Year End Wrap, New Year's Outlook

From the Castle Creek Launchpad Fund team

Welcome to 2024! We asked our portfolio company founders, who have an on-the-ground vantage point, what they expect to see in 2024. We're not keeping a scorecard on predictions, instead we've been most interested in hearing how nimble founders deal with uncertainty or adversity, while delivering value to their partners and customers.

Inflation rates and the pressure on household budgets were top of mind for two founders.

Matt Pierce: Inflation will continue on a similar path and the American workforce will continue to seek additional streams of income to make ends meet. The companies and financial institutions that can provide creative ways to help stretch paychecks further will win big in 2024. HR leaders will increasingly turn to innovative benefits to lure and retain talent as a way to improve business continuity and customer service. Fintechs offering these types of benefits (like Immediate) will reap the rewards of these economic tailwinds to drive growth and financial impact across the country.

Eddie Chung: Inflation and the overall tightening of the economy has negatively impacted the average American. Our key goal of the year is to directly deliver early tax refunds (Grid PayBoost) to our customers to help with any cash/liquidity shortfalls. We plan to onboard 1M new customers and directly provide $200/month ($100 per pay period) in early tax refunds onto their Grid Card.

Meanwhile, the housing market faces opposing macroeconomic pressures from interest rate decisions.

Tim Herman: The Fed will have to be on the aggressive side of the dot plot when it comes to rate cuts in the coming year. In our industry the underlying problem is a supply and demand imbalance for single-family homes due to demographic trends and a lack of adequate building over the past 20 years. The shock of the past two years has done nothing to address this underlying imbalance. As we move from contractionary to expansionary

monetary policy, a wave of pent up demand will be unleashed across asset classes, but particularly in real estate. UpEquity has weathered a particularly intense storm in real estate and we are excited to enter a new market cycle from a position of strength.
Our founder in wealth management offered a comprehensive view of market forces, and concurred with Herman's positive real estate outlook.

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Lee Calfo: The increase in equity market valuations as well as a reduction in inflation, and a pause and interest rate increases by the Federal Reserve, was well received particularly in the second half of the year. The increase in equity markets in 2023 was primarily driven by technology companies, which had their best year for price increase in decades. Economic growth also remains strong and optimism for 2024 is increased versus expectations earlier in 2023. 2024 should also see higher levels of activity in the capital markets as investment banking, initial public offerings, and other investment deal transactions have been running at reduced levels since 2022. Activity in the real estate market remains robust with deals continuing to transpire despite the higher interest rate environment. There are concerns about aggregate indebtedness among both individuals (principally credit card payments) as well as companies (particularly those that have borrowed money against real estate) that will be coming due over the next two years. Continued growth in the economy, in conjunction with a somewhat cloudy outlook for credit quality, will likely result in significant capital raising activity among financial services companies, particularly banks, in 2024. Also, 2024 is a presidential election year. Our outlook is for pullbacks to occur at random in the equity markets followed by periods of the market grinding higher through the election.

Falling inflation and rising equity prices has put our financial advisors and clients, as well as companies that we deal with, in a better mood as they look to 2024. We expect a pick up in capital markets activity as well as continued growth in asset prices in 2024, and feel that activity in general will continue to increase over the very low levels of 2022 and the more muted but slightly better levels of 2023.

The growth of financial technology, and its impacts on both traditional and newer business lines in the financial services industry, has continued to accelerate in 2022 and 2023. We view this as the most disruptive future factor determining the way that financial services companies conduct their business and interact with customers. Harnessing the opportunities, while dealing with the challenges, that this technology will bring is going to be a key defining factor in many areas of the financial institutions space.

The following three founders overlap on themes from regulatory scrutiny to overcoming the limits of legacy core technology.

Zach Bruhnke: Banks will continue to adopt new vendors that help them modernize at a faster pace, and augment the functionality of legacy providers, in order to provide best-in-class user experiences. HMB is well positioned to help banks bring new features to market quickly and without switching their core provider.

HMB will also play a big part in curbing ACH and check fraud throughout 2024 as banks look for new ways to fight a century-old problem on the rise. The past two years, 2022 and 2023, have been consecutively the two largest years on record! HMB has developed a virtual account layer that allows banks to put stronger controls around account numbers to tamp down fraud and generate unique rulesets per account number or even lock them down further by counterparties.

Nikkee Rhody: In 2024 the trends seem to point toward simplification. Adoption of emerging solutions is likely to slow given the trepidation by banks witnessing 2023's regulatory hammering. Instead, more consolidations and very selective partnerships are on the horizon. This highlights opportunities to combine expertise between banks and fintech for a stronger, more efficient future—so long as these partnerships have a shared objective, technological compatibility, regulatory considerations, and the ability to address evolving consumer needs.

The traction of decentralized finance and embedded finance will likely get the spotlight. Both sectors have barely tapped the addressable market that gives significant opportunity for growth and transformative change for the betterment of consumers and their financial access.

Last but not least, the time of jargon and over-embellished lingo is disbanding. I believe we'll see a sunset to " _ aaS" in order to make way for clearer, more transparent, and straightforward descriptions of products and services. Along with language choice, the bent toward more intuitive interfaces is on the rise. Adopting simplicity across the industry can only stand to serve legislation and regulation; thereby moving the industry forward for all.

RiskScout **Justin Fischer**: From a technologist and compliance perspective we see three important themes in banking for 2024: Demand for technology providers, increased regulation and scrutiny, and non-traditional revenue sources.

Most technology in use by financial institutions is provided by larger entities and has quickly become legacy technology that's not keeping pace with the needs of the market. This problem is especially apparent if you are a sub $10B asset institution (98% of the market) and hope to get the latest and greatest from your core or digital provider. More institutions will look outside the handful of legacy companies for solutions. There are many tech companies focused on fintech and not as many on FIs directly. It's not a nuanced differentiation. We will see more FIs going out on a limb to develop in house, work with a new company, or even install middleware/side cores to meet their needs.

There's no doubt, like death and taxes, that ever increasing regulation and scrutiny is coming from the examiners. In 2024 we will see more focus on the BaaS, crypto, and lending spaces as they bleed over into traditional money movement and financial products. Many FIs that sponsored BaaS solutions with little to no oversight paid the price last year and the orders, C&Ds and MRAs will continue in 2024. The resourcing of compliance and BSA team members will continue to get worse in 2024 as there is no steady pipeline for new recruits to fill the need. Hang on to your people and train the next generation before it's too late!

In the post-pandemic years we have seen FIs expand their markets by banking non-traditional entities (ATM, MSB, cash intensives, cannabis, etc.) or by growing in regions beyond their typical branch footprint. RiskScout was inundated in Q4 with FIs looking for technology that enables the reach, operational efficiencies, and risk management to help scale new market programs without increasing hiring.

We are excited to announce that RiskScout will be releasing a full BSA/AML system specifically designed for FIs, and priced to meet the needs of small and large alike, this year. It will carry forward our client-facing market tools that have enabled millions in low cost deposit and fee revenue growth. It's time for compliance and BSA to be a business enabler not just a risk management tool.

Our Outlook for 2024

From Gen AI possibilities to Gen Z expectations, the need for significant change in banking took on greater urgency over the past year. The industry must find new operating models and technology to match the on-demand pace and fresh eyes of younger customers who've grown up with apps for everything, TikTok financial influencers, and streaming as a given. They expect seamless services, assume transactions are real-time, turn toward virtual assistants—and are quick to seek better offerings.

In the past year we saw new infrastructure at the deepest layer of transactions, the Federal Reserve rails, with the launch of FedNow. Core banking technology is the next infrastructure layer. The U.S. has over 4,000 FDIC insured banks—yet a mere handful of core technology providers dominate the market for all but the big banks. Ultimately banking will need a full transition into cloud-hosted, API-enabled core technology. A recent Economist survey found that replacing legacy IT infrastructure is a top priority for at least 24% of bank executives, a further 35% saw migrating data and processes to the cloud as essential.

The Financial Brand asked Ryan Gilbert for his perspective and shared his observations in several "Banking 2030" installments, such as:

> "Gilbert argues that physical proximity and community connections give smaller banks a distinct advantage over 'large institutions sitting in the Ivory Tower.' In an era where digital interactions can sometimes feel impersonal, community-oriented banks have the unique ability to foster trust and deeper relationships with their customers."

Now, here are some lists, imperatives, and predictions in our own words.

Five fintech themes for 2024

1. Developers are buyers

The technology teams at banks, nonbanks, and fintechs want to build new products to better serve customers. How can they turn those intentions into results? Companies that offer tools, sandboxes, documentation, and infrastructure for digital transformation, beyond core technology, can support more change reaching across more organizations.
Portfolio examples: HMBradley and Grid

2. Services for safer banks

The focus on security, compliance, and risk management will continue to increase—along with the threats and challenges. Risk mitigation measures include educating employees about cyber hygiene, adopting zero-trust infrastructure, and implementing advanced fraud detection and prevention systems. Regtech, especially for onboarding and ongoing customer management, will be worth the time and investment.
Portfolio example: RiskScout

3. Supercharge financial advisory and wealth management

Take banking beyond the bank account. Customers are looking for guidance to make the value of their assets keep up with inflation. They recognize that they need to put their money to work. Integrated wealth management and advisory services, powered by on demand insights, can boost asset acquisition and create sticky long-term relationships. While serving retail customers is an obvious pathway for many banks, the B2B opportunity to serve advisors and wealth management firms should not be ignored. Billions in deposits could be up for grabs.
Portfolio example: Alden Investment Group

4. Warm your real estate pipeline

NAR forecasts the housing market to grow in 2024 with 4.71MM existing homes to be sold. Falling mortgage rates should drive sales, along with an 31% increase in inventory as more sellers begin to list after delaying selling over the past two years. Remember that the average American homeowner moves every 7 years, and this trend is likely to maintain and even accelerate with work location flexibility. Also, regulators are watching banks closely and calling on the sector to do more to protect and support consumers—especially first-time home buyers. Many lenders are adopting emerging technologies to make the mortgage processes easier with accelerated risk assessment in real-time application and document analysis. Solutions that offer increased liquidity and buying power to homeowners and buyers remain top of mind in the current market.
Portfolio example: UpEquity

5. Leverage existing customer relationships

You've on-boarded your customer, but now you need to compete for a broader range of their financial activity. The SVB bank run of '23 shook the concept of monogamous banking, and multiple banking relationships are now more of a threat than full account switches. Value-add services and products in recurring and reliable areas, such as wealth management, payroll, and B2B services, help banks make deposits sticky.

Portfolio examples: Central Payments, Immediate

Four big trends for 2024

1. Open data and Dodd-Frank section 1033

The CFPB plans to publish the final rule granting customers data portability, and laying out the timetable for compliance, in the Fall of 2024. Pent-up frustration with captive core provider partnerships has been building. We expect to see significant shifts in technology provider categories as data-centric innovators seize this opportunity. It goes beyond regulatory compliance to digital transformation.

2. Embedded finance going further

Advances in Gen AI and data analytics (read more below) will drive personalization and specialization, especially in consumer lending (BNPL, credit card, mortgage) and business banking. Banks can lead the charge themselves or partner with the platforms that have been meeting customer demand at decision-making points with flexible, convenient payment options. Models continue to unlock new revenue streams and blur the lines between financial and non-financial industries. Businesses are digitizing and integrating financial services into their operations, which leads to more complex B2B use cases for embedded finance to solve. Banks will have to become more agile and customer centric than ever before in providing modular, customizable solutions via APIs that can easily be integrated into the business ecosystems.

3. BaaS is down, but not out

It's clear that not all banks are ready to be BaaS banks. Some have struggled in partnerships due to limited qualified resources, insufficient infrastructure, and over-reliance on non-bank partners. At the end of the day the chartered institution holds the compliance responsibility. With the intensifying regulatory scrutiny over the past couple years, the handful of "open for business" BaaS banks and trusted software platforms have the whole fintech ecosystem ready for the taking. As our advisory board member Shamir Karkal pointed out in a recent fund podcast, most of the terminology around "third-party vendors" has the partnership dynamics backward: Fintechs are the clients. Banks are the vendors.

4. Bank-fintech investment in action

With over 500 community banks now investing in fintech startups through venture funds, getting these new tools and services to use with bank LP will fulfill the mandate of such funds, create a stronger dual banking ecosystem, and generate better financial returns. Tech automation and efficiency creates more room for meaningful human interactions. For us that means listening to LP community bank needs, evaluating relevance as well as profitability in investment decisions, and facilitating introductions.

Generative AI will affect everything for years ahead

This isn't the first, or the last you'll read on the topic, which dominated technology news over the past year. This subset of artificial intelligence is disrupting every industry. The ability to leverage unstructured data and deliver sophisticated responses—all at great speed—far surpasses previous advancements. Gen AI can summarize complex information, make online interactions more conversational, and develop content in real time. It speeds up digital research to guide strategy and can run comprehensive analysis of internal and external datasets to make information more accessible and useful. In financial services, use case examples included synthesized financial documents, personalized recommendations, and many possibilities for operational efficiency.

Banks accelerating AI powered innovation must ensure that their organizational infrastructure meets enterprise grade security and privacy standards. The risks are real. Experts anticipate an increase In cyberattacks that use Gen AI to carry out sophisticated phishing attacks using natural language processes to craft convincing fake emails that mimic the style of trusted senders to trick recipients into sharing sensitive data. They'll use deep fakes with realistic synthetic images, audio, and video, and automate tasks like pass cracking and identifying system vulnerabilities.

Similarly, and fortunately, Gen AI will empower a new class of cybersecurity tools and solutions to detect anomalies, predict threats, and protect data and infrastructure.

Banks will recognize that adopting Gen AI isn't a plug-and-play panacea, but rather a transformative journey requiring strategic planning. Banks will need to skill up their workforce, and perhaps establish new roles like a chief AI officer. Banks and wealth managers are starting to adopt the technology for internal functions such as research and knowledge management, and cost centers like customer service. Many businesses are starting to provide "co-pilots" within applications.

We expect that this emerging area of financial services will continue to be a place where startups have an opportunity to explore and experiment. Banks will watch carefully and adopt these features as consumer trust and regulations adapt.