It is important to realise that microfinance is not philanthropy, it is a business line and there needs to be a financial return," says Federico Gomez Sanchez, Head of Sustainability for Grupo Santander. Nevertheless, the general benefits to society are wide and varied.

Across Latin America there are currently around 17 million micro, small and medium-sized enterprises, according to the World Bank, but many of these entrepreneurs have no access to traditional sources of capital. Instead, they have started their companies by borrowing small amounts – perhaps as little as $130 – at relatively low rates of interest to buy a vital piece of machinery or a vehicle to transport goods to market.

The first micro loan, conceived by academic Muhammad Yunus in Bangladesh

Customers are often self-employed, household-based entrepreneurs. Their diverse 'micro enterprises' include street vending, artisan manufacture and providing hyper-local services. In rural areas, micro-entrepreneurs are often involved in food processing and intra-community trade.

The scope has extended far beyond the original concept and today's evolution includes a range of financial services such as credit, savings, insurance and money transfers aimed at individuals on low incomes.

The result is that by the end of 2017 almost 140 million people worldwide were in the microfinance system with loans totalling $114 billion, according to the latest Microfinance Barometer. Latin American and the Caribbean, represent almost half the total loan book.

Santander tailors services to the needs of individual markets

Financial inclusion programme in Mexico

A new financial inclusion programme offering low-income groups financial products and services

Microfinance Santander Rio

Since 2015, Banco Santander has offered microcredits to customers of its financial inclusion branches

Cuenta Life Chile

An "account for everyone" offering current accounts and a credit card, regardless of salary level

Santander Microcredits Brazil

Banco Santander is recognised as the leading provider of microcredits among the private banks in Brazil

Microfinance Santander Uruguay

A pilot programme launched in May 2019

Potential for growth

Proportion of unbanked population in the main Latin American countries in which Santander operates

300 million adult population

129 million unbanked

20 million total MSMEs

10 million unbanked

Impressive though this expansion has been, the numbers of financially excluded remain high and there is a growing body of opinion that microfinance needs to evolve once more.

SMEs largely use the financial system to make deposits and as a means of payment. They make little use of credit products which puts pressure on cashflow and balance sheets and restricts the ability of firms to expand and grow.

What is required is smarter microfinance that makes use of technology to cut costs for banks and customers alike and allows for the introduction of more sophisticated products that will drive efficiency and encourage customers to take their fledgling companies to the next stage.

In Brazil, Santander's Prospera business is showing the way, having nurtured 70,000 micro firms into entities large enough to transfer into the Group's mainstream banking system.

70%
of microentrepreneurs helped by Santander were women

Helping women and tomorrow's workers

Latin America is a cauldron of innovation with products and services being created that are unique to the needs of the region's diverse populations. However, evidence is emerging that women and young people are likely to be helped most by financial inclusion.

Many institutions target women for a variety of reasons that are both good for business and society. On a practical level, experience shows they are more likely to repay their loans as agreed, while ideological reasons include supporting them to become less economically dependent on men.

Research has also shown that women are more likely to invest in areas such as nutrition and education, thereby improving the health and general wellbeing of family members.

Santander calculates that around 70% of micro-entrepreneurs it has helped so far in 2019 were women. For its Tuiio programme in Mexico, the figure is 90%.

Economists say redressing the gender imbalance is crucial to improving Latin America's overall economic growth rate. McKinsey Global Institute calculated that closing the gender gap in business could create up to $2.6 trillion of additional gross domestic product (GDP) in Latin America by 2025.

There is still some way to go to achieve a better balance, according to a recent report from US-based credit card and payments company Mastercard. There is already an average eight-percentage-point gap in account ownership (67% of men have an account compared to 59% of women). The result is that women are much less likely

to have made or received a digital payment, more likely to have used non-traditional forms of finance, and less able to come up with funds in an emergency.

The young face their own difficulties of exclusion from traditional financial services but, as the majority have mobile phones, they have much to gain from Digital Finance 2.0.

$2.6tn

of additional GDP could be produced by 2025 by closing the gender gap

Source: McKinsey Global Institute

For Latin American teenagers and young adults it is less about raising money for a new venture and much more about the simple financial transactions of everyday life.

On average, says Santander, less than half of the people over 15 years old in Latin America and the Caribbean have access to the financial system. This is lower than the global average of 61% and well behind most developing regions. In addition to being comparatively low, financial access is very uneven.

“Financial inclusion is a tool to break the circle of poverty for youth and is the first step towards social, economic and political inclusion,” say the authors of *Financial inclusion among youth in Latin America*. They explained: “We discovered in a survey that 71% would rather go to the dentist than to their bank and that 33% are open to switching banks in the next 90 days.”

The study, published by Proyecto Capital, a social inclusion project partly funded by the Ford Foundation, concluded there are two types of financially excluded among the young: the involuntary and voluntary.

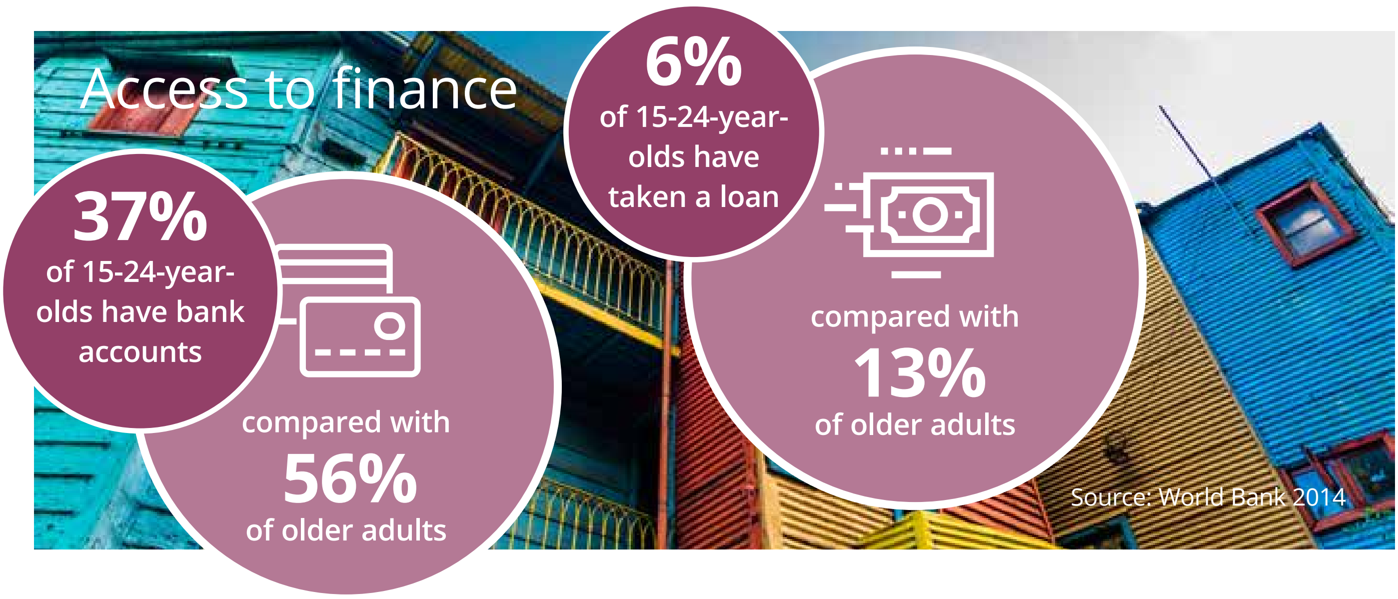
The involuntarily excluded do not have access to financial services because the products are inappropriate, unaffordable or difficult to understand.

Voluntarily self-excluded young people have access to mainstream finance but choose not to take advantage. Typically, they entered the workforce in one of the region’s many economic crises and lived through a slow recovery that has made them mistrustful of the banking system.

In addition, they do not wish to be passive consumers but expect to have a say in the development of financial products directed at them.

71% of young people would rather go to the dentist than to their bank

Source: Proyecto Capital



Banco Santander (SAN SM, STD US, BNC LN) is a leading retail and commercial bank, founded in 1857 and headquartered in Spain. It has a meaningful presence in 10 core markets in Europe and the Americas, and is the largest bank in the euro zone by market capitalization. Its purpose is to help people and businesses prosper in a simple, personal and fair way. Santander is building a more responsible bank and has made a number of commitments to support this objective, including raising over €120 billion in green financing between 2019 and 2025, as well as financially empowering more than 10 million people over the same period. At the end of September 2019, Banco Santander had €1.04 trillion in customer funds, 144 million customers, of which 21 million are loyal and 36.2 million are digital (51% of active customers), 12,700 branches and 200,000 employees. Banco Santander made underlying profit of €6,180 million in the first nine months of 2019, an increase of 2% compared to the same period the previous year.