The New Industry Poised To Dethrone Greedy Banks

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UK banks have had it pretty good, for a long time. Their unspoken deal with the state ran as follows: banks kept the economy ticking over nicely, while raking in cartel-like profits. To keep this seemingly-safe situation working smoothly, the government erected barriers to entry. This has prevented seemingly-risky newcomers from taking a piece of the market – meaning that the UK's retail banking sector is highly concentrated, with just a few long-established firms dominating. The state also bails any faltering banks out – lest their rampant greed (or simple foolishness) destabilises the entire economy.

This deal has worked wonderfully for the banks, for a very long time. But the financial crisis tested everyone's patience to the limit. It looks like the party might finally be over for the British retail banking sector. Coincidentally, while the bankers' PR account with the UK public is overdrawn, a whole new wave of financial technology firms has come along. London is the global capital of this new "fintech" sector. It's an ideal place to seek out profits, particularly if you like small-cap and startup stocks.

This industry is where I spend much of my time, in the "day job". Last week was London Tech Week, and I spent a couple of days at the Tech XLR8 trade show – where various fintech firms were promoting their particular brand of disruption. One that caught my eye was Ummah Finance – an Islamic challenger bank. (I'll hopefully be bringing you an interview with it, soon.)

Of course, there's more to financial-services disruptors than Sharia-compliant banking, and comparable niche products. However, much of the recent activity is also based on trying to take a piece of the retail banks' business. High street incumbents are now getting attacked from all sides – and it's difficult to see how they'll ride out this storm.

Here's who's eating their lunch…

Challenger banks

Perhaps the most obvious attacks are from conventional banking startups – with Metro Bank being the most prominent example. At a time when other banks are closing their high street branches, Metro Bank's model is to move back to a bygone era of customer service. Metro Bank is attracting affluent, desirable customers – using this very old-school approach. This is certainly noteworthy – and potentially places conventional banks under quite a bit of pressure. Nevertheless, I don't think the high street incumbents need to be running scared of Metro Bank. It'll take a piece of the market – but it won't bleed the majors dry.

Digital banks

Next, we have the online and app-only challenger banks – and they're potentially a bigger threat. A generation ago, brands like First Direct posed a similar threat of disruption – but these firms were usually linked to incumbents. In today's economy, startups such as Monzo and Atom Bank are the new kids on the block – and they're app-based disruptors, sporting very low cost bases. This approach emphasises good quality user experience, over face-to-face customer service. The incumbents are definitely failing to keep up, on this front. I can count on the fingers of one hand all the online transactions I've ever made, using my high street bank. The digital experience from NatWest is so appalling that it's actually easier to drive to the bank, than to fight my way through its awful online systems. (I'm no Luddite, however – and frequently transact online using PayPal.) The new online and app-based banks are looking to shake up that dreadful, backward customer experience from the majors. These challengers might presently be attracting chiefly millennials and early adopters, but this could be a major threat to the high-cost incumbents, in due course.

Interface layers

Another way of addressing the same problem is the forthcoming torrent of interface layer apps for banks. These are apps and services which let you control your bank, using another firm's product. It's a bit like sending your butler to the bank counter. (What? You haven't got a butler?) The government is currently pushing banks to allow startups to access their data and systems. An API (application programming interface) is the tool that allows this to happen – which is why you'll often hear people in fintech talking about Open Banking APIs.

These interface firms leave conventional banks holding the deposits, but provide an alternative user interface on top. These tools have varying degrees of capability – with some merely providing analysis, and others providing management. An example of one large, established firm is Yodlee – which powers the better-known Mint brand. It also has a direct-to-consumer offering: Yodlee Money. Such firms give you visibility over your spending, without requiring you to move your bank account. There are many other such services, all based around giving you better access to your existing banking data. This is a sector that is likely to experience fast growth in the future. If you'd like to invest, one firm currently raising money is Ernest – and it's based on a chatbot. You can find its current fundraising round on Crowdcube.

Unbundling

Finally, it's worth mentioning that banks' services are rapidly becoming eroded by unbundling. Frustrated by poor consumer experience, and high-priced products, consumers are leaving their banks in droves to purchase secondary services elsewhere.

Meanwhile, they maintain core banking services at traditional high street banks. The rise of independent mortgage brokers was an early example of this movement – but now it has diversified rapidly. Everything from children's credit cards (Osper, goHenry) to loans (Wonga, Zopa) and foreign exchange (TransferWise) are all handled outside of the banking sector, by very successful newcomer firms. This leaves banks struggling to monetise many of their customers. That's a large part of the reason why so many branches are closing – as poor sales on secondary products mean that the expense of face-to-face banking isn't easy to justify.

All of the above sectors are likely to experience continued growth in future. I don't think the traditional high street banking model is doomed (yet) – and that's where my money is currently kept. But it's very likely that these fintech upstarts will pose major challenges for the retail banking incumbents.

As always, if you want to make sensible investments, make sure you're on the right side of history. At the moment, this is certainly not with the high street banks.

How do you do your banking today – and is this changing? Let us know: andrew@southbankresearch.com.

Best,

Andrew Lockley
Exponential Investor