The Future of Banking Profits:

Innovation Decisions for Retail and Commercial Banks

January 2016

Why did:

- JPMorgan Chase partner last month with small business lender OnDeck Capital;
- Citigroup, Goldman Sachs, and others increase their venture investment in young FinTech companies over the past 2 years; and
- American Express open a technology lab in Silicon Valley?

Customers and competitors are forcing traditional banks to accelerate innovation. In both services and delivery, innovation enables banks to remain relevant and retain primacy with their retail and commercial customers. Innovation also enables banks to compete with incumbents and non-traditional players.

Bank margins face new pressures in the long term

At their core, banks have been a major driver of both developed and developing economies. Bank lending enabled consumer spending and business investment. Banks facilitated payments. Banks provided savings options and other financial services to a variety of customers, from individuals to businesses and municipalities.

Of course, banks still do all of these things today and will do them for the foreseeable future. But in the absence of innovation, the past tense emphasizes that Tech brands could become the primary intermediaries with "banking" customers.

For years, banks have been dealing with an already difficult environment for interest rates and regulation. If banks are relegated to the background and commoditized, they would face further pressure on margins and related metrics like ROA and ROE.

Customer preferences are changing

In every industry, customers evolve in their behaviors and corresponding needs. Customer evolution is driven by a host of factors, including the economy and technology. In the media industry, customer adoption of cord-cutting alternatives is challenging the business models of incumbent cable giants. In equity brokerage, mass-market customers found low cost, transparent stock trades outside of the large brokers.

"In retail banking, broad advances in consumer technology have created new expectations"

In retail banking, broad advances in consumer technology have created new expectations, such as on-demand financial services. Bank customers want efficiency, convenience, ease-of-use, and a breadth of options - all whenever and wherever they want to transact. In dozens of developing countries, populations are using smart- and feature-phones to access mobile money accounts, which don't need a bank account. For example, the majority of Kenyans use M-PESA for just about any purchase, bill payment, or peer-to-peer transfer. Will younger generations in developed economies, like America's "millennials," use banks as their parents do?

Consumers increasingly use mobile phone apps for payments. With the so-called "internet of things," consumers can also make payments with their wearables and other connected devices. Of course, broad access is critical to banks, as are the associated security requirements.

Digital currencies, like bitcoin, promise simplified and low-fee transactions. But given bitcoin's persistent speculation and volatility, risk-averse consumers may ultimately rely on banks to implement the underlying blockchain technology for a distributed and encrypted database to transfer standard currencies. Such an innovation would also address another large mobile opportunity: low-cost money transfer across borders.

Borrowers, who were traditionally bank customers, faced tightened credit post-crisis and turned to lending alternatives. Peer-to-peer lending marketplaces connect borrowers and providers of unsecured loans. Small businesses seeking more efficient approval and convenience found other non-traditional lenders that use technology, including Big Data algorithms, to improve their credit underwriting. Since this data is usually publicly available, such processes are replicable by banks that choose to invest in operational efficiency and favorably weigh the quick turnaround times against their standard credit approval process.

"banks must reconsider their strategy and investments in everything from product mix to retail and digital distribution."

Overall, as a result of evolving customer preferences, banks must reconsider their strategy and investments in everything from product mix to retail and digital distribution.

Competitors extend well beyond rival banks

Historically, industry rivalry was between financial institutions. Direct competition increased the importance of fee-based services and led to consolidation. Traditional banking infrastructure supported a large physical presence and regulatory compliance of processes. With such investment, incumbent banks erected major entry barriers, including physical and capital scale, long-standing customer relationships, and proprietary data for risk management.

Today, the competitive landscape and financial services ecosystem includes non-banking players like consumer technology brands, telecoms, a wave of start-ups, and other technology vendors of financial services (FinTech). These firms produce enabling technologies – transaction processing, low cost data & analytics, alternative modes of lending and payments, connectivity, etc. They own the technical intellectual property (IP) underlying these technologies. And through the introduction of new products, these firms are at least partially responsible for changing customer preferences.

"Non-banking players enjoy other advantages…less encumbered by regulatory restrictions…"

Non-banking players enjoy other advantages. Their flexibility is less encumbered by regulatory restrictions and capital structure requirements. They have lower overhead relative to the traditional bank distribution system and the associated occupancy expenses of its branch networks. As previously mentioned, telecom operators and mobile money accounts in developing countries have filled the void in traditional banking and payment services because the required bank infrastructure is not economically viable.

In terms of brand intangible assets, most end consumers are unaware of merchant and payment service providers like First Data. But consumers are engaged with other non-banking brands. Alternative lenders Prosper and Lending Club have amassed nearly $10B in issued loans over the past 8 years on their peer-to-peer platforms. Nonbank lender Social Finance (SoFi), which recently raised $1B in private capital, began with student loan refinancing and has expanded to mortgages and personal lines. For further proof of brand recognition, the crowded mobile peer-to-peer payment space includes Square, PayPal, Facebook, and others.

Perhaps the most competitive segment is mobile wallets, which serve as the digital front-ends of legacy credit and debit cards. Large consumer technology companies like Apple and Samsung made major product introductions in the past year. In China, established Tenpay and Alipay will now compete with the Apple Pay's near field communication (NFC) product after Apple partnered with the state-controlled UnionPay, which controls payment cards in China.

Ultimately, a mobile wallet needs to offer an integrated solution for merchants and seamless experience for consumers. Adoption is a large hurdle, as evidenced when large merchants like Walmart, RiteAid, CVS, Lowes, 7-Eleven, and Best Buy disabled NFC and Apple Pay. Of course, retailers prefer to avoid unnecessary intermediaries and associated credit card processing fees. With their own mobile payment system, retailers can improve their slim margins by processing payments from checking accounts and store credit cards. Several big names have formed a joint venture to introduce their own mobile payment app: CurrentC. And Walmart has gone a step further in announcing its Walmart Pay service as a feature in its existing app. Growing merchant leverage also manifests outside of mobile, such as Costco's recent dissolution of its exclusive deal with AmEx.

"Although FinTech and other players possess valuable IP and manage it effectively, incumbent banks own the complementary assets"

To be clear, banks do not face imminent extinction. Although FinTech and other players possess valuable IP and manage it effectively, incumbent banks own the complementary assets - customer relationships, well-known brands, proprietary data, and costly-to-replicate infrastructure (distribution). The most threatening new entrants would offer a menu of bank-like services, not just a small piece disintermediated from a large bank's one stop shop.

Banks must weigh trade-offs

Adapting to the changing customer and competitive environment revolves around a number of questions. Only one question is easy to answer: is "do-nothing" a viable option? No.

Then how should banks innovate? In what area(s) should they innovate, partner, acquire, or incubate? Some recent actions by large banks hint at their strategies for partnering and investment:

- JP Morgan Chase partnered with OnDeck Capital last month. While JPM brings its relationships, experience, and scale, OnDeck provides a small business lending platform and the OnDeck Score to serve its small business customers. In his annual letter to shareholders, JPM CEO Dimon discussed nimble startups "We are going to work hard to make our services as seamless and competitive as theirs. And we also are completely comfortable with partnering where it makes sense."
- Deutsche Bank announced its investment in digital products and services by opening three technology innovation labs in Europe and America. DBK is partnering with IBM in

Silicon Valley, HCL in London, and Microsoft in Berlin, in addition to engaging with academic institutions on new technology evaluation.

- Barclays partnered with TechStars on an accelerator program in order to give the large bank more exposure to small, innovative companies.
- In 2014, both Santander and HSBC announced the launch of $100M and $200M funds, respectively. The banks provide capital to early stage FinTech companies and the banks gain know-how.
- Several banks plan new consumer-centric technology introductions. For example, Wells Fargo announced its roll-out of biometrics in 2016 using 2-factor authentication of voice and image scan to provide more efficient security.

"For long-term impact, banking innovation is about establishing a distinct position for the future"

In the short term, banking innovation might target operational effectiveness, like improving credit processes. But as in all industries, continual improvement is just the foundation for satisfying customers and competing profitably.

For long-term impact, banking innovation is about establishing a distinct position for the future, based on today's choices. By definition, these choices force trade-offs and prioritization of opportunity and risks. With a thoughtful innovation strategy, whether that innovation is bought, partnered, or internally generated, banks can maintain and grow profitability in a rapidly changing environment.

About ipCapital Group

ipCapital Group (ipCG) is an innovation and intellectual property (IP) consulting firm serving clients that range from early stage to Fortune 500 in over 900 engagements since 1998. For more information, visit www.ipcg.com, or contact Adam Bulakowski at abulakowski@ipcg.com.