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Why partnerships are appealing

The chairman of Credit Suisse explains how digital innovation may lead to unexpected outcomes.

by Urs Rohner

Digitization has the power to transform whole industries—not least banking, where technological innovation is among the forces behind the recent wave of profound change. Incumbents have been busy rebuilding the financial system and complying with new rules and regulations in the wake of the 2008 financial crisis. Meanwhile, fintech start-ups have moved swiftly from the sector's periphery toward its core. In 2015, global investment in fintech companies totaled nearly $20 billion,[1] confirming a continued interest within the venture-capital community and a growing appreciation among incumbents of the sector's importance (exhibit).

The process of disruption tends to have a calm beginning followed by a storm of profound change. The basic proposition is usually both simple and powerful: a previously exclusive service becomes available to a broad user base in a more customer-friendly way. Most important, it is offered for a fraction of the original price. At this point, incumbents typically either go into denial about the customer's desire for a better product or service or question the competitors' ability to generate sustained profits in a lower-margin environment.

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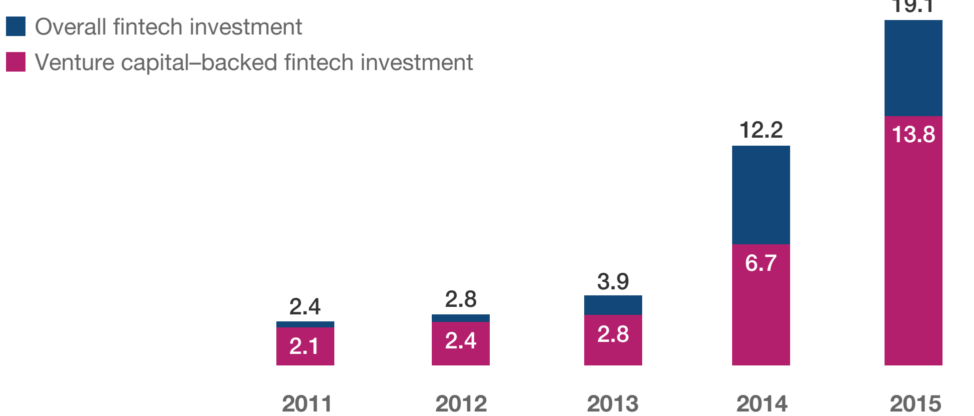
[1] *The Pulse of Fintech, 2015 in Review*, KPMG and CB Insights, kpmg.com.

Exhibit

Venture capital–backed fintech companies accounted for nearly three-fourths of overall fintech funding in 2015.

Investment in fintech companies,[1] $ billion



Number of deals	457	607	759	933	1,162
	298	397	484	587	653

[1]Fintechs are financial-services businesses, usually start-ups, that use technologically innovative apps, processes, or business models; investment data include angel/VC investors, private-equity firms, mutual funds, and corporate investors.

Source: CB Insights; *The Pulse of Fintech, 2015 in Review*; KPMG

As we have seen recently in the music, photography, and mobile-phone businesses, standing back from the action can be fatal. Cautionary tales from these sectors have helped clarify the challenge for many banks. Although time will tell which of the banking sector's structures remain intact, I contend that disruption is more likely to open up new segments for partnerships between start-ups and incumbents than to usher in an era of head-to-head competition.

INNOVATION IN PAYMENTS

So far, the most significant signs of disruptive innovation in financial services have appeared in payments and lending. Traditionally dominated by a handful of established players, these two areas are now home to more than two-thirds of the world's fintechs valued at above $1 billion, also known as "unicorns." Incumbent banks, arguably, are not investing enough to retain their leading position. For reasons I will explain below, I believe the willingness and the ability of both the incumbents and the newcomers to collaborate will, to a large degree, determine each side's chances of longer-term success. For the moment, apart from a handful of high-profile but modestly performing IPOs, acquisition by established players is probably the most attractive mode of exit for payments fintechs. But different partnership models are developing.

That's not to say the outlook for incumbents is straightforward. Consider mobile points of sale, one of the next major areas for innovation in payments. A multitude of young businesses, such as San Francisco–based Square, are developing solutions to execute and document mobile and tablet merchant payments. This is not only changing the world for small businesses and virtually all merchants in low-margin segments but also affecting the development of hardware and end-user software. Moreover, retail banks under pressure from tech providers competing for market dominance face considerable uncertainty as to which technology to invest in.

CROWD-BASED FINANCING

Just as disruptive as what's happening in payments, albeit less successful in business terms, has been crowd-based lending and financing. It's not hard to see why this space has immense innovation potential: after all, the legacy of bloated back offices and often-underinvested big data capabilities puts a major restraint on incumbent capital intermediaries. Although know-your-client provisions will probably become a bigger issue for challengers in future, LendingClub, the current market leader in peer-based lending, spends much less on credit scoring, billing, and overall compliance than established players do. But it also spends more than the average retail bank on attracting new customers and about as much as other lenders on technology.

As some banks try to reduce their balance-sheet exposure to the small- and midsize-business segment, the fintechs' lean credit-assessment approach and lending services start to look attractive. Collaboration with fintechs could become desirable. In my view, that helps explain why crowd-based fintechs have attracted substantial attention from investors, despite their failure so far to deliver meaningful profits. According to recent industry reports, lending attracted $3.6 billion of investment in 2015, and the aforementioned LendingClub raised just over $1 billion in the largest fintech IPO of 2014. The *Madden v. Midland Funding* case, though, raised a question mark over the future of certain securitization practices behind unsecured consumer loans in the United States, and LendingClub shares lost half their value and have since been largely trending downward.

We also have yet to see the impact of LendingClub's announcement that it would mimic the Federal Reserve's benchmark interest-rate decisions, including the 0.25 percent increase from last December. Overall, I see great possibilities for companies like LendingClub—but risks too, as they must address significant business and compliance issues before they can live up to their full potential.

CHALLENGES THEY POSE, CHALLENGES THEY FACE

Besides being challengers, fintechs face several hurdles of their own. Some stem from the current hostile market environment; others are less predictable. Take the aforementioned crowdfunding space and one of its most promising areas, corporate funding. This particular segment was recently encouraged in the United States—in every respect the world's largest crowdfunding market by far—thanks in part to a decision of the Securities and Exchange Commission to let small businesses raise up to $50 million from the general public, in connection with the JOBS Act.

Such mini-IPOs could be a first step toward challenging and ultimately disengaging key players in the investment-banking business. But regulators are alert to the dangers of exposing private consumers to complex risks. Germany, for example, recently introduced a law capping the ability of private investors to participate in equity crowdfunding at €10,000, on top of several income-related restrictions. Further jurisdictions may follow with similar investment constraints.

Most fintech innovators, meanwhile, would appear to enjoy the advantage of not owning a bank license. In my view, that could become a major limiting factor. For instance, consider legislation against money laundering in relation to virtual currencies, which help facilitate borderless, cost-efficient transactions. The absence of regulated intermediaries reduces the likelihood that money laundering or terrorist financing will be identified and reported.

Regulators have zero tolerance for noncompliance with rules against money laundering by anyone, licensed banks or otherwise. In 2015, for example, the fledgling crypto-currency provider Ripple was fined $700,000 by US authorities for, among other violations, failing to report suspicious transactions, and further cases are likely to follow. The recent investigations into several fraudulent peer-to-peer lending platforms in China raise further serious questions about this young business's level of regulation.

Besides regulation, innovators face other challenges. One, paradoxically, relates to their core strength: the focus on specific customer pain points. As a result, they often try to solve one—but not more than one—issue. A singlevalue model may be superior in itself but doesn't even come close to revealing a client's full financial situation. For truly focused innovators, acquiring additional know-how or extending the value proposition is rarely an option. Multiservice providers, such as universal banks, may not be the innovation leaders in every piece of the value chain. But they are at an advantage in developing a comprehensive understanding of a client's situation and the capabilities required to meet the client's financial needs.

Issues like these in no way call into question the massive wave of disruptive banking innovation, which has already benefited customers and enriched the industry in countless ways. Some of the challenges the innovators face, though, are embedded deeply in their business models. They will doubtless continue to compete with banks in some areas, while relying on and working with them in others. But from my perspective, collaboration will ultimately prove an extremely promising proposition, allowing incumbents to reduce their mounting cost pressures and increase their operating efficiency, while helping the newcomers to remain a part of the big picture in the long term. Q

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