

# Banking and the E-Book Moment

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Cast your mind back to 2007, the year that saw the launch of the first-generation Kindle. At that time e-readers were widely available in electronics stores but there was no real indication that a revolution was about to sweep the publishing industry. The merits of the e-book were widely discussed by book buyers, but the printed word still reigned supreme – digital consumption was very much a minority sport.

Fast-forward to the present day and both readers and publishers are in a very different place, and sales of e-books have rocketed. According to figures published by Statista,<sup>1</sup> the US digital book market was worth just US\$0.27 billion in 2008, but by 2015 that figure had risen to \$5.69 billion. Physical book sales haven't collapsed; what we have seen is digital publishing taking a rapid route from the periphery of public consciousness to the mainstream in less than 10 years. The e-book is now part of our lives. It's a journey that reflects the willingness – and eagerness – of consumers to embrace convenience even where this is made possible by complex new technologies, delivery channels, and business models. And this journey is currently being echoed in the financial services industry.

## The Shifting Financial Landscape

The world's major retail banks still dominate the financial services landscape, providing the deposit, payment, and credit facilities that we all use and take for granted, but they are no longer the only players in town. Today's online shopper might pay with a debit card but equally they might choose PayPal. The business that would once have relied on its bank for credit can now borrow from peer-to-peer (P2P) platforms or specialist lenders. And digital banks are vying with their bricks-and-mortar counterparts for customer deposits. It's all about access and convenience.

<sup>1</sup> Revenue from e-book sales in the United States from 2008 to 2018 (in billion US dollars), <http://www.statista.com/statistics/190800/ebook-sales-revenue-forecast-for-the-us-market/>.

As alternative finance gains traction with customers, FinTech is approaching its e-book moment – the point at which a critical mass of consumers and business customers see the technology-driven solutions offered by new players in the marketplace as a viable – and often preferable – alternative to the services offered by incumbent banks.

The implications for the traditional banking industry are immense. Developments in FinTech have the potential to erode the brand equity of the incumbent players and eat into market share. But banks also have an opportunity to embrace FinTech innovation and offer new solutions to their customers.

## An Unfinished Revolution

Anyone seeking evidence of the potential market power and reach of technology-driven finance providers need look no further than the now venerable PayPal. Launched in 1998, the company was taken over by eBay in 2002 and became the default payment system across all of the online auction operator's international sites. Since then PayPal has expanded its offering and it now sits alongside debit and credit cards as a payment option on an ever-increasing number of e-commerce sites. Whether that online performance will translate to dominance in face-to-face transactions remains to be seen. Today, the company boasts more than 100 million active accounts and processes an average of US\$315 million in payments every day.<sup>2</sup>

The payments market is evolving fast and this evolution will chase convenience, speed, and data collation. Witness the initial success of Apple's contactless payment system Apple Pay, which allows consumers to purchase and pay for goods and services simply by placing an iPhone 6 in proximity to a point-of-sale terminal. Apple Pay is just launching in the UK, but it currently accounts for US\$2 out of every \$3 processed by contactless systems in the US.<sup>3</sup>

One of the single greatest obstacles is ubiquity – the consumer can be faced with a myriad ways to pay. We are now witnessing a global wave to introduce 24/7

<sup>2</sup> Paypal Company Statistics, <http://www.statisticbrain.com/paypal-statistics/>.

<sup>3</sup> Bloomberg, "Apple Sees Mobile-Payment Service Gaining in Challenge to PayPal", 28 January 2015, <http://www.bloomberg.com/news/articles/2015-01-27/apple-sees-mobile-payment-service-gaining-in-challenge-to-paypal>.

real-time bank account-to-account transfers in all the major jurisdictions. This shift, coupled with regulatory reform, will create opportunities for new players to enter the market and provide data aggregation services and payment initiation options to give life to the Internet of Things revolution.

The use of pre-paid cards is also on the rise. A 2012 report from MasterCard<sup>4</sup> predicts that the market for so-called e-money (cards pre-loaded with cash) will be worth around £822 billion by 2017. If these numbers are impressive, they represent only the tip of the FinTech iceberg.

Borrowing and depositing is also undergoing something of a revolution, thanks in no small part to the emergence of P2P lending platforms. In the UK P2P lending emerged shortly before the financial crisis with the launch of Zopa in 2005. Other platforms such as Funding Circle and RateSetter followed. To date, the industry has lent a cumulative figure of £2.6 billion and the market is growing. Lending in the first quarter of 2015 came in at £459 million, an increase of one-third on the previous three months.<sup>5</sup> These figures are small when compared to the sums advanced by the big banks but it is a young and rapidly growing market.

Importantly, the P2P market not only provides businesses and private borrowers with a source of cash, it also offers investors and savers a place to deposit cash and earn higher interest rates than in a conventional bank account. Elsewhere, challenger banks – some of them digital only – are also moving in on the deposits market.

Some aspects of FinTech innovation remain well outside the mainstream. Digital currencies, such as bitcoin,<sup>6</sup> potentially offer an opportunity and means to exchange value, but most would agree that the real value will emerge from the application of the supporting distributed ledger technology. The use of the distributed ledger brings additional value in the recording of non-financial asset ownership and, coupled with digital currency, could provide a platform for future

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<sup>4</sup> 2012 Global Prepaid Sizing Study, commissioned by Mastercard: A look at the potential for global prepaid growth by 2017, <https://www.partnersinprepaid.com/pdf/a-look-at-the-potential-for-global-prepaid-growth-by-2017.pdf>.

<sup>5</sup> P2P Finance Association, "Strong Growth Continues in Peer-to-Peer Lending Market", 30 April 2015, <http://p2pfa.info/strong-growth-continues-in-peer-to-peer-lending-market>.

<sup>6</sup> For more information on crypto-currencies, blockchain technology, and bitcoin, see Part 9.

innovation to reduce costs and speed up transactions. Effective regulation of this environment is required to reduce risk for all participants.

Move away from the corporate face of FinTech innovation – PayPal, Apple, Google, et al. – and thousands of companies are working in technology hubs around the world on ways to make familiar activities such as stock trading or money transfers not only more convenient, but also more attuned to the way consumers use their smartphones, tablets, PCs, and smart watches. This wave of innovation is not only coming from established FinTech centres but also from emerging hubs. For example, Johannesburg has become a centre for bitcoin development, while across Africa entrepreneurs are developing mobile-based banking and payment systems appropriate to the local telecoms and financial services infrastructures.<sup>7</sup>

## The Challenge to the Banks

So how will financial institutions – and particularly the big banks – respond to this wave of FinTech innovation? The banking sector is vulnerable to disruption, partly as a result of recent history. Until the onset of the financial crisis, banks enjoyed a degree of public trust that was crucial to their brands. Although that trust hasn't been entirely eliminated, it has certainly been eroded. As a study by the CCP Research Foundation revealed in June 2015, the world's top sixteen global banks have, between them, incurred US\$306 billion in conduct-related costs since 2010.<sup>8</sup>

In contrast, the leading lights of the digital era tend to be viewed positively. Research carried out for the Millennial Disruption Index report found that 73% of respondents (teens to mid-thirties) would be much more excited about a new financial service delivered by Google or Apple than one announced by their incumbent bank.<sup>9</sup> In that respect, traditional financial service providers are at risk. Customers no longer necessarily see the bank as the default provider or first port of call – what's out there in the market is more exciting. And what's out there in the market is trading heavily on the toes of incumbents. So, while individuals and businesses will always need banking services, will they still need banks?

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<sup>7</sup> For further insights regarding emerging and established FinTech hubs, see Part 3.

<sup>8</sup> Financial Times, "Banks' Post-Crisis Legal Costs Hit \$300bn", 8 June 2015, <http://www.ft.com/cms/s/0/debe3f58-0bd8-11e5-a06e-00144feabdc0.html#axzz3eT1XUB4B>.

<sup>9</sup> Millennial Disruption Index, <http://www.ritholtz.com/blog/2015/04/millennial-disruption-index/>.

At the most simple level, retail banks provide three crucial functions, namely:

- They take deposits and provide customers with a secure place to store cash and earn interest, backed by deposit insurance and significant regulation.
- They facilitate payments through a range of systems, including cash, cards, and transfers.
- They lend money.

To a financial services agnostic the same services can be provided by the new generation of technology-driven challengers. In terms of retail banking, money can be deposited with challenger banks, placed in pre-paid cards, stored in PayPal accounts, invested in bitcoins, or invested through P2P lending sites.

Credit is available from challenger banks and alternative lenders (including P2P), and customers have an increasing choice of payment options, including PayPal, e-wallets, and phone-based systems. While many of these options still use the plumbing of the banking system, in the medium term we may see payment and foreign exchange mechanisms that completely bypass the incumbent banking systems.

## The Utilities Risk

So the major risk for the incumbents is that they come to be perceived as utilities that do little more than supply the infrastructure while the FinTech companies take the credit for providing innovative consumer-friendly services – and ultimately own the customer relationship. When this happens, the brand equity of banks will surely take a hit.

Unlike the major banks who are often constrained by legacy IT systems and operating models, the new players have designed their digital services from the ground up to meet the needs of specific customer groups. FinTech challengers can be both agile and completely focused on positive customer outcomes.

While traditional banks are dealing with increasing layers of compliance, consumer protection, and their own bureaucratic structures, P2Ps have a transparent approach to borrowing and lending, based on disclosure by the company seeking credit, and assessment by the community of lenders (rather than faceless credit

committees). This approach speaks to a generation raised on social media and these lenders regularly score high on customer satisfaction. Equally important, P2P sites have lower operating costs than banks and the capital requirements they face are also lower.

## The Future for the Banking Sector

BBVA chairman and CEO Francisco González forecast in early 2015 that up to half of the world's banks will disappear through the cracks opened up by digital disruption of the industry.<sup>10</sup> That may be so, but I would argue that the most forward-looking banks will not just survive the wave of digital disruption, but will thrive, as these FinTech-driven challengers gain momentum. The world's major retail banks enjoy huge advantages, not least in terms of their collective customer base and the data they hold on their clients. These “thrivers banks” will migrate the majority of their customers to their own digital banking services. They will reposition themselves in the value chain from being a provider of infrastructure and product, to being at the heart of the customer relationship in a secure and holistic digital environment. In effect, they will become financial app stores showcasing a range of financial solutions from different providers. In doing so, they remain relevant to customers as a single source for the best global financial solutions.

So, in the future, once I have logged into my mobile bank (presumably using heart biometrics or face recognition) I will be able to borrow money P2P via Ratesetter, make an international payment using Transferwise, top up my Starbucks e-wallet, or make a deposit into my Alibaba money market fund. In order to achieve such a goal, collaboration will have to become the norm. Corporate incumbents can't match the speed to market and the ability to innovate that the best FinTech developers bring to the table. So, rather than trying to reinvent the wheel by developing their own solutions, banks will have to work with innovators to bring new services to their consumers.

From start-ups working in shared spaces in London's Tech City or Johannesburg, to the corporate giants such as Apple and Google, FinTech is a dynamic sector. But while market leaders have emerged, no one really knows where the next successful payment system or bitcoin wallet will come from. And for all those ideas that make it to the market, many others will fail. The services that succeed will be those that

<sup>10</sup> Half of the world's banks set to fall by the digital wayside – BBVA, <http://www.finextra.com/news/fullstory.aspx?newsitemid=26965>.

genuinely make life easier, perhaps by mixing FinTech with other technologies. The bank of the future could be a place to deposit not just your money, but other valuables – for example, your medical records, your will, or the biometric data used to start your car.

With their customer base and experience in securely handling data, banks are in an ideal position to create holistic customer solutions that combine financial services with a wider range of digital offers. It could be the key to their future prosperity.