Banking is not an industry, nor a business model: lessons from transportation

Despite our newfound excitement and fear, disruption is not that new in the annals of history. This article will focus on the lessons banking executives and regulators can draw from the transportation industry and will discuss how they can be practically applied to modern day banking.

Lesson 1: Major breaks in seemingly unrelated industries can impact our own

The theoretical father of disruption, Joseph Schumpeter, discussed extensively the impact of 'railroadisation' to the agricultural practices of the southern United States. In his 1942 book 'Capitalism, Socialism & Democracy' Schumpeter concluded that "The Illinois Central [railway] not only meant very good business whilst it was built and whilst new cities were built around it and land was cultivated, but it spelled the death sentence for the [old] agriculture of the West."

In hindsight, the profound nature of Schumpeter's analysis gets – as always – lost. Yet, it aptly illustrates how developments in seemingly unrelated industries (such as railways and agriculture) can have a material impact to one another. With the benefit of hindsight once more, the impact that technology has on banking is obvious and does not warrant further analysis. However, it does illustrate the significance of studying innovation outside closed systems thinking. Hence we will continue with analyses borrowing from the transportation industry, in this case.

Lesson 2: Disruption is often the outcome of poor industry definitions

In 1960, about two decades after Schumpeter's work, Ted Levitt questioned the ability of railway executives to define their own industry. The quotations deserves full reproduction: "The railroads did not stop growing because the need for passenger and freight transportation declined. That grew. They let others (cars, airplanes, trucks, even telephones) take customers away from them because they assumed themselves to be in the railroad business rather than in the transportation business." (Theodore Levitt 1960, Marketing Myopia, Harvard Business Review)

It becomes obvious that a poor definition of an industry can hinder the accurate analysis of competitive strategies as well as competitive threats. So let's be clear: ***banks are not in the banking industry***. Banking is not an industry, nor a business model. Instead, banking is an umbrella term referring to a number of services that *have happened to be performed* by banks.

Practically, banks are in a number of industries, namely lending, payments, transaction processing, advisory, investments and so on. As a consequence, their competitive strengths and weaknesses have to be evaluated per industry; their competitors as well.

This line of analysis has been (unintentionally) proven by the 'fintech' wave: technology companies do not try to disrupt banking; they try to disrupt payments, transactions, settlements and the likes. Similarly, attempts by banking executives and scholars to redefine or protect 'banking' are likely to result in trees falling for the protection of an imaginary forest.

Lesson 3: Core banking operations will survive, but banking may never look the same

Two decades ago, being an airline pilot was a rather well paid and respected profession. Currently pilots working for low cost airlines are hired for a fraction of the salary they would have earned in the past; full service airlines hardly hire at all, in comparison. Having said that and despite predictions to the contrary full service, hub and spoke airlines continue to exist alongside their low cost competitors.

The parallels to banking are quite obvious. Bankers, a group of well paid and respected professionals, are now threatened by technologically nimble, low cost competitors (well, the loss of respect may also have to do with bankers' own actions). Will the traditional, full-service banking model eclipse? Or will it co-exist for the less price conscious, convenience seeking customer segments?

Let's be clear: banks perform a fundamental role in the economy, namely the transformation of short term deposits to long term financing. It is not an easy business model (defaults, liquidity mismatches, capital requirements) and it is unlikely that many firms will attempt to enter the field (more on this later). Unfortunately for the banks, the new suitors would like to skim the ‘cream’ of banking activities, such as transactions, and leave incumbents with the riskiest activity of the lot, lending (we can safely assume that prop trading is not part of a bank’s portfolio of activities any more).

As for low cost (technology based) bank subsidiaries, a common response by a number of banks recently, executives have to brace for cannibalising their own revenues and upsetting their own staff. Who would like to give up a well paid job at a luxurious office building to work in a remote campus? Yet, if such internal upsetting does not occur, traditional institutions will be outpriced by low cost competitors or robots, the way that Amazon logistics undercut most other companies in that industry.

Lesson 4: regulating Uber is not the same as regulating the taxi industry

Banks will survive, or at least some of their ‘core’ activities, but they will be a lot different. Retail banks may be totally different, as their activities are a lot more likely to be replaced by software, bots and AI. The future of advisory-based corporate and investment banking is probably brighter, which makes the regulatory separation of these activities from retail operations ironic: we are ring-fencing the business model that is most likely going to be disrupted.

There is one more irony in regulation: the heavy burden on traditional maturity transformation-based business models not only impedes economic growth but it also guides banks to take on a ‘utility provider’ business model, thus further exacerbating disruption risk.

Concluding lesson

In summary, banking analysts can draw a number of lessons from other industries that have experienced disruptive forces in the past. An analysis of banking as an industry is likely myopic and would require a decomposition of the business models that make it up. Don’t look for answers in banking; instead, try to understand and improve the actual industries you are really in.