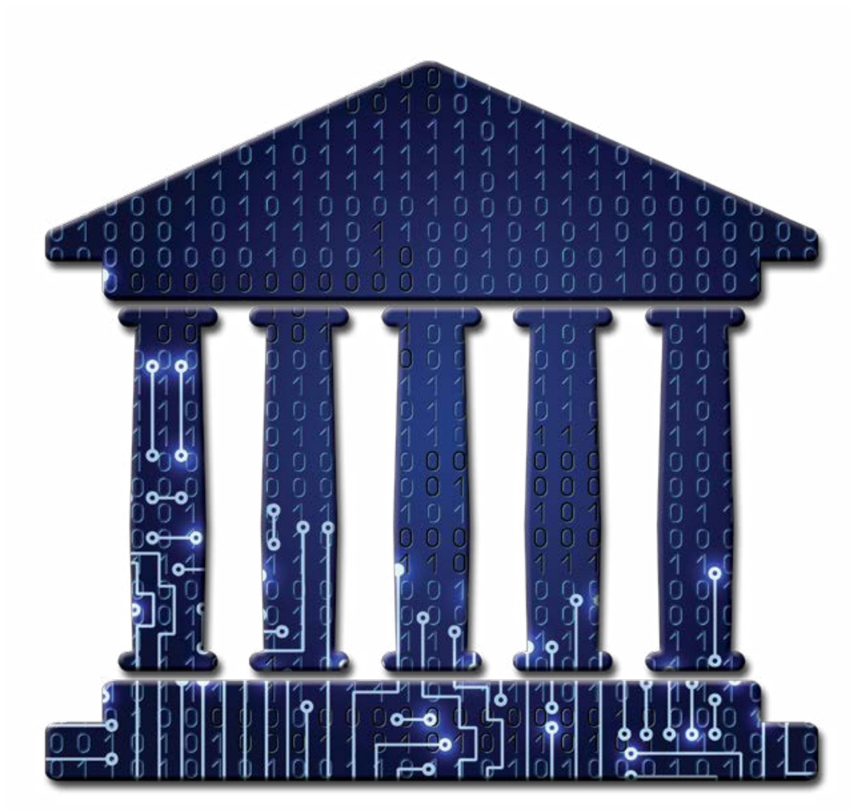
The Economist Intelligence Unit

A report from The Economist Intelligence Unit



# The disruption of banking

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# Introduction

Digital disruption is the top-of-mind technological issue in the C-suite today. Senior executives in virtually every industry are wondering whether their firm will be Amazoned or Ubered. Others take a more nuanced view that new digital players might skim off their best customers or steal a share from their most profitable product lines. All are trying to determine whether they should ignore, acquire, partner or compete with their new technology-driven competitors.

One of the most publicised disruptive challenges is the one posed to the multi-trillion-dollar banking industry[1] by financial technology upstarts, known as "Fintech".[2] More than $25bn has been poured into Fintech in the past five years, making it the number-one target for venture funding. An estimated 4,000 firms are challenging banks in every product line in their portfolios—from payments to lending to foreign exchange. As Jamie Dimon, CEO of J.P. Morgan told his shareholders about Fintech: "They all want to eat our lunch. Every single one of them is going to try."

Although it accounts for less than 2% of the market, Fintech has its share of hype and promotion. In order to develop a fact-based perspective, The Economist Intelligence Unit (EIU), sponsored by Hewlett Packard Enterprise, has conducted parallel surveys of more than 100 senior bankers and 100 Fintech executives. The objective is to determine their respective views on the impact of Fintech, the strengths and weaknesses of the participants and the likely landscape for the retail banking industry over the next five years. ■

1 For the purposes of this research, banking is defined as retail banking plus lending to small business.

2 Fintech is defined as new entrants that use Internet-based and mobile technologies to create new or superior banking products. Fintech firms range from start-ups to the bank product offerings of large tech firms like Google or Apple.

# Fintech—the perspective of banks

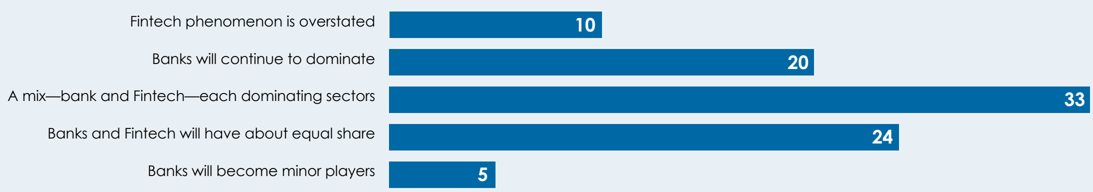
> "The holy grail for banks is to become the best at 'fintegration'."
>
> Andres Wolberg-Stok, Global Head of Emerging Platforms and Services at Citibank

Banking is one of the most entrenched of incumbent industries, boasting trillions in assets and comprising six of the top ten companies in the world. More than 90% of households in developed economies use a bank. Most important, banks' positions are protected by a maze of government regulations that restrict new entrants and stifle new forms of competition.

So what do banks have to worry about? By their own assessment, the formidable merger of financial services and digital technology, or "fintegration". "Customers' underlying financial needs haven't changed dramatically but the way in which they want to fulfil those needs has. It is a commercial imperative for banks to continuously innovate and upgrade their services to meet evolving demands," says Miguel-Angel Rodriguez-Sola, Group Digital Director at Lloyds' Banking

### Banks' views on the Fintech challenge

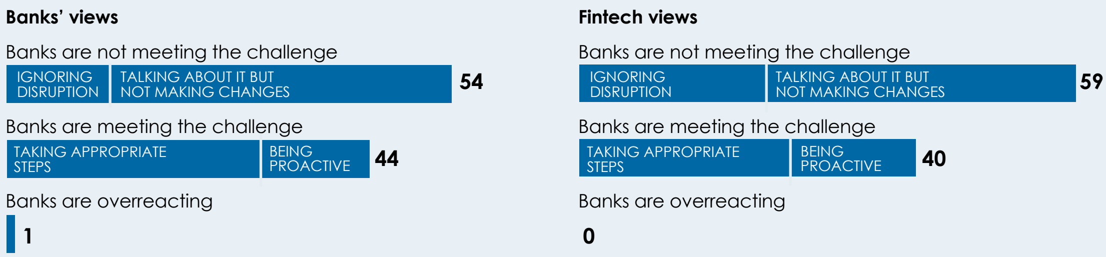
**Which scenario best describes your views on how Fintech might disrupt traditional banking?**
(% respondents)




Source: The Economist Intelligence Unit survey, 2015.

### Banks' response to the Fintech challenge

**How do you view the banking industry's response to Fintech competition?**
(% respondents)




Source: The Economist Intelligence Unit survey, 2015.

Group in London.

Some executives believe that digital disruption is hype that will go away. Not bankers. More than 90% of bankers project that Fintech will have a significant impact on the future landscape of banking. Almost a third project that Fintech will win an equal share or even dominate the market.

While apparently concerned, banks do not appear to be stepping up to the challenge. A majority of bankers (54%) believe that banks are either ignoring the challenge or that they "talk about disruption, but are not making changes". An even larger percentage of Fintech executives (59%) agree with them.

## What is holding the banks back?

By their own admission, banks see the chief barriers to responding to Fintech as the "soft issues"—lack of a clear digital strategy, cultures unsuited to rapid change and an inability to attract

top technological talent. "It is a challenge we face as banks to sustain the entrepreneurial spirit" says Hector Lagos Donde, President and Managing Director of Mexico's Grupo Monex.

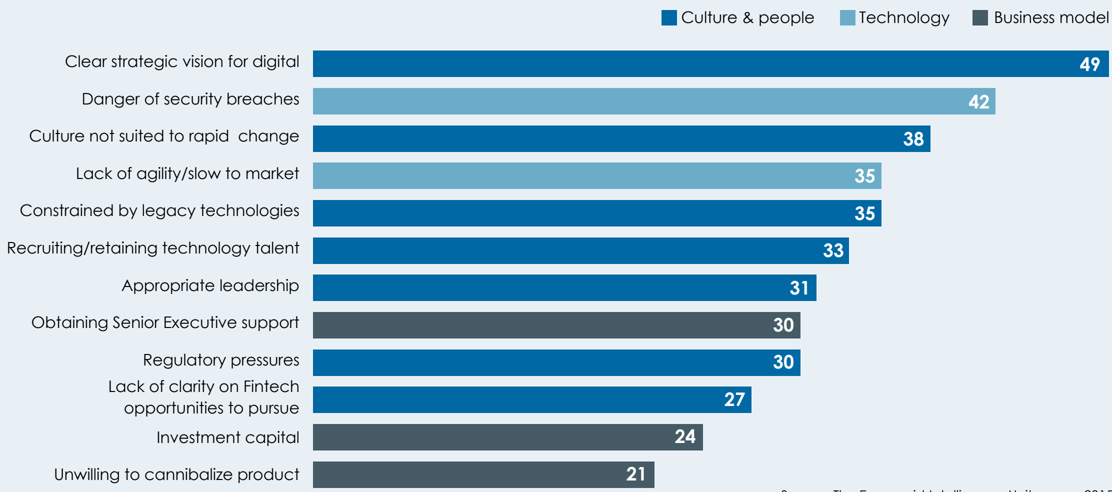
One banker described this as a vicious circle—because banks are risk-averse, they do not attract the right talent. Without the right people, they cannot pursue the best strategies … and without strong Fintech initiatives, they cannot attract risk-oriented technology leadership … and so on. "It's the personality of someone who chose banking as a career versus someone who wakes up and sees himself as an innovator or entrepreneur," says Steve Streit, Chairman, President and Chief Executive Officer of Pasadena-based Green Dot.

An oft-cited challenge to banks is their legacy technology systems. Granted, banks' networks are necessarily complex—they provide the back-office operations for thousands of complex products, need to support stringent security requirements and must support exacting regulatory and risk- management standards.

However, many banks' IT systems are ramshackle structures that include systems installed in the 1970s, 1980s and 1990s. "People now retiring are the only ones who understand how some of these systems work" says Noah Breslow, Chief Executive Officer (CEO) of OnDeck, a small business lending platform. An industry built on acquisitions has resulted in multiple install bases. Many of these systems are in-house and based on mainframe or client/server technologies. "Banks' systems are so complex and

**Banks' self-assessment of their weaknesses in competing against Fintech**

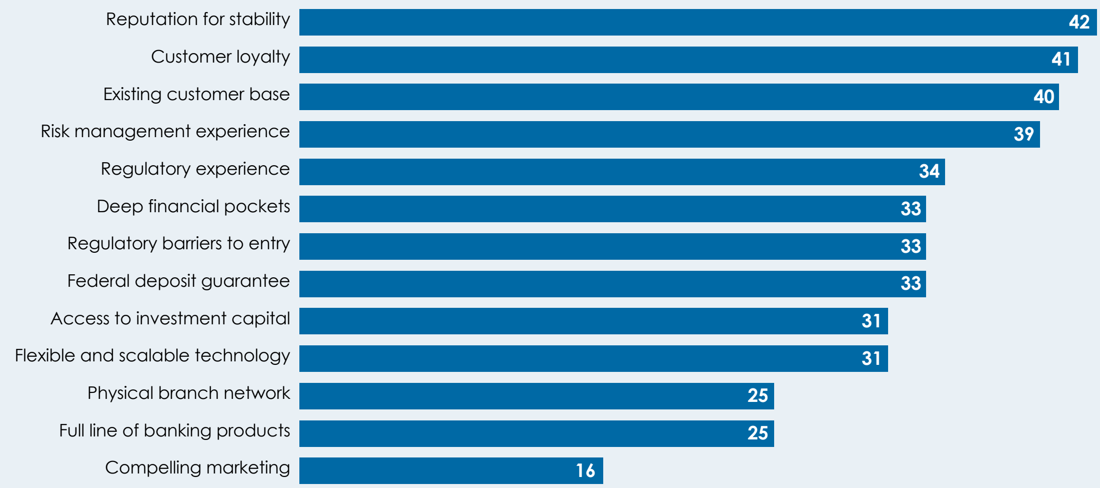
**How important are each of the following in driving competitive disadvantage for banks?**
(Bankers who cited "Very Important")




Source: The Economist Intelligence Unit survey, 2015.

**Banks' self-assessment of their strengths in competing against Fintech**

**How important are each of the following in driving competitive advantage for banks?**
(Bankers who rated each "Very Important")




Source: The Economist Intelligence Unit survey, 2015.

clunky that it takes a bank two years to do anything," says one Fintech executive whose firm provides payment services to leading banks.

Regulation presents a double-edged sword to banks. A majority of bankers (56%) believe that regulation protects banks within their traditional businesses. But 62% also agree that regulation will restrict banks in their response to Fintech—as reporting standards, risk-management practices and capital requirements make establishing and expanding new business models within the banking system difficult to impossible.

Finally, Fintech presents the challenge of product cannibalisation to banks. A bank considering a peer-to-peer lending business must accept that it will transfer share directly from its long-established, deeply ingrained consumer lending operation. And it will do so on a lower fee basis and at lower margins. No wonder that banks are hesitant to meet the challenge of Fintech.

But banks should not be underestimated—they bring considerable strengths to the Fintech fight. Banks' greatest strength is clearly their customer franchise. One of the hallmarks of the customer relationship is a reputation for trustworthiness and stability—no major retail bank failed in the financial crisis of 2008. Banks are also one of the most highly penetrated of all service providers—more than 92% of US households have a banking relationship.[3]

Second, banks bring hard-won expertise in the critical fields of regulatory compliance and risk management. This is more than just know-how—it is hardwired into the technology networks that banks have spent billions to create.

Finally, banks have capital. They have the capacity to invest and build new ventures and the staying power to weather intense competition. No wonder, then, that 95% of bankers and Fintech executives believe that banks will remain in a strong position even as Fintech gains ground.

3 Federal Deposit Insurance Corporation, June 2013.

# Fintech—the perspective of Fintech

> Banks often underestimate the constraint of legacy systems that can hobble innovation in new products and services.
>
> René Lacerte, CEO,Bill.com, a Fintech devoted to accounts payable and accounts receivable for small business.

One of the more interesting findings from our surveys is that Fintech executives respect the banks more than the bankers do themselves.

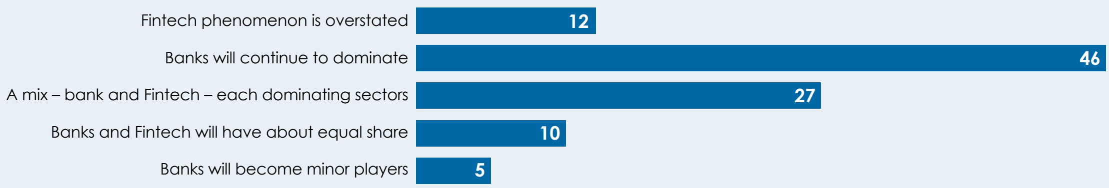
When asked about the future balance between the two segments, Fintech executives were more than twice as likely to predict that banks would continue to dominate the market (46% v 20%). In a segment known for hubris and confidence, only 1 in 20 Fintech executives predict that banks will become minor players. "Lots of banks have such incumbency advantages that it is hard to see a start-up beat them head on. Instead we're seeing more Fintech players and banks working together to deliver innovative solutions and superior customer experiences," says Sam Hodges, co-founder and U.S Managing Director of Funding Circle.

- Light regulatory hand. The lack of regulatory constraints on Fintech feels like a competitive advantage today, says Moven CEO Brett King, but in the future that advantage will diminish. In the meantime, Fintech innovators enjoy a freer hand than banks. "Fintech may not be as aware of regulation," says Mr King, "until they get slapped down by it." Fintech appears to understand this—and to accept the future need for experience in managing risk and maintaining regulatory compliance. "A Fintech that competes head on with banks needs a compliance and regulatory team bigger than any other division in the company" according to Erik Engellau-Nilsson, Marketing Director for the Swedish start-up Klarna.

- Investment capital: Start-ups have a ravenous appetite for cash. Business models that require scaling up to millions of customers in just a few years will always see lack of investment capital as a constraint on their business. In the absence of available funding, adroit Fintechs find alternatives. "Collaboration rather than competition between banks and Fintech can help startups overcome typical challenges of balance sheet capacity and distribution reach," says Lloyds' Rodriguez-Sola.

**Fintech's views on the bank-Fintech competition**

**Which scenario best describes your views on how Fintech might disrupt traditional banking?**
(% respondents)




Source: The Economist Intelligence Unit survey, 2015.

## Fintech's self-assessment of their weaknesses in competing against banks

**How important are each of the following in driving competitive disadvantage for Fintech?**
(Fintech executives who cited "Very Important")


Source: The Economist Intelligence Unit survey, 2015.

- Building a customer franchise: Fintech firms are now less than 2% of the banking market. They are competing with the banks and 4,000 other disruptors to win customers of all kinds—and have only a few years to do so. Fintech executives consider building a customer base to be an important challenge to the industry.

- Winning customer trust: Fintech is essentially asking millions of households to move their financial relationships to untried entities. Fintech customers generally do not benefit from government guarantees. "Trust for new organisations does not occur at the speed of technology" says Eugene Danilkis, co-founder and CEO of Germany-based Mambu, a cloud-based alternative to traditional banking platforms. "You can build technology in a year or two but trust takes as long as human behaviour requires." Fintech will be challenged to gain customer trust as they move beyond the early adopters.

## Fintech's self-assessment of their strengths in competing against banks

**How important are each of the following in driving competitive advantage for Fintech?**
(Fintech executives who cited "Very Important")


Source: The Economist Intelligence Unit survey, 2015.

- Providing a single product: Fintech executives are aware that banking customers are used to having all of their banking needs met under one roof. They lack the ability to cross-sell or build common platforms for just a single product.

But Fintech firms also bring important assets to the arena.

Foremost is the ability to take a "category killer" approach to banking portfolios. Fintech firms are able to maintain a laser-like focus on a single product, building excellence into both the technology and the customer experience. Second is their nimbleness in technology—both an attribute of a disruptive firm's culture and of Fintech's "clean slate" technology base.

But Fintech's greatest underlying strength is its culture, which provides an ability to move fast, to take risks, and to innovate. This strength is acknowledged by both the Fintech firms and the banks that compete with them.

## The disrupted banks—why they need Fintech

As noted, Fintech firms are typically focused on a single product and have created business models and technology structures tailored to that product's market. Therefore, disruption is not likely be a monolithic attack on incumbents (compared with iTunes in the music industry or Kindle in books) but will, instead, be the sum of individual product-by-product battles.

With this in mind, we asked Fintech executives to give their views on the likely competitive balance between themselves and banks in the nine primary retail products in five years. Their responses show some interesting patterns:

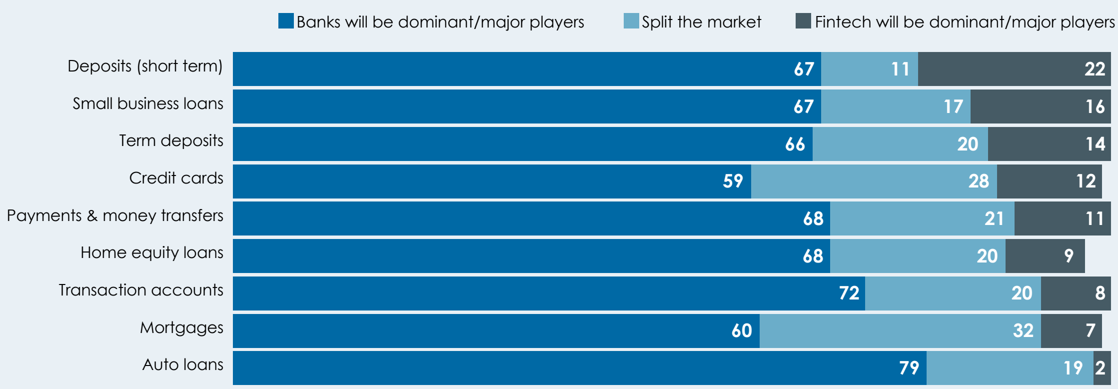
- Banks will continue to be the dominant players in all categories: Even disrupting firm executives—usually known for their hubris—expect banks to remain the dominant financial institutions in all product categories. This not the case in other industries (for example, the music or travel industry) where disruptors expect to and have become market leaders.

- All bank products are on the table for digital disruption: Fintech executives believe that Fintech will take a share in products ranging from mortgages to payments and from deposits to small business loans—a view echoed by bankers. There will be no safe haven from disruption.

- While Fintech will not dominate, it will take a

### The future landscape—balance of banking and Fintech by product

**For each banking product, what is the most likely competitive balance between banking and Fintech in five years?**




Source: The Economist Intelligence Unit survey, 2015.

significant share: Even allowing for a certain level of hubris, Fintech looks poised to take a significant share of the total market. They are showing early success, with Fintech reporting strong growth in revenue in 2014.

Across the board, banks are being presented with compelling, transparent business models that challenge them for market share in each product. In foreign exchange payments, start-ups are matching individual holders of euros and dollars to lower exchange fees by 90%. Google Wallet makes possible the use of a smartphone as a wallet, cutting bank fees and giving Google control of a customer segment that is younger, wealthier and more tech-savvy than the average. Lending Club uses a peer-to-peer model that allows it to avoid most regulatory burdens, while offering lenders and borrowers dramatically better rates. And so on throughout the product portfolio.

So the danger to banks is not corporate oblivion like that experienced by travel agencies or Eastman Kodak. The danger is that innovative business models take a bite out of every part of banks' product portfolios— skimming off their best customers and driving down fees. The problem is likely to grow as tech-savvy millennials, who have little loyalty to banks, begin to take larger shares of financial assets. In their worst-case scenario, banks become commodity providers of back-office functions, with lower growth and squeezed margins.

Banks can stop this "death of a thousand cuts". They need to co-opt the challenge by selectively adopting Fintech as their own and marrying the disruptors' innovative business models to their own strengths and considerable assets. "We don't see disruptors as a threat" says Chad Ballard, Director of Mobility and New Digital Business Technologies, at BBVA Compass (the US arm of Banco Bilbao Vizcaya Argentaria). "We see opportunities to collaborate and work to create new product innovations and better experience for clients."

## The Fintech disruptors—why they need banks

Fintech executives are very aware of the challenges they face in the retail banking market.

The first challenge is the odds. More than 4,000 new firms (with more than 1,000 in payments along) are vying for banking customers—perhaps 100 will be truly successful. Candidates will need every advantage to win in a crowded market.

The second is scale. The business models of many Fintech entrants require that they ramp up to millions of customers or transactions if they are to make the return on investment (ROI) work. Making their products and brand known, with limited name recognition and smaller marketing budgets, will be a challenge. Earning the trust of customers as a financial partner will be an even greater challenge.

The third is time. Fintech firms are in a land-rush environment, needing to be the first to establish a dominant standard or to gain a critical mass of networked customers. Furthermore, many of them work under a venture capital model that funds them for only three or four years—if not successful by then, they go bust. So Fintech firms are in a hurry.

Finally, as the successful firms emerge, they will have to make the painful migration from start-up to being a real financial services firm. In the banking world, this requires taking on the regulators, becoming proficient in the art of risk management, ensuring data security and building the technology to support these capabilities.

For many Fintech firms, the key to success will be partnering well. The lucky few that can marry their models to existing institutions with trusted brands, deep pockets, industry expertise and millions of customers will be the ones that pull ahead of their peers to achieve rapid scale. The logical partners for the winners in Fintech will be the banks. ■

# Banks and Fintech—symbiosis

"This is a whole universe far beyond banking."

Beatrice Cossa Dumurgier, Chief Operating Officer, retail banking at BNP Paribas, which operates digital HELLOBANK, a captive Fintech in the Eurozone

As part of our research, the EIU asked bankers and Fintech executives to assess their own strengths and weaknesses as they prepare to compete with each other. What is interesting is a remarkable match between the strengths of banks and the weaknesses of Fintech, and, conversely, the strengths of Fintech and the weaknesses of banks.

One complementary factor is obvious: Fintech needs customers and banks have customers. But their mutual interest goes further. Banks' brands and resources can provide assurance to customers in a sensitive product field. The Fintech offering can be one of a number of products for customers who want to bank under one roof.

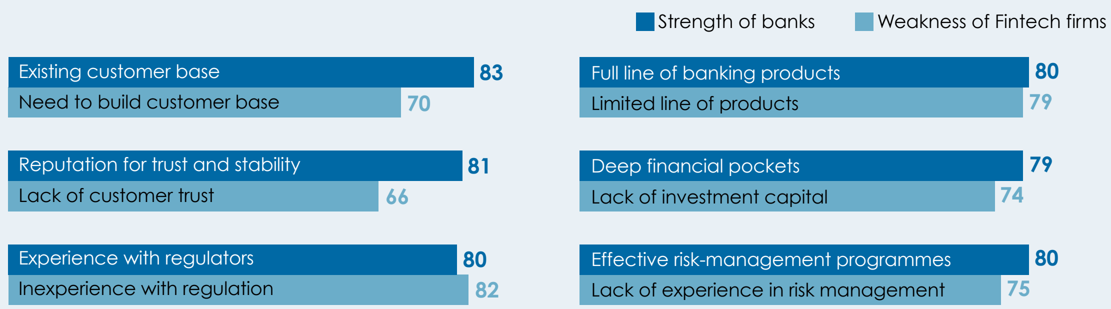
What Fintech can provide for banks is a mirror image—the ability to move quickly and to innovate using technology. "In some instances, your fastest pathway to delivering client value could be via Fintech" says Kobus Van De Venter, Executive Head: Group Technology Strategy, Execution Office and Insight at Nedbank in South Africa. The question is whether, in leveraging the assets of their larger partner, a Fintech partner or acquisition can maintain its identity and freedom of action.

What's more, can the new Fintech operators avoid past mistakes with systemic consequences? Many Fintech firms act as new intermediaries (eg brokers in peer-to-peer lending) that do not bear the risk for the loans they make. We all remember the consequencies of that in 2008.

Banks and Fintech firms have more business interests in common than issues that divide them. Clearly, some Fintech firms will choose to go it alone and some banks will stick to traditional banking products. ■

**Assessment of banks' strengths versus Fintech's weaknesses**

**How important are the following in giving banks/Fintech an edge in competition?**
(%, Banks and Fintech's self-assessments, citing "Very Important" or "Somewhat Important")




Source: The Economist Intelligence Unit survey, 2015.

# Banks and Fintech—integration

> “Fintech is the main topic that bankers want to talk about at bank forums.”

Matt Wilcox,
Senior Vice President,
Marketing Strategy and Innovation, at Fiserv, a company that arms banks worldwide with high-tech products including Popmoney, a peer-to-peer payment system.

“If I were a betting person” says Phil Heasley, CEO of ACI Worldwide, “I’d say that some really smart banks are going to survive by merging with some really smart Fintechs.“ The special challenge of this “Fintegration” is preserving the acquired company’s agility and innovation, while marrying it to the controls and assets of the bank. Here are some guidelines from those who have gone there before (in very rough order of implementation):

**1. Include IT in the due diligence and integration planning**: Combining a bank and Fintech is at its heart combining two technologies. When IT is involved early, it can pre-audit the two infrastructures, identify the touchpoints, and create the integration plan. The acquisition should not be closed without an “IT battle plan” that maps the current state, transformation plan, and future state of the combined entities.

**2. Ringfence the new culture**: Banks have risk and process-focused cultures because their regulators and their business practices demand it. Imposing these practices on a free-wheeling start-up may suffocate the very agility that is the goal of acquisition. In today’s talent market, it can also drive attrition of the human assets. It may be advisable to “ringfence” the new entity—with its own leadership, compensation, rules and even physical location—to preserve its innovative mindset.

**3. Make regulatory integration an early priority**: This opposite is true for regulatory compliance. Once the deal is closed, Fintech employees should be on-boarded onto the bank’s

**Assessment of Fintech’s strengths versus banks’ weaknesses**

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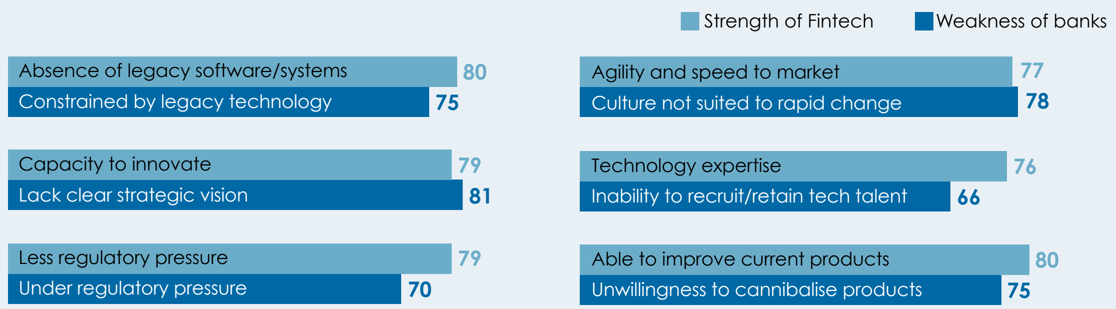


Source: The Economist Intelligence Unit survey, 2015.

compliance platform. Mandatory training should take place, and policies, contracts and guidelines should be integrated into the highest standard of the two entities.

**4. Make data security an early priority**: Our research has shown that many Fintech firms do not place as high a priority on security as do their counterparts at banks. A security audit should be part of due diligence, and immediately after close both entities should be brought within common protocols and networks, preferably at the higher standard of the two.

**5. Data integration**: A centrepiece of the IT Battle Plan should be a roadmap for the integration of data. In particular, a primary data management system that allows an integrated, common view of customers should be an early priority. Utilisation of flexible cloud or hybrid cloud systems may accelerate this process.

**6. Integration of enterprise infrastructures**: Once these priorities have been met, the process of integrating the two infrastructures—data centers, data networks, network and application architecture, etc—begins. For some banks, this may be a stimulus for migrating legacy systems to more cost-effective cloud networks.

This process could be summed up as "keep two cultures, but integrate the technology back office". This solution is designed to preserve the culture of innovation, marry it to the assets of the bank, and accelerate the combined offering to market.

True, not all Fintech firms will partner with banks, and many banks will choose to home-grow their models. But we project that a dominant trend in retail banking over the next five years will be banks' co-option of Fintech models.

Banks have proven their adaptability before; for example, when they digitised themselves and went online in the 1980s and 1990s. We expect to see many of the same banking names in 5-10 years, but the way we receive banking services will have shifted. As is the case in so many disruptive events, the winner will be the consumer, who will receive lower prices, more innovative products and better service in a transformed banking world. ■

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