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FINTECH - DID SOMEONE CANCEL THE REVOLUTION?

“REVOLUTIONS ARE NOT ALWAYS ABRUPT, AND SOMETIMES THEIR ORIGINS REMAIN OBSCURE”

This was the view of the Governor of the Bank of England in a Mansion House speech last year, entitled Revolution, Restoration, Reformation, highlighting the way Fintech could impact the UK banking sector.

But has the Fintech phenomenon already burnt out? After a revolutionary birth, has it become a victim of cost containment and lacklustre productivity throughout the UK banking industry? And are uncertain political and economic conditions muddying the waters further? Shifts in the balance of global power appear to be underway – Eastern markets are gaining traction, while the West appears mired in both legacy and new challenges to its besieged banking system.

Given Fintech’s seeming failure to live up to its transformative promise, this is an ideal moment to pause and reflect on how far the phenomenon has come, and to look forward to the next steps in the revolution. What challenges does Fintech face, and what should be considered in the battles ahead?

SUMMARY

There are indications the Fintech revolution has stalled. It promised to change market structure, to radically improve products and services, and to save the incumbent banking sector from a slow slide to invisible utility status.

But these promises are yet to come to pass. Yet the revolution could still be completed – the underlying technologies are real and, deployed in the right way, they can still have a transformative effect on the financial services industry.

Incumbents face threats from all quarters. China has become the focus of global investment, and GAAFAs (Goggle, Apple, Amazon, Facebook, Alibaba) continue their quest to become universal portals for all services. Whether their potential advantages in creating revenue feedback loops to fuel R&D enables them to dominate new financial services markets is too early to say. Large parts of the financial services value chain remain locally specific, making the complete replacement of incumbents unlikely.

Fundamental changes to market structures are taking place across the industry. A fragmentation is likely between those providing customer experience and access to financial services and those offering manufacturing, connectivity and balance sheets, where a small number of large players structured more or less as platform businesses and cross-market services will dominate.

There are challenges for both individual companies and nation states in winning in the next phase of the Fintech era. These challenges go beyond technology. Countries and trading groups should look to accelerate changes to market structures, encourage an infusion of scale-up capital and create 'export tunnels' to enable returns from innovation to exceed a zero-sum game in saturated markets. The UK, for example, has always needed innovation to help it punch above its weight – Fintech should be seen as a major differentiator in this battle, and as a valuable counterpoint to the risk of isolation in the Brexit era.

Individual incumbents and challengers on the other hand need to understand their desired place in the new market structure, increase investment to scale Fintech, and build roadmaps to become more dynamic businesses that can change and enhance services like other Fintech-enabled 'living services'.

Whether the Fintech revolution succeeds or not will take time to play out. It will depend on the end state of the evolving market structure, on profitability improving by more than the bow-wave of interest rate increases, and on prices reducing for all forms of banking, from retail to institutional services.

PLUS ÇA CHANGE: WHERE ARE THE FINTECH UNICORNS – HAS THE REVOLUTION LOST ITS PROMISE?

Defining Fintech success purely in terms of the demise and replacement of incumbent businesses makes little sense

Expecting challengers to appear overnight in a complex industry with high barriers to entry is unrealistic. But after five years of anticipation, it is now time to ask whether or not the industry is witnessing a Fintech revolution at all. How much of the hype is truly justified? Or are Fintech players trading on hot air?

External investment certainly seems to be running out of steam in mature markets. VC investment in Fintech declined by a third in the UK last year, dropping from $1.1 billion in 2015 to $0.7 billion in 2016, even though the number of deals over that period actually increased by 5.5 percent[1]. That could perhaps reflect a fall in confidence in the wake of the Brexit vote and of the UK financial industry's position within global financial markets. But whatever the reason, it's fair to say that Fintech unicorns have not yet emerged as promised. And the net book value of over 60 percent of incumbent banks in mature markets has remained below 1 – these companies aren't going anywhere anytime soon.

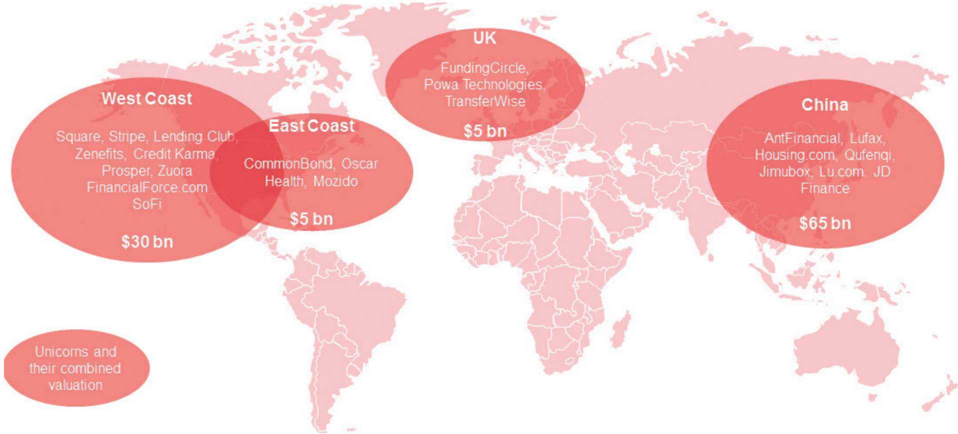
Payments and peer-to-peer lending models are two Fintech success stories that stand out . The UK led the 'alt lending spring', and Germany also saw a large growth in challenger models in these fields. But then the Chinese stepped in and dwarfed everyone. While these models will probably endure the stress test of a proper credit cycle, and have already been embraced by incumbents, they only make light use of new technology. They can hardly therefore be said to represent a revolution in the marketplace.

The true litmus test for Fintech success, for both challengers and incumbents, is customer acquisition – and this test is yet to be passed. Number 26 in Germany and Nutmeg in the UK – two companies offering new and compelling technology-enabled propositions – have thus far failed to capture the market, for example. Analogies can be drawn with the past. In the 1990s, Prudential's Egg was a fresh direct banking challenger that quickly attracted a million customers. But its marketing costs equalled the savings made from having no branches – and when those costs were reduced, customers stopped joining. Whether or not Nutmeg and Number 26 are now facing a similar fate might be just a question of time – the huge costs of building a balance sheet and slow customer acquisition make creating a full-service challenger bank a 15 to 20 year journey - even Che Guevara would have ended up in a desk job in that timeframe.

[1] *Accenture analysis of Pitchbook data*

WILL CHINA BE THE CENTRE OF FINTECH VALUE CREATION?

Pundits frequently highlight the success of Fintech in the East, and point to Chinese Fintech giants like Alipay and JD Capital who have 445 million and 226 million customers respectively. Is this the model for sustainable Fintech value creation?

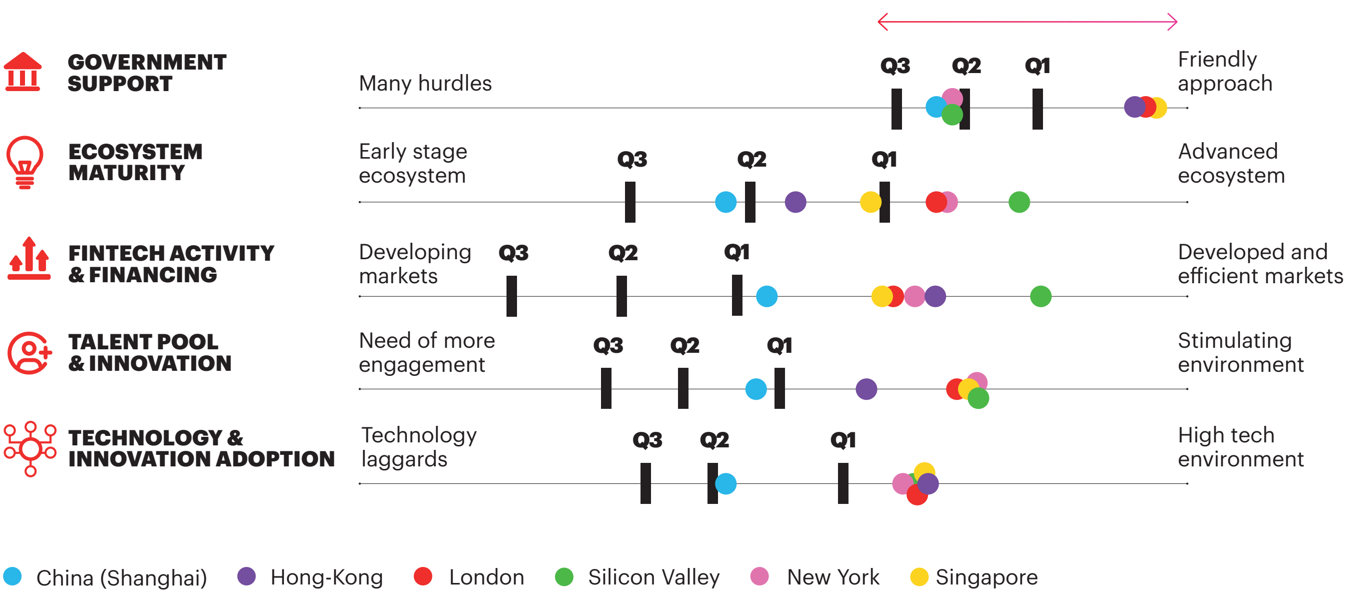


Not necessarily. These Chinese Fintechs might be meeting the needs of their home markets but are unlikely to have material advantage elsewhere. They have predominantly leveraged relationships with their parent and market demographics (in which 20 percent of people are unbanked) to overcome the biggest Fintech obstacle: customer acquisition.

Local regulation is also contributing to the dynamism of the Chinese market. But recent changes to P2P regulation will likely take some wind out of these companies' sails. The Chinese Fintechs will develop some long-term market advantages through product innovation, but they'll be starting from the same position as everyone else (ie those without large customer bases and brand equity to leverage) when entering Western markets.

China also has ground to cover to create the environmental factors that allow Fintechs to thrive. This can be seen in the results of Accenture's Fintech Hubs Maturity Model:

By looking at the model results, it is clear to see that China, although prospering from favourable demographics, lacks the maturity of other Fintech hubs.



Incumbents in Western markets should nevertheless be careful to avoid complacency. If there was ever a stigma that the giants of the East can't innovate, it's now gone. So if Western incumbents don't act quickly and decisively, they might find those innovations exported into their home markets at pace and at scale. Incumbents will need to watch carefully and adopt exportable behaviours in order to be on the front foot should the battle come home.

There are also signs that Fintech challengers are rethinking their pricing strategies as the operational realities of building new technology on legacy industry infrastructure force them to compromise their revolutionary ideals. Revolut, for example, started out with a compelling card-based FX offering with significant fee and conversion savings. But after struggling to build revenues, and in the face of spiralling operational costs, it had to raise its prices and lower its cap on free ATM withdrawals. Fintech outcomes don't look much better on the inside either.

Internal incubators and innovation streams have universally failed to produce killer apps. 'Death after proof of concept' has become the norm. Promises of 20 to 30 percent improvements in cost–income ratios show little evidence of coming to fruition, and costs remain stubbornly correlated to revenues.

That UK retail banking Fintechs seem to be perpetually stuck in beta, and risk being overtaken by the next wave of technology, adds to this sense of stalled progress. And this is having a knock-on effect on external collaborations and the investment available from banks and venture capital. Fintechs thus face a catch-22 situation. They need investment and collaborative opportunities to gain customer trust and volumes. But those opportunities won't materialise without proof that Fintech products can attract meaningful customer numbers and offer value for money. Getting banks to realise the potential upside of the innovative, game-changing technologies already available would be the first step in breaking this cycle.

“DON’T BLAME THE TECH: A QUESTION OF WHEN AND HOW, NOT IF”

Defining Fintech success means first defining Fintech itself. It’s best defined as the deployment in financial service business models of a set of technologies singularly or in combination that have matured in the last ten years to the extent they are usable and which can deliver transformative benefits and savings.

What is Fintech?

Fintech is the application of recently matured technological advances to financial services. But, in fact, most of the household names in the Fintech business today make only light or early-stage use of the latest technologies. And some use none at all, and are deploying legacy technology to deliver new products or reach new customer segments.

So what is the ‘Tech’ in Fintech? Accenture’s view is set out below (Fig. 1). Of course, this is a rapidly evolving landscape, and new technologies will emerge and existing technologies fade in the future. Quantum is two to five years away from realistic use, for example.

Fintech’s failure thus far to contribute meaningfully to productivity has been driven by a slow start to investment. In the post-crisis world of re-structuring, retrenchment, balance sheet rebuilding and regulation, the industry could not afford to invest, even when it saw the potential. The lag between deploying a new technology and seeing a benefit is another factor. Large timeframes spanning many years can be required to adjust human resources and physical assets to new models.

Incumbents must resist complacency, however. The period of slow Fintech adoption in the financial services sector will likely be short lived. Deployments will speed up as adjustments to the technology (block chain) or to risk management (artificial intelligence) are made. Just a couple of years ago, cloud was viewed as an impossible solution for financial services, for example. Today it’s often thought to be more secure than a company’s own servers. The cost benefit of these new technologies will eventually be realised.

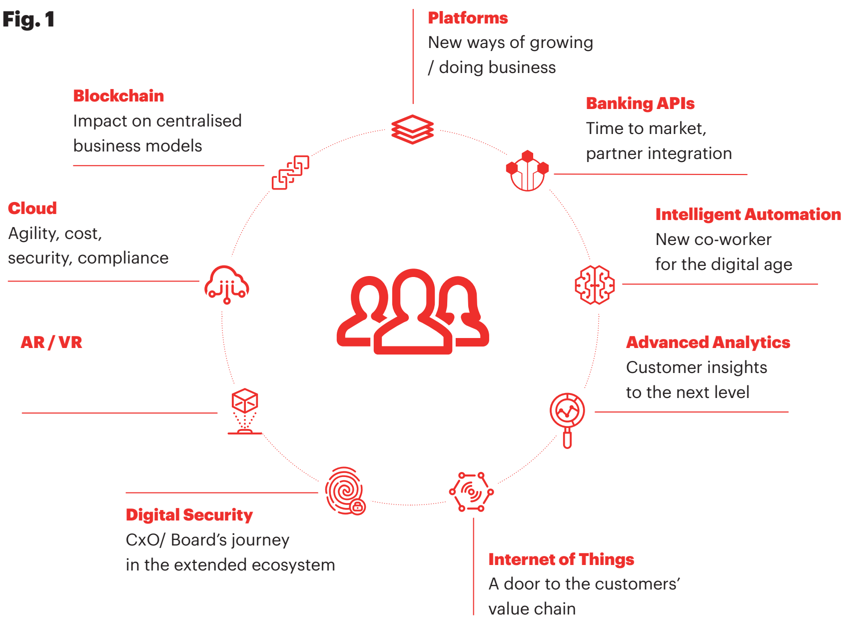
And while challenger Fintechs might have seen slow growth in customer acquisition so far, financial functionality in areas like social media is accelerating. Accenture’s international survey of consumer preferences also found a clear generational divide in attitudes towards providers. Over three quarters of Generation Z and X respondents in mature countries said they would trust an entity other than a bank for the provision of banking services (compared with zero percent of other segments) . Incumbents might put this down to the wisdom of age – but it should act as a warning that customer acquisition could be about to hit a point of collapse.

But when? At what point can incumbents expect the Fintech revolution to really bite? There are a number of progress indicators to look out for:

- Radically more efficient business models showing 20 to 30 percent improvements in cost–income ratios or cost per trade.
- An increase in visible competition, including price decreases, greater price transparency and more switching.
- New ‘surprise and delight’ customer experiences emerging in the sector.
- Net new revenue for companies who deploy the technology – and valuations that reflect this – > 20 Price/Earnings ratio.

Whether Fintech’s value will be evenly distributed when this happens, and whether a fast follower strategy will be supported, are equally important questions. Answering them means first understanding the changes to market structures that are already underway.

Fig. 1



A NEW MARKET IS TAKING SHAPE - THE END OF L'ANCIEN REGIME

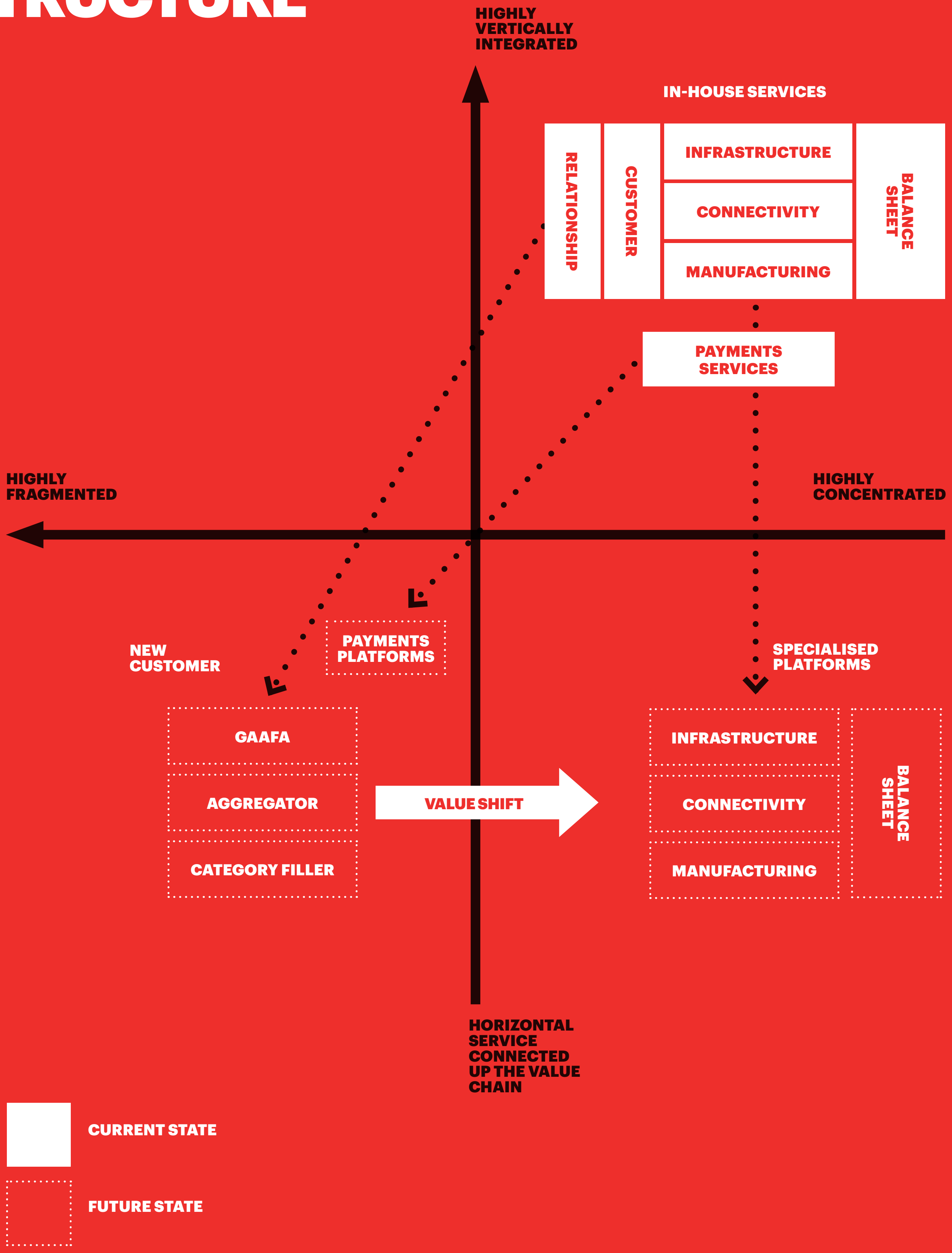
The structure of the financial services market is changing, irrespective of the Fintech phenomenon, driven by economics, customer needs and regulatory responses to market failure. While the precise end state of the new structure is still to be defined, it will likely mean the end of vertical integration and a proliferation of new businesses providing customer access to financial services.

These new players will coalesce around the different specialisations needed for capital efficiency. Some may be able to justify integrating different specialisations, but there will likely be substantially less cross-subsidisation between specialist business models than at present. This will enable more transparent and fairer pricing, and will enable the surplus efficiency created by Fintech to flow more meaningfully towards customers than it can in the current market structure. Early signs are apparent in the collapse in the fees payable for asset and wealth management services, for example.

A value chain shift from customer relationships (ROE c 22 percent today) to manufacturing, infrastructure and connectivity (ROE c 2 percent today) is predicted, as Fintech tackles the complexity and surplus capacity embedded in the current structure, and as economies of scale are released. The profitability of balance sheet provision will over time reduce with greater pricing transparency driven by fierce competition in customer relationships and platform business models buying services. Regulation (through the opening of APIs, for example) and cloud technology (through scalable solutions to banking operations) will act as enablers in these shifts.

Fintech will offer a wide set of tools to build new business models within this new structure. But it will inevitably take time for the market to work out how best to deploy them. How could this process be accelerated?

CHANGE IN BANKING MARKET STRUCTURE



"A PATH LESS ORDINARY – WHAT NEEDS TO HAPPEN TO ALLOW MARKET RESTRUCTURING TO ACCELERATE"

The current trajectory of Fintech adoption shows a relatively slow progression towards a better version of the current business model. Value is thus likely to remain locked in the existing market structure for some time. Even though GAAFAs will continue to dominate customer relationships and increase pressure on incumbents, those incumbents won't have the time and investment capacity to quickly align themselves with the new market structure.

To capture the greatest value from the Fintech revolution, markets should redefine the roles of market participants, focus on attracting more late-stage investment to enable Fintechs to cross over from R&D to real solutions, and create export tunnels and bridges that allow Fintech investment to grow. This will offer a far greater return than simply making a domestic market a better version of its current self.

Redefining markets – is it time for Big Bang 2?

In 1986, the British government implemented a set of regulatory and structural market reforms – known as the Big Bang – that promoted growth, competition and a new phase of electronification. Subsequent reforms have attempted to open banking infrastructures and allow further competition, but these have often been piecemeal and made in response to regulatory concerns rather than overall market effectiveness.

The UK regulator's leading role in fostering innovation has been justly praised, but it must now go further in establishing an environment where credible players can emerge to run horizontal platforms and services across the industry. This might include new categories of banking licenses or structures for insuring for operational loss across the industry for utilities. It would also need to account for the access provided to foreign players in conjunction with Brexit negotiations on passporting rights into the EU.

Such an endeavour would be hugely complicated. But the existing market structure is already complicated. And the Brexit process offers an opportunity to simplify aspects of the structure and incubate the next generation of banking platforms.

[2] *Accenture analysis of company reports*

Grow investment to help Fintechs move up to the next level

The decline in Fintech investment is undeniably a concern, even accounting for uncertainty in global politics. Securing greater funding from banking incumbents, and encouraging them to reinvest in innovation once initial cost savings are realised, is thus crucial. Investment from bank's VC funds is currently relatively low – the cumulative sums available from Barclays', HSBC's, and Santander's technology-focused funds have totalled just $500 million since 2014[2]. Keeping a supply of dry powder to reinvest in new technologies should be a top priority for banks, both to create effective partnerships by investing from internal expenditure, and to benefit from new revenue streams unlocked by Fintechs through their own VC funds.

Other forms of funding, such as non-financial-services-related private equity, could offer a potentially large cash injection. But this brings risks for Fintechs, who could lose control of their businesses by agreeing equity stakes with partners with little or no experience of their technology. Further, many private equity funds invest through a mix of equity and leveraged debt which may be unattractive to start-ups and scale-ups. These options will also be out of reach for Fintechs who fail to meet the minimum valuation levels needed from private equity investors.

Ensuring investments can be exited is also crucial. Effective IPO and capital markets are key to this, and will be highly scrutinised by investors, particularly as the impact of Brexit is felt. Maintaining an infrastructure capable of raising the sort of exit prices expected from investors should remain a high focus for regulators and market-makers.

PSD2 will give Europe a comparative advantage over other regions in forcing incumbents to an open up their platforms and is a case of good regulation that aligns with market forces. Smart incumbents will see it as an opportunity to get closer to their customers not a threat. The US is likely to follow on a more voluntary basis but this could make standards and speed of execution more challenging. One way or another it will seem bizarre in ten years that customers had to put up with their identity and the context of their request being forgotten at the digital entrance to the bank.

Encourage first-mover innovation and strengthen export bridges

Making the UK banking market more efficient and competitive in and of itself is a zero-sum game. To create new revenues, new business models need to work in other geographies, either as platforms or B2C businesses. The former option will likely be the more feasible given local needs and brand affiliations in each country.

Gaining access to new revenues from international exploitation is just as important to the success of Fintech as supply-side factors like talent, access to capital, and domestic regulation. The UK's Fintech bridges with China, Singapore and Australia are a step in the right direction. But there are clearly other large markets, with significant amounts of unmet financial service needs, to be tapped. Launching Fintech-enabled customer relationship businesses in high-growth markets like Mexico, Russia and China could be a valuable strategy. It's been tried many times before with legacy technology – Fintech could be the key that makes it viable.

Incumbent banks remain the key channel for scaling, exporting and realising Fintech value. So more ambitious strategies are required to encourage banks to reinvest savings into Fintech solutions. Investment from in-house VC funds will also be required to supplement this.

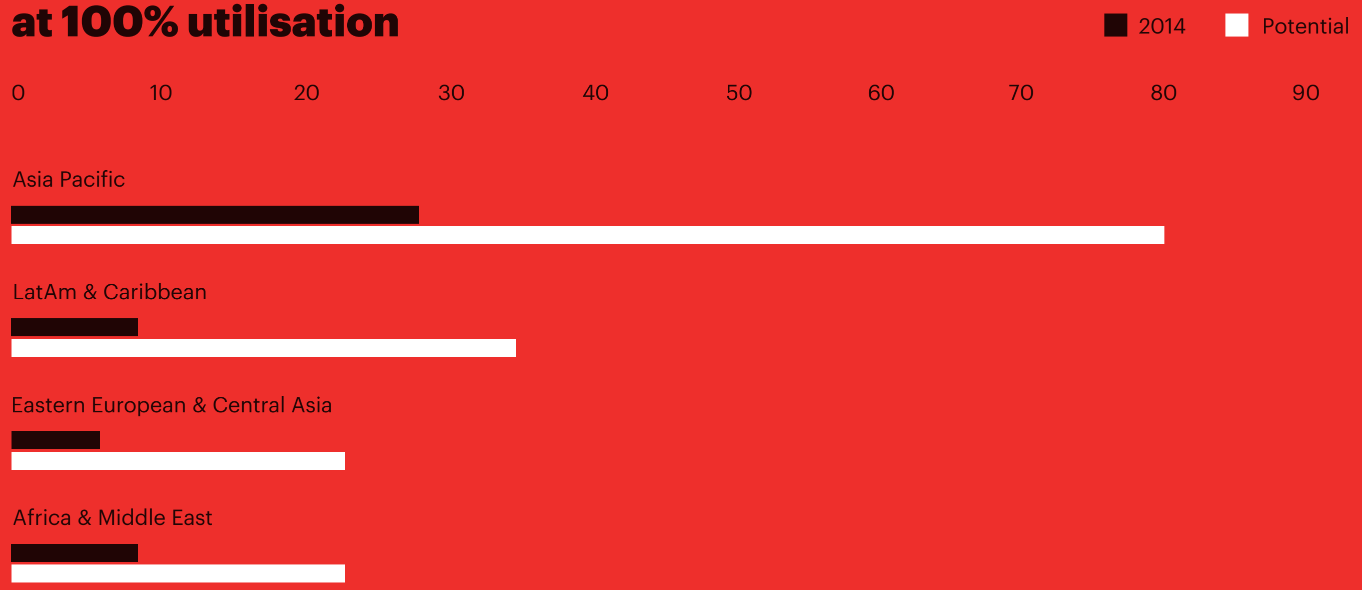
Exporting a platform or a service is an alternative strategy. The UK's Vocalink runs retail payment schemes and platforms and is heading for autonomy from its bank owners . It will use its freedom to sell a wider range of services but will also expand international sales of its faster payments know-how and infrastructure. And Worldpay is a company that was separated from RBS in 2010 and now operates payment services right across the globe . While RBS was forced to sell Worldpay, its success raises the question – how many other processing category killers could be released from vertically integrated domestic banking models to earn revenue in a wider field?

Banks have tried in the past to monetise their internal software in this way. Most attempts have been half-hearted and the spin-off entities not given enough freedom or capital to dominate a sector. There is no reason this cannot be successful - Amazon created AWS from its core business and it now dominates public cloud infrastructure. To make such a move around bank platform software would require a significant cultural shift for internal bank IT functions many of whom still accept their role as a silent back office support function.

Acquiring a reputation as a hub for a particular Fintech expertise could also be a sound market-level approach. Israel's brand as the global centre for security technology will no doubt lead to a significant external revenue stream, and this model could be applied elsewhere. Countries would need to first define their specialisations and then work out how to create export opportunities for them by combining research with applied use. Nations with strong and outward-facing research and education systems will be well-placed to exploit this opportunity.

2 BILLION CUSTOMERS WAITING FOR FINTECH

Personal banking revenues $110Bn at 100% utilisation



There are currently around 2 billion unbanked people worldwide[3]. Most either live too remotely to have access to a bank or are excluded by the cost of holding an account. They include approximately 90 percent of the migrants around the world, the number is now approaching 300 million, many of whom are in great need of financial services and are often highly financially educated. The World Bank and its partners are aiming to provide financial transaction services to approximately half of these people by 2020. Mobile and internet-based services are clearly one way of doing this – while only about 20 percent of the populations of UN-classified 'least developed' countries have access to a financial services account, over 60 percent have access to a mobile phone or the internet at home.

[3] *Accenture analysis of World Bank and UN figures*

CONCLUSION: AUX ARMES CITOYENS!

The Fintech revolution offers the prospect of a new energy source to power financial services.

But making the best use of that power will require new infrastructure and a new ecosystem. And finding new revenue streams will be essential – no-one joins a revolution merely to optimise costs.

Forming bridges between countries will be a key part of realising that value – this is already happening, and it could and should expand further.

The spectre of Brexit is casting an uncertain shadow over the UK's financial services industry, and is placing a new urgency on issues like attracting talent and making trade agreements.

The reality of the Fintech scene today is that its full impact can't yet be predicted. When Zhou Enlai the Chinese Premier said 'its too early to tell' when asked if the French revolution had been a success he was actually referring to the 1968 disturbances. His sentiment can still be applied to Fintech. This revolution has not been cancelled, the old world is indeed changing, and the financial services industry will still be living in interesting times for some years to come.

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