Fintech
CIOs as venture capitalists

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Financial technology is following the model of many successful start-ups in the services industry: one does not need to own a product or a service to improve it, or to build further services around it. For instance, Uber is the world's largest taxi company and owns no vehicles, Facebook is the world's most popular media owner and creates no content, and Airbnb is the world's largest accommodation provider and owns no real estate. Something interesting is happening.
The world of financial services IT start-ups is currently so vibrant that it has been given its own name: Fintech.

Introduction

Start-ups and tech-savvy individuals now have a chance to shake up the business model of well-established financial institutions. To leverage this new channel of technology evolution and disruptions, CIOs should now shift from the traditional buyouts towards cooperation. There are several ways to go about cooperating with these new players and they are often far from the vision of large financial institutions. CIOs can prepare their organization to deal with future trends by looking at Fintech companies from a venture capitalist point of view.

In recent years, huge mergers and acquisitions in the field of technology have taken place. A widely known example is the acquisition of Whatsapp by Facebook for US$19 billion. Whatsapp did not emerge from a large organization that wanted to revolutionize the world of digital communication. It was instead created by two former colleagues who identified an area for improvement that would benefit from the support of wider innovations such as the Apple App store and the new wave of smartphone applications. Fintech start-ups are no different from Whatsapp in its early years. While the core business of banking and financial services is clear, the digitization of these services creates a large margin for improvement that is not always visible from an insider's point of view. Fintech start-ups benefit from their proximity to end users and an external view of the industry. There are many reasons for CIOs to pay attention to the Fintech industry. There are even more reasons for them to do so quickly.

Why is Fintech so hot?

Financial institutions have been operating in a challenging environment over the past few years. Consumers and regulators keep putting pressure on the business models of large players while giving an edge to small organizations that benefit from more flexibility. Such companies operating under the Fintech umbrella are now threatening to bring about even more change in the way financial services are delivered. Customers expect more from their interaction with financial institutions, particularly in terms of interaction on digital platforms.

There has been a structural shift in banking IT. IT solutions no longer need to be built in-house

There are two main reasons behind Fintech's current boom. The first is the 2008 financial crisis. This crisis resulted in a recruitment freeze and lay-offs for large financial institutions, leaving space for qualified finance professionals to join or create new start-ups.
The second reason is linked to technology cost reduction. CB Insights shows that the cost of starting a business has come down by a factor of around 1,000 since 2000. Cost used to be a big barrier for start-ups willing to break into the financial services world, but the rise of supporting technologies like cloud computing dramatically reduced entry costs into this market.

Moreover, the digitization of services is becoming the norm in all industries and customers expect more flexibility and interactivity through digital platforms. These kinds of services can easily be developed by small and flexible companies that are able to provide a good user experience, but often lack the underlying core business to put it in context. On the other hand, large financial players have a strong core business but lack the flexibility and capability to put in place innovative services in a timely manner.

Why are financial services firms making venture capital investments with Fintech start-ups?

But why are banks and other financial institutions investing in Fintech? Is it to make early investments in companies in a growth sector, as they have traditionally done, or is it not to be left behind and be part of the evolution of an innovative IT sector dedicated to providing digital services to meet customer demand? Since the financial turmoil that began in 2008 with the collapse of Lehman Brothers—or arguably with Northern Rock's demise a year earlier—banks have reined in their spending, with large IT budgets cut along with a reduction in IT support staff.

There has been a structural shift in banking IT. IT solutions no longer need to be built in-house. Third-party suppliers are considered as viable for even the most core IT systems. But the biggest changes are driven by the digital revolution. Core system maintenance and the challenge of meeting ever-tightening and changing regulations are very costly.

But while replacement of these legacy systems is rarely in sight, banks cannot avoid investing in apps to provide customers with the services they want. The same research revealed that the replacement of core banking systems is not on the agenda of most European banks, with investments instead being made to maintain current systems and make incremental changes to meet business needs.

Online and mobile banking services, contactless payments, mobile-to-mobile payments and even the use of wearable technology for banking are all being designed, planned or discussed. With in-house development no longer a default choice for banks, the digital revolution means they need to find new ways of developing IT. Meanwhile, IT-savvy firms such as Google and Facebook are gaining regulatory approval to offer certain financial services. Although core financial functions will not be attractive to them, they are perfectly positioned to provide information enrichment in financial services. By making venture capital investments with IT start-ups that offer services to finance firms, CIOs can hopefully create an ecosystem of trusted suppliers from which they can eventually obtain products. To keep their dominant position, CIOs need to introduce digital services quickly.

A clear set of incentives have emerged from the momentum that start-ups and small companies have created, as well as from the risk that competitors might find and invest in the gem that will change the banking landscape first. Investors with a taste for riskier investments may be convinced to engage with this new industry that attracts more venture capitalists every year, growing from about US$2 billion in funding activity in 2008 to US$12 billion in 2014 (CB insights – The future of Fintech and banking, 2014). There has been a large increase in the amount of resources invested in financial technology. Companies in the insurance technology space, a subset of the wider Fintech environment, have raised US$2.12 billion since 2010, a whopping US$1.39 billion of which has come since the start of 2014. The current year is already the biggest year on record. Investor interest in the space is now as much as nine times its original level (CB Insight). CIOs have a role to play as intermediaries between these growing companies and the large pool of funds that lies in the banking sector.

Making a point for venture capital investments in Fintech start-ups is obviously a challenge in comparison to traditional investments. CIOs acting as venture capitalists must overcome the fact that IT spending is often perceived as a cost with little short-term return and a high failure rate. Nevertheless, cooperating with start-ups is an option that can yield great returns if the idea becomes successful, while limiting the liability of a CIO’s organization in the event of failure. Cooperation can be founded on financial contribution or access to resources that would be out of reach for start-ups. A CIO must learn to approach interesting ventures with the right incentives because start-ups often reject the idea of cooperating with large players.

How are they making venture capital investments with start-ups?

Large financial institutions that invest in Fintech obviously want to support the best start-ups, in other words start-ups that have the highest potential for disruption. Herein lies the central paradox for big financial institutions pushing into Silicon Valley. Some want to borrow ideas from the start-ups—or even buy their technologies outright. Yet, those start-ups that are the most successful at disrupting the industry's profitable business activities are the ones that are the least likely to be convinced of the merits of teaming up with an established bank. On the one hand, the culture of big, lumbering banks or insurance companies is antithetical to nimble start-ups, and given the attention that they receive, start-ups have their pick of venture capital investors. On the other hand, financial institutions are not completely out of the picture because they have something that Fintech start-ups often need, such as credibility, trust or authorization to operate (a banking license, an insurance license, etc.).

Meanwhile, larger players who do not need the support of financial institutions are also focusing on developing financial technology. Large companies like Amazon or Google are on the forefront of this revolution and they are able to exert more influence on the tastes and expectations of customers than banks. For instance, if Amazon starts accepting Bitcoins as payment, this will give the virtual currency a boost in credibility due to the reputation of Amazon. On the other hand, if a bank starts accepting Bitcoin deposits without communicating its strategy clearly, it might not have a positive impact on customers.

Regulators have strongly cautioned financial institutions against providing banking services to virtual currency companies and enabling their customers to buy and hold such currencies because it is difficult to track the flow of the money (Coindesk, 2013). Regulators have been cracking down on banks that have faulty money-laundering controls or checks against money flowing into countries that are under U.S. sanctions. Nevertheless, banks continue to invest in those companies because they need to stay up–to-date with the latest trends and technologies. Deloitte Belgium is cooperating with ING Belgium to develop an accelerator of Fintech start-ups with precisely this purpose.

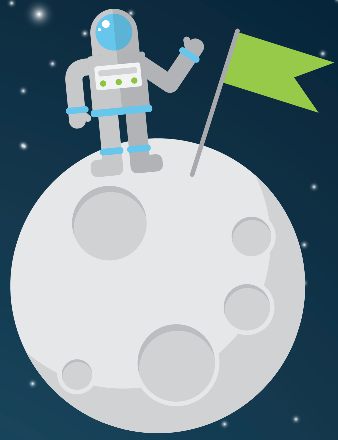
Virtual currencies still present very high innovation potential and banks cannot simply bypass small companies in this field. The ecosystem in which they are used and the underlying technology hold great potential even if the company itself does not represent a viable investment. For example, the block chain concept used by Bitcoin architecture to record transactions has been extended to support the new concept of smart contracts.

These investments could eventually lead to a deeper relationship if the virtual currency industry receives wider regulatory approval to use banks for more back-office services. And this Bitcoin story is only a small example of disruptive innovations arriving on the financial services provider landscape.

Scenarios of evolution

Fintech start-ups are increasingly concentrated in geographic clusters. Places like Silicon Valley or London hold opportunities for the most successful ideas. Large companies are offering incubators and accelerators to increase the chances of cooperating with future leaders in the field.

Fintech companies continue to inspire financial services firms to offer more digital services. However, the Fintech industry is highly fragmented and as it deals with people's money it must have a clear image that conveys ability and trust. This is where financial institutions have leverage over small Fintech companies. People know their financial institutions and trust the regulatory environment in which they operate. This creates a trust relationship that can be used to facilitate the acceptance of new financial technology.



Financial institutions are not the only players assessing this trend. Apple Pay and Google Wallet are clear examples that Fintech products and services are not the exclusive domain of banks or major financial institutions. The competition between banks and digital service providers to develop the next best Fintech product or service will also help identify the best of breed in Fintech companies with which they will attempt to cooperate.

We are currently in the early phase of an exponential shift. As more and more Fintech companies emerge, more products and services will become available. As more traditional models decline, the new Fintech offerings might become the majority rather than the exception if nothing is done to integrate them in a new, revised, disintermediated financial services industry economy. Financial institutions and their CIOs have to start preparing for this change right now.
Moreover, banks have to start assessing the likelihood that their customers will accept adoption of these technologies. There is a clear demand from the customer side to improve the current service offering of banks, however customers do not give directions, but rather assess what is offered and decide to engage with it or not.

When Fintech companies start doing IPOs and mergers with large public organizations, the field will gain even more attention and clear leaders will emerge. This will give more direction to the industry and filter out companies that are either too small or not innovative enough to survive on their own.

Conclusion

There is no guide to Fintech start-ups and this will not change until someone revolutionizes the industry. CIOs of large financial organizations must start building bridges between their organization and smaller players. The Fintech world is likely to be hit with changes that are difficult to replicate and will therefore give a competitive advantage to those who engaged with the change early.

CIOs need to act as intermediaries between more traditional executives and those from the new generation who are developing innovative solutions for the financial industry. They have the expertise to determine whether the technology is credible and to put it in the context of financial services. They need to leverage this expertise to convince both sides that cooperation is the most direct path to success.

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