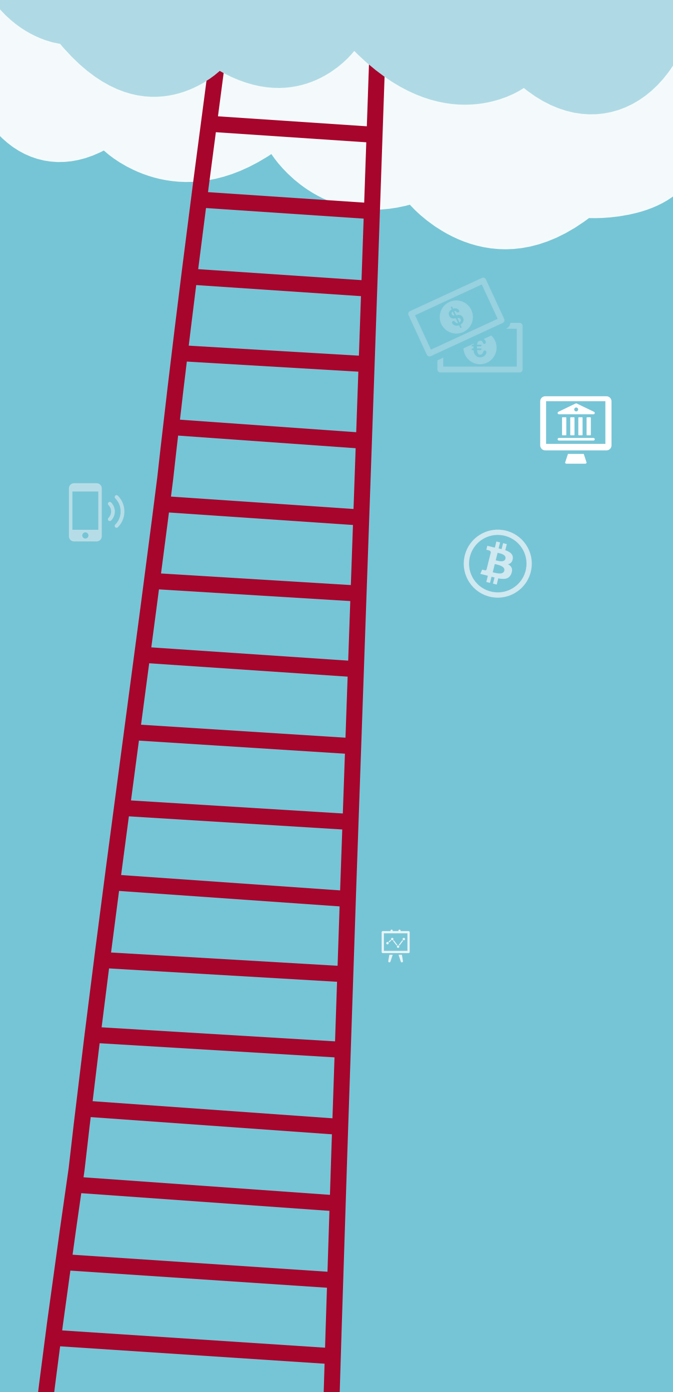
ATTACK OF THE NON-BANKS

AGENDA FOR THE NEW BANKING ECONOMY



Stern Stewart & Co.

ATTACK OF THE NON-BANKS

AGENDA FOR THE NEW BANKING ECONOMY

Stern Stewart Research // Volume 63
Dr. Titus Kehrmann, Stefan Heppelmann

Management Summary

"Silicon Valley is coming," warns Jamie Dimon, CEO of J. P. Morgan. In the wake of PayPal and Lending Club, thousands of new FinTechs have shot out of the ground, and they don't limit themselves to payment transactions anymore; they are competing directly with the core business of traditional banks. Several factors contribute to this development: exponentially growing capital inflows, the large number and wide range of business models, the market-readiness and spread of the social, mobile, analytics, cybersecurity/Cloud technologies and, not least of all, the vulnerability of the traditional banks. Banks run the risk of losing earnings and the control over the client relationships to these new competitors, in particular when it comes to high-margin products. To combat this trend, most banks have launched "digital transformation" programs in the magnitude of six to ten percent of their discretionary investments. To date, many of these programs are made up of individual measures that are branded as "digital", but a transformation agenda should contain immediate measures based on a clear understanding of the opportunities and risk potential, and at the same time formulate a goal for what the envisaged business model in the New Banking Economy should look like.

---

1. The situation: Traditional banks are still occupied with the after-effects of the financial crisis 2. The new challenge: FinTechs are on the rise – what is it that makes them such a force to be reckoned with? 3. The reaction of the banks: They delegate innovation to IT and organizational silos 4. The solutions: Banks should exploit the opportunities that have arisen and develop a target vision for their business model 5. The future: Alongside FinTechs, we see three further bank models prevalent in the long term Final thought: Captive Finance 4.0 – the reintegration of the financial and real economies?

---

1. The situation: Traditional banks are still occupied with the after-effects of the financial crisis

Since the financial crisis, banks have been investing in adapting themselves to the "New Normal". In doing so, they have not only had to deal with a lasting low-interest phase, intensive regulation and stricter supervision (e.g. shorter auditing cycles), they also find themselves faced with much tougher competition in the field of high-margin products. The measures they have taken to date include re-capitalization, large investments in regulatory requirements, renewing core-banking systems and cost-reduction programs.

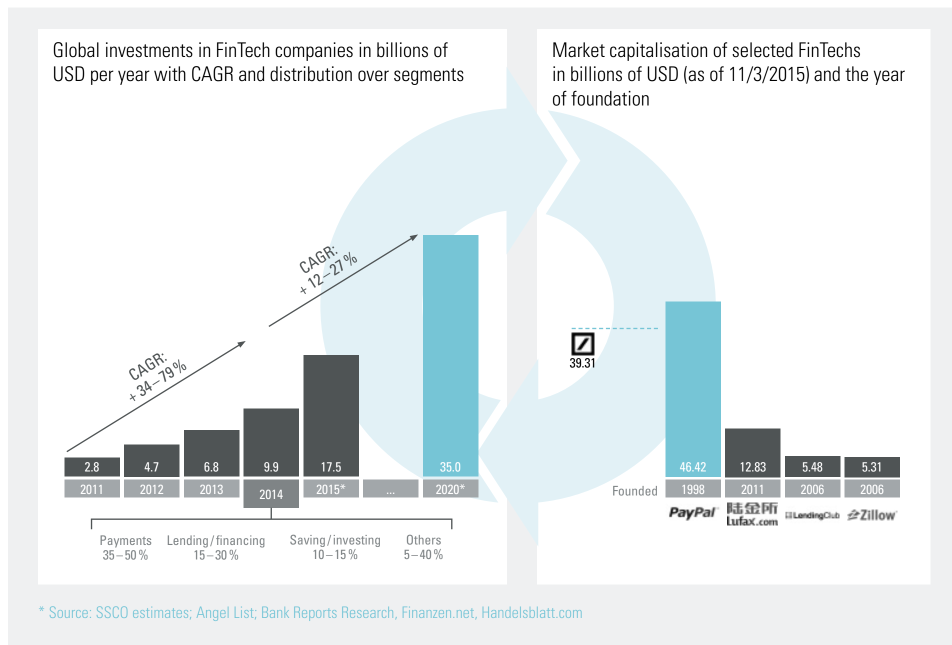
And yet, despite this, European banks are still destroying value, with returns that lie below the cost of capital. For a long time it looked as though they would at least be able to keep the New Banking Economy business models at bay better than other industries managed (retail, media, telecoms, logistics), but it was a hope that was founded largely on the fact that the service ranges of the FinTechs were limited to two main niches: direct and internet banking providers and e-payment companies. While the first of these two models builds on the internet being a less expensive sales channel and on economies of scale, the latter fills the gaps in the product and service ranges offered by the banks that have come about due to the rapid growth of online business, and the demands on payment processing and risk management that this brings with it.

2. The new challenge: FinTechs are on the rise – what makes them such a force to be reckoned with?

A new landscape of technology-driven business models that offer financial services has evolved since the beginning of the decade. Today, the number of new FinTech companies can no longer to be assumed as being only in the thousands.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

FIG. 1: INVESTMENTS IN FINTECHS ARE EXPLODING (LEFT) FIRST GENERATION FINTECHS WITH HIGH VALUATIONS (RIGHT)



What is also new is the variety of business models they are offering. Despite their often high level of specialization in terms of products and services, in their totality they offer financial services in all product fields of the retail and commercial-client segments, as the following diagram shows.

And despite all of the differences in their business models, FinTechs as a rule pursue one or more of only four ways of generating value targeting consumers and entrepreneurs of Generation Y, whose high level of education and simplified access to information go hand in hand with fundamentally changed needs as customers, and as a result, changed customer behavior.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

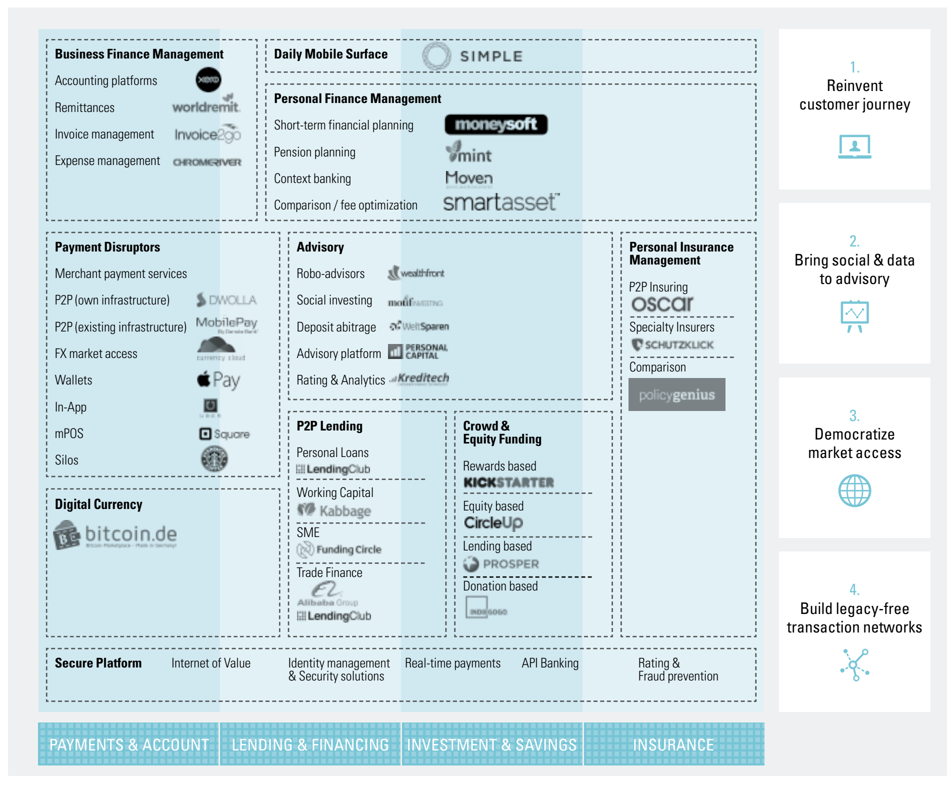


FIG. 2: LANDSCAPE OF THE ATTACKERS – NEW BUSINESS MODELS COMPETING IN EVERY SEGMENT

1. **Improvements to the customer experience of value-adding services:** While banks and insurance companies tried to make financial products "tangible" as independent products and to brand them (the consumer credit in the metal box of Deutsche Bank and the credit card are examples of this), FinTechs take the other road. They endeavor to reintegrate financial services into the consumer experience in a way that enables them to work almost "invisibly" in the background. The examples range from in-app payments, as are offered for instance by Uber or mytaxi, in order to make the paying process an intuitive and integral part of the customer experience, through to "Context Banking", i.e. the real-time usage of transaction data, for example for fraud prevention or to help consumers make decisions (e.g. Moven) or to fully integrate the financing into the price, such as with use-based financing models in the leasing market.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

2. **Advisory processes based on artificial intelligence and access to data:** At the latest in the financial crisis, if not already before it, many customers became aware of the weaknesses in the personal advisory processes. The MiFid II regulation aims at making the costs of advisory services transparent. Many attackers exploit the falling costs of information processing, the improved access to data and the further development of algorithms and analysis tools to avoid the weaknesses of the personal consulting processes, and to reduce costs. There are examples of this on the investment side, such as the replicating of indices in ETFs (wealthfront), and on the financing side, such as the automation of the access to information and of lending-decision algorithms (Kreditech, iwoca). Many products, for example personal loans, can only be offered profitably if the evaluation processes are automated.

3. **Democratization of market access:** FinTech providers help their customers save bank fees by giving smaller retail and business customers the access to the financial markets that had in the past been reserved for mulitnationals and large corporate clients. P2P platforms offer access to the debt-capital market (Lending Club), crowd-funding platforms offer access to equity capital (CircleUp), and FX platforms offer access to currency markets (Currency Cloud).

4. **Inexpensive transaction platforms:** Are the enabler for many new offers, because they make it possible to further develop existing transaction infrastructures (e.g. real-time payments processing), create new platforms (e.g. in the field of digital currencies), integrate infrastructures and product offerings (e.g. API banking) or to exchange assets through the internet (decentralized ledger technology).

The explosion of new business models in the financial field can be attributed to several factors, which are shown in the following diagram.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

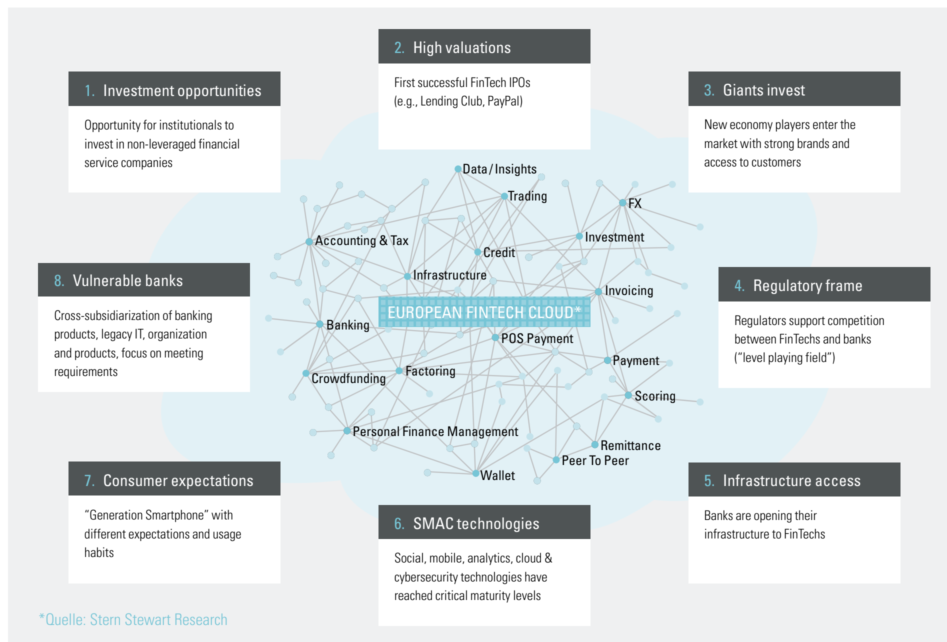


FIG. 3: REINFORCING FACTORS ARE DRIVING THE TAKE OFF

The new companies and business models of the New Banking Economy are causing a shift in the earnings pool away from traditional universal banks, and toward price pressure on high-margin products and services. In some product areas such as e- and m-payments, traditional banks run the risk of being "out-arbitraged", or even of losing their role as intermediary between clients and companies. The regulatory demands in the banking industry are much more exacting than in other industries, with a full or partial banking license being required for some services, but FinTechs have developed strategies to deal with this, integrating themselves into existing ecosystems – Apple Pay and Android Pay use existing payment transaction infrastructures. They are also increasingly entering into co-operations with banks, in order to save the time and cost involved in obtaining and maintaining a banking license, and to gain access to customers. Some banks offer this service to FinTechs and end-customers via open interfaces to their bank platform (API) (e.g. Wirecard, Fidor). At the same time, the regulators like the European Commission and the British Government are at pains to promote the competition between banks and non-banks, for instance by regulating the access to account information (PSD II) or by creating a regulated space for specialist banks.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

3. The reaction of the banks: Innovation delegated to IT and organizational silos

Banks have in the past proven that they can adapt to new technologies – automating branches, online banking, securitizing assets. But at the same time, banks are more dependent on the security and reliability of their technologies than start-ups.

In reaction to the competition coming from technology-driven companies, the major European banks have launched digital transformation programs. As a rule, the investment volume for many large banks is around 200 to 300 million euros, and hence in the order of magnitude of six to ten percent of their discretionary investments. The focus is on introducing new technologies, such as integrating Apple Pay or big-data pilots, developing mobile solutions or on accessing transaction platforms.

The main challenge lies not in the speed of the technical innovation, but in focusing the business model with the right strategic decisions and in accelerating the organizational innovations. Even more than industrial companies, banks are set up in product silos and functions – sales channels, operations, loan appraisal and lending decisions, IT, etc. The structuring in functional silos and products is further cemented by their mapping in the systems, and the increased complexity of the business models is multiplied by the organizational complexity. Customer-friendly products and processes, the integration of new technologies and the automatization of processes on the other hand, require an organizational structure that is based around processes. For this reason, many banks have not adjusted their processes and reduced their branch costs at the same speed in the past as they have introduced online banking.

Many banks have recognized the challenge raised by the new providers on the market, but delegate financial innovations to IT or organizational silos such as the product management instance or a Chief Digital Officer. And this although the benefit can only be garnered from innovations if they are perceived and driven as a responsibility of the bank as a whole.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

4. The solutions: Banks should exploit the opportunities that arise and develop a target vision for their business model

Initially, a further loss of earnings and margins is to be expected. It is to be assumed that 30 to 40 percent of earnings and up to 60 percent of profits in retail banking are endangered by FinTechs. Ultimately, however, how and to what extent these consequences leave a mark will depend on the reactions of the banks and regulators. Banks still have some important advantages: access to the customers, strong brands (especially when it comes to giving a feeling of security), banking licenses, regulatory know-how and their infrastructure. As most FinTech start-ups don't have a customer platform yet, another decisive factor is whether companies with customer access open up their platform to them. And these needn't be only banks; they can also be New Economy incubators (Apple, Facebook, etc.) and companies from other industries (telecoms, industry).
Despite the threat scenario described here, digitalization and the new FinTech business models also open up opportunities for banks to adapt their own business models and react to the change in the competitive environment. Among these opportunities are in particular:

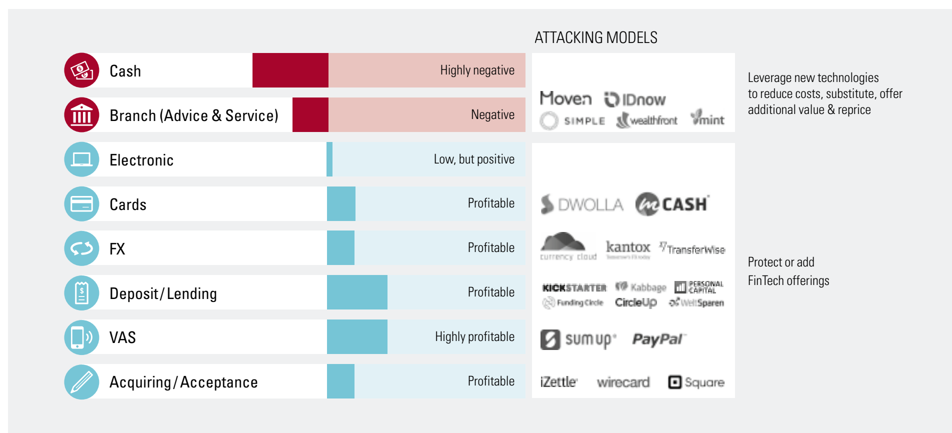
- **Additional earnings by offering value-adding services and improved customer experiences:** If the traditional banks can manage to integrate the innovations developed by the FinTechs into their own product range and offer them to their customers, the digitalization could also open up new markets and needs for them, and hence additional sources of income. Many of the new services are in fact of particular interest to banks because they bind so little equity.

- **Improving the structure of the cost items:** The competition with new providers will further raise the cost pressure on banks. Many of the new models offer services much more cheaply, either because they don't have legacy infrastructures and branches, or because they leave out or automate some links in the value chain. Conversely, banks can learn from precisely this way of doing things – automating advisory processes with "Roboadvise", automating credit scoring and using information on customers and collateral (e.g. co-operation with Alibaba and Lending Club), offering direct access to trading platforms (e.g. in FX) or providing customer-friendly authentication and authorization processes.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

Of fundamental importance for the agenda in the New Banking Economy is having clarity on which elements of the business model and which products are vulnerable to the new technologies and FinTech offerings, and where opportunities arise for new income and improved margins. To gain this clarity, banks should know the "real" margins of their products and product parts: what fees and interest rates are used to fund which costs? This is not only the basis they need to examine FinTech business models, to recognize financial risks and opportunities for the existing portfolio and to launch the immediate measures required, it is also the starting point for the transformation process.

FIG. 4: BANKS SHOULD NOW WATCH THEIR PROFITABILITY AND REACT TO THE THREATS OF FINTECHS



5. The future: Alongside FinTechs, we see three further bank models prevailing in the long term

With all the many and varied requirements that the New Banking Economy brings with it, tougher regulatory restrictions and the economic context in general, the universal bank model is coming up against its limitations. In addition to opportunistic immediate actions, banks also need a discussion on what they specifically want to achieve over the medium term, in order to give their own employees orientation and to focus the transformation. "Pure" models should also be examined when defining the targets, to sharpen the strategy process. In addition to the FinTech companies, we also see three kinds of bank models, which differ in terms of their degree of integration and the scope of their product range.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

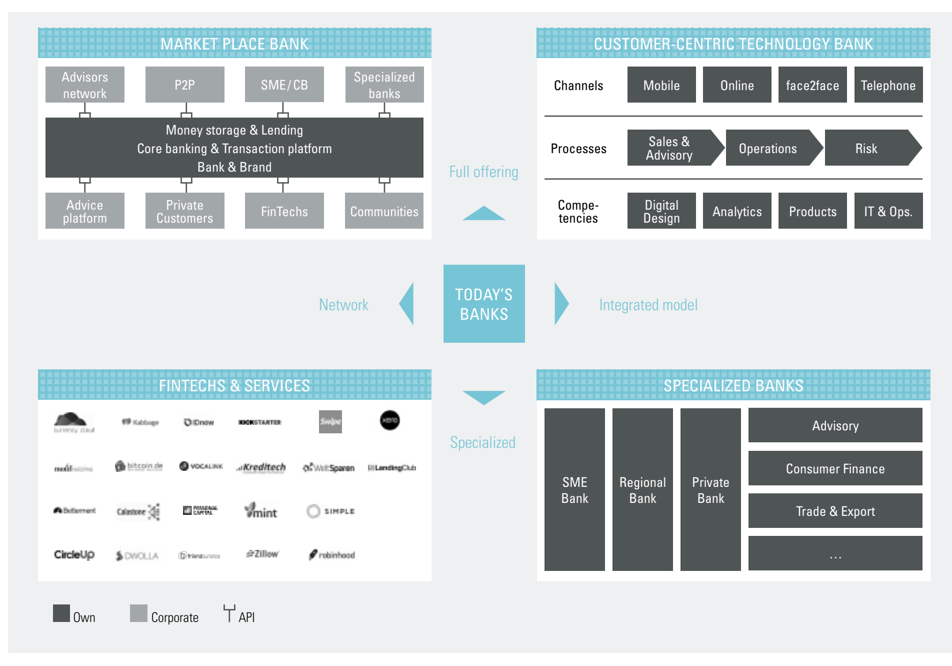
- **The marketplace bank:** If Google, Apple or Facebook were to decide to develop a bank business after launching/relaunching their payment processing ranges, what would that bank look like? It would provide the platform (as with the iPhone and the AppleCloud), the brand, the rules and the security measures for the ecosystem and the customer access. The actual added value for the customers, however, lies in connecting the platform with third-party service providers. Some banks (e.g. Fidor Bank or Wirecard in Germany) have started transferring this principle to the financial services sector. The bank provides the transaction platform and the access to the (inter-)bank infrastructure, and offers basic banking services (in particular a basic account with depositing and credit functions). Other services are provided by third parties, e.g. via API (Application Program Interfaces). Personal services such as from lawyers and tax consultants and other experts, and investors can be integrated through social networks, even if major banks are already entering into co-operations with FinTechs. To date, it is more the start-up banks that are pursuing this model. And this although it is large banks that wish to develop in this direction that can base their activities on a number of existing strengths and infrastructures: transaction infrastructure with scale, customers, experience with regulators and financial products, and confidence in the brand. It must be said, however, that large banks transforming in the direction of becoming a marketplace bank, do sacrifice value-chain depth.

- **The customer-focused digital bank:** Unlike the marketplace bank, customer-focused digital banks place their trust in their own generating of value. They work on digitalizing end-to-end processes and on improving the customer experience. Integrating new technologies, recalibrating the sales-channel mix and providing core products and services themselves, help to achieve these objectives. Designing and realizing digital customer journeys has not been a strength of the more product-oriented banks up to now. To change that, they buy digital design agencies or mobile front-ends (acquisition of Spring Agency and simple by BBVA). Some banks have introduced Chief Digital Officer and Chief Data Officer positions (for instance Barclays) to systematically redesign the customer processes, and to test them regularly, initially with data and then with test customers. The special challenge for these banks lies in scaling the services to the overall customer base. There are two ways of approaching this: 1. Rebuild the entire organization into an "agile bank", with an organization that is restructured based on end-to-end processes instead of functional and product silos, hierarchies and smart sourcing. 2. Spin-off a new bank from the old bank, as could be observed when direct banking became an issue.
  BBVA is taking this perhaps the furthest of all at present, having split its organization into Execution and New Competencies.

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

- **Specialized financial services providers:** In addition to the full-service providers described above, there will also be specialists in the future. These companies dispose over strong special expertise that cannot be replaced by technology – or at least not entirely. This know-how may be product related or customer related, such as at regional banks and traditional private banks. Of course it can also make sense for specialist service providers to consciously invest in new technologies, but their key to success in doing so is not scale, but individually-tailored solutions.

FIG. 5: WE EXPECT FOUR PURE MODELS IN THE NEW BANKING ECONOMY END GAME



Final thought: Captive Finance 4.0 – Reintegration of the financial and real economies?

In conclusion, we would like to briefly touch upon one consideration, the detailed discussion of which would go beyond the scope of this paper, but which we don't want to leave out entirely. This aspect is the potential for industrial companies. The attack of the FinTechs shows how the real economy and the financial economy are being reintegrated on the basis of new technologies: be it in the form of

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

in-app purchases on mobile phones, or in the use of analytics and big data to obtain better and faster risk scores using data from forwarding, accounting, social media or payment processes. Or be it in the form of Supply Chain Financing 3.0, as is being demonstrated by Lending Club and Alibaba by passing on to investors loans to American importers for financing goods from Chinese exporters, using transaction data from the marketplace. For industrial companies, new opportunities are arising to utilize information about customers and suppliers, goods and order flows, and to offer financing. At the same time, the new FinTech companies offer alternatives to the services provided by banks, or the opportunity to build up own IT platforms, which have to be looked into.

Stern Stewart & Co.

Stern Stewart & Co. is an independent strategy consulting boutique. Our advisory focus is on the core issues of management. These include strategy, corporate finance, organization and performance management. We see company managers as strategic investors in the business, and support them to increase the value of their company.

The authors

Dr. Titus Kehrmann, tkehrmann@sternstewart.com
Stefan Heppelmann, sheppelmann@sternstewart.com

© 2015 // ALL RIGHTS RESERVED FOR STERN STEWART & CO.

Stern Stewart & Co.

München
Salvatorplatz 4
D-80333 München
T +49.89.242071.0
F +49.89.242071.11

Dubai
Emirates Towers, L 41
Sheikh Zayed Road
PO Box 31303, Dubai
United Arab Emirates
T +971.4.319.9963
F +971.4.319.9964

Kopenhagen
Ryesgade 3A
DK-2200 Kopenhagen N
Denmark
T +45 33 17 00 00

London
2nd Floor,
Berkeley Square House
Berkeley Square
London W1J 6BD
United Kingdom
T +44.20.7887.6265
F +44.20.7887.6001

New York
1330 Avenue of the Americas
23rd Floor
New York City NY 10019
United States
T +1.212.653.0636
F +1.212.653.0635

Shanghai
Office 1206, 12/F Shui On Plaza
333 Huai Hai Zhong Road
Lu Wan District
Shanghai 200021
P. R. China
T +86.21.5116.0564
F +86.21.5116.0555

I www.sternstewart.com
E info@sternstewart.com