Facing up to the fintech challenge

__Helene Panzarino__ and __Jeremy Takle__ discuss the changes fintech is bringing to retail banking and look at how incumbent banks will need to offer better value and more personalisation to customers if they are to remain relevant

Fintech does not change the critical societal purpose of banks: providing risk and maturity transformation, also known as taking deposits and turning them into loans. But fintech is hailed as a great shift in banking, so what are the fundamental differences between fintechs and traditional retail banks – and are banks as we know them likely to disappear altogether? And, if fintech does change everything, what will a successful retail bank look like in the future?

Part of a new world

During the dotcom boom of the late 1990s and early 2000s, people talked about 'paradigm shifts' and how 'this time it's different'. But they were also still using faxes, stamping paper invoices and making orders by telephone. In 2000, less than half the adult population of the UK had a mobile phone, only around a quarter had internet access at home, and iPhones hadn't been thought of.

Twenty years later, it is different. Not only does technology really enable new products and services but industry disrupters such as Airbnb, Just Eat and Uber have set new standards for customer service. They have brought customer-centric product design, frictionless delivery and seamless integration across devices. Consumers expect the same smooth personalisation in everything they touch online, including financial services.

Neo-banks and fintechs have already solved many of the customer pain-points, but that is not the same thing as industry disruption. In 2019, the average neo-bank lost £9 per customer and fewer than 2.5% of UK bank account holders switched bank. Overall account switching has since declined.

If fintech has the power to disrupt, why are traditional retail banks both dominant and profitable, while the neo-banks are loss-making? The answer comes down to the basic role of banks: risk and maturity transformation. Banks' purpose is to take essentially liquid deposits and turn them into various forms of committed loans, which is maturity transformation. They also remove the risk of loss for individual depositors by carefully pooling together many loans that would be risky on their own and holding reserves – ie risk transformation. In return for this activity, banks earn a spread between the interest they pay depositors and that which borrowers pay them. But the proportion of deposits that has been captured by new entrants is fractionally small and few are engaged in lending.

Another important reason for the underperformance of neo-banks is that many have been busy trying to reinvent the banking models they see. They do this by trying to acquire current accounts – which few people really switch – and offering new types of financial dashboard or market-place, which only a small number of customers use. Another approach is bundling various insurance or travel products in premium packages, which, it turns out, few are willing to pay for. What none of these models do is capture material savings and loan balances. And they don't solve the fundamental personal finance problems of funding your life: buying a car, buying a home, or retirement.

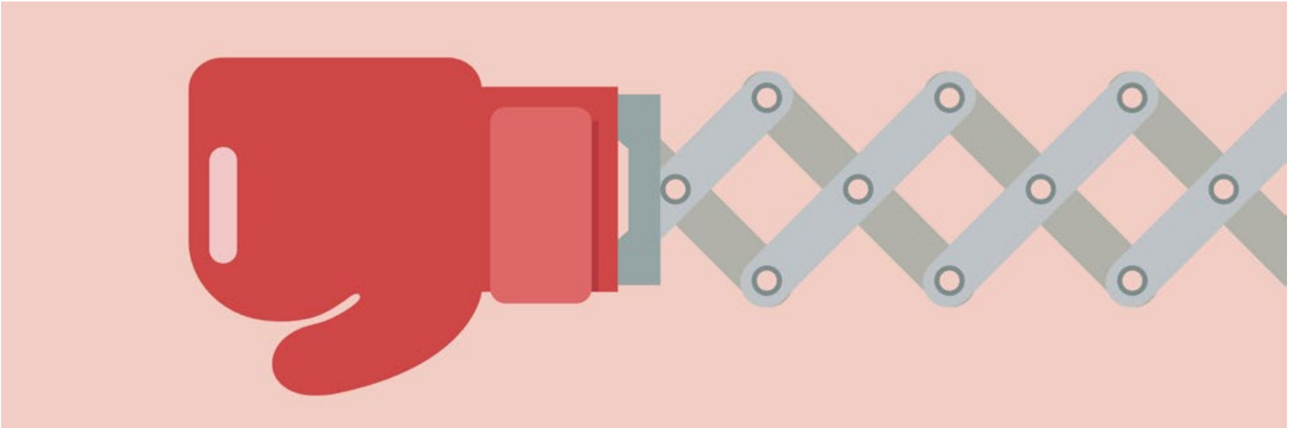
> *With the change in consumer behaviour and advances in technology, the economics of banking have altered*

Since the majority of balances are still held by only a few incumbent banks, the needs of most people aren't well served and banking is, in that sense, broken. But where should innovation be directed to fix retail banking?

Changing the economics of banking

Running an incumbent bank, complete with high-street branches and outdated technology infrastructure, is expensive. But with the change in consumer behaviour and available technology, the economics of banking have changed. There is now an opportunity to change fundamentally the value and personalisation that consumers get from their banks. This has two elements:

1. Lower operating costs for banks and better value for consumers. Banking no longer requires large-scale investment in branch networks and data centres. The broad adoption of digital banking, the availability of low-cost cloud computing and the rise of 'software as a service' have changed the way banking can be delivered.



2. More personalisation. Better unit economics at a small scale and more direct connection between bank and user let banks target underserved segments. For example, there is a large advice gap – particularly for customers who cannot afford traditional wealth management services. The first wave of neo-banks has hardly made a dent in this, partly because the technology they had to use was neither particularly cost-effective nor very tailored.

What role does 'big tech' play?

The big tech giants have made no secret of their intentions to become the dominant providers of all things digital. Alphabet, Facebook, Apple and Amazon are all manoeuvring into payments and banking. These established tech giants, with their extensive data assets, can service their vast customer base with greater ease and at a fraction of the cost of traditional banks.

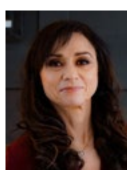
Will big-name bank brands disappear because banks become the back-end providers of regulated financial services that are fronted by big tech brands? Perhaps. But we're sceptical of the idea that banks will become back-end utilities (whether for big tech or otherwise). There are a number of reasons for this. Look at personal financial management. A vast array of personal finance management apps have tried to be the front end for regulated services but take-up has been slow and they seem to appeal only to a narrow set of customers. They also struggle with a revenue model. They either have to charge the customer for advice, which is difficult, or get paid by the bank providers as an introducer, which creates all sorts of incentive problems.

And having lots of data is not the same as knowing and understanding customers well enough to underwrite or assess the suitability of financial products for them. Once fintechs can offer both highly personalised financial planning and great-value balance-sheet products directly – as the Marcus online savings account at Goldman Sachs aims to do – there seems little room, or reason, for third parties to stand between customers and their banks.

Survival of the big retail bank – does size matter?

If personalised banking is the way forward, will the incumbent banks be able to adopt these new models? Unsurprisingly, size only seems to work against them. Incumbent banks are large, complex and organised as functional silos, all of which makes them unresponsive and slow to change. To adjust, global banks should consider breaking up or breaking out into more manageable and adaptive businesses. Doing nothing is no longer an option. Banks that do not adjust to this new reality should expect to be gradually run down. That said, they are likely to continue to be profitable for some time, while capital is gradually returned to shareholders.

So, is the future of banking settled? Hardly. New technologies and ideas are certain to emerge. Banking's core function will remain, but changing consumer demands and changing industry economics will continue to reshape how banks work. ■



Helene Panzarino *is the Director of the FinTech Programme for The London Institute of Banking & Finance Digital Banking Centre. Originally a commercial banker, she is an experienced fintech 'sherpa', programme director, entrepreneur, educator and author*

Jeremy Takle *has been building banks globally for more than 20 years at Barclays. He is now the Co-Founder and Chief Executive of Pennyworth, a start-up that aims to be the UK's first digital bank for the aspiring affluent*