Disruption and innovation in financial services

Banking innovation series

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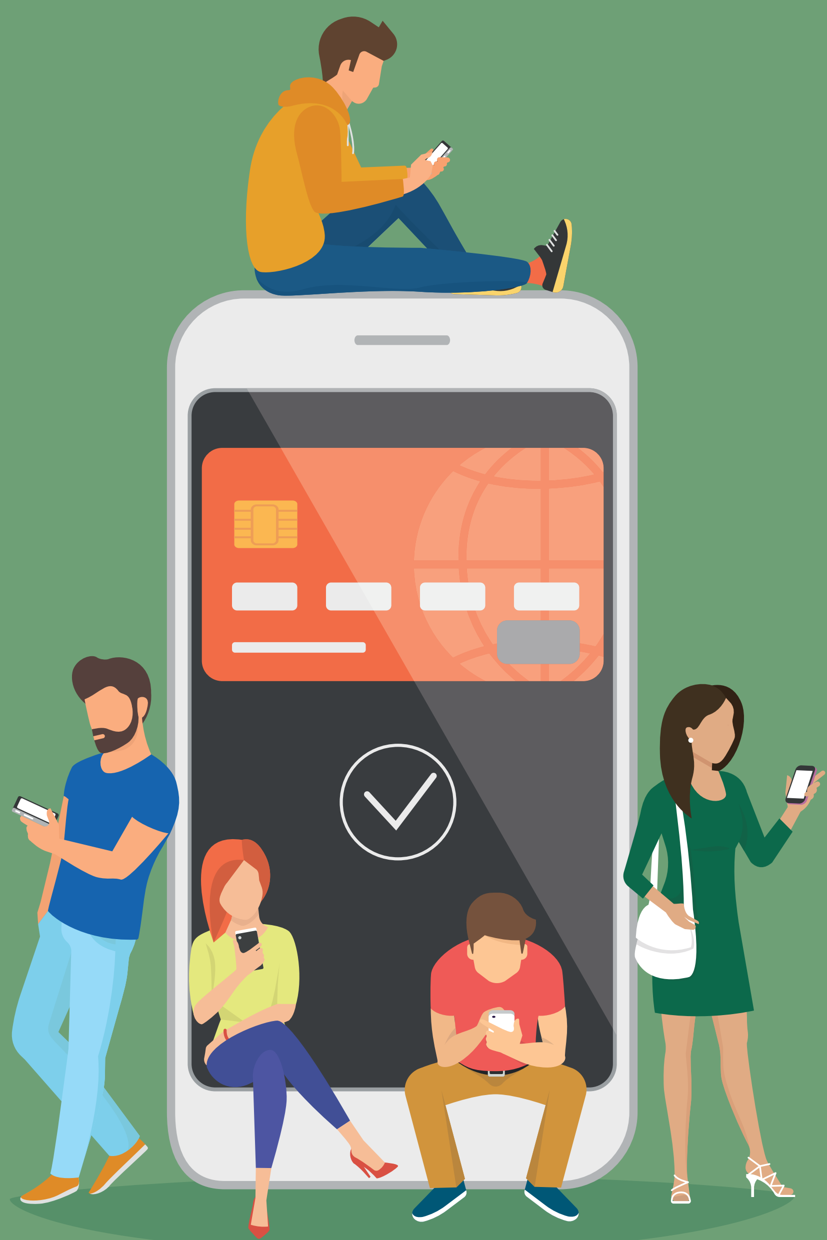
There has never been a more exciting or a more challenging time to be leading a financial services organization. We are living in a period of unprecedented change. That change is coming from all directions, some familiar and some less so. In financial services, that change is resulting in some unexpected threats as well as some surprising opportunities. Here, we will look at some of those sources of disruption, as well as the recent major trends in innovation as financial organizations try to capitalize on it.

Sources of disruption

There are four familiar sources of disruption: regulation, new technology, changing customer expectations, and competitors. These sources are nothing new, and they have long worked in isolation to affect the financial services industry incrementally. Now, in 2018, these four factors are converging, multiplying the force of their impact.
Regulation has been a persistent driver of change in banking for the last decade, although the introduction of GDPR and PSD2 in 2018 are perhaps unusual in their scope for disruption and, in the case of GDPR, the scope for enormous fines for malpractice. This is forcing FS firms to rethink their approach to managing and sharing data. Digital technology in particular mobile phones, automation, and biometrics, has been re-shaping the way we interact with our financial services institutions for several years now, too.



We'll look at some of the ways AI is moving beyond automation and into something far more powerful later in this article.
However, the most unfamiliar catalysts for massive disruption in the last year have come from two sources: a new breed of competitors ranging from the start-up to the tech giant, and customer expectations being set by organizations that have nothing to do with financial services.

Competitors

Challenger banks

Major financial services institutions have been a stable cohort for decades, and in some regions for centuries. To set up a new bank, the barriers to entry have always been prohibitively high, and, as a result, incumbents have faced little threat.

Digital technology has drastically lowered those barriers, and EU regulators have worked to make the process of getting a banking license significantly easier. Some regions are seeing a huge rise in so-called "challenger banks". These are small, nimble, mostly app-only retail banking propositions with scalable IT architecture, almost zero front-end costs, and fast, paperless turnaround for account opening.

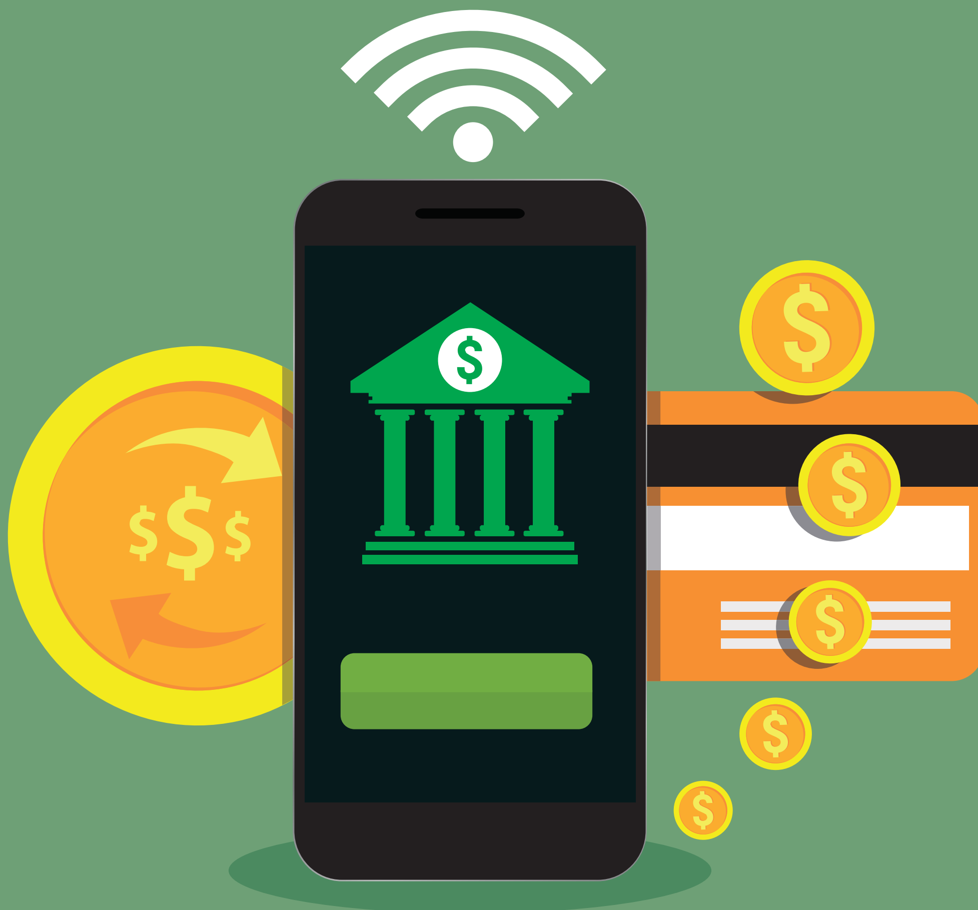
Banks in Europe such as N26, Monzo, and Starling that were not even possible just a decade ago are beginning to gain market share and pose a serious threat to the status quo, staking their business model on the belief that customers want to interact with their finances but not with their bank.

Product specialists
It's not just full-scale challenger banks that threaten the incumbents. Disaggregated product specialists are also contenders. The payments market has seen TransferWise gain widespread adoption. Moneybox, Nutmeg, and Acorns are providing a simple, low-fee way to invest modest sums of money. Habito and Blend are re-shaping the mortgage market by proactively seeking better deals for customers and linking existing financial accounts to shorten the offer process. All these previously high-reward, low-effort revenue streams for banks are being eroded by tech-savvy specialists, offering better rates and a simpler interface thanks to recent advances in technology and a regulator that has encouraged competition.

Even if your money is where it always was, new specialists are coming between you and your bank to offer a simpler, more versatile interface. Plum and Cleo are both chatbots working through Facebook messenger to provide intelligent AI feedback on your spending, data aggregation from multiple sources, and even payment services through the bot. Yolt and Blend are PSD2-ready aggregators offering a single view of multiple bank, credit card, and savings accounts.

Non-financial services players entering the financial services arena
There are countless new companies like these nibbling away at the incumbents' advantage. But we are also seeing something different: non-financial services giants taking advantage of their dominance in other industries to offer financial services. Chinese retail giant Alibaba and communications behemoth Tencent between them or their respective payments companies, Alipay and WeChat Pay in 2016 made up 92 percent of the Chinese mobile payments market, in total worth around US$9.3 trillion. In the US, Venmo, now owned by PayPal, is doing something similar. Apple, previously known for its gadgets, provides a thin layer on top of your payments with Apple Pay, facilitating online and at-till transactions, whilst using the opportunity to harvest data it can monetize elsewhere.

As PSD2 comes into force in Europe, there is less reason than ever for customers to make payments via their banks, particularly when abroad, as they can avoid punitive foreign transaction fees by using services outside of the incumbents' orbit. The consequence of technology's lowering of barriers is that customers now have a far broader choice when they make their payments, and they are not necessarily choosing incumbent financial institutions.



Customer expectations

To understand what's fueling the ever-increasing expectations of customers in financial services and a rise in the adoption of challenger banks and alternative providers, we need to understand the way customers are consuming other services and how this has changed.

The latest and most successful companies, usually fueled by digital technologies, provide a frictionless, mobile-centric proposition. We call an Uber with a tap and expect it to know where to pick us up and drop us off without a word being exchanged, at a reasonable price, without delay, and without having to produce cash or a card. When abroad, we can book an Airbnb in the city we find ourselves in and have the details taken care of automatically.

When we order something on Amazon, we expect to receive it the next day and to pay no postage.

Customers are not interested in whether these are platform business models, whether these companies are disproportionately advantaged by having been born in the internet age, or how (or even whether) such firms are turning a profit. From a customer perspective, this is how services, from buying clothes to selling your house, are provided, and it sets their expectations. Banks must deal with cumbersome legacy IT architecture, huge fixed costs, impending regulation, and the inertia of any large organization. So how can they meet these customer expectations, stay ahead of their nimbler competitors, meet the requirements of regulation, and make the most of the possibilities afforded by the latest technology?

Innovation

Large financial institutions are going to need to innovate to avoid lagging behind nimble start-ups and powerful non-financial services players. Whilst there are benefits to being small, the incumbents have some serious advantages when it comes to innovating if they know how to exploit them.

First, incumbents have resources start-ups can only dream of. Whether in terms of funding, staff, or equipment, major financial institutions will always have a better supply of finite materials than even a VC-backed young company. Then, there is expertise. Large companies have at their disposal not only cumulatively millions of hours of experience of their industry, but also of the various technologies, techniques, and connections inherent in the people who work for them. They can also provide a safe sandbox environment with realistic data and scenarios in which to experiment, and the power of a huge existing customer base.

There will, of course, be disadvantages. Large organizations suffer from inertia, resistance to change, bureaucracy, a risk-averse culture, and individuals still having a day job and their concerns about the impact of experimentation on their promotion and reward prospects.

C-suite leaders need to know how to incentivize experimentation and innovation. That will sometimes mean rewarding those who try something bold and fail but learn from the experience, instead of those who repeatedly try something safe and succeed.

The latest trends

We can track the latest trends and try to keep up with what's going on in the market. As the four forces above converge, here are our picks for 2018.

Cryptocurrency and blockchain are going mainstream

The past year has seen bitcoin move from the fringes of conversation to front-page news. As barriers to the acquisition of bitcoin were lowered thanks to more user-friendly platforms, late 2017 saw a flurry of buying, pushing prices to extraordinarily levels before the inevitable crash in early 2018. Although it's been easy to sneer at the get-rich-quick traders, enjoy some schadenfreude as the prices plummeted, and mutter to ourselves about the South Sea Bubble and Tulip Mania, it's hard to deny the progress cryptocurrencies have made in the last 12 months. Every newspaper now has an opinion about blockchain, bitcoin, and the hottest new cryptos.

But it's not just investors. Customers are paying for daily services, from sandwiches to train journeys, in cryptos, and, partly by design, banks are excluded from these transactions. **Revolut** now offers in-app currency exchange from 25 traditional currencies into three cryptos (Bitcoin, Ether, and Litecoin). **KFC**, perhaps tongue-in-cheek, but genuinely is offering to take bitcoins in exchange for a more reliable commodity: buckets of chicken. And cryptos aside, blockchain and distributed ledger technology is being used in all sorts of arenas, from cross-border payments (**Veem**), to ship certificates (**Deloitte** and **DNV GL**), and diamond tracking (**Everledger**).

Bitcoin may have been overvalued. In fact, it may still be overvalued. But we can no longer take seriously suggestions that cryptocurrencies are a temporary blip on our financial services radar. Together with blockchain, they are going mainstream.

AI cognition is becoming useful at last
Narrow AI has been around for a long time. Even a pocket calculator counts. But recently, we've heard a lot about cognitive AI. We may be a long way still from artificial intelligence that is in any way human, but useful applications are finally emerging within financial services.

Chinese internet search giant **Baidu** is partnering with China Citic Bank to launch an AI-based banking service called aiBank. **Nordea** has begun using AI to triage incoming queries from email or text channels and direct them automatically to the right department, in a move that reduces customer wait time and cuts operating costs. **Skandiabanken** is investing in robotics and AI, and **MasterCard** have bought Brighterion, a firm creating technology that uses AI to observe spending habits and provide an early warning system in the event of credit card fraud.

The next challenge for banks is going to be combining solving back-office process automation with AI whilst simultaneously improving the customer experience through empathic, intuitive AI. That way, banks can save money on expensive humans in call centers and shift the demand onto sophisticated artificial intelligence.

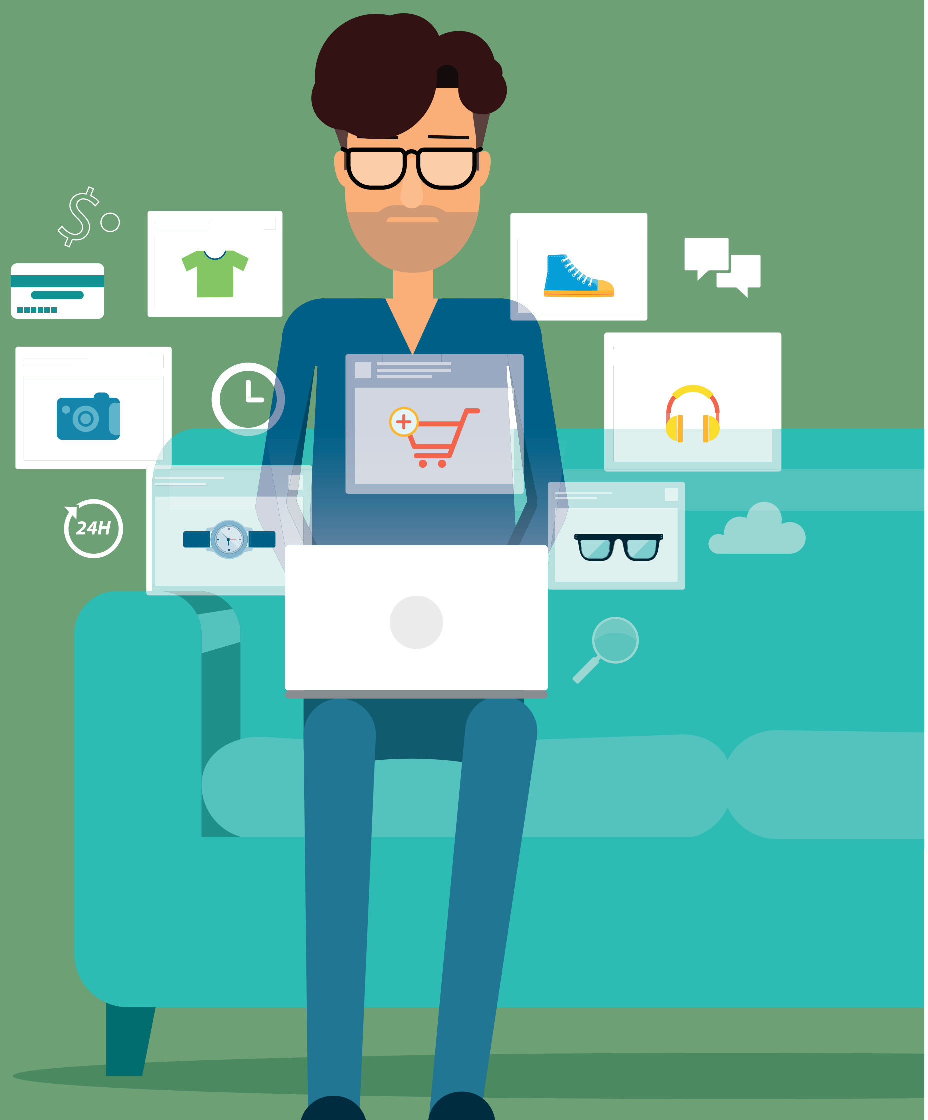
Mortgages and other lenders are catching up on innovation
Mortgage lending has not changed significantly over the last decade whilst other areas of financial services have been utterly transformed. Payments, spending tracking, AI assistants, and car insurance have all seen huge improvements not just in terms of channels and products, but also in service and business model. Coupled with the fact that some of the worst experiences anyone seems to have had with a bank have been in applying for a mortgage or loan, it's about time mortgages and other lending caught up.

The most common complaints about the mortgage process are the time and documentation involved, and a lack of transparency around the process. **Rabobank** have introduced gamification to make it easier for customers to learn about the process, coupled with a beautiful UX to make uploading endless documents a pleasure rather than a chore. **Blend** is a software provider currently working with some major US banks which allows applicants to link their existing financial accounts, reducing both effort and the time for approval by five days.

Instabank is using Provenir's technology to approve loans instantly, in much the same way that insurance company Lemonade are reducing the time it takes to approve a claim (their record, for a stolen coat, standing at three seconds).

Although time and effort are concerns, so too is the size of the interest payments reaped by banks on relatively low-risk homeowners. Loan Dolphin is an Australian platform business that sets up auctions in which banks and brokers bid to provide the cheapest loan to customers, offering savings of up to 60 percent on the regular fees.

And if legacy mortgage providers weren't already on guard, **Trussle** is a mortgage comparison site with a twist: it promises to contact you proactively if it thinks it has found you a better deal.



Conclusion

We're starting to see evolution in the industry from largely peripheral disruption of products and services to wholesale change in how customers interact with banks.

Data, computation, and connectivity are combining, resulting in effects far greater than the sum of their parts. This process will take time but will change the industry beyond recognition.

The big question against a backdrop of radical change is this: what will happen to banks in the next financial crisis? Things are very different now from how they were in 2008, but have those changes made banks more or less prepared? Perhaps, in fact, it is the FinTechs that will struggle, given that very few of them have figured out a sustainable business model. A downturn could see start-ups flail in the market, and banks move to purchase their capabilities and bring them in-house at a knock-down price.

Consumers will continue to benefit from better, cheaper, more innovative services and offerings in the financial services space.

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