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Slings and arrows

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Financial technology will make banks more vulnerable and less profitable. But it is unlikely to kill them off, argues Stanley Pignal.

FROM THE WAY Silicon Valley talks about banking, you might well conclude that the industry was ripe for oblivion. The T-shirt-wearing whizz-kids and their backers reckon that newcomers will do to JPMorgan Chase, HSBC and the rest what e-mail has done to post offices and Amazon to bookshops. So far bankers have simply failed to notice that their sprawling firms will become tomorrow's low-margin utilities. Finance, all bits and bytes, is at heart a tech problem, the Valley believes, and will be solved by tech companies, not the lumbering banking gerontocrats.

This is not just intemperate youth speaking. Strikingly, many more entrepreneurs and investors now believe that it is possible to take on the banks. In San Francisco, London, New York and elsewhere, venture capital is pouring into financial technology, or "fintech", making it arguably the hottest spot in a bubbly funding environment for startups. Last year firms in this sector attracted $12 billion of investment, up from $4 billion the year before, according to CB Insights, a research firm. A handful of fintech insurgents have already graduated from startups to listed companies, achieving billion-dollar valuations. Plenty of others seem to be heading the same way.

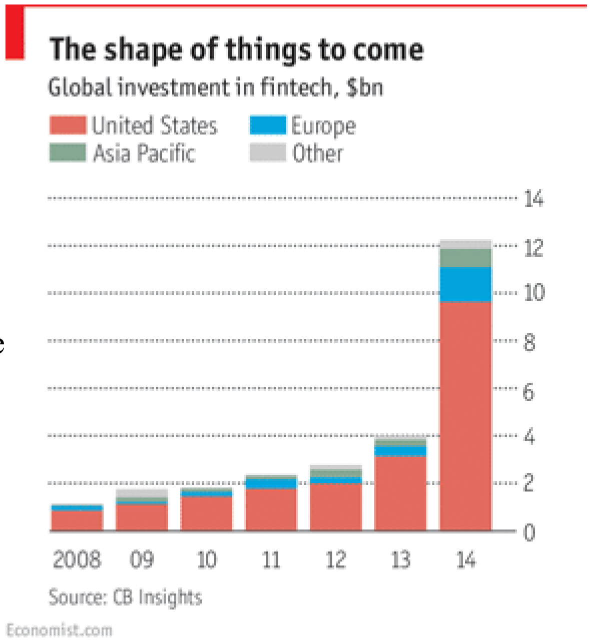
The momentum is such that all of banking's many metiers seem up for grabs. Fancy a loan? Forget your local bank branch and head to Lending Club, a peer-to-peer platform which matches people who need money with those who have some to spare. Want to send cash overseas? Eschew your bank's rip-off foreign-exchange charges in favour of a startup that specialises in international money transfers. And why have a Porsche-driving wealth manager handling your retirement pot when an algorithm can replicate his advice for a small fraction of the cost? From payments to insurance to business lending, one newcomer or another has its eye on almost everything that financial-services firms offer. AngelList, a website that tracks startups, lists around 4,000 of them in fintech.

This wave of innovation is all the more noteworthy because financial services used to sit above the Silicon Valley fray: an industry so regulated and so politically connected that tiddlers trying to take it on stood little chance. The startup ethos of "move fast and break things", whereby repeated failures are accepted as staging posts to success, seemed incompatible with banking's conservative culture in which a single crash could send the global financial system into convulsions. Regulators, once considered too lax about allowing innovation in finance (synthetic collateralised-debt obligations and other pre-2008 inventions will not soon be forgotten), were expected to deal cautiously with this new burst of financial creativity. Yet so far they have let fintech flourish, and thereby done more good than harm.

All told, financial-services firms in fields that fintech could potentially disrupt generate global revenues estimated at $4.7 trillion a year and profits of $470 billion, according to analysts at Goldman Sachs, a bank. Incumbents once believed that finance was immune from such disruption, but now they are less sure. "Bankers used to think regulation would make financial services less appealing for new entrants. Now the penny is dropping that non-bank rivals can just attack more profitable areas and skim the cream," says Huw van Steenis at Morgan Stanley.

A slide that has been making the rounds in Silicon Valley shows the new competitive landscape for Wells Fargo, a bank based in nearby San Francisco. These days its rivals are not Bank of America or some Chinese newcomer that offers the same wide array of services. Instead, dozens of startups are each trying to lay claim to a small sliver of the business: saving for college, say, or payroll services for companies.

Few want to take on the central, regulated core of taking deposits. Each may offer a superior or cheaper service in its specialist field. Most of these startups will fail, and even successful ones will be little more than pinpricks for a banking mastodon with trillions in assets. Yet in combination they may amount to something more substantial.



"Silicon Valley is coming," warned Jamie Dimon, JPMorgan Chase's boss, in a recent letter to shareholders. "There are hundreds of startups with a lot of brains and money working on various alternatives to traditional banking." Banks' cost bases--IT systems, smart headquarters, staff, branches and so on--require income from a wide range of services. If even some of those services get "unbundled", in the parlance of fintechers, the economic models that have sustained banks for decades will be under threat. So the incumbents pay lip-service to the newcomers, and some even have in-house teams scouting for innovators to stop them from eating their lunch.

Several factors have made the banks more vulnerable. New technologies such as smartphones and cheap data processing have lowered barriers to entry. However, "technology is necessary but not sufficient" to change attitudes towards finance, says Mike Cagney of SoFi, a peer-to-peer lender based in San Francisco. The financial crisis has left consumers more open to trying alternatives to the banks they had to bail out. Fintech newcomers are tapping into a deep reservoir of consumer mistrust towards incumbents. And as with tech generally, the sector is attracting a lot of bright graduates who would rather not be working on Wall Street or in the City of London.

The coming-of-financial-age of the "millennial" generation, which is both large and perennially glued to its iPhones, certainly plays a part. This cohort of 18- to 34-year-olds has grown up with the internet and turns to it to find anything from a taxi to world news, turning many established industries upside down. They seem willing to trust web-based newcomers with their financial affairs, too. Few millennials visit bank branches. A third of them do not think they will need a bank account at all before the end of this decade. One survey found that 71% of them would rather go to the dentist than call on their bank. And in so far as they care about financial innovation at all, they expect it to come from tech groups, not today's incumbents.

At the same time the financial crisis has led to a bout of introspection at banks. Some of them have been overwhelmed by successive waves of new regulation requiring immediate management attention. Whatever IT budget they may have is likely to be spent largely on ensuring that ATMs go on spewing cash. Innovation of the sort that will pay off years after the current boss has decamped to his next job is not high on their list of priorities. Newcomers with no legacy systems and no pension deficits to worry about can do things more cheaply.

Don't rest on your laurels

As a rule of thumb, banks make money in three ways, in roughly equal parts. All of these are now under attack. The first is the difference between the rates they charge borrowers and the interest they offer savers, known as the net interest margin. This requires skill in identifying creditworthy customers, which fintech outfits reckon they can do better than banks. "Think about the scenario of a loan officer talking to a prospective client. To software people, that looks like voodoo," said Marc Andreessen, a tech billionaire whose venture-capital fund has made large bets on fintech, at a conference last year. "The idea that you can sit across the table from somebody and get a read on their character is just nonsense." The approach of fintech peer-to-peer lenders is based on using data more adroitly than banks do. But their methods have yet to pass the test of a serious downturn in the financial sector or the wider economy.

The second way of earning money is by charging for making payments, for example through credit-card fees. Established giants such as Google or Amazon would once have been wary of tarnishing their brands by having anything to do with payments systems, but now all kinds of contestants are getting interested. Apple Pay, launched in America last year, allows people to pay in shops with a mere tap of a phone or watch, gatecrashing a payments ecosystem that used to be the prerogative of the banks. PayPal and others are offering buyers the option of settling in instalments, thus extending credit to customers who might once have looked to their banks for funds.

The third source of profits for banks is a cornucopia of fees, from charging for overdrafts to brokering investments. These look unlikely to survive intact. Human investment professionals are now being challenged by "robo-advisers" doing much the same job for a tiny fraction of the price. Outrageously unfavourable exchange rates imposed by banks when sending money abroad, once unavoidable, can now be circumvented via dozens of online money-changers.

No matter which service fintech newcomers "unbundle" from incumbents, the banks' business model will suffer. For the moment, fintech's leading companies are still doing mere billions in trade where banks handle trillions. To fintech's detractors, that shows the newcomers have not got very far, despite all the hullabaloo. To its fans, it demonstrates that many years of exponential growth lie ahead.

This report will concentrate on new ventures with a consumer or commercial angle, leaving aside the well-established business of providing IT services to banks. It will focus mainly on what is happening in rich countries, though it will also touch on emerging markets, where technology is providing financial services to billions for the first time. Even so, the spectrum covered will be wide. Some parts, such as peer-to-peer lending, are not all that innovative (the technology has been used by eBay, an auction site, for nearly two decades), but are growing rapidly. There is more genuine innovation in the world of payments, which is likely to have the biggest impact on consumers.

At the extreme end of the spectrum are advances in technology that have yet to find a mainstream application, but soon might. Bitcoin, a digital currency made possible by clever cryptography, has lost its lustre as its price has tumbled from over $1,100 in late 2013 to $225 now. Many have dismissed it as a medium of exchange fit only for anonymity-seeking drug dealers and tax evaders. But enthusiasts imagine something like this will recast the entire financial system. They are bowled over by the technology that underpins the currency, a decentralised, immutable ledger called a "blockchain" that allows people to transact business without the intermediation of a trusted third party.

Banks, which often play just such a third-party role, are watching all these developments closely. They used to dismiss fintech as an amateurish attempt to take on a venerable industry, with no hope of disrupting it, but have stopped scoffing. Enough billion-dollar firms have been created to tempt entrepreneurs. No doubt plenty of venture capital will be squandered on dud fintech companies. But if even a handful of them thrive and take on the banks, it could make a difference. And nowhere is that happening as fast as in the activity at the very core of banks' business: lending.

Source: The Economist