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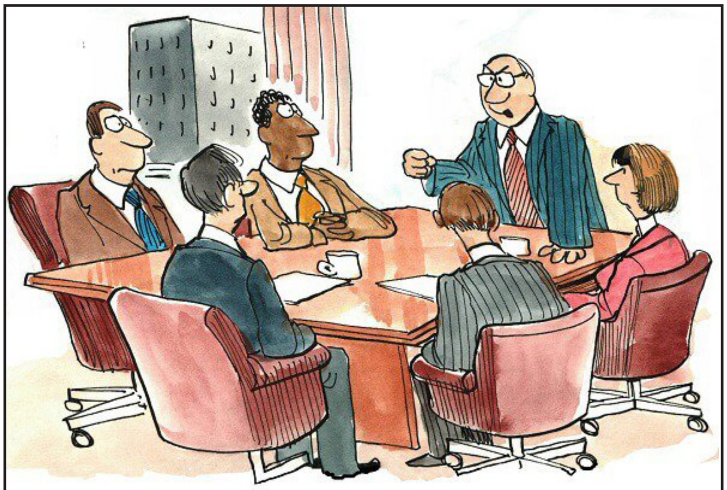
Financial Services

FINANCIAL INDUSTRY DISRUPTION CONTINUES… IS CHINA THE MODEL?



"I don't want to change. I want all of you to change!"

"Are you interested in helping us disrupt an entire industry?" reads Amazon's latest job postings query. Which industry now, Amazon? Financial services. Having already disrupted books, bricks-and-mortar retail, groceries, cloud computing, television distribution, prescription drug delivery and then some, Amazon is hiring again, seeking those with financial-industry experience to help further remake that industry as well. The irony this time may be that Amazon is already lagging in an industry that has been restructuring for the better part of five years. What is happening now to cash, payments, lending and consumer financial services, even before Amazon's ramped up efforts to "disrupt an entire industry"? (*Financial Times, 6/16/19*)

TAKEAWAYS

- For five years, the financial industry has been going through a restructuring process. As digital natives start to control more money and assets, this process will quicken.
- Many of the upstarts of digital finance, or "fintech," align with characteristics of the digitally trained consumer, featuring the speed, convenience and anytime-anyplace capabilities increasingly sought by consumers.
- In Western countries, including the U.S. and Europe, many legacy financial systems remain in use, but the number of digital alternatives is growing, coming not just from digital upstarts but also from within some of the legacy financial providers and banks themselves.
- In China, due to the "skip a step" nature of their emerging and innovating economy, most consumer and many business financial transactions are already conducted via digital, mobile payments, and an entirely digital-first industry of financial services has arisen in their wake, which may present a model of the ongoing transition in the West.

IMPLICATIONS

- Chinese digital payment and financial services make inroads into Europe, as well as already targeted emerging markets. Other Western economies are in their sights.
- Credit-card companies will experience increased competition from other forms of payment, which, in the long term, may force them to cut transaction fees and do away with many consumer rewards programs.
- Traditional financial services will find that barriers to entry are falling and that their fields will experience increased competition. They may either have to buy upstarts (akin to Walmart buying Jet.com) or develop innovative experiments and new workforce cultures of their own to succeed as digital-first services.
- Lower fees and tighter margins will become commonplace across the sector.

The Great Restructuring Continues for Financials

In a 2014 *inFocus* we made note of the Great Restructuring that had been impacting and that continues to impact several sectors of the economy: "Many industries are experiencing heightened and frequent disruptions, often stemming from innovations in their fields, falling barriers to entry, transgressions into those markets by former non-competitors, oversight and regulation from government and, in some cases, wholesale sea changes that seek to reinvent the entire business model of the industries." We further noted that the financial services industry was becoming the next victim of such disruptions. (See **inF 917**, "Escalating Disruptions in the Financial Sector," 12/1/14)

From Cash to E-Money

Such disruptions continue, and China may offer a model. In recent years, with the country's penchant for practicing Skip-a-Step development, or "leapfrogging" legacy infrastructure and technologies, China has become an early exemplar of how legacy industries in the developed economies might get disrupted by new ways of operating – a reality that has come true in terms of financial services. As many tourists visiting China now discover to their dismay, many businesses and vendors won't take cash at all, or bank-issued cards, only accepting payments through barcode-scanning mobile-payment apps like Alipay (a service of Ant Financial, affiliated with Alibaba) and WeChat (a service of Tencent). As of 2018, the annual volume of mobile financial transactions conducted in China stood at \$41.5 trillion (277 trillion yuan), 28 times more than five years ago, with 90 percent of the market controlled by Alipay and WeChat. Building on their mobile-payments platforms and consumers' familiarity with treating money as a digital store of value, both Alibaba and Tencent now also provide a full suite of financial services to customers, including savings accounts, personal loans, small business loans, money market funds and investment products – all without the need for physical branches or the handling of paper money. (*Caixin*, 3/22/19; *Pymnts*, 2/5/19, 3/7/19, 3/21/19)

Recently, at least one Western institution figured out how to tap into China's digital-first market for financial services. By linking its Chinese joint venture, Invesco Great Wall, into Alipay's money management app, Invesco has seen a sudden \$14 billion intake of new capital from Chinese consumers using the app. (*Financial Times,* 5/21/19)

The question remains: Where is the West in terms of a similar restructuring of the financial services industry? It may already be further along than the exemplar of disruption, Amazon, would like it to be in order to lead such changes. While electronic forms of money are not yet as common in the U.S. as in China, we have reached the point at which 49 percent of Americans do some amount of banking on their phones. Meanwhile, some 60 percent of U.S. bank customers say they are willing to try a financial product from a tech firm they already use, and that figure rises to 73 percent for those aged 18 to 34. (*Economist*, 5/4/19; *CB Insights*, 8/23/18)

As in China, a move (albeit it much slower) to a cashless economy can facilitate other innovations in how money is handled. Sending friends and family money or paper checks is increasingly being replaced by the use of peer-to-peer (P2P) e-money services. In the fourth quarter last year, Venmo recorded an 80 percent year-over-year increase in transaction volume, to \$19 billion, and as of the first quarter it had 40 million active users. Together with its parent company, PayPal, the company processed \$39 billion in P2P payments in the fourth quarter. However, many e-payments are not peer-to-peer, but rather from consumers to business (C2B), such as consumers paying for goods on eBay using PayPal. With this C2B figure included, PayPal saw

"I'm just checking my balance..."

a payments volume of $163 billion in the first quarter of this year, generated from 277 million accounts. (*Pymnts*, 4/24/19, 4/25/19)

One important implication of a move to alternative payments systems, like those of PayPal, is that they can be used to sidestep traditional credit cards, by drawing directly from consumers' digital-savings balances or from their traditional checking accounts using the Automated Clearing House (ACH) system. In the push to go cashless, some retailers are building payment methods directly into their apps, many of which use or promote the use of ACH to bypass credit-card companies (and their hefty merchant fees). Bypassing such credit-card fees can enable merchants to offer deals and discounts directly to customers, much as credit-card companies do now with their reward and cash-back programs. For instance, Cumberland Farms charges 10 cents less per gallon of gasoline for customers paying with the company's SmartPay app. Starbucks, meanwhile, tries to bypass credit-card expenses by encouraging customers to load prepaid amounts on the company's app. (*Internet Retailer,* 12/7/18)

Some U.S. restaurant chains, particularly a few attempting to cultivate a hip and youthful image in major coastal cities, now no longer accept cash, taking payment only with credit/debit cards or through the chains' proprietary apps, which can sidestep credit-card companies. Chains such as Sweetgreen, Tendergreens, Dig Inn, as well as four chains operated by Union Square Hospitality Group and a few test locations of Starbucks, will accept only credit card payments or payments by app, eschewing cash drawers or counting change. Some in the restaurant industry also want to pay workers and vendors with cashless systems. Ingo Money and Kickfin are each payment platforms that allow restaurants to make payments, including daily cash-out of tips, to workers and vendors. (*Forbes*, 4/27/19; *Pymnts*, 4/24/19)

The move to a cashless economy may be only in its infant stages in the U.S., but attempts to move in that direction continue to mount, whether in the form of revamped services like ApplePay, or Facebook's plans to become a more commercial transaction-oriented service by introducing its own blockchain-based currency, Libra. Yet some in the United States are not keen on the potential for a future cashless economy. New Jersey and the city of Philadelphia have both banned physical stores from refusing to take payments in cash, while San Francisco is considering adopting similar legislation. Cashless systems, as of now, are seen as disadvantaging the poor or the "unbanked," who have access neither to such digital services nor to traditional bank products. Nonetheless, the number of ways to pay **without** using cash is growing. The number of ATMs in service globally fell by one percent last year, while the number of bank branches worldwide has fallen five percent since 2012. (*Crain's NY,* 5/29/19; *PYMNTS*, 2/5/19, 3/7/19, 3/21/19)

Following Retail into the Brickless, Mortarless, Digital-First World

While Amazon may not currently be at the forefront of disrupting the financial services industry, its role in restructuring retail helped usher in an expanding online-only world of stores with a limited or nonexistent bricks-and-mortar presence. The financial services industry is now following this model into a digital-only or limited-physical way of operating. Consider in the following examples that both digital upstarts and relative unknowns are pushing such innovations, as are traditional banks:

• Chime is a so-called neo bank, or a digital bank without branches. It offers spending and savings accounts, debit cards and a mobile app and is adding 150,000 new bank accounts per month. The operation doesn't actually hold customers' deposits, but rather places them with a traditional FDIC-insured partner, Bancorp. (*CNBC,* 9/17/18)

• Stash, a New York-based start-up, allows consumers to save small sums of money and make micro-investments through its mobile app. The company has launched a new stock-back rewards program through which users can receive fractional shares of companies' stock when they make certain purchases. Customers using Stash's debit card to shop on Amazon.com or buy food at Chipotle, for example, will receive a fraction of each company's publicly traded stock. (*TechCrunch, 3/12/19*)

• Acorns, a digital savings assistant, launched in 2014 with a product that rounds up users' daily purchases to the nearest dollar and automatically puts that into investment accounts. The company now has more than 4.2 million users, who have access to IRAs, checking accounts, and a debit card through the platform. (*Ringer,* 3/1/19)

• Brazil's NuBank, with 8.5 million customers, is the largest online bank outside Asia. The company requires very little paperwork to sign up for credit cards, debit cards and other programs via smartphone. The company has announced an expansion to Mexico. (*Vox*, 6/5/19)

• TransferWise is Europe's most highly valued fintech firm. The platform allows users to send money along 1,600 currency routes for 15 percent or less than typical bank fees, and accounts for 15 percent of outbound money transfers from Britain, more than any bank. (*Economist,* 5/25/19)

• In April, T-Mobile went national with T-Mobile Money, a banking app service with infrastructure by BankMobile. The new service offers millions of U.S. phone customers a low-fee bank account and interest rates of up to four percent on cash balances. (*Crain's NY,* 5/29/19)

• JPMorgan Chase is expanding an array of digital services. It acquired online payments service provider WePay, and the bank established a way for consumers to open accounts online without coming into a branch. Customers can use its mobile-only bank, Finn, which is run out of a separate office from the rest of the institution: "We think of ourselves as a start-up in the bank," says its head. (*CB Insights*, 8/23/18)

• JPMorgan Chase is the first consumer bank to offer free trades to all retail customers on its digital platform, You Invest. Meanwhile, Fidelity has introduced no-fee index funds, and Vanguard has started a commission-free ETF trading platform. (*CNBC*, 9/17/18)

• Fintech companies such as Lenda, SoFi, Lending Tree, Quicken Loans and Rocket Mortgage are in the "one-click" loan market, which uses forms of machine learning to automate much of the application process for loans, and helps these upstarts keep up with the regulatory framework of the Dodd-Frank Act. (*CNBC*, 9/17/18)

• Five of the top-ten mortgage originators are now nonbanks, as is the largest mortgage originator, Quicken Loans. (*Economist*, 12/1/18)

• The average closing time for a home mortgage is 45 days. However, a number of upstart providers can process the applications in less time, as little as eight days in the case of LoanDepot, or at most 21 days, by Better.com. In all such cases digital automation helps locate public records and verify uploaded documentation. (*Bankrate,* 3/13/19)

• Robo-advisors such as Robinhood, Acorns, Money Lion, Stash, Betterment and Wealthfront had a combined average 95 percent year-over-year user growth. For instance, Robinhood added three million accounts, a 150 percent year-over-year increase and greater than the 2.5 million accounts added last year by Fidelity. Users of such platforms can be very active. For instance, among those Robinhood users who have an active position on the platform, the average number of times they check the app per day is 10. As the company's cofounder says, users engage with the app the way they use Instagram. (*CNBC,* 9/17/18; *Wall Street Journal*, 1/22/19)

• At least a dozen different providers, such as Lemonade, offer apps and fully automated platforms on which to purchase renters or auto insurance, and to make claims. Many such programs use an AI chatbot to gather the purchasers' information, or photo-recognition analysis to make claims adjustments on damage. (*Bloomberg,* 8/2/18; *Pymnts*, 2/25/19 and 3/7/19)

There are now roughly equal amounts of money invested in passive U.S. stock market funds and actively managed U.S. equity funds, both about \$4.3 trillion. Among financial advisors, 71 percent say they experience moderate or high stress, and that things are getting worse amid fee compression and shrinking margins in the industry, according to a survey. This is a result not merely of a world increasingly moving into passive investment products, but also one in which digital platforms and robo "advisors" are taking a share. (*Quartz,* 5/20/19; *Investor's Business Daily*, 5/27/19)

A question one might pose is: Might the Chinese, who already have the lead in this digitization of money and banking, make inroads into the West? Alipay is teaming up with six European mobile wallets, Bluecode, ePassi, Pvio, Vipps, Momo and Pagaqui, to roll out a system of QR-code-based payments, akin to those used by Alipay in China, at merchants across Europe. Is this simply a *pied-à-terre* before the Chinese attempt a further expansion into Europe or elsewhere? Such efforts would be somewhat more of a challenge in the U.S. where 50 states are governed by 50 differing sets of financial regulations. (*South China Morning Post*, 6/10/19)

An important analogy can be drawn between financial services, still in the early stages of disruption, and retail, which has experienced 15 years of upheaval. In retail, there were companies like Amazon, which led and fed off the disruption; there were those like Walmart, which thrived under the old model but had the capital and wherewithal to weather the storm and make innovations to catch up with e-commerce; and there have been Sears-type companies, which did not recognize the importance of the retail shift and have gone bankrupt, or have nearly done so.

A similar divergence is likely in the restructuring financial community. Some financial giants will likely follow Walmart's lead by investing in internal experiments and buying smaller upstarts. In any case, the competition is heating up, and legacy financial providers need to be watched carefully to see if they can align with the preferences of today's increasingly digitally trained consumer.