A decade down the line. Banking evolution accelerates in 2019

Ten years after the global banking crisis, 2019 looks like it could be a year of tipping points in the evolution of the industry globally.

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There's no such thing as a perfect crystal ball for banking, so some of my predictions will undoubtedly be wrong. Nor is the industry perfectly homogeneous and global. Some markets will evolve more slowly, while others are already over the top of the digital disruption roller coaster and picking up speed on the down-slope.

But if you're a retail and commercial banking executive or even just an investor paying close attention to the industry, here are the issues that you should be paying attention to in 2019.

1. Banks will keep unbundling their services. Open banking regulations from Europe to Hong Kong, Australia, Singapore, and — soon — Canada are fragmenting traditional retail asset and liability gathering in most markets. Open banking – a term for common interfaces among banks and other third parties to facilitate more competition – creates new business opportunities.

   For decades, banks have sought to become more vertical, offering services from top to bottom. Now many new entrants want to be horizontal, dominating a lucrative specialty. They're going after things like account aggregation (like Yolt in the UK) or back-office enablement (Cross River in the US and Clear Bank in the UK). Some are seizing upon esoterica — The Narrow Bank arbitrages the US Federal Reserve deposit rate for corporate depositors.

In response to open banking, the UK already has 62 registered third-party providers, all of whom plan to take advantage of a fragmenting value chain. Stripe, a seven-year-old specialist payments, now commands a valuation within touching distance of Deutsche Bank – a sign that horizontal can be very attractive. We will undoubtedly see more fragmentation in 2019 — along with, undoubtedly, efforts to re-bundle those components.

2. Banks will be keen to justify a future premium. Banks are taking a cue from tech firms, whether Amazon or some A round startup, that have mastered the art of telling investors a compelling story about the future. Confidence in the business model evolution can command a 'future premium' of over 50% to current valuations.

   We are beginning to see a similar phenomenon emerge among traditional banks. Effective storytelling by BBVA and JP Morgan Chase have resulted in a 'future premium' of around 25%, while the rest of the industry struggles to get their current business priced at book value. For now, compelling stories of digital transformation are just that — stories. We haven't seen profits leap ahead noticeably from the rest of the industry.

   In 2019, digital leaders among the traditional banks are going to need to show that the investment, creativity, and ambition that built their premium valuation has resulted in higher enterprise ROEs. If they can't, the conclusion of investors may be that for the foreseeable future, the "new" will be no more profitable than executing well on the old. Then we'll see the digital bubbles burst.

3. Banks will move to AI that won't nag. Verbal AI banking capabilities, like Bank of America's Erica, have fast become table stakes. But what passes for advice often feels a bit like scolding. "Did you know you spent $50 on Starbucks last week!?" or "Don't buy those new sneakers or you'll go overdrawn." So banks are trying to offer more true financial wellness advice that doesn't feel like nagging. Ideally, they'll let you know if you're unnecessarily paying more for utilities than your neighbor or if you're burdened with an overly high mortgage payment. But for the moment, most banks are still struggling with the table stakes of digital advice and will let us enjoy our overpriced venti macchiato without their disapproval.
4. The sun may begin setting on community banking. These should be golden days for small US banks. The economy is booming, interest rate spreads have widened, credit losses are minimal, and compliance costs are at last coming down. But being a small local player has lost its competitive edge.

   Instead, banks with a compelling digital customer experience are winning big everywhere. In deposits, the big three of Bank of America, J.P. Morgan Chase, and Wells Fargo have only 24% of US branches, but took nearly 50% of new deposit-account openings last year. In contrast community banks have 50% of branches but have taken only 20% of deposit growth in the last three years.

   Outside of the top 25 banks, the credit-loan assets of US banks shrunk by over $30bn in 2017, while digital-only originators like Kabbage and On Deck and direct credit investors like Apollo and Blackstone boomed. If smaller banks can't find a way to start offering better digital services without spending billions of dollars, we'll begin to see the twilight of the American community banking era.

5. The Chinese will keep going mobile — pulling the rest of us along, too. In a stunning transformation of retail financial services in China, Alipay and WeChat pay now have well over a billion regular users of mobile payments and conduct two-thirds of all global mobile payment transactions. Western bankers who dismiss what is happening as unique to China are making a mistake. Consider how this Chinese trend has spread to, say, Finland. In 2015 500,000 Chinese tourists visited Finland.

   That number is likely to balloon to 5 million this year, and the Chinese tourists are staying twice as long and spending three times as much. Thousands of Finnish merchants now accept QR code-based mobile payments. Elsewhere, look at how Chinese influence is changing mobile pay in Singapore (which is adopting QR for low-value payments) and shaping India’s through Ant Financial’s stake in market leader PayTm.

With Ant Financial now worth $150bn and scaling its transaction processing system to handle 100 billion transactions per day, it’s only a matter of time before the Chinese also reshape western banking. Will the Chinese change come from direct interventions (like Ant’s aborted attempt to buy MoneyGram) to working in partnership with Western institutions (like Alipay’s partnership with Standard Chartered for remittances)? We’ll probably find out this year.

6. Fintechs are approaching a tipping point in the UK. Accenture research shows that the UK is the most disrupted traditional banking market in the world, with 15% of revenue and over a third of new revenue going to new entrants. The combination of eroded trust and a regulator keen to stimulate competition has as seen a plethora of new financial institutions appear, including Monzo, Starling, N29, Revolut and Marcus from Goldman.

   While they have signed up millions of customers, the vast majority are secondary accounts. Less than 20% of their customers use these neo-banks for their primary checking. The reaction of the entrenched UK banks has been to launch their own digital challengers (RBS claims to have six in development) and upgrade their core digital services. Market share data in 2019 will start to give us an indication of whether the new entrants have enough momentum to win long-term, or if the counterattack of the traditional banking industry will be strong enough to fight off this incursion from the digital newcomers.

7. Banks will keep leaving legacy core systems behind. The prediction last year was that most big banks would stop short of ripping out their antiquated core legacy systems, looking instead to wrap them in digital services that enabled more speed and agility. While this trend will continue we have also seen plenty of interest in core alternatives like Mambu, Thought Machine, Leveris and Finxact.

   In 2019 we are going to see a lot of build activity on these new systems, with banks around the world experimenting with new technical architectures that are digital to the core. So far, these are mostly targeted at relatively simple retail and SME customers. Will we see a traditional bank take the leap and move from a parallel digital build to a full migration of their legacy core systems to one of these new solutions? 2019 won’t be a year of rip and replace but it might be a year of build and migrate.

8. Banks keep pushing into the computing cloud. This past year the debate quickly moved from benefits of moving into the cloud to operating effectively within it. At the 2018 AWS re:Invent conference, while there was some bare iron pitches for migrating to the cloud, much more of the focus was on what you do with your data once it’s in the cloud and, specifically, the analytical tools available from cloud providers.

   The allure of an intelligent brain indicates that the winners in digital banking will be defined by offering creativity and data quality, not the quality of algorithms. We are moving to a world where every banking carpenter will have the same toolbox and be able to access many of the same raw materials, but some will be capable of building beautiful furniture that customers’ will pay a premium for, while others will turn out shoddy mass-produced items that lack differentiation. Knowing how to create something of value rather than just having the right tools is what will matter in 2019.

9. Tech companies may finally show their banking hand. The boundaries between banking and the rest of the digital economy will continue to blur, and 2019 may be the year we see some of the big tech players make some definitive moves. There’s reason to think that Amazon and the rest of big tech will be forced to show their hands with respect to banking. In Europe, PSD2 will start to have an impact on the payments market.

   Major retailers, including Amazon, will need to decide whether they want to offer account to account payments that bypass the card networks. In the US we are seeing Uber, Amazon, and Walmart follow Starbucks’ focus on prepay accounts that internalise payments by offering incentives to use proprietary apps. The most fascinating market to watch in 2019? India, where almost all the big tech players compete. Walmart and Amazon will battle for digital commerce supremacy, while Ant Financial continues to fund mobile wallet Paytm, and Facebook launches WhatsApp payments.

10. Banks will stop all the loose talk about platforms. The word platform has been stretched to the point where it has become meaningless, particularly in banking. So, the last prediction for 2019 is that the word will get banned in at least one bank. A true digital platform business is an easily accessible two-sided marketplace that makes money by bringing buyers and sellers together and driving growth through network effects – think eBay, Airbnb and Uber. Amazon and Apple are only partly platform businesses.

    And Facebook and Google are almost pure aggregation businesses that focus on capturing your attention and then selling it to advertisers. In 2019, any bank that wants to talk about being a platform business needs to be very specific about the business model it is trying to pursue and stop just throwing the word around to claim some of tech's shine for itself. A pure platform business would be economic suicide for most banks as it would involve giving up their balance sheet. So, if someone in your bank starts to talk about 'platform banking', demand that they explain themselves until you get an acceptable and clear answer. Still, as we are seeing in the UK, hybrid models like Bo or Starling, which offer core banking services while leveraging open banking to create a wider services platform, could be viable.

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