Some comments on Fintech

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FinTechs: reality and *hype(*r)-reality

- **Beyond Fintech: A Pragmatic Assessment Of Disruptive Potential In Financial Services, World Economic Forum**

https://www.weforum.org/reports/beyond-fintech-a-pragmatic-assessment-of-disruptive-potential-in-financial-services

Fintech Successes

- FinTechs have seized the initiative – **defining the direction, shape and pace of innovation** across almost every subsector of financial services.
- The customer experience bar set by large technology firms, such as Apple and Google, can be met in financial services.

But,...

- Customer **willingness to switch away from incumbents has been overestimated**.
  - Customer switching costs are high, and new innovations are often not sufficiently material to warrant the shift to a new provider, especially as incumbents adapt.

- Fintechs have struggled to create **new infrastructure and establish new financial services ecosystems**, such as alternative payment rails or alternative capital markets.
  - They've been much more successful in making improvements within traditional ecosystems and infrastructure.

FinTech and banks

- Fintech companies mostly provide the same services as banks, but in a different and unbundled way.

- Example:
  - Like banks, crowd funding platforms transform savings into loans and investments.
  - Unlike traditional banks, the information FinTechs use is based on `big data' rather than on long-term relationships.

  - There's no reason agile banks can't use both sources of data

FinTech and banks

- Access to Fintech services is decentralized through internet platforms

- Risk and maturity transformation isn't carried out since lenders and borrowers are matched directly.

- Such pure FinTech unbundled activities have limited scope.
  - Example: it's difficult for platforms to offer clients diversified investment opportunities without keeping part of the risk on their books or otherwise securitising loan portfolios.
  - Example: it's hard for platform providers to benefit from maturity and liquidity transformation.

FinTech and Banks

- The value chain of banks includes many bundled services and activities.
- FinTech companies generally focus on one or a few of these activities in an unbundled way.
- Economies of scope:
  - Economics of banking is precisely based on the ability of banks to bundle services like deposits, payments, lending, etc.
- FinTechs will also have to bundle several services if they want to want expand their activities (become more bank-like) or integrate their services with those of banks

FinTech and Banks

- Not clear FinTech companies have a competitive advantage over banks, apart from legacy costs that banks face in re-organizing their business.

- As FinTech companies expand their range of activities, the scope for regulatory arbitrage – which the much lighter regulation of their activities has granted them so far – will surely decline.

Where has disruption occurred?

- Traditional bank distribution models and economics are at risk of being disrupted by the drive towards platform models of banking.
- Banks no longer define customer expectations of the banking experience; instead, FinTechs and large technology companies set the standard.
- Incumbents are starting to migrate core systems to the cloud, as legacy infrastructure creates challenges in meeting customer needs
- BUT: few customers have moved away from traditional deposit accounts despite significant efforts from online and mobile challenger banks

Banks and FinTech

The future of digital banking will be impacted by the unravelling of uncertainties around regulation, increasing digitization and the behaviour of technology giants

1 WHAT WE KNOW

Fintechs are now setting the level of expectations that customers have for banks. With the emergence of platform banking models, banks are trying to evolve, but are weighed down by legacy systems. However, though fintechs may offer superior digital experiences, consumers have yet to shift away from incumbent banks to online and mobile challenger banks.

Through these findings, the following uncertainties around digital banking emerged:

2 UNCERTAINTIES

- Will PSD2 be a game changer for the industry in Europe?
- Will customer interest in open banking models continue in light of growing cyberinsecurity?
- What are the business models for large tech companies expanding into banking?
- How can incumbent banks transfer their competitive advantages to the digital world?
- What partners will banks choose to set out their long-term digital strategy?

3 POSSIBLE FUTURES

The resolution of these five key uncertainties paints three diverging pictures of the future of the digital banking industry:

- Controlled, Curated Platforms
- Tech Aggregation Platforms
- Open Platform World

Value of Physical Presence

- Customers' preferences are quickly shifting to digital channels, but physical branches remain a critical component of the banking experience.

- Many customers have banking needs which only physical locations can currently fulfill (e.g. getting a same-day wire transfer for a home purchase), while other customers prefer a channel based on human interaction

Poor Challenger Bank Economics

- Because challenger banks are unable to meet more complex needs, they tend to be used as secondary bank accounts by most customers, causing them to lose out on a large share of revenue.

- Also, to attract customers, they often provide either lower fees or higher returns on deposits than incumbents, both of which lower profitability

Incumbents Targeting Attractive Customers

- The profitability of many customer segments declined following the financial crisis, as wealth levels fell and interest rates approached zero.

- In response, incumbents refocused their efforts on optimizing their client base – retaining their most profitable customer segments, and ensuring that only less profitable customers would be tempted to switch to challenger banks.

Ability to Fast Follow

- Very few technological barriers to entry affect the development of an online or mobile challenger bank.
- The majority of the barriers concern regulation.
- So bank incumbents are quickly following FinTechs with visually appealing front-end offerings or an online bank of their own.

One possible (likely?) outcome: retail banking as a controlled curated platform

- Banks outsource product design for less profitable products
- Banks form collections of best-of-breed products from various sources
- Customers benefit from diverse and customized offerings
- Fintechs focus on white-label and co-branded products

As banks focus on cost-cutting, they start embracing controlled, curated platforms as a cost-effective way of offering services

1. *As banks face margin pressures, they make the decision to cut less profitable products and services in order to focus on differentiated offerings*
2. *To fill the resulting gap, banks approach fintechs and other service providers to form partnerships based on products*
3. *Over time, banks form a small, highly curated ecosystem of products and services – based on partnerships with other organizations – which they can then offer their customers*
4. *Customers benefit from access to best-of-breed offerings without having to switch banks, but lack the choice they would have in an open platform*

CRITICAL CONDITIONS

- Banks are not forced to develop open data solutions by regulators
- Banks make the decision to offer outside products to their customers instead of building in-house
- Product designers are willing to make partnerships with banks for greater access to customers

EARLY SIGNS

- Banks form product-level partnerships with fintechs to use the bank as a platform
- Open data regulations are not broadly adopted or are weakly enforced

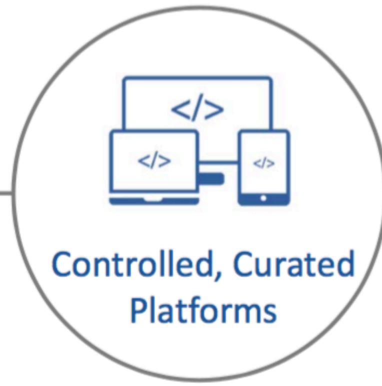
Controlled, curated platforms give much greater power to the curator, at the expense of customer choice

Implications for Banks

- Banks get to choose the areas of banking they want to specialize in, and can offer other features to their customers via partnerships
- Banks will need to ensure that they and their partners, whether platforms or manufacturers, provide a unified experience for customers

Implications for Customers

- Customers benefit from best-of-breed products, but have less choice than in other platform end states
- Customers face higher switching costs between product ecosystems



Implications for Regulators

- Regulators must closely consider the market power of platform owners to ensure they are not using their position to distort market forces
- Regulators must also track the spread of customer data between platform owners and product manufacturers to ensure the data is handled and stored properly

Implications for Fintechs

- Fintechs can partner with banks to extend their reach, but lose out on control over distribution
- Fintechs can also use partnerships to broaden their suite of offerings and compete directly with banks more effectively

Alternative scenario

- Large tech firms create distribution platforms
- Fintechs and smaller banks extend partnerships with large tech firms
- Customers embrace the ability to purchase from large tech firms
- Incumbents are forced to decide whether to join tech platforms or stay isolated

Least likely but possible scenario

- Legislation or customer pressure forces banks to use open APIs (application programming interface)

- Third parties use APIs to develop their own products

- New entrants directly compete with traditional bank products

- Financial institutions choose to focus on single segments of the value chain