forestreet

Bank Dis-Intermediation

The Role of eCommunities

Alessandro Hatami

The rapid growth in digital banking is driving profound change in the banking industry. Today mobile devices are the most popular channel for customers to interact with their bank. New business models are emerging each with their own strengths and weaknesses. One of the more interesting models is where non-financial digital communities, using the banks as subcontractors, provide banking services and directly own the customer relationship.

The objective of this paper is to outline the potential opportunities and risks associated with banking provided by these eCommunities.

A. Current reality: what is happening in this field?

Retail, business and commercial banking customers are increasingly frustrated with the traditional bank offering. They are dissatisfied with what they perceive as poor service, lack of transparency, unnecessary costs and - more recently - untrustworthiness.

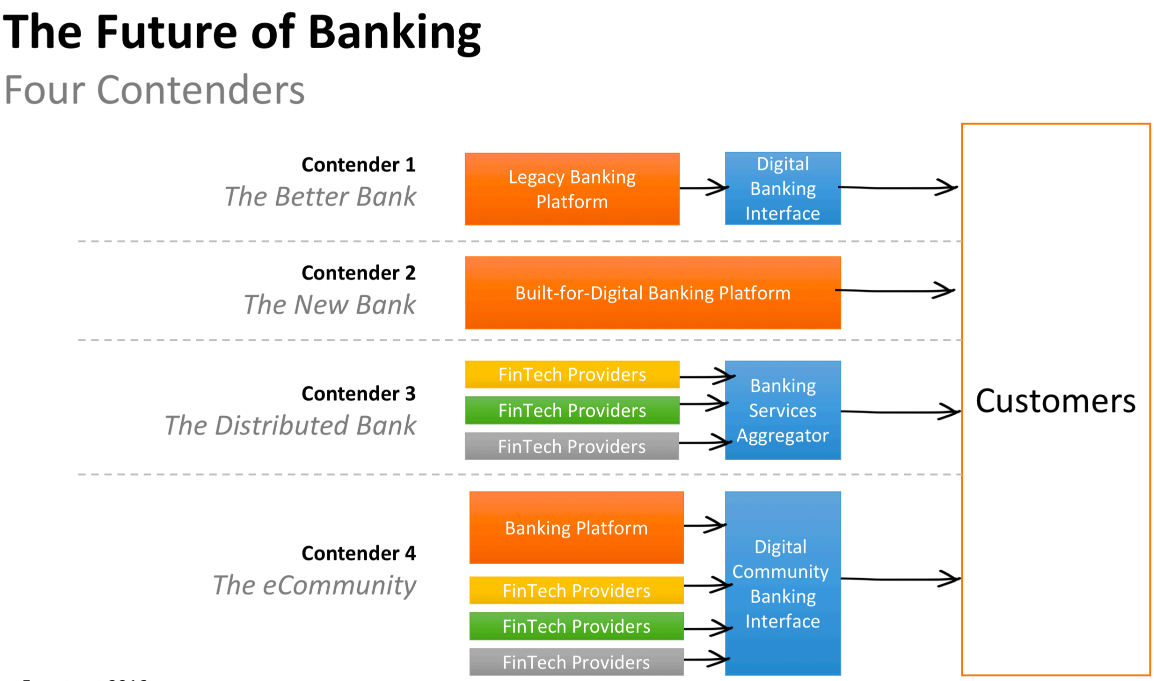
The sharp rise in the use of the digital banking and the fall in branch visits is probably an indication of customers' desire to change the way they engage with their banks. This dissatisfaction has also led customers to seek new providers creating a wave of alternatives to the incumbent banks. 4 out of 10 consumers have used nonbank providers in the last 12 months and an additional 2 in 10 customers who have not yet used them plan to in the near future.

In looking at the most recent development in the banking industry we can roughly characterise the four major contenders as follows:

- **Incumbent Banks** – these are established financial services providers with large customers bases and substantial capital to invest.
- **Challenger Banks** – These are new usually full-service banks that benefit from modern delivery infrastructure and are therefore able to provide services similar to those of the incumbent more efficiently.
- **FinTech Firms** – these are non-banks businesses that provide a specific financial service using a digital delivery model. They often deliver a limited set of products

compared to the incumbent and challenger banks.

- **eCommunities** – These are an emerging challenge (or even ally for some) to the banks and FinTechs. They are large social ecosystems that own, manage and interact with their own customer base. They offer their customers banking services by acting as a gateway to a wide range of financial products that are provided by the banks and FinTech providers.



Forestreet 2016

B. Stresses and strains: what are the pressures on the current reality, and from where?

The four contenders in today's banking landscape are affected by digital in different ways:

The Incumbent Banks

The growth of digital banking has a dual effect on the existing banks.

On one hand digital provides the opportunity to cut costs while delivering better customer service by levering their strong brands, large customer bases and access to substantial investment.

On the other hand, digital change clashes with what made the banks so successful in the past: legacy, predictability and consistency. These strengths have translated into large fixed costs, inadequate legacy IT platforms and out-dated policies & procedures.

The average big bank uses around 75% of its IT spend on maintenance. Their organisations are often managed along products lines rather than customer needs - where a customer with multiple holdings is treated as multiple customers. Lastly, their business culture is often averse to change and frequently excessively focused on short-term return.

That said, the incumbent banks have certain key assets that competitors will find hard to beat. They have strong well-known brands, very large customer bases and substantial financial resources to invest in new things. They are the ones to beat.

The Challenger Banks

These are often built for digital, avoiding many of the challenges and issues faced by the incumbent. They were set up to be more efficient and more customer-focussed than the traditional banks.

Their main constraints are, that compared to the incumbent banks, they have low brand awareness, small customer bases and much less capital than the incumbent. This could mean that gaining significant market share will be a challenge – and without market share long-term viability of some of these banks may be difficult.

Good examples of these are Starling Bank, Fidor Bank and Monzo Bank.

The FinTech Firms

These face the same opportunities and challenges of the Challenger Banks, but their niche focus may give them two substantial advantages.

Firstly growth; customers are often more confident about buying a single - often simple - financial product (a wallet, a loan or a cross-border money transfer for example) from a start-up than they are about making a new challenger bank their main banking provider.

Secondly costs: the FinTech firms' niche focus enables them to have less costly delivery model than both the incumbent and challenger banks, with smaller infrastructure and more contained regulatory requirements.

Good examples of these are Transferwise, Zopa and Betterment

The eCommunities

The eCommunities are potentially the most game-changing new contenders in banking. They combine the provision of banking with their core existing non-financial offering, aiming to simplify how their customers manage their finances. They focus on creating a great banking offering by using existing financial providers to deliver the actual banking and developing the best possible user experience to deliver the service to customers. These eCommunities are not the "manufacturers" of the banking services they provide, they are value-add resellers that own the customer relationship.

They are beneficial to customers in two ways:

- Providing access to smaller providers that would be dwarfed by the brand awareness and spending power of the incumbent
- Raising the bar in terms of transparency and user focus. These non-financial organisations have millions of customers because they focus on constantly

understanding and addressing their customers' needs. They will adopt the same principles in financial services.

By leveraging their strong brands, large customer bases, their customers' trust, a profound understanding of digital user experience and deep financial resources they can become key players in the banking industry without being banks.

A good example of an eCommunity is Wechat. This multi-million user mainly Chinese social network has created a virtual world where its members can engage with each other but also order services and pay for them directly while on the app. Unlike other payments companies WeChat Pay understands that a payment is not an end but a means to an end, and they have built their user experience accordingly. WeChat's banking subsidiary WeBank has recently moved from payments to offering personal loans.

The eCommunities emerge from a variety of communities - each has its own motivation to offer banking:

- **Social networks** – to get customers to visit more often – see WeChat Hike Messenger Payments and Facebook
- **Hardware manufacturers** – to ensure customers keep buying their products. See Apple Pay, Samsung Pay and Android Pay
- **Retailers and Service Providers** – to drive fidelity and raise barriers to exit. See Amazon, Orange Bank, Mint Bills and PayPal
- **Search Engines** – to enhance the quality of their search and paid search services. See Google and Yandex Money

The main objective of these communities is to strengthen, extend and deepen the relationship with their existing customers. Therefore, most eCommunities will probably not see generating income through financial services as a prime objective – at least in a first instance.

The eCommunities would provide all or some the following:

- Superior Customer Interfaces – The eCommunities help their customers improve how they engage with financial products they own by providing them with better designed and managed interfaces than the banks.
- Personal Financial Management – The eCommunities can provide PFM tools that enable customers to understand and manage their finances across multiple product holdings.
- Whole-of-market View – eCommunities can create transparency on all the products and providers in the market.
- Better Choice – because they are not manufacturers eCommunities can provide customers with access the best-of-breed banking providers (be it incumbents, challengers or FinTechs) in the market.
- Personalisation – With access to customer financial data and other behavioural information the eCommunities could use Big Data and Artificial Intelligence to help

customers make choices that are right for their specific circumstances

- Authentication – The eCommunities can provide customer identification and authentication making product transfers and product purchases easy, quick and secure.

The eCommunities provide financial services with three different operational objectives that are largely mutually exclusive:

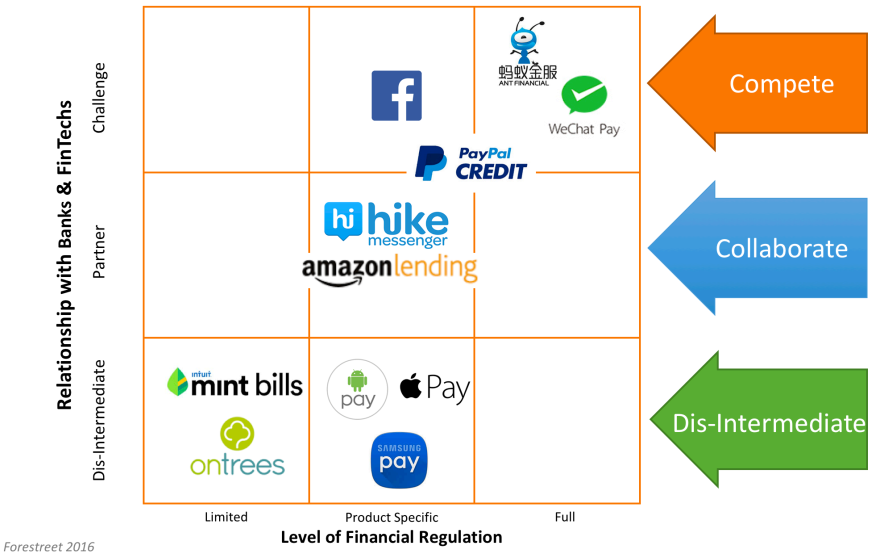
Dis-Intermediate – In this model the eCommunities aspires to be a whole of market solution giving their customers the ability to engage will all providers in the market from their platform.

Collaborate – In this model the eCommunities selects a subset of all financial services providers in the market to provide their banking services.

Compete – In this model the eCommunities become a financial services distributor. They would replace the existing banking relationships of their members with their own financial offering.

The eCommunity

Three Growth Strategies



In Europe (and possibly in the UK if EU regulation will continue to apply post Brexit) the eCommunities will be boosted by the implementation of the upcoming Payment Services Directive 2. PSD2 aims to increase competition in the financial sector by mandating banks to create APIs. These APIs will eventually enable "Trusted Third Parties" to directly engage with individuals' and businesses' bank accounts, access transactional data and authorise banking transactions as instructed by the customer.

C. What could influence the future and how could this play out?

The success of the eCommunities depends on three main interrelated factors:

Firstly, customer acceptance – will customers feel comfortable to buy financial services from their favourite retailer, handset manufacturer or search engine? Even though only 22% of customers feel they can get unbiased advice from their bank 90% of them still think their money is safe with their banks. The eCommunities may find it hard to displace the banks. Their success in making customers switch will depend strongly on whether they can make customers believe that their money is as safe as with the banks.

Secondly, return on investment – does providing financial services to its eCommunity deliver the best return on investment for a social network? Social Networks are businesses that generate returns by serving their user-base well. The launch of a banking proposition will have to deliver both a real measurable benefit to their members and offer better returns than other investment opportunities.

Lastly, regulation - will the Regulator continue to proactively support innovation in banking? In promoting competition and openness, so far, the Regulator has been an advocate for innovation. Mandating PSD2 and the FCA Regulatory Sandbox are great examples.

In principle, the Regulator should see the eCommunities as a desirable addition to the financial services market. By generating more transparency, more customer engagement and better access to the smaller players they are improving financial services for consumers. There are, however, considerable challenges in implementing a regulatory regime to cover eCommunities that both stimulates competition and protects the consumer.

The success of the eCommunities can potentially have a considerable impact on the shape of the banking landscape. If the eCommunities become a primary engagement channel for customers, they could lead to banking and financial services providers seeing a substantial fall in customers engaging with them directly. This would make it increasingly financially unattractive to sustain a direct customer channel, almost certainly leading to branch closures – a trend already in play. Pushed further this could lead to the creation of a new type of bank which relies entirely on third parties for it sales. Some banks could opt to be manufacturers but not retailers of financial services. This should – as it did for manufacturing of physical goods decades ago – lead to consolidation, improved efficiency and, if the Regulator is effective, a fall in prices. Also within the right regulatory framework his could also lead to offshoring, with a potential impact on UK employment in the sector. In summary, the eCommunities could result in:

- More customer choice
- Increase in account and product switching
- Better and easier user experience for buyers of financial products
- More transparency on pricing and features of financial products
- Lower prices for consumers
- The emergence of a banking services industry with no direct customer engagement

- Change in the economic models of the banks likely to lead to reduced employment in the sector

The role of the Regulator in making sure that the eCommunities model delivers on its promise is fundamental. To ensure that eCommunities function properly, the Regulator may need to develop expertise that go beyond financial services. The questions the Regulator needs to answer would include:

- Are customers being provided unbiased access to the banking provider of their choice?
- If an eCommunity provides access to a limited number of providers, are they an aggregator or an advisor?
- Are Personal Financial Management tools simply analysing customer data or are they providing financial advice?
- Are customers' rights protected if and when eCommunity Banks share customer data with their partners?
- Personalised insights can be a powerful way to help customers make financial decisions. How does the Regulator verify the analysis?

The role of the Regulator is going to be fundamental in enabling the growth of eCommunities as new players banking. The upside for the customer is clear but the risks are not yet completely understood.

D. Assumptions: which broadly held assumption could/should be challenged in exploring alternative plausible scenarios of the future?

The key assumptions that, if inaccurate, could challenge these propositions are:

- **Customer Buy-in** – Customers will continue to migrate to digital channels and will continue to grow their acceptance of banking services provided by non-banks.
- **Technological Development** – Technology will continue to develop in ways that support the provision of financial services through digital channels. This will go beyond better interfaces (eg apps and mobile devices) to areas like:
    - Big Data analytics,
    - Robo-advice and artificial intelligence,
    - Advanced identification and authentication,
    - Distributed ledgers, blockchain and cybercurrencies,
    - Fraud management and cybersecurity.
- **Regulatory Support** – Regulators will continue to be open to new business models and will not hamper the eCommunities Banking proposition.

A completely new engagement model is emerging in banking, driven by change in technology, customer expectations and the competitive landscape. Many established players, that are strong today may soon be in trouble or even disappear. New business models are appearing that are challenging the status quo by direct competition, dis-aggregation and, in the case of eCommunities, dis-intermediation.

The future will see a combination of old and new, direct and dis-intermediated players defining the banking landscape. It is hard to tell who the winners will be – only one thing is certain: customers will be in control like never before. The challenge for the Regulator is to assess whether this new empowerment will result in better outcomes or simply more opportunities for customers to be taken advantage of.

About Alessandro Hatami

Alessandro is a Managing Partner of Forestreet; an advisory firm focused on helping businesses identify and engage the right partner organisations to design, build and launch innovative digital propositions with.

Before Forestreet, he was the Director of Innovation & the COO of Digital Banking at Lloyds Banking Group. His former roles include Managing Director of PayPoint.net, Director of Large Merchant Services at PayPal and Marketing Director at GE Capital. He is also a mentor at several FinTech startup accelerators and advises a number of businesses and PE firms.

Web:	www.forestreet.com
Twitter:	@ahatami
Linkedin:	uk.linkedin.com/in/aehatami
Medium:	medium.com/@a_hatami