FinTech: The Disruptive Enabler

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Wrap-up report of conference held in Toronto, Canada on 30th November 2016 – Hosted by SWIFT Institute and Ivey Business School's Scotiabank Digital Banking Lab

This event featured speakers from Scotiabank, RBC, BMO, CIBC, TD Bank, Bank of Canada, Payments Canada, World Economic Forum, University of Toronto, University of Delaware, clearXchange, Kabbage and MaRS Discovery District.

Try to picture shopping without credit cards or mobile payment solutions, or managing a self-directed investment portfolio without online brokers or investing apps. Now, imagine needing to vacation with traveller's cheques or visit a bank simply to withdraw cash. The first automated teller machine (ATM) in Canada required customers to use a key, user card and access code just to get their hands on $30. But the ATM's introduction in 1969 was a revolutionary development because it opened the door to 24/7 banking, which meant no more lining up on Fridays to get money for the weekend. Technology has long been the driving force behind improvements to back office and front office banking operations alike, which is why the industry's combined annual IT budget currently tops US$350 billion worldwide. And thanks to this money, along with the US$40-plus billion that has been invested in so-called FinTech ventures since the global financial crisis, it is safe to assume revolutions of banking-sector past will pale in comparison to what is coming.

What is FinTech? There are a variety of answers to that question, but the term essentially refers to innovations in financial technology. Nobody knows exactly how big an impact the current digital wave of FinTech will have on the financial sector over the next two decades. But by 2036, you can certainly forget about regular branch visits or banking at an ATM. In fact, you can probably even forget about using banking apps, according to thought leaders at *Digital Disruption in Financial Services*, a special FinTech event recently hosted in Toronto by SWIFT Institute, the global financial sector's cooperative, and the Ivey Business School's Scotiabank Digital Banking Lab. Assuming cyber security remains manageable, panellists at the 30th November 2016 event predicted the digital world will eventually allow you to bank anywhere at any time without access to a computer or smartphone. Think about all the wasted time you currently spend in traffic. That won't be an issue in 2037, when you will probably travel around with a personalized AI assistant (think Siri, Google or Cortina on steroids) embedded in special glasses or a hat (or in your head). After hailing an automated transport pod to take you to work or out for dinner, your robo life manager will be there to offer advice on investing matters, help you find the best deals on consumer goods or do other productive things like arrange a crowd-sourced mortgage or peer-to-peer loan. As you travel from A to B, you might just earn enough reward credits making transactions to pay for your trip.

"You never know, the cool new thing amongst the kids in 20 years might just be carrying around paper-based bank books," Jesse McWaters, the World Economic Forum's financial innovation lead, told the conference room packed with bankers, tech entrepreneurs, regulators, lawyers and academics. But the future-of-banking panellist also pointed out that the world tends to overestimate changes expected in two years while underestimating the changes that a decade will bring. And so in 20 years, McWaters figures the banking customer experience will be nothing like it is today. Financial institutions, he says, will likely exist below the surface of consumer perception, providing a secure platform for an ecosystem of products and services, including plenty of third-party offerings. And visible or not, banks will not just be in the business of providing financial services and offering market advice. Using a combination of behavioural science, biometrics, transaction data and customer tracking data, financial services firms will exist to offer advice throughout your day. For example, your bank will coach you to be a better spender. “I think that’s a fundamental shift in the way we perceive the role of financial institutions that really could be coming over the next 10 to 15 years.”

Behind the scenes in 2037, blockchain technology will enable distributed ledger systems and digital currency options that will vastly improve payment and settlement systems, reducing industry costs along with consumer frustrations. In the future, for example, consumers will probably no longer receive service calls from bankers with legacy systems that force customers to reveal sensitive account security data over the telephone just so their bankers can check if customer security has been breached. According to a digital survey conducted at the SWIFT Institute/Ivey event, the disruptive potential of blockchain technology was the top area of interest amongst attendees.

When industries are disrupted by technology, a battle for market dominance typically takes place between the old guard and new entrants. Incumbents often lose, especially ones that try to defend leadership positions with business models that are past their best-before dates. Think about what technology did to the music industry. That’s why interest in FinTech has exploded over the past few years. But as explained by Ivey Professor Michael King, one of the directors of Ivey’s digital banking research, there is a false perception, generated by a misquoted McKinsey study released early in 2016, that FinTechs are expected to take away 60 per cent of banking industry income. What the report actually said was that FinTech firms are targeting areas that generate 60 per cent of industry revenue. If truth be told, nobody really knows how the battle for market share will turn out. There will, however, almost certainly be massive disruption to existing business models. But what does that mean? King told the industry gathering to imagine trying to travel around Europe by plane back in 2010, when the volcano Eyjafjallajökull erupted in Iceland, forcing the largest air-traffic shut-down since World War II. Despite that comparison, attendees were still advised not to expect traditional Canadian banks to be universally grounded by FinTechs.

There is no question that financial institutions have proven relatively slow to innovate in the past – even when motivated to do so – thanks to institutional size, long development cycles, heavy procurement processes and legacy systems. When challenged during the dotcom boom, however, the heavily regulated sector also showed significant resilience. As McKinsey noted, “In the eight-year period between the Netscape IPO and the acquisition of PayPal by eBay, more than 450 attackers—new digital currencies, wallets, networks, and so on—attempted to challenge incumbents. Fewer than 5 of these challengers survive as stand-alone entities today. In many ways, PayPal is the exception that proves the rule: it is tough to disrupt banks.” But times are changing. As King pointed out, financial sector resilience partly stems from consumer inertia, especially in developed markets, where banking customers have historically shown little interest in leaving the perceived stability of established brands. And this consumer inertia is being quickly eroded by demographics since millennials are much more open than the Gen X crowd to using non-traditional financial service providers. A reported 53 per cent of millennials already have more faith in tech companies than major bank brands. Meanwhile, expectations of all consumers are on the rise.

Over half of the customer interactions at Canadian banks are already conducted through digital channels. And this is just the beginning. Consumer demands for innovation will continue to grow with the digital economy. Indeed, thanks to the so-called uberization of market expectations, an ever-growing number of banking customers are seeking seamless and on-demand access to services. And as venture capitalist John Sculley, the former CEO of Pepsi and Apple, recently noted when you combine the rising expectations of consumers with the emergence of low cost and reliable new technologies – such as the cloud, mobility, data analytics and the Internet of Things – you get the game changer of all game changers that threatens established players across all industries.

Simply put, the financial sector faces seemingly unstoppable transformative forces better understood by much more entrepreneurial entrants committed to elevating the customer experience to digital world standards. But an all-or-nothing war for market share doesn't appear to be in the cards, at least not between incumbents and FinTech ventures. After all, as pointed out by SWIFT Institute Director Peter Ware, since banks and FinTech firms exist at "opposite ends of the spectrum," they are almost a "perfect match" for strategic partnerships, especially when you consider the additional threat posed by social media companies, cable and telephone providers, and foreign banks looking to move into Canada's lucrative market. "Rather than being a disruptor," Ware told the audience, "I believe FinTech represents an opportunity and an enabler for the financial industry."

When asked about the smart path forward for incumbents and new entrants, "better together" was the consensus of presenters and panellists at the Digital Disruption gathering, the first in a series of local SWIFT events leading up to Sibos 2017 in October, when Toronto will play host to the global financial sector's premier annual conference, exhibition and networking forum. According to Ware, Canada is an ideal location to discuss the future of banking because it has a vibrant FinTech sector that the nation's Big Six banks – which posted combined net income of $34.9 billion in 2015 – are proving increasingly willing to embrace as they devise strategies to bring new innovative solutions to the market. Partnerships between major Canadian financial institutions and FinTech ventures will likely become more common as the disruption process enters what appears to be the last of three phases. "The first phase was FinTech start-ups trying to disrupt," Professor King noted. "The second phase saw banks trying to respond, and the third stage is FinTechs and banks realizing that they need each other."

The SWIFT Institute/Ivey event could not have been more timely. At the time, Bitcoin was well on the way to closing the year by outperforming gold, the monetary system's former anchor, by a big margin. Payments Canada was finalizing plans to update the nation's payments infrastructure and change rules that underpin financial transactions, aiming to meet growing demand for modern payments system that is "fast, flexible and secure, promotes innovation, and strengthens Canada's competitive position."

And as year-end earnings are reported, growing pressure on bank profitability is a major reason why it makes perfect sense for Canadian (and all) banks to embrace FinTech partnerships. FinTech can be seen as a revenue and cost disruptor as well as a revenue enabler, which represents both a threat and opportunity for Canadian banks. Major Canadian financial institutions have been growing earnings by 5 to 10 per cent annually with ROE targets of 15 to 20 per cent. But with Canadian GDP expected to grow at a rate below 2 per cent on average, previous levels of profitability are unsustainable, especially with regulators requiring higher capital levels and rising competition for lucrative revenue streams such as wealth management.

Moving forward, there are various options for banks to maintain high profitability. First, they can use FinTech to disrupt operational costs while making staff more productive. Second, banks can break free of legacy system chains by partnering with FinTechs, using external innovations as a source of competitive advantage to target new customer segments and expand into foreign markets. Third, banks can use FinTech to enable revenue growth in higher margin, less capital-intensive businesses such as wealth management and insurance. Using FinTech applications these businesses can be scaled more rapidly while profitably providing a much higher level of customer service. To thrive in the future, bank revenues may have to suffer in the short term. Building a robo-advisor business, for example, can cannibalize existing wealth management revenues. But to be a strong player in the future, it may be wise to keep this revenue in-house rather let it go to FinTech companies.

What do FinTech's get out of partnerships? As pointed out by Dinaro Ly, Director of MaRS Discovery District, a Toronto-based FinTech cluster, anyone looking to easily disrupt financial services really doesn't really understand the industry's regulatory challenges and other significant barriers to entry, not to mention just how difficult it is to scale a consumer business. But he says "the majority of FinTech ventures that we work with understand the dynamics, so it's never been about stealing business. The easiest way to gain traction as a FinTech, he says, is figuring out innovative ways to help players with scale better address tech issues and service gaps that currently exist at the enterprise level.

As Professor King noted, there was once a lot of euphoria about peer-to-peer lending, but sources of funding have now dried up, which is a classic problem for start-up banks. "I'm not saying that I don't believe in them. I just think that there's been too much hype over the threat to traditional brands. There are a lot of obstacles that FinTechs must overcome. The clear answer is for them to partner up. And I think that is what we're seeing."

Peter Steger, head of business development at Kabbage, explained the logic behind the "better together" philosophy that was presented by one of the other panellists by outlining the bumpy evolution of his employer's international growth strategy. Founded in 2008, the U.S.-based company set out a few years later to expand into the U.K., where it expected to apply for a lending licence and then simply go it alone as a small business loan provider, attracting customers with the firm's unique automated platform that doesn't force potential clients to wait for a lengthy investigation of their financial histories before getting an answer. But then Kabbage started running into unexpected roadblocks. British regulators, for example, asked, "Where are the British citizens that are going to be part of your board?" There were no British employees on the small company's payroll. The continued regulatory challenges and differences that existed in the UK market forced Kabbage to take a step back and ask itself, "What is our core competency?" The answer wasn't marketing banking products or following regulations. It was data and technology.

However, while partnerships between FinTechs and banks may seem like the ideal way forward, conference attendees were told significant changes need to take place to help foster them. Developing joint ventures is extremely challenging due to the risk-adverse nature of banking culture and inflexible procurement rules. After all, working together requires getting together and current procurement and sourcing processes can actually keep FinTech founders with brilliant ideas from even getting to participate in an RFP issued by the conservative banking sector. In many cases, it is easier for a bank to buy a start-up than partner with it.

Technological innovation in financial services is clearly required to support economic growth in the digital age, which is why Canadian Banks are working on disrupting themselves internally as well as forming external partnerships. But while banks can innovate internally, they cannot fully replicate the entrepreneurial culture that exits at start-ups, which is precisely why banks are also partnering with FinTechs.

To lead the world in financial-sector innovation, Canada needs a thriving FinTech ecosystem. As things stand, financial sector innovation in this country is supported by a tech-savvy population, a stable and secure financial system, a high-concentration of banking institutions, a large pool of talent and high-living standards. But our FinTech sector is not as advanced as in other markets. In China – where social networking giants Alibaba and Tencent offer super-apps providing multiple banking services – FinTech ventures already have more customers than traditional banks. And jurisdictions such as the United Kingdom, which aims to lead the FinTech revolution, clearly provide better industry funding from both the public and private sector. On the policy front, Canada is also lacking in initiatives directly aimed at boosting innovation in financial services. In October 2015, the European Parliament adopted the revised Directive on Payment Services (PSD2), which promotes the development of innovative online and mobile payment solutions by forcing banks to grant third-parties access to “industry plumbing” via public application programming interfaces (APIs). Outside the industry, this may not sound like a big deal. But as the FinTech Finance website noted, companies such as Google, Apple and Facebook use public APIs to allow third parties to add functionality to their core offering, so PSD2 “is in fact a first step towards what could be referred to as banking-as-a-platform.” Other countries – including Australia, which has similar market dynamics to Canada – are now looking at following the EU’s lead on open APIs.

If Canada wants to be a FinTech leader, the market clearly needs to play catch up, which is why Professor King concluded the SWIFT/Ivey event calling for a national FinTech champion that can proactively promote investment and encourage collaboration between traditional players and new entrants while also ensuring that the traditional focus of Canadian regulators on market stability and customer protection doesn’t stifle innovation.