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KOHO FINANCIAL INC.: FACING A NEW BANKING ERA[1]

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On November 28, 2019, Daniel Eberhard learned that he had secured a sixth round of funding for his Toronto-based company, Koho Financial Inc. (Koho). Investors saw that his start-up had the potential to continue its growth trajectory and had provided a series B capital injection of $25 million,[2] bringing the total amount raised to US$57.5 million.[3] Over the previous four years, Eberhard had demonstrated that there was a need for a financial innovation like Koho and had shown that the company was ready to scale.[4] Koho's services had improved significantly since its inception, but Eberhard needed to determine a strategy to grow the financial technology (fintech) company as quickly and successfully as possible.

KOHO FINANCIAL INC. (KOHO)

Koho was launched in 2015 in Toronto by Vancouver-born Eberhard, who had previously worked as a consultant and entrepreneur.[5] Canada had some of the highest per-capita banking fees in the world. Eberhard sought to disrupt the banking industry in Canada, where the banking experience was the same for both younger and older demographics by founding Koho as a new way for millennials to manage their money with no fees.[6] Koho partnered with the Peoples Trust Company, Galileo Financial Technologies LLC (Galileo Processing), and Visa Inc. (Visa) to create a fintech solution that provided a range of financial services, including a mobile application (app) and Visa card.[7] All three partners were vital in ensuring Koho's success: the Peoples Trust Company held consumers' money and issued cards, Galileo Processing processed transactions, and Visa allowed users to make purchases.[8]

Koho's initial product offering included a prepaid Visa card and a mobile app that had all the same functionalities as a traditional bank account, including direct deposit, automatic bill payment, and e-transfers.[9] The company focused on creating a frictionless customer experience by mapping it from scratch and challenging the typical role of a bank. One of Koho's unique features was its practice of providing each user with two balances: the total amount in the user's account and the amount that the user could spend.[10] Koho's spendable balance provided users with a more realistic cash position than a typical chequing or savings account balance. Coupled with a modern user interface, this feature helped Koho's users save more, spend less, and better understand their financial positions.[11]

By 2019, Koho had grown its services by offering real-time balance updates; giving users 0.5 per cent cash back on all purchases; rounding up purchases to add to users' savings; securing partnerships to reduce foreign-exchange fees; and establishing, in partnership with Flinks, its first openbanking, leveraged service, What the Fee, to uncover how much users were paying their banks in fees.[12] To diversify its revenue stream, the fintech start-up also began offering a premium account that offered 2 per cent cash back, no foreign exchange fees, free financial coaching, and more, for a fee of $9 per month or $84 per year (see Exhibit 1).[13] In November 2019, Koho had over 200,000 users, had raised a total of $57.5 million, and hoped to grow its user base and deliver complementary products.[14]

Koho combined two unique fintech business models: a digital wallet and digital banking. Under the digital wallet model, Koho's main source of revenue came from merchant discount rate (MDR) fees from vendors (see Exhibit 2).[15] When a customer made a purchase with their Koho card, the vendor received the payment minus the MDR,[16] and this fee was then shared between Koho and Visa.[17] Fintech businesses leveraging the open-loop payments model effectively removed costs to achieve profitability. Similarly, the operation of the digital banking business model was almost identical to that of traditional banking businesses, with two main differences: (1) a tremendous savings on human capital and real estate costs, and (2) the forgoing of high-risk services such as loans, which allowed fintech start-ups like Koho to offer low-cost products.[18] This unique business model created an accessible and affordable option for customers, who no longer had to pay traditional banking and credit card fees. Koho also used machine learning technology to better understand customers' spending habits and curate product recommendations. As a result, Koho also earned commission from referrals to other products, such as Wealthsimple and Willful.[19]

MARKETING

Koho's main marketing messaging was about restoring financial balance. Koho strategically positioned itself as an anti-establishment option that offered low prices.[20] Aligned with its message of transparency, Koho created custom content to educate its users on how to better manage and save money using its platform. Both growth and customer acquisition were vital to ensuring its successful long-term viability as a fintech start-up.[21]

As a mobile app, Koho gathered data and real-time insights on users' spending habits. For example, Koho discovered that Canadian users put one-third to one-half of their paycheques into their Koho accounts every two weeks.[22] These users also logged in and opened the Koho application an average of eight times per month—far more than regular online banking platforms, which they used an average of once per month.[23] Armed with this data, Koho could hyper-target specific customers with recommendations for other products and earn commissions from merchants. This user-level data also allowed fintech start-ups to create personas and to develop a better understanding of different types of users. Social media platforms such as Facebook offered services that enabled them to create lookalike audiences—audiences that shared similar traits and interests—when creating digital advertisements.[24]

STAKEHOLDERS

Koho's recent funding round included fintech venture capital firm Portag3 Ventures and U.K.-based Greyhound Capital, among others.[25] Investors in Koho's current series B funding round expected the company to grow further by increasing customer acquisition, entering new markets, or developing new products and services. In exchange for mentorship and funding, venture capital firms typically expected successful portfolio companies to generate returns up to 10 times the size of their investments, with a typical time horizon of eight to 10 years.[26] Exit strategies of venture capital firms included initial public offerings, acquisitions, and management buyouts.[27]

Like other fintech companies, Koho mainly targeted millennials, who prioritized convenience, value, and trust when choosing the products and services they would adopt. Unlike older consumers, who preferred traditional channels such as brick-and-mortar stores, millennials sought digital user experiences that were seamless and fast. Millennial users also sought products and services that provided the best value. According to a study, 93 per cent of millennials saw a fee-free service as essential when choosing a financial institution, and 83 per cent would switch to banks that offered better terms or rewards.[28] Finally, millennials tended to have little trust in financial services due to the impact of the financial crisis in 2008.[29] Fintech companies had to recognize that trust and security were of utmost importance to retaining users.

One of Koho's main value propositions was the PowerUps cash back program, where users received rewards when shopping at select merchants.[30] Merchants participating in the program included Foodora, Greenhouse Juice Co., and Chefs Plate, which offered customers 1.5–5.0 per cent cash back when they used their Koho cards.[31] This feature enabled merchants to use Koho as a marketing platform to attract new customers to shop at their stores and benefited both merchants, through increased sales and loyalty, and customers, through cash back rewards.

OPEN BANKING

Open banking, also known as consumer-directed banking, was a framework that enabled third-party providers (TPPs) such as fintech companies to securely access consumer financial data. Through application programming interfaces (APIs), fintech companies were able to leverage financial data, traditionally available only to banks, to improve their product offerings by providing personalized solutions (see Exhibit 3). Typically, customers were required to provide consent to allow third-party access to their financial data. Open banking was commonly used to analyze customers' transactional data, aggregate data from multiple banks, and create new transactions.[32]

Open banking allowed fintech companies to understand consumers better by analyzing their financial data. Benefits of open banking included innovation, lower barriers to entry for new fintech start-ups, efficiency through faster data sharing, standardization, and the creation of opportunities for marginalized communities. Consumers benefited from open banking as businesses were able to leverage user-level data to fuel insights and provide more personalized experiences. Businesses and financial services benefited from open banking as data sharing allowed for a more holistic, accurate portrayal of a consumer's financial position.[33]

Open banking, which required consumers to share their personal data with multiple stakeholders, came with major security and privacy risks. Open banking invited many stakeholders—such as payment processors, banks, customers, regulators, and start-ups—to share information. This resulted in information asymmetry and made it possible for parties to take advantage of consumers through methods such as predatory lending.[34] Moreover, open-banking operations were entirely online, and the digital environment created a higher risk that hackers would attempt to access financial data. Consequently, the higher potential for financial crime made it more difficult to identify suspicious behaviour.[35]

In Canada, the *Personal Information Protection and Electronic Documents Act* (PIPEDA) applied to private-sector uses of personal information in the course of commercial business.[36] Under PIPEDA, companies had to be transparent and clearly identify, for consumers, the information they were collecting, the purpose of collecting the data, the stakeholders that had access to the data, and any potential risks that might arise.[37] However, PIPEDA was not specific to open banking or technological uses.[38] As a result, the industry was constantly undergoing regulatory changes to ensure that consumers were protected.[39]

REGULATION

In January 2020, the Canadian Department of Finance's Advisory Committee on Open Banking released *Consumer-Directed Finance: The Future of Financial Services*, a report that presented findings and recommendations regarding open banking.[40] The report aggregated over 100 written submissions in response to the consultation paper the committee released in January 2019, *A Review into the Merits of Open Banking*.[41] The submissions were written by various stakeholders, including consulting firms, financial services firms, and regulators (see Exhibit 4).

Key findings stated in the report were that the Department of Finance, along with industry stakeholders, should develop a white paper regarding an open banking framework and that open banking would help support Canadians' financial health. The most common method of sharing financial data was screen scraping, which involves copying information shown on a digital display for future use;[42] however, screen scraping involved sharing password information to access user data and so created security and liability risks for all stakeholders. Additionally, the report emphasized the importance of integrating consumer privacy and protection when designing user experiences and user interfaces.[43] That report also said that financial institutions and start-ups needed to incorporate tools and processes to better educate consumers about the usage of their financial data.

Governments and fintech start-ups needed to look to other markets that were leading in open banking, for example, Europe, and specifically the United Kingdom.[44] In Europe, two frameworks had been created specifically to regulate fintech innovations: the Payment Services Directive (PSD2) and the General Data Protection Regulation (GDPR).[45] The United Kingdom's Competition and Markets Authority had recognized the importance of open banking as a tool that would allow smaller fintech players to compete with traditional banks.[46] As a result, the Open Banking Implementation Entity was created to work directly with the government, banks, and fintech start-ups to build a framework and educate consumers on open-banking opportunities and risks.[47]

COMPETITION

Koho faced competition from several other financial services providers.

Stack Fintech Inc.

Stack Fintech Inc. (STACK) was a fee-free mobile banking alternative that provided rewards, tools for money management, and a reloadable Mastercard.[48] Similar to Koho, STACK operated in partnership with Mastercard Incorporated and Peoples Trust Company.[49] The start-up leveraged machine learning to provide customizable tools to users and offered instant access to multicurrency and cryptocurrency services. Its main competitive advantages included fee-free foreign-exchange cash back at over 140 retailers and free money transfers. Despite its recent presence in the media, STACK had not raised any public funding rounds, suggesting a potential lack of capital and growth prospects.[50]

Drop Technologies Inc.

Drop Technologies Inc. (Drop) was a Canada-based fintech start-up that leveraged open-banking APIs and targeted financially conscious millennials. Drop was a mobile loyalty and shopping platform that implemented a system which automatically rewarded users for their purchasing behaviour via reading their transactional data. Drop had raised a total of $75 million in funding by the spring of 2020 and had over 3 million users, mostly in the United States.[51] Drop's business model was unique: its revenues were derived mainly from payments marketing or advertising from merchants.[52] Using user-level data allowed Drop to uniquely target specific groups of users using machine-learning algorithms.

American Express Company

The American Express Company (Amex) was a card issuer and payment processor.[53] Amex operated a closed-loop payments business model: the company issued cards to and also processed payments for its users.[54] The closed-loop model allowed Amex access to cardholder spending and transactional data, which it could leverage to attract merchants and incentivize higher spending. The majority of its revenues were derived from the fees charged to merchants who decided to accept Amex cards. Amex members had access to many perks, such as access to airport lounges and high cash-back values. However, there were issues with Amex cards, including a high exposure to credit risk and difficulties with merchant adoption.[55]

ALTERNATIVES

To better understand Koho's potential options and analyze which strategy would provide the most returns for Koho's investors, it would be beneficial to know the return on investment of the various alternatives.

Eberhard could choose to continue Koho's strategy by focusing on the fintech's current business model without further external investments. Compared to regular brick-and-mortar banks, Koho already provided significant cost savings to both shareholders and users. Most of Koho's revenues were currently derived from MDR fees from the transactions made by Koho. The small portion of revenues derived from commissions was negligible. Eberhard would have to calculate the estimated revenues from the average MDR. Koho had made more than $500 million in annualized transactions over the past year,[56] and its major costs included marketing costs and salaries for approximately 96 full-time employees, who all received market average fintech start-up salaries.[57] Technological investments made were related to the maintenance of digital infrastructure required to store data and develop the application.[58]

Another alternative that should be considered was expanding Koho's open-banking capabilities. This option would require making major investments in the infrastructure required to build an API or working directly with a current open-banking API start-up such as Flinks or Plaid. Koho could also follow the lead of its competitor STACK by offering cryptocurrency services. However, Koho had not yet entered the cryptocurrency industry and had no knowledge or experience operating in this space. Costs for this alternative would include hiring a specialist and engineer to develop this feature. It would require major investments in cryptocurrency infrastructure or software.[59]

Other fintech business models that Koho could consider were asset management, digital insurance, small-ticket loans, and peer-to-peer lending (see Exhibit 5).

NEXT STEPS

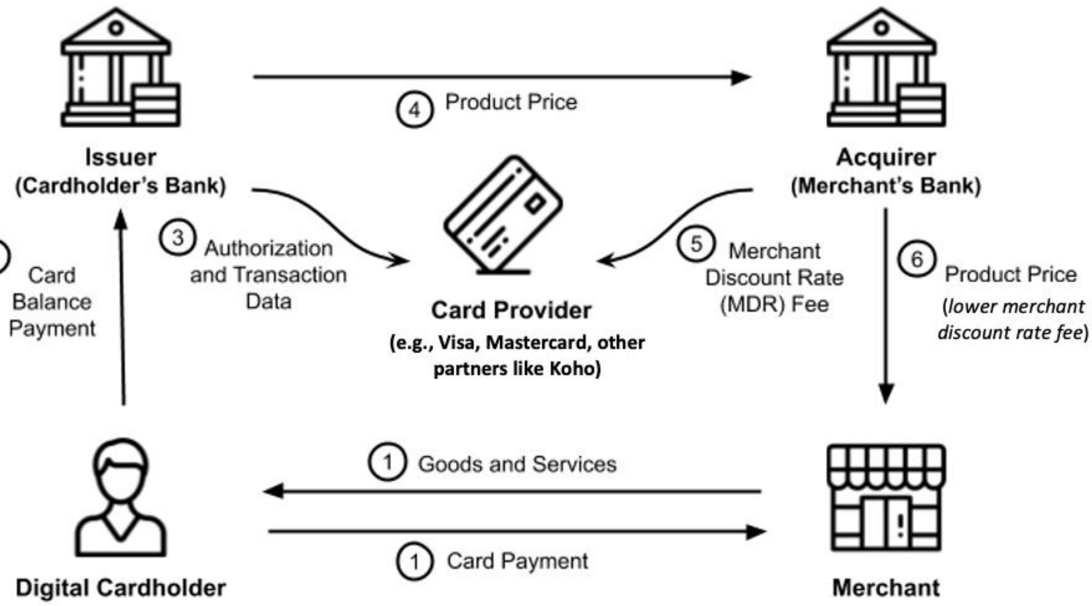
Eberhard had decisions to make: How could he effectively deploy Koho's latest $25 million investment to satisfy all stakeholders? Should Koho continue its current strategy and compete directly with traditional banks, or should it invest in new technologies and compete with other fintech start-ups? How could Koho's marketing strategy be improved to acquire more customers? How would the changing fintech regulatory environment affect Koho's strategy, and what could Eberhard learn from similar companies in other locations?

EXHIBIT 1: KOHO PRODUCT FEATURES

Feature Name	Premium?	Description
No Fees		No account or card fees; no non-sufficient funds fees; no minimum account balances; no maximum number of transactions
Virtual Card		Virtual prepaid Visa card—used a different card number to protect user's physical card numbers
Physical Card		Physical prepaid Visa card for in-store purchases
0.5% PowerUp		Instant 0.5% cash back on all purchases
2% PowerUp	✓	Instant 2% cash back on all purchases
Merchant PowerUp		Users could earn additional cash back (1.5%–5%) when using their Koho card with participating merchants. Merchant partners included Well.ca, Foodora, Chef's Plate, Sunwing Airlines Inc., Greenhouse Juice Co., Freshii Inc., JJ Bean, Public Mobile, Frank and Oak, and Altitude Sports.
RoundUp		Every purchase a user made was rounded to the nearest $1, $2, $5, or $10. The extra amount was set aside in the user's savings account.
Automated Savings		Money was automatically moved from a user's spendable account (the suggested amount the user had to spend) to that user's goal savings account.
Dialogue	✓	A third-party partner that provided access to healthcare professionals to chat and refill prescriptions
Price Match	✓	Users uploaded receipts for recent purchases at select merchants, and Koho scanned to see if the price dropped or if the item was being sold for less elsewhere.
Insights		An algorithm that showed and categorized transactions in real time
Referral Program		Each time a use referred a friend to Koho, both users earned an extra 1% in PowerUps on all purchases for 90 days.
ATM Withdrawals	(✓)	Users could withdraw money at any ATM. Premium users got one free withdrawal at ATMs outside of Canada each month. Withdrawals were typically charged $2 to $3 by the ATM provider.
e-Transfers		Free and unlimited Interac e-transfers
Foreign Transactions	(✓)	Foreign transactions (FX) were charged a 1.5% fee. Premium users did not pay FX fees.
What the Fee		
Financial Coach		An in-application expert to help users with money-management questions: Koho's financial coach held an Accredited Financial Counsellor – Canada designation.

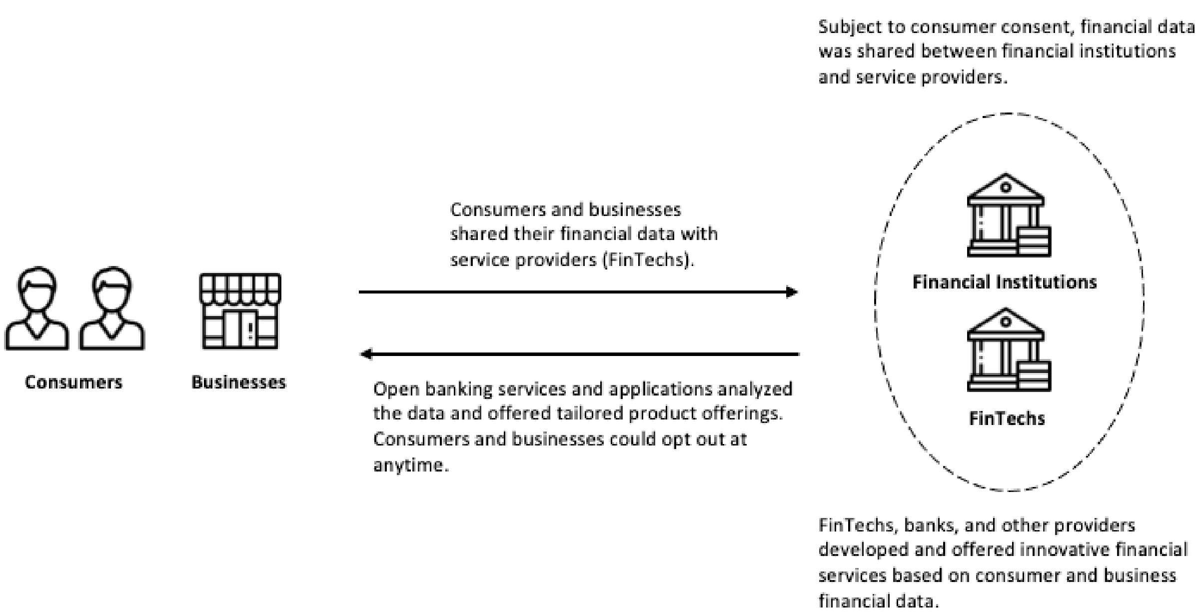
Source: Created by case authors based on "Simple. Smart. Banking.," Koho, accessed April 13, 2020, www.koho.ca/features/.

EXHIBIT 2: DIGITAL WALLET BUSINESS MODEL



Source: Created by case authors based on "Interchange is a Part of the System that Makes Electronic Payments Possible: Interchange Rates," Visa, accessed April 14, 2020, www.visa.ca/en_CA/support/small-business/interchange.html.

EXHIBIT 3: OPEN BANKING MODEL



Source: Created by case authors based on "A Review into the Merits of Open Banking," Government of Canada, January 2019, accessed April 13, 2020, www.canada.ca/en/department-finance/programs/consultations/2019/open-banking.html.

EXHIBIT 4: SUBMISSIONS FOR CONSULTATION PAPER ON OPEN BANKING

Accenture	Impression Ventures
Amandeep Batra	Interac
Andrew Bond	Kiblr 1
BC Freedom of Information and Privacy Association	Kiblr 2
BMO, CIBC, National Bank, RBC, TD, Scotiabank	Jeremy Kronick
Borrowell	Larsen & Toubro Infotech
Canadian Association of Mutual Insurance Companies	Law Society of Ontario
Canadian Bankers Association	Law Society of Ontario (Annex A)
Canadian Chamber of Commerce	Law Society of Ontario (Annex B)
Canadian Credit Union Association	Luge Capital
Canadian Lenders Association	Manulife
Canadian Mortgage Brokers Association (BC)	MaRS Discovery District
Canadian National Institute for the Blind	Marwa Ahmed
Canadian Venture Capital and Private Equity Association	Michael King (Ivey)
CCI	Michael Sivan
Celero	Mortgage Quote Canada Corp
Centre for International Governance Innovation (CIGI)	MX Technologies
CGI	Mylo Financial Technologies Inc.
Chuck Grace (Ivey)	National Aboriginal Capital Corporations Association
CLHIA	Office of the Privacy Commissioner of Canada
Coast Capital Savings	Payment Source
Competition Bureau of Canada	Payments Canada
Electronic Transactions Association	PayPal
Epiphany	Plaid
Equitable Bank	Portag3
Evree	Power Financial Corporation
Expertus Technologies	PwC
Fairstone Financial	Questrade
Ficanex	Ratehub
FIME	Salt Edge Inc.
Financial Data and Technology Association of America	Sunlife
FinTech Growth Syndicate	Symcor Inc.
FormFinTech	TransferWise
Funding Circle	TransUnion
Great West Life Assurance Company	Trust Companies Association of Canada
Home Trust Company (Home Capital Group)	Vic Hamilton (Bayield Mortgage)
HSBC	Wealthsimple
IGM Financial Inc.	WSO2
	Xero
	YodoPay
	Zafin

Source: "Submissions for Consultation Paper on Open Banking," Government of Canada, February 18, 2020, accessed April 14, 2020, www.canada.ca/en/department-finance/programs/consultations/2019/open-banking/submissions.html.

EXHIBIT 5: OTHER FINTECH MODELS

Fintech Business Models	Description	Example
Asset Management	Asset management start-ups enabled investors to buy stocks or mutual funds without having to pay traditional commission fees. In exchange, consumers provided personal data.	Robinhood Markets
Digital Insurance	Start-ups that operated across the entire insurance process, including sales, underwriting, distribution, claims and renewal. Many start-ups employed blockchain-based models to speed up claims processing and to ensure security for their end users.	Lemonade Insurance Company, Dig-In
Small Loans	Short-term credit loans were offered by innovative fintech platforms. As these services were more flexible and fast, consumers were able to receive customized loans with varying repayment options.	Affirm Loan Services, Sezzle, Klarna Bank
Peer-to-Peer (P2P) Lending	P2P lending was an innovative business model where individuals or businesses received loans from other individuals or businesses. P2P lending was similar to digital banks in requiring lower overhead and major investments to start a company.	Loop Securities Ind. (Lending Loop), Funding Circle Limited

Source: Created by case authors based on data from “10 Innovative FinTech Business Models,” Board of Innovation, accessed November 1, 2020, www.boardofinnovation.com/blog/10-innovative-fintech-business-models/.

ENDNOTES

[1] This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Koho Financial Inc. or any of its employees.
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