The digital economy is storming finance

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Abstract:
Till recently, the "universal bank" was the dominant model, long protected by regulations and shielded by customer loyalty. In a challenge to this model, FinTechs, a new category of players, have introduced innovations and are gradually becoming service platforms. Operators in telecommunications and big retail chains, as they try to lessen the attrition of their business, are joining them. However the major danger comes from the giants of the Internet, which are fully conscious of the exceptional value of the data garnered by financial services. The technological revolution — artificial intelligence, blockchains and the Internet of things — and new EU regulations are speeding up the trend toward a hybridization of models and cultures. In this moving context, France has a few major advantages: its world rank in the cognitive sciences and its privileged access to the single European market.

"*The present would be full with all futures were the past not already history.*"
André Gide, *Les Nourritures terrestres* (1897).

To see where we are heading, we must understand where we come from. Discerning current trends in financial services means recalling, at least briefly, history.[1] Where does the current business model for banking and insurance come from? This model has four fundamental properties:

- It is a universal type of model for providing global services — what English-speakers call "one-stop shopping". This general-purpose model fosters an excellent knowledge of clients, but a knowledge that has hardly been leveraged.

- It is a complex economic matrix with a large number of products and services that yield scant, if any, profits and might even run a loss (bookkeeping of client accounts, flow management, etc.). Many of these products and services (like real estate loans in France) are intended to attract clients and make them loyal. As a result, the cost of winning over a new client is high and is constantly rising. Turning a profit depends, therefore, on a small number of products and, till recently, on a low-cost access to clients' deposits.

- There are costly, mandatory regulations that, however, provide a high level of protection for all parties.

- A very special relationship is formed with clients characterized by a sort of consecration of the role of bankers and by exceptional customer loyalty.

This state of business has lasted for about fifty years now.

[1] This article, including any quotations from French sources, has been translated from French by Noal Mellott (Omaha Beach, France). The translation into English has, with the editor's approval, completed a few bibliographical references.

The digital transformation attacked services early on, targeting the spheres of culture, entertainment, transportation and retail business after the invention of three revolutionary concepts: search engines, roaming uses (smartphones, tablets) and the social media. Financial services have been spared for a long time now, but this time has passed and is over for three major reasons:

- Owing to cultural and sociological changes, bankers and insurers have, like all authority figures, lost their aura; and financial services have become ordinary.

- The disappearance of several market entry barriers as regulations have fostered innovation and venture capital, a major source of funding for startups.

- The recognition that financial services are ideally fit for “uberization”: the high cost of access to clients; the demand for mobile, roaming solutions; the margins on certain products; and the production of quality data along with its potential.

In this context, insurers are no better off than bankers. In fact, their situation is more exposed to risk: less knowledge of their clients, possibly reduced margins and a tarnished image.

Where do alternative service offers come from?

First of all, there are the players who can propose a new “customer experience”, for example online banks (many of them subsidiaries of established banks). The online banking model is now under economic pressure owing to the continually rising cost of winning new clients — a cost ever harder to amortize in a context where a client opens accounts at more than one bank. Startups (FinTechs) are also proposing new offers: crowdfunding, payment facilities, advice for automated investments (robot advisors), etc. Finally, alternative offers are being made by players who, thanks to their heavy “inbound traffic”, have frequent contacts with users and obtain abundant data from them. They can thus reduce the costs of winning new clients under condition that they are seen as legitimate for offering financial services.

There are three families of players:

- the telecommunication operators that are taking up banking mainly for the purpose of reducing their client attrition rate;

- the big retail chains that benefit from an abundant flow of customers (whom they do not know very well however); and

- the giants of digital technology. GAFAM (the Big Five) and BATX (the Chinese Big Four) are very interested in the first-order data represented by financial services. A bank account, a loan, an investment and even a payment are preferential sources of knowledge and of customers, and a means to make them loyal. Nearly all the digital giants have entered the game: Apple (payments), Facebook (loans), Amazon (insurance), and so forth. Every month, five million people in France search for a financial product on Google; and Alibaba is already the tenth bank in the world.

This is just a start….

The deep change that took off in the preceding decade has had two phases: innovations in the access to banks (online banking) and innovations in uses. A third phase has started.

New business models, initially centered around a "vertical" offer of specific services (loans, bank transfers, advice), are gradually moving toward the platforms that propose a broader "customer experience", even "relationship banking". Some of these platforms are new insurance companies or "neobanks". This fundamental trend will probably accelerate owing to two factors other than consumer demand (in particular from clients less than 35 years old: the Y Generation).

The first factor accelerating this trend is the overhaul of regulations, mostly of European origin (more than 80% in financial services). The two major pillars of these changes are the EU's GDPR (General Data Protection Regulation) and its second Payment Services Directive (PSD2). To simplify, the first protects users by restoring ownership of their data to them, whereas the second provides clients with the legal and technical tools (application programming interfaces, APIs) for using this property and making money from it. PSD2 is the cornerstone of a global construction that will endow clients with the capacity for appropriating all their financial data, both static (electronic identifiers) and dynamic (behavioral algorithms). Clients will thus be able to play an active role in transactions. In Europe, this leads to new categories of players (payment services, account aggregators and other platforms specialized in account information services, AIS), including French players (Bankin, Linxo, Budget Insight, etc.) who have honed their skills.

The second factor of acceleration is the place of data-related technology in the development of FinTechs (which played a restrained role during the first two phases). Whereas the technological component in payment applications or online banking is limited, technology is now the driving force in the invention of innovative services. I might mention three bricks: artificial intelligence (AI), blockchains (BC) and the Internet of things (IoT), all of them based on big data and the ever increasing capacity for processing data and computing. Thanks to these bricks, very efficient counseling services can be provided (AI); autonomous communities without intermediaries can be created (BC); a new approach to handling risks can be worked out (AI and BC); interactions with clients can increase (IoT); and massive productivity gains can be made.

A paradigm shift

This deep paradigm shift is reflected in several ways.

- The traditional trusted parties (banks, insurance companies, governments, regulatory authorities, stock markets) are being defied not just by newcomers who often benefit from an astonishing level of public sympathy and confidence but also by the technology itself (blockchains) or tech-based communities (peer-to-peer in insurance).

This "disintermediation" is widespread, a trend that is accelerating as traditional players, under pressure from prudential regulations, strive to improve their financial statements.

For consumers, financial services are no longer an exclusivity of traditional service-providers. "Banking is leaving the bank", and as much can be said about insurance. No one is any longer surprised to be able to open an account with his telephone company or in a store or, soon, with one of the Big Five. Good drivers are starting to look for insurance for… good drivers.

While banks and insurance companies have difficulty switching from a business model focused on supplying products and services to a customer-centered approach, customers are turning into users with whom it is necessary to communicate continually (and not just when they are consuming). These users have new benchmarks: accountability, interaction, meaning, advice from other users.

- The field of action has changed scales.

Banking used to be a neighborhood service. At most, a bank had offices in several locations (one subsidiary per country), but the economies of scale were low, since generic services could not be offered owing to taxes, regulations and the general culture (except in asset management and investment banking). Newcomers are offering procedures and uses with a much broader appeal. The "consumption" of payment services or of crowdfunding is nearly the same in Bordeaux as in Hong Kong, even more so since digital technology abolishes in several market segments the requirements related to a critical size.

- The underway trend is reshuffling the deck of cards at the regional level.

Whereas finance used to be a "Western sport", the New World is facing zones of stiff growth in Asia (in particular, China) and Africa. Lacking a heavy legacy laden with an infrastructure of banking outlets and agencies, players in these regions are undergoing remarkable growth. Half of the applications for payment systems in the world concern Africa,[2] and the biggest FinTech on the planet is Chinese.[3]

Varied strategies of adaptation

To cope with this tidal wave, diverse strategies of adaptation are being pursued. Traditional businesses have switched from wariness toward FinTechs to interest in them. This switch is reflected in a whole range of possibilities: partnerships, incubators, equity investments, even buyouts. In newspeak, this is "coopetition", a contraction of competition and cooperation. Malleability is the new imperative — to the point that bankers have decidedly engaged in "deconstructing" their historical proprietary business model (open banking, bank as a service, etc.).

Bankers and insurers have enough grace and intelligence to admit that FinTechs are not the problem but the solution, or at least part of it, a faster and better means for moving toward a corporate "culture of agility" (a "strategic pivot" that is not in their DNA). Evolve faster, because everyone agrees that the time is short. Traditional financial businesses feel that the real danger comes from the digital giants, American and Chinese. The battle will be tough, since GAFAM and BATX have nearly unlimited resources and access to our data. However it is not lost in advance.

Besides, banks have several aces up their sleeves: skills and a capital of consumer confidence (eroding, it is true, but still strong). As they continue adapting, they must devote efforts to productivity and investments in electronic technology. Above all, they have to change their "mentality" closer to that of their new rivals and their younger clients.

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[2] "L'Afrique, épicentre de la *mobile money*", *La Tribune*, 17 November 2016.

[3] KPMG (2018) "Classement FinTech 100" at https://home.kpmg/fr/fr/home/media/press-releases/2017/11/classement-fintech-100-6-francais-dans-le-palmares-2017.html.

FinTechs are springing up everywhere. They are the world leader of investments in startups;[4] and consumers are steadily switching to their services, as a third of Europeans have done.[5]

The GAFAM are not immortal. They also face several daunting challenges:

● Their image has been tarnished. They are increasingly seen as Big Brothers, as a danger for democracy, local economies, short supply chains… and even for national security. Amazon, for instance, controls more than a third of the market for cloud computing, its sales amounting to more than the sum of its three major competitors.

● Their business model is based on for-free data (acquired more or less without users being aware that their data are being collected) and a windfall from advertising that will not last forever. Not only have Google and Facebook already captured approximately 80% of online advertizing, but also they pay low taxes (9% in Europe). This is no longer politically acceptable. In fact, they are trying to make their business model less dependent on advertizing. As the number of Facebook users has stagnated in the United States and is decreasing in Europe, the firm is trying to migrate toward "stories".

● Given their position as quasi monopolies, these big tech firms increasingly face antitrust law suits. The world has already seen giants "big enough to swallow everybody". Without going back to Standard Oil in the 1930s, we need but recall AT&T, the tech giant during the post-WW II boom that was dismantled in 1984.

The likes of GAFAM-BATX are clearly superpowers capable of partitioning the world among themselves. However we cannot exclude the possibility that their extreme power might prove to be their weakness. Economic history leads us to be prudent and ponderated when marking predictions.

A place for Europe and France?

For want of a vision for its industry, Europe has settled into the easy chair as a compulsive regulatory authority. America innovates, China copies, and Europe regulates… so it is said.

A paradoxical movement is under way however. Europe's regulations are becoming worldwide standards, in particular the GDPR for protecting individuals and perhaps too the PSD2 for payment services. This endows business models built on the continent with an advantage. Besides, the "EU regulatory passport" means that firms have access to all markets in the Union once they have obtained approval from one member state. Startups thus gain access to the world's biggest market.

Till recently, France has been acting like a developing country in matters of technology. It educates top brains in the cognitive sciences, exports this "raw material" to Silicon Valley and, afterwards, buys the finished products. A change might be in the works.

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[4] $31 billion raised in 2017. See KPMG, "Le financement des FinTech dans le monde", 22 February 2018 available at https://home.kpmg/fr/fr/home/media/press-releases/2019/02/le-financement-des-fintech-dans-le-monde.html.

[5] *Cf.* EY "FinTech Adoption Index 2017: The rapid emergence of FinTech", 44p., available via https://www.ey.com/Publication/vwLUAssets/ey-fintech-adoption-index-2017/$FILE/ey-fintech-adoption-index-2017.pdf.

France has made progress in dealing with some of its weaknesses. For instance, regulatory authorities are now more favorable to innovation and venture capital. The country has several major advantages, in particular world class skills in the data sciences. It ranks second in Europe for the number of startups in AI (308 compared with 774 for Great Britain) and first for the number of laboratories (82 compared with 43 for Germany).[6] Furthermore, France seems well placed to benefit from Brexit. Nonetheless, it must not let up on its efforts, since the competition is ferocious.[7]

French FinTechs are effective and are becoming more and more international. In fact, some of them figure among the most promising.[8] Their major challenge is to reach the critical size for the international arena.

Time is short. Innovative finance is now seen as a strategic priority worldwide. The stakes are much bigger than for a branch of the economy. Growth is at stake, and its funding by local parties. Skilled jobs are at stake, as is our security and, in general, our sovereignty.

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[6] Source: Roland Berger October 2018 on http://www.francedigitale.org.

[7] "The government has promised to devote €1.5 billion to AI during its term of office, China is investing €20 billion per year…", *Lés Échos*, 21 October 2018.

[8] Three French FinTechs in KPMG's world ranking in 2018. See note 3.