CHANGING DYNAMICS - BANK OF THE FUTURE: BANKS, TAKE YOUR HEADS OUT OF THE SAND

Dr Ranee Jayamaha
Lead Consultant - South Asia
World Bank Group

Introduction

The digital revolution is moving rapidly with diverse impacts on global and the nation's state and, in general, day to day life of human beings. Banks are not safe from the immense transformations wrought by technological innovation. So far, banks have proved that they are resilient but the dynamic world can change its course and radically transform the future bank. Today, money can be sent to anywhere in the world simply by tapping an app, without even interacting with a traditional bank. However, the impact of digitization on financial services industry or banks' current business is yet to be assessed. The future of savings and lending by traditional banks is uncertain as competitive pressures from alternative lending platforms grow requiring the overall savings and lending industry to compete. Alternative lenders could successfully move upstream to replace traditional banks in intermediating loans and advances while regulators will continue to be stringent on traditional bank lenders, through high capital requirements, liquidity ratios and other credit restrictions. On a positive note, it may well be possible that banks and financial institutions (BFIs) and alternative platforms will continue to cater to different classes of investors and borrowers, especially with growing partnerships between the two parties. Digital disruption has the potential to shrink the role and relevance of today's banks, and simultaneously help them create better, faster, cheaper services that make them an even more essential part of everyday life. To make the impact positive, banks need to shake themselves out of institutional complacency and recognise that merely navigating waves of regulation and waiting for interest rates to rise won't protect them. Self-imposed ignorance of alerts and lackadaisical attitudes can pull them down sooner than expected.

Embracing these themes and creating the right environment creates challenges to the rate of change and approach to risk that are hardwired into the way banks currently adapt to innovation[1]. This is advantageous to challengers who only hit regulators' radar once their new business models have found ways to cherry-pick services and customers. Banks are anticipating

[1] Accenture Financial Services (2015) - "The Future of Fintech and Banking", Digitally Disrupted or Re-imagined

this move and are trying to create new businesses within their existing structures that adapt and collaborate to meet these challenges using vast amount of customer data and information. Existing banks will know they are winning in digital when bank valuations start to factor in the future value of proven innovation, in addition to protecting the core banking franchise.

Over the last decade, the Asian economies have been growing steadily and the largest banks have enjoyed double-digit growth in return on equity, staying well ahead of their European and US counterparts, some of whom are still recovering from the credit crisis. Today, the Asian financial sector accounts for nearly 40% of the world's banking and insurance market capitalization, more than double what it was a decade ago. Finance in Asia has been historically dominated by large banks, which, while being slow to embrace technological change thereby leaving some sectors of the economy underserved in terms of access to financial services. This has left them vulnerable to a host of non-bank players who have entered the market, promising to make banking simpler, cheaper and more accessible[2].

Contained Systems and Ostrich Characteristics of Banks

The ostrich is one of the biggest birds living on earth and they are flight-less animals. It is arguable whether ostriches actually bury their heads in the sand when they are in danger or they only bury their eggs in the sand and keep vigil by keeping their heads on the sand. If need be, ostriches can also run very fast like cheetahs and sustain a velocity no other earthly animal can par[3]. The human ostriches automatically strikes their heads in the sand at the slightest indication that they may have to deal with a situation perceived as being complicated, frustrating, boring or otherwise unpleasant in some way.

A future in which core banking services are delivered outside of the regulated banking industry is feasible. Traditionally, banks have expanded lending to favoured sectors and build up customer relationship or lent to spur growth as demanded by their respective governments. In undertaking these activities, the banking industry has operated as a contained/closed system. Within this system, banks have: assumed credit, liquidity and maturity risk; been protected / supported by regulation; invested in complex operational and technological structures; benefited from an assumed implicit state support and behaved like monopolists or oligopolists in smaller countries. Insured deposits and access to central bank funding have enabled banks to benefit from greater access to low-cost liquidity than other players in the financial sector. Historically, these attributes have created a high level of trust between customer and bank and also acted as significant barriers to market entry – thus protecting banks from challengers to the status quo. Banks, even if they followed these "oligopolistic and unconcerned" attitudes in the past, have now realized that banking being a service, should cater to customer demands and should accommodate themselves to the former's preferences in a highly competitive environment.

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[2]I am very grateful to Mr Dhammike Amerasinghe, Advisor to the Minister of Special Assignments for reviewing this article and providing valuable editorial comments.

[3]Wikipedia –

Historical Changes in Banking Landscape and Survival of Banks:

In the 1970-1980 period with the patronage of respective governments, the state owned banks dominated the banking landscape in many of the developing countries. In the late 1980s,the world of banking was invaded by non-banks, finance and leasing companies, investment banks, and portfolio/asset management companies but in a short time, many of them lost credibility due to frequent failures, fund embezzlements and lack of governance. They did not succeed in becoming a forceful rival to banks and banks survived with minimal transformation. The emergence of domestic private banks and entry of foreign banks in the 1990s, changed the competitive banking landscape in many of the developing countries as state owned banks lost their market share mainly to domestic private banks. Foreign banks patronised the multi- national companies and concentrated only on import export business with one pervasive goal to enter new markets. State and private banks expanded their branch network, installing ATMs, providing financial information, telephone and internet banking and continued to adopt new technology offering new products and services which sometimes took banks beyond their traditional roles (for example, HDFC Bank in India offered news to its clients through an association with cable network broadcasting corporation (CNBC), while, some banks offered advice on investments and mutual funds). Banks were still doing well and continued to stay in the comfort zone with less or no attention to customer preference. Banks used aggressive marketing and sold bank products to customers instead of understanding customer preference.

The world financial crises during 2008/09 and the loss of confidence in banks, including global giants, draconian regulatory enforcements on banks, and rapidly moving globalization and digitization led to the emergence of Financial Technology companies (FinTech) and start-ups outside the regulatory radar and have become a threat to banks primarily due to rapid changes in customer preference. At the beginning of the decade, when FinTech companies started their appearance, most banks were unconcerned and continued to enjoy their comforts. There was no compelling reason to raise their heads from the sand. In the post crises period, some global and regional banks were smart enough to add new facilities to their traditional role and held on to their long standing clients. To date, banks facilitate direct debit transactions; perform multi-currency transactions; monitor and track credit card spending; optimize branch networks and provide convenience and quality service through multiple channels; invest moderately in open systems and scalable architecture that allow them to ramp up easily and handle the rapidly growing volume of clients, in addition to reducing costs.

The Expansion of Internet Banking, Reduced Geographic Barriers and National Boundaries

Electronic fund transfers accelerated the ongoing process of “financial deepening” and the Internet became an extremely efficient device for banks of all sizes to collect and manage information in order to meet the various financial needs of individuals and businesses. The Internet allowed financial firms of different sizes to enter markets and reach customers who were previously out of reach[4]. Furthermore, the proliferation of Internet Web sites enabled

[4]An International Indexed Online Journal www.darpanonline.org/GIRT ISSN 2347–8861 Global International Research Thoughts October-December 2013 Global International Research Thoughts (GIRT)

banks to distinguish their products from those of other institutions. Several trends contributed heavily and are still contributing to the growth of e-banking, e-banking infrastructures, speedy and efficient retail payments, collating information and facilitating alliances between information companies and retailers, such as AOL and Wal-Mart and between Yahoo and Kmart. More recently, the proliferation of mobile devices has facilitated customers to effect peer to peer (P2P) transactions, pay bills, transfer money, and in some countries, to trade securities electronically (USA and Europe). More online transactions increase revenues and encourage financial service providers to frequently re-launch their programs in response to consumer preferences and technology innovations, and employ multiple channels rather than confining them to a single channel. Some banks have launched online banking services to retail customers while retaining more high-value customers through enhanced customer-bank relationships.

Internet Banking has significantly impacted on the structure, efficiency and performance of the banking industry. The use of online banking, while forecast to grow considerably, is still relatively modest, although the usage patterns of clients could change rapidly. As a whole, electronic banking could offer entry and expansion or spreading out opportunities that small banks lacked previously and the Internet / Online products and services have the potential to provide substantial value to customers. Banks that implement best practices will have the highest chance of on-going success in these varied electronic commerce efforts. However, electronic banking presents policy makers and regulatory authorities with a set of significant challenges.

The Internet has successfully dealt with new challenges it faced in security and trustworthiness. Fortunately, Internet security technologies solve issues of privacy, authentication access control, data integrity, and non repudiation. The use of the widely accepted public-key technology and the public-key infrastructure that supports it, can create the secure, trusted environment essential to the exchange of personal, financial, and transaction data over the Internet. There are cases of many banks whose annual costs for Internet banking are higher than those for their core systems. One of the most crucial areas of decision making for banking is financial product pricing. Many banks signed their original e-banking and bill-pay contracts several years ago. [5]

Understanding and Acknowledgment of Changing Dynamics are Imperatives

Banks now acknowledge that they should adapt to changing dynamics for their future survival by innovating, transforming and disrupting their own business models rather than watching models of challengers or disruptors disintermediation. Traditional banks are still big in size and they could also transform their processes and technologies, potentially absorbing alternative platforms and adopting more efficient features of alternative lending business models. More recently, some global and regional banks have tried to innovate themselves by becoming formidable competitors, while, high street retail banks confront the digital threat by offering Omni-channels, mobile apps and linkup with utility companies to benefit from customer experience that influence consumption habits and change their operations [6]. The modern day

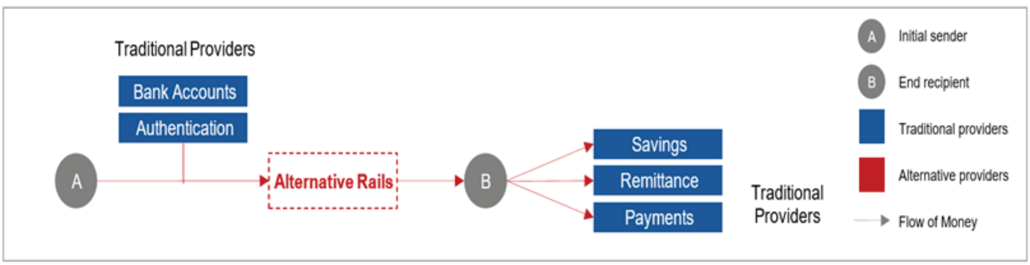
[5]An International Indexed Online Journal www.darpanonline.org/GIRT ISSN 2347–8861 Global International Research Thoughts October-December 2013 Global International Research Thoughts (GIRT)

customers, the millennials in particular, are the main drivers of these changes. Lending platforms leveraging P2P models have experienced rapid growth by using alternative adjudication methods and lean, automated processes to offer loans to a broader base of customers and a new class of investment opportunities to savers. Openness, Collaboration and Investment are the critical themes that emerge for existing banks if they are to benefit from growth driven by new services and productivity. Banks also recognise two other fundamental steps needed to be net winners from digital disruption, i.e. successfully dealing with the issue of legacy technology and managing a large infusion of new talent. Banks now recognize the urgency of embracing digital transformation to ensure they capture the massive value at stake. As banking is run on customer demand, banks should cater to satisfy the changing wants of customers. Some banks have invested heavily to transform all business segments and are likely to become "digital only banks" in the near future.

Discover New World outside the Comfort Zone

Traditional BFIs made hay day in the sunshine and accumulated significant profits on their core banking solutions for centuries when the world was confined to banks only. They also gradually handled investment and portfolio banking for their long standing customers, while capturing corporate customers. Due to many bank failures as a result of high risk exposures in investment banking and regulatory tightening, banks were forced to diversify or separate investment banking from core commercial banking functions. The investment banks' assets managers as well as portfolio managers and finance and leasing arms of banks in the Asian region too brought in stresses on banks but they managed to survive or have subsidiary companies and still make high profits. Banks thus sailed through to the modern day digitized world of banking. Many global traditional banks themselves began restructuring as they themselves were keen to be leading the digitization process but many others had their own problems and continued regardless. Customers had no choice but to go after banks and be their valued customers to get a few notches high on deposit rates and a few notches low on their borrowings. Hence up until late 1990s, and in Sri Lanka until the corporate governance code came into existence in 2008, banks relied heavily on "relationship banking" which did not demand much of a business transformation.

Fig 1: Incumbent institutions facilitate alternative payment schemes as complements



Source: World Economic Forum, Final Report with Deloitte, June 2015

[6]PWC (2014) - The Future Shape of Banking, Time for Reformation of Banking and Banks, July

Digital Transformation in Payment Industry is Primarily Led by Non-Banks

As seen from Fig 1, compared to traditional banks, the alternative rails do not necessarily require bank accounts and authentication (A) and they are capable of providing leaner, faster payment options within the existing network through the use of new technology (B). Innovative banks also can eliminate (A) as done by alternative rails through the use of apps. Since the introduction of credit cards in the 1950s, debit cards in the 1980s and the rise of e-commerce through the 1990s, electronic payments have grown in popularity, displacing cash and cheques. Electronic transactions rely on a number of intermediaries, which provide acceptance, convenience and security of transactions, and are generally coordinated by large scale-based payment networks.

Banks Ignored Payment Services

For centuries, banks held the monopoly in payment services and did not care about facilitating customers with newer techniques or making payment services more affordable. While many banks in the developed world began transforming payment services on their own volition, many commercial banks in Asia, Sri Lanka in particular, guarded heavily their payment forte in favor of primitive modes of payment, i.e. cheques, bank drafts, and paper based payment methods. Some banks in Sri Lanka did not support or cooperate with the Central Bank of Sri Lanka (CBSL) when it pioneered payment system reforms during 2002-2008 period. In retail payments, some banks preferred to have their own clearing systems instead of central clearing and use their own switches instead of the Common Switch established by LankaClear Private Limited and objected to application programme interface (API) connections and preferred manual transfer of data discs to Lanka Clear [7] . In high value payments, banks preferred end of day net settlement (with potential settlement risk to CBSL instead of real time gross settlements-RTGS) making a huge fuss about replacing CBSL cheques with RTGS transfers. Not only did some banks refrain from cooperating with CBSL but they also protested about the modernization of payment systems in Sri Lanka, only to retain small revenues from float generated between clearance and settlement of paper based payment instruments. Following the state of the art payment reforms during 2002-2008, CBSL was able to raise Sri Lanka's high value payment reform ranking to third place, and the cheque imaging and truncation system to first place in Asia. With the assured support from CBSL, this provided a golden opportunity for banks in Sri Lanka to create a payments hub in the region but banks ignored this rare opportunity and paved the way for non-bank service providers to enter the retail payments industry. Surprisingly, until recent times, some banks did not join the ATM Common Switch and continue to adopt a non-cooperative attitude towards payment reforms, which is a pillar in digital financial services. In later years, the wave of digital payment systems enveloped the entire region and non-bank payment service providers have surfaced as a threat to banks' retail business. In this area too, banks in Sri Lanka miss an opportunity by not linking their core banking systems with mobile payment service providers and foregoing lucrative business of joining with mobile operators and extending outreach to a larger network of retail clients. To date, except from mobile operator's

[7] Changed more recently to on-line data transfers

front, there has been no approach to regulatory authorities by banks for permission to link up core banking and mobile payments. In contrast, in the Association of South East Asian Nations (ASEAN-5), especially banks in Singapore, Malaysia and Indonesia have already linked up mobile payments and core banking and are now joining with FinTech to promote digitization of financial services. For a long time, banks in Sri Lanka avoided discussions with mobile operators and other ancillary service providers, except the provision of custodian services to mobile operators. Banks must realize that they have only a short sweet window to decide or let their retail business segment perish in time to come.

Banks Lost Monopoly in Remittance Business

World over, banks were slow in capturing this business and facilitating customers to encash their foreign exchange earnings. In the past, many remitting banks not only discouraged remittances from senders end but also charged relatively high commissions and fees from remitters. Banks at the disbursing end too, frustrated customers by not crediting their accounts as soon as funds were received. Instead, banks used customer remittances for their overnight lending and for various other purposes and credited customer accounts after a few days. This exploitative situations led non- bank courier services and other service providers to capture remittance business at affordable charges and reduce inconvenience to customers by delivery at the door step. For example, Western Union and Money Gram were smart enough to thrive in this business, not by reducing charges but by avoiding the bank route and facilitating speedy delivery to recipients. According to World Bank estimates, in the remittance business, migrants' remittances alone will total $586 billion in 2017, representing a tremendous growth opportunity for money transfer companies to compete with banks. Due to the efforts of the World Bank-led Global Remittance Working Group and its continued pressure for banks to reduce remittance fees and charges, global banks have gradually reduced their charges by about 5% as of June 2017, which is a huge boost to the bank dominated remittance industry. Banks in Asia are less concerned about this achievement and do not seem to be swayed by this positive move but often continue with old fee structures. In Sri Lanka, banks use remittances for investment in Sri Lanka Development Bonds (SLDBs) and sovereign bonds (if permitted) helping successive governments to finance their fiscal deficits. The same goes for India with respect to Patriot Bonds issued by Government of India. The World Bank continues to educate customers, banks and other service providers of the importance of remittance business and affordable charges on them under its 5* 5 programme [8].

[8] World Bank Group- Global Remittances Working Group (XXI Meeting), October 2017

Challenges and Perceived Threats to Banks

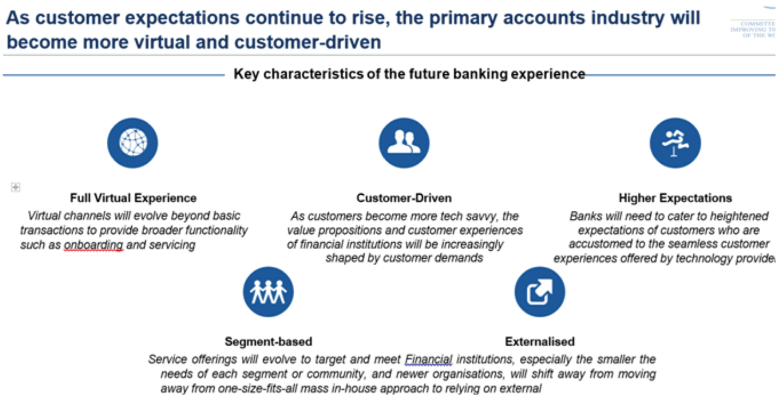
Shifting Customer Preference

As savers turn to alternative platforms, traditional deposits and investment products will be gradually eroded; distribution of customers' credit portfolio over a number of alternative platforms may make it difficult to measure customer's creditworthiness; and shifting customer preferences for "Virtual Banking and "Banking Through Mobile APPs" compel banks to provide access to core banking to non -bank intermediaries/ mobile network operators. The New entrants will make meeting customer demands more important, creating an imperative for banks to reconsider their roles and banking processes. The implications for banks would be: financial products will increasingly be offered on a stand-alone basis limiting incumbents' ability to competitively cross-subsidise; encourage banks' ability to collaborate with non-traditional players and other institutions; make banks aware of threats from Crowd Funding and Capital Sourcing; require banks to choose where they will specialise and where they will leverage external partners (e.g. product manufacturing vs. creation of customer experience). [9] Even with these changes, millennial don't want to go into a bank to meet with an investment advisor, who may try to sell them expensive, actively managed funds."Transforming their core business with three fundamental digital strategies, i.e. customer, enterprise and operational strategies would help banks to provide an Omni-channel experience, with new products or services that better suit customer needs and expectations. Across the enterprise they will need a digital culture using collaboration tools to support more intelligent business. Finally, information technology (IT) lies at the heart of banking and having an open architecture and flexible technology platform would be essential, not just to be more efficient, but to open up the possibility for new business models[10]. As seen in Fig 2, the Bank in the future will have to strategize today to survive in the future and that process will begin with opening up core banking systems to non-bank intermediaries, the mobile operators in particular. In Sri Lanka mobile operators are awaiting regulatory approval for such a link up.

[9] World Economic Forum, Final Report (2015) , The Future of Financial Services, Completed with Deloitte

[10] An International Indexed Online Journal www.darpanonline.org/GIRT ISSN 2347–8861 Global International Research Thoughts October-December 2013 Global International Research Thoughts (GIRT) Page 128

Fig 2: Key Characteristics of Future Banking



Source: Deloitte, Final Report, June 2015

While 69% of customers have tried bank led mobile banking, only 25% use it regularly. Much like the challenge other mobile apps face in maintaining ongoing engagement, banking apps tend to lose relevance by using a one-size-fits-all approach, failing to leverage recent activity patterns and context, and not taking advantage of different modes of engagement based on what users prefer.

Turn Branches into Experience Centres

Nearly 6,000 bank branches have been closed in the U.S. since 2009. According to the Federal Deposit Insurance Corporation (FDIC)-USA, with greater digitization, the trend seems to shift away from physical touch points. But as seen in retail business, the leaders are figuring out how to rationalize their physical space with smaller footprints and automation while also equipping employees to become ambassadors in the customer experience. This is because brick-and-mortar conversion rates (25%) are still significantly higher than online (2.3%). "Banks have an enormous amount of data on customers and their needs. Yet most of this data lives in silos across disparate data sources."Retail brands like Sephora and Nike have enabled customers to easily move from online to the local store experience by allowing them to browse store inventory, make appointments and even interact with associates. Bank of America has started to connect its online and local branch experience more tightly via its mobile app, and Capital One now has 16 banking cafes aimed at creating a more relaxed banking environment. But the industry as a whole is still behind when it comes to offering a truly connected and personal branch experience. To make the experience more like Starbucks, banks will need to ramp up investments in automation (digital integration, automated tellers) as well as attracting and training talent to match the new digital-savvy customer base.

Adopt a Customer-Centric Innovation Model

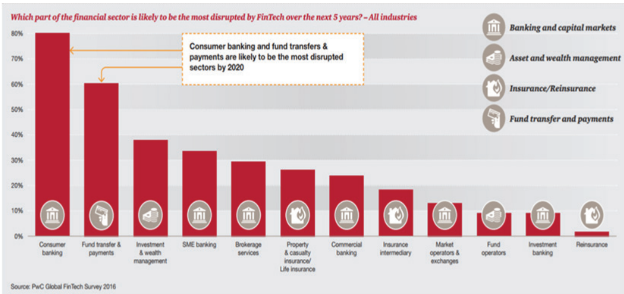
In this new era of empowered digital end-users, either banks find a way to make the customer part of its innovation model or customers will innovate them. M-Pesa was created by Vodafone, UK after acquiring 40% of Safari.com which was the wholly owned land line phone service providing subsidiary of Telecom-Kenya. The Central Bank of Kenya (CBK) took a bold decision and permitted commercial operations by a mobile network operator to launch M-Pesa in 2007 without any regulations. In 2011, the National Payment System Law was passed and CBK issued National Payment System Regulations in 2014, still not discouraging M-Pesa's innovative plans to enhance financial inclusion to a large population of unbanked, mobile consumers in Kenya. In later years, M-Pesa and banks teamed up to expand payment facilities throughout the country. Now M-Pesa has become the largest payment platform in sub-Saharan Africa. Banks still have a long way to go to fend off consumer-centric players like Apple, Google and Amazon from disrupting their markets. "Banks need to start transforming themselves from inflexible, analogue monoliths to delivering highly personalized physical and digital experiences."The growing importance of digital banking throughout the ASEAN opens opportunities for incumbents and attackers alike. Along with improving customer service generally, digital banking is a promising platform for increased product and services sales. Digital disruptors or attackers can take advantage of cost savings achieved by bypassing expensive branch networks and focus on their digital capabilities– fulfilment platforms and innovative products and services to gain market share.

The growth of digital banking in ASEAN also has their fair share of obstacles. In all surveyed countries, except Singapore (because banks provide equally efficient products and services), respondents were five to seven times more likely to have purchased general products or services online than banking products or services. Most transaction banks in Asia are still very focused on improving existing digital capabilities and products with less attention towards future growth opportunities. That being said, some of the traditional banks in ASEAN have become champions in the digital revolution. For example, with close collaboration with FinTech, the Development Bank of Singapore (DBS) has established a "Mobile Only Bank" (bank deposit –linked payment facility through mobile phone) branch in India for experimental purposes.

Watch out for Disruptive Trends and Loss of Retail Business

In recent times, new lending platforms are transforming credit evaluation and loan origination as well as opening up of consumer lending to non-traditional sources of capital with implications for BFIs. This intensified competition will narrow the spread between deposits and loans while decreasing BFI's, especially banks' profitability.

Figure 3: Areas of Disruption



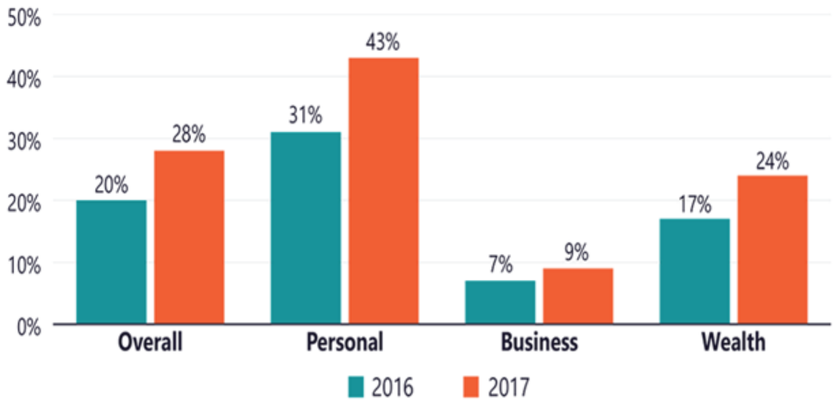
As shown in Figure 3, consumer banking and fund transfer and payments appear to be the main areas of disruption over the next five years. Payments being a key pillar of digital financial services are faced with a threat from unregulated FinTech operations.

Digitization of financial services is mainly driven by FinTech and non- banks. Banks should be forward looking and proactive in embracing digitization. Governments in Emerging East Asia (EEA) are clamouring to develop their financial markets, in particular, the domestic bond markets. At the national level, efforts are being made to: remove policy distortions; enhance market infrastructure to support the functioning of bond markets; strengthen regulation and supervision of financial markets in accordance with international best practice; and develop government bond markets that can provide benchmarks for corporate bonds. Depending on the collaboration between global/regional banks and FinTech, joint ventures are likely to lead in the enhancement of capital flows into ASEAN markets. That will change the Asian financial landscape profoundly and create more opportunities for digitally powerful regional banks[11].

As seen in Fig 4, improvement to banking products and services were notable in 2017 over 2016, but less than 30% of overall products can be applied for using digital channels, while only 43% of personal banking products are enabled for mobile customer acquisition (but up from 31% in 2016). For more than half of the banks, the majority of their personal banking products cannot be applied for online as most banks fail to capitalize on their investments in digital marketing and digital channels, resulting in 70% - 90% abandonment rates when potential customers try to open an online account. Only 66% of personal banking products were deemed ready for online sales and fewer than 25% of wealth and banking products were found to have online applications.[12]

[11]Scott A Snyder (2017) , How Banks Can Keep up with Digital Disrupters, Safeguard Scientifics , Feb 01.
[12]Avoka State of Digital Banking Report

Fig 4: Comparison of Digital Sales Capabilities



Source:Avoka State of Digital Banking Report

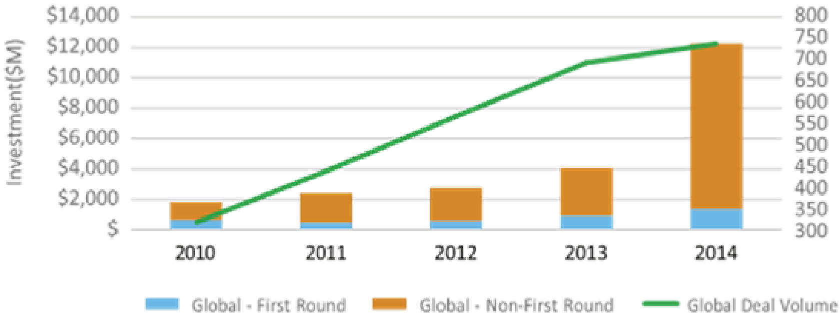
FinTechs are Driving Digital Revolution

The combination of geeks in T-shirts and venture capital companies has produced FinTech start-ups that have put the financial services industry on alert. From payments to wealth management and fromP2P lending to crowd funding, a new generation of FinTech are aiming to drive the digitization of financial services industry in an innovative way. The term "FinTech" encapsulates a variety of ventures that offer financial products in new and innovative ways with a heavy utilization of cutting-edge technology. Examples of well-known FinTech entities include Square, Stripe, Kickstarter, Lending Club, Apple Pay, and Bitcoin. Nevertheless, 2016 was a tumultuous year for Lending Club, in that the company, once considered the standard bearer in a new generation of online lenders, has faced severe reputational risks due to revelations of lending improprieties, a U.S. Department of Justice investigation, the departure of loan investors, and layoffs of 179 employees[13].

Goldman Sachs[14] has estimated the FinTech revenue pot to be worth \$4.7 trillion. According to a 2015 report from Accenture, global investments in FinTech firms totaled \$4.05 billion in 2013 tripled to \$12.2 billion in 2014[15] and was predicted to reach \$ 19.7bn by 2015.

[13]http://www.Bloomberg.com/2016/lendingClub and Reuters-May 9th 2016
[14]Goldman Sachs Report in March 2015,
[15]MarketResearch.com publications and Banking Reports

Figure 5: Global FinTech Financing Activity



Source: Accenture and CB insights

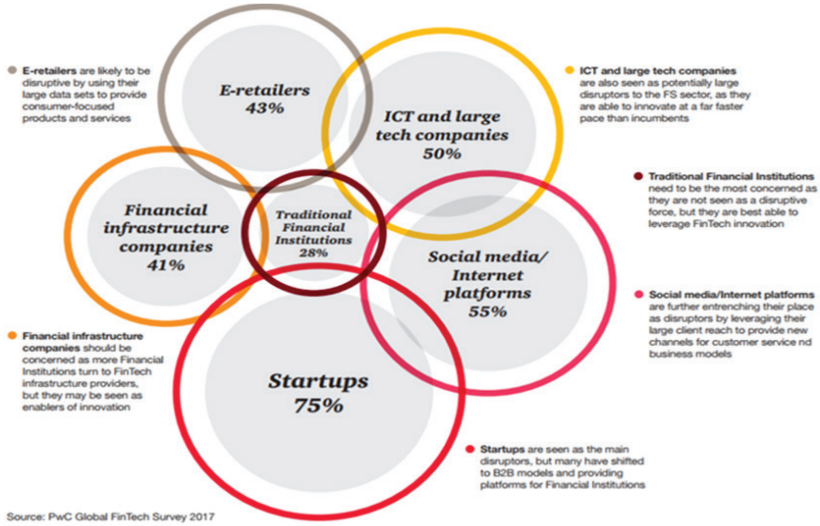
Fintech represents a wide ranging group and sub categories. FinTech Enablers support incumbent BFIs by delivering digital solutions for existing offerings using their strength in technology-driven software, platform and infrastructure. Enablers are usually focused on features enhancement rather than product or solution specific augmentation. Some enablers and Disruptor FinTech are making inroads to banking businesses and have impacted on transaction banking solutions, such as cash management, trade services, trusts and securities. [16]Fintech Disruptors are changing the dynamics in how businesses is done, with strong differentiation in offerings or revolutionary business concepts. They use advanced digital platform solutions and product/service differentiation that could potentially displace traditional transaction banking solutions. As illustrated in Figure 6, start- ups have been branded as the most disruptive group of Fintech although some of the start-ups have changed their mind set and become more collaborative than disruptive.

The bigger effect from the FinTech revolution will be to force flabby incumbents to cut costs and improve the quality of their service. It is expected that the FinTech revolution will reshape finance - and improve it - in three fundamental ways. First, the FinTech disrupters will cut costs and improve the quality of financial services. They are somewhat unburdened by regulators, legacy IT systems, branch networks - or the need to protect existing businesses. Second, they have adopted new ways of risk assessment. This kind of data-driven lending has clear advantages over decisions based on a single credit score or meetings between banker and client. FinTech works on the premise that “humans are more prejudiced than algorithms” and discrimination in lending will be minimized. For young businesses and borrowers on the fringes of the banking system, risk assessment that scours the online world for information is better than a loan officer in a branch. Third, the FinTech newcomers, start-ups in particular, create a more diverse, and hence stable, credit landscape. Banks take in short-term liabilities such as deposits and in turn invest them in long-term assets such as mortgages. FinTech lenders

[16]Jayamaha Ranee, Thriving in a Digital World- Non-banks Have Challenged Retail Business of Banks- Association of Professional Bankers, 28th Annual convention, 2nd November, 2016

like Lending Club, Prosper and Zopa simply match borrowers and savers directly. Banks borrow heavily to fund lending, but the new FinTech platforms do not. Instead, a lender commits its money until the final payment is due and it bears the risk of default. The Fintech start-ups will force banks to accept lower margins but conventional lenders, banks in particular charge more for services that the newcomers cannot easily replicate, including the payments infrastructure and the provision of an insured current account

Figure 6: FinTech and Disruptive Entities



Source: PwC Global FinTech Survey 2017

FinTech: Partners, Collaborators or Competitors?

Whether a FinTech is seen as a competitor or partner depends upon whether it is a traditional bank or a digital bank. Digital banks in Europe are probably still able to compete against FinTech, that need scale and to build trust amongst consumers. Banks are selling financial services, which are based on trust.

When compared to Fintech, the regulatory playing field is disadvantageous for banks as the former comply with minimum regulations in most countries, whereas banks are subject to a strict regulatory framework. Another main difference that banks already have a banking licence. Some FinTechs won't be strong enough to build enough scale if they don't have a banking licence. This point to the fact that FinTechs are competitors. Many banks believe that FinTechs are competitors that will ultimately take away banks' business; customers might prefer the solutions provided by FinTechs because they are able to move rapidly than banks can, they are customer centric and banks could lose the customer relationship on the Internet to the FinTechs. However, in the medium term, customers will want to keep their accounts with banks due to the confidence factor which makes Fintech to partner with banks. It is also notable, that much of the venture funding and seed investments for FinTechs is coming from banks and such operations are faster and more customer-centric.

There are many opportunities for partnering. The FinTech companies have the advantage in terms of speed, agility, and the capacity to understand and quickly build a very good user experience. However, they don't have the legacies that banks have and they have a completely different mind-set – and with the lack of scale and trust, it's not as easy as it might seem for FinTech to move forward without banks. In any case banks are more advantageous because they have more information about customers – and the existence of this information relies heavily upon transactions. Therefore, the bank in the future is more likely to partner and converge or acquire larger Fintech in the future if the business preposition is appealing to both parties. Everything is evolving and any combination is possible in a dynamic world.

Regulators have a critical role to play in digital financial services and take a view of the future operations of banks, non-bank financial service providers and joint operations of both these groups. The current regulatory frameworks applicable to banks in Sri Lanka are tough enough to avoid any disruption to the financial system stability by banks. The well balanced regulatory and supervisory regime has insulated the country's banking sector from the last few financial crises, from which European and US banks still suffer. Despite the current stringent regulatory structure, the finance and leasing company sector in Sri Lanka is still vulnerable due to numerous problems they are confronted with. Operating under the Payment and Settlement Law and with CBSL approval, the mobile operators have made a significant contribution to retail financial services in Sri Lanka and are moving in an orderly fashion. Some of their innovative and customer centric moves are discouraged by regulatory approval that takes a long time. The newly emerging Fintechs and start-ups are not in the regulatory radar and they have entered into the financial services industry, some as facilitators and others as disruptors. Currently, banks have reservations in linking up with an unregulated and foot lose type entities and are waiting for CBSL to come up with a light touch regulatory structure for FinTech and start ups before they can cause any disruption to the financial system.

Critical Areas of Strategic Transformation for Banks

The Bank in the Future will be Digital and Personal

Banking used to be viewed as an industry that was impervious to the digital revolution. Stalwarts argued that personalized services offered inside of a branch could never be replaced by computers, much less a hand-held device. It is reported that by the beginning of 2017 over ¾ of millennial, who are quickly becoming the most important consumer demographic in the world, prefer to interact with their bank digitally rather than through a branch.

Consumers are clearly ready for purely digital banking experiences, but businesses are not fully ready as yet[17]. McKinsey found that just a few years ago, European banks were only investing 5% of their total budgets on digitization efforts, which shows that there is still a huge opportunity for banks to align with the digital demands of their customers.

For banking customers, digital has become the new normal. Fifty years ago, very few customers had the educational background (or time) to invest in the stock market or complex financial instruments. Instead, financial advisors, most likely located at the nearest local bank, helped customers walk through a financial plan based on their personal goals. Over time, investing in financial instruments became more accessible. The internet generated a boom in day traders who were able to buy and sell stocks, futures, and commodities from anywhere in the world, not just on Wall Street. As a result, today over 15 million people in the U.S. are trading stocks personally using an online investing or stock trading service. The internet also made it much easier to find advice on investing, which significantly reduced the cost of becoming financially literate. As a result, banks are no longer just competing with other banks—they are also competing with customer self-reliance[18].

To continue adding value, the bank in the future must change its approach by becoming truly Omni-channel and offering consistent experiences across in-branch, online, and mobile interactions. Consumers also want to be able to start an application in one place, and pick up where they left off in another. By sticking to a branch-first approach, banks risk becoming those dinosaurs that Bill Gates predicted."It's impossible to predict just what the future has in store for the banking industry, but we know two things for certain—banking will respond to consumer demand, and that means becoming more digital, and more personal"[19].

Focus on Drivers of Change in New World of Finance

Digital Readiness

Banks should assess their readiness to face the next wave of digital innovations and that will also give them space to decide on strategic partnerships with those who revolutionize digitization. As strong global and regional banks can still hold on without taking considered decisions if they begin with stocktaking. The regulatory environment in ASEAN, particularly know-your-customer rules and other anti-money laundering programs that compel face-to-face meetings, implies that it may take some time before pure digital offerings will be widely available in the region. In Germany, banks can satisfy know-your-customer requirements using Skype or other video-conferencing tools. In Australia, due diligence for new accounts and other transactions is satisfied not only using registered mail to the account holder's home address but also in person at a branch.

[17]Fundera, an online lending FinTech company, recently conducted a survey and found that 60% of small business owners indicated that they would prefer to apply for loans entirely online. That number is astounding when compared to the fact that only 9% of business banks have true digital sales capabilities.

[18]Dambisa –Moyo (2015), Will Banks Survive Digital Disruption? Technology Impact on Financial Services, 13, November

[19]Don Bergal-CEO, Avoka, Tech # NewTech, Fintech – retail Banking

According to McKinsey[20], throughout ASEAN, retail banking is a nascent market with considerable room for growth. Incumbents and attackers have an opportunity to reach out to those without any banking relationship and others with relatively small portfolios of banking products.

Openness, Collaboration and Investment will Hold in Good Stead

Since the global financial crisis (GFC), leading Asia-pacific countries (APAC) -based banks have outperformed the global banking sector. Forecasts point to the region continuing to offer important growth opportunities, particularly in the emerging markets. However, with an increasingly challenging trading environment, taking advantage of these opportunities will require a more strategic approach[21]. Those remaining in the game will need to choose their strategic focus, revisit their business models and develop new sources of competitive advantage by harnessing digital technologies. As international banks downsize or withdraw from APAC, domestic and regional banks are stepping in - with a wave of new competitors hot on their heels. The region is already seeing new types of competitors from the rapidly-developing FinTech sector, offering new banking and payment and financing options. "National Champions" are on the rise across the region, hastened by the market integration promised by the upcoming ASEAN Economic Community (AEC) Initiative, which will enable banks to operate more easily across borders. Regional banks from Japan, Australia and the ASEAN are also building their presence. These strong, well-capitalized institutions have spent the last five years expanding their regional footprints, following intra-region trade flows and the geographic expansion of their customers. For example, during the past decade, ANZ, Australia has positioned itself as a full-service bank in emerging markets in Asia, focusing mainly on retail and wealth operations in the region. More recently however, ANZ has pulled out its Asian retail wealth operations from five locations by announcing a new Asian strategy of focussing on providing banking services to large customers. In early August 2017, DBS Group Holding Ltd has bought over these operations from ANZ[22] thereby further strengthening DBS's presence in the ASEAN region. With DBS in the lead, major banks in Singapore and the rest of South East Asia singularly or in partnership with FinTechs have been drivers of digitization of financial services[23].

Recognize Benefits of Electronic Transactions, Cut Costs and Improve Quality

Convenience, Traceability, Protection and Accessibility are said to be the key benefits of electronic transactions. Where will digital investment yield the greatest gains? Banks will also need to harness technology-driven innovation to both differentiate them and operate

[20]Barquin, Sonia, Vinayak, H V, and Heidi Yip, Digital banking in ASEAN, McKinsey and Company, kuala Lumpur office.

[21]An Industry Project of the Financial Services Community. Prepared in collaboration with Deloitte Final Report, June 2015

[22]Financial Review – www.afr.com/ business/ banking and finance/anz/sell/Asian/retail and wealth operations to DBS

[23]Jayamaha Ranee, (2017) The Fintech Revolution: Reinvention of Financial Services, Uni-Apro –Finance 5thAnnual Conference in Indonesia

their business more efficiently. The under-banked population does not have access to primary accounts and therefore only uses cash in transactions. This is important for the FinTech sector not only to reduce costs and drive efficiencies but also to respond to those who have been denied access to financial institutions. In fact, the role of technology is so significant that the lines are starting to blur between technology companies and banks. While reinvigorating the customer experience in retail banking using data analytics to provide personalized, proactive services and create new customer experiences, banks need to partner with governments that are keen to open up financial services and encourage innovation. More online-only banks, such as WeBank and Alibaba-affiliated MYbank are likely to emerge initially, at national level with the potential to become regional. This calls for simplifying and standardizing operating models to transform cost structures and equip banks with a single customer view and detailed profiles of accounts and interactions that are vital to delivering an engaging customer experience. Banks should use Smartphone apps to achieve a breakthrough in financial inclusion. Mobile solutions offer the potential to reduce the cost of obtaining banking and payment services in emerging markets and increase penetration rates.

Bank in the Future Should Concentrate on Technology Based Frauds and Cyber Threats

Despite the safety measures increasingly adopted, electronic transactions create opportunities for fraudulent activities that are vulnerable to cyber risks. Sharing of relevant information and working in cooperation are the main preventive measures one can think of as legislation alone would not be sufficient to handle upcoming digital and cyber risks. If any bank thinks that it is insulated from these risks, especially cyber risks, it's the biggest mistake that a bank could be making – a mistake which will place all their customers at risk. They should open eyes to what's going on in the financial services in the industry at present and assess how banks in the world cooperate in handling unknown cyber related risks. In addition to global efforts, regional banking groups have initiated many alert systems to manage risks beyond their country risks.

Concentrate on Cross Border Transactions and Facilitate on-line Remittance Business

The technology is developed to such an extent that bank to bank direct transfers can be done at a minimal cost and within minutes. Sri Lanka is heavily dependent on foreign remittance flowing into the country (helps finance over 70% of trade deficit) from professional and non-professional workers who send part or entirety of their earnings for the support of their families or for investments in financial and real estate. At one stage, the remittance collection by banks was competitive and banks even employed collecting agents in many of the remittance spots, such as the Middle East, Italy, and Korea etc. Banks should continue this business with further vigour and now compete by facilitating on-line remittance transfers which is already being done by telos. Banks in Sri Lanka should pay early attention to this area of business as Belt and Road Initiative (BRI) financial integration will further facilitate remittance business in BRI participant countries. The Government of Sri Lanka should encourage remittance flows into the country for the good reasons known to it and avoid taxation of such remittances.

Digitize and Transform Main Business Segments /Pillars

It is high time for banks in Sri Lanka to stop ad hoc patching up type of digitization and start doing end to end digitization of selected major business pillars. In this regard, banks have a good opportunity to use reliable FinTech facilitators and make arrangements to restructure front, middle and back office functions of banks or may even consider joining up with FinTech and make full use of FinTech facilitators, the approach taken by most of the digital champions in South East Asia. This does not mean that banks should not scare away their valuable non-tech savvy customers who would still prefer to continue their customer-bank relationship. Exaggerated advertisements on digitization may bring in short term gains but banks may not be able to sustain such gimmicks in time to come. For example, some of the bank branches located in Colombo are still unable to get customer profiles on to a single desk top computer and customers have to wait hours for authorization from head office or other branches. Such is the state of digitization of some segments of leading banks in Sri Lanka.

Skills Management in Dynamic Banking World should be Different

It is imperative for the Bank of the Future to give up its traditional approach to managing human resources. Training modules of most banks in Sri Lanka and also in some of the South Asian countries are archaic as most of the modules include ways and means of improving the bank branch model and paper based payment processes. In a world where customers demand, the Millennials in particular, for the Internet of Things, mobile apps, electronic fund transfers, cognitive analysis, alternative methods of funding, such as crowd funding, algorithm based decision making and machine based financial services, the training modules should go beyond paper based instruments. Staff training and talent management should be tailor made to cater to the demand for banking services, encouraging bank staff vision, talents and aspirations. Banks should identify young talents and deploy them to drive digitization rather than training them to collect door to door customer deposits. The digitized financial services are looking for talents to develop web apps, engage in back office transformation, connectivity between core banking, mobile applications, interoperability between and among similar business players, combined services on insurance and capital market products, supervision on network management and devices for risk mitigation in cyber threats, data base hacking etc.

Concentrate on Risk Management and Cooperate in Handling Unknown Risks

Globalization and digitization of banking and financial services have diversified risk into known and unknown areas. Inherent and traditional risks, such as those stemming from the macroeconomic front will continue to be there until such time the economy becomes prosperous, stable and less vulnerable to external influences. Banks are experienced enough to safeguard themselves from known risks (capital adequacy, credit, liquidity and market risks)as they are under regulatory scrutiny to be in compliance with Basle III and corporate governance guidelines, and credit risk analysis etc. The newer and unknown risks that are spread by digitization, in particular operational risk, cyber risks, KYC/CDD, money laundering and terrorist financing related risks are difficult to be sized or estimated and to take risk mitigation measures. In this connection banks must realise that they cannot mitigate these risks alone and joint efforts and sharing of information is the key.

Digital Transformation and Technology Adaptation in Asia

Pay Now Singapore

Seven major retail banks in Singapore launched a peer to peer (P2P) transfer service that promises a seamless way to split the cheque or make home-tutor payments using mobile numbers or identity card numbers.[24] With the fund-transfer service potentially extended into commercial transaction, from 10 July, 2017 customers of participating banks - Citibank, DBS, HSBC, Maybank, OCBC Bank, Standard Chartered Bank and UOB - will be able to use a service known as Pay Now, through which they can send and receive Singapore-dollar funds. For customers to receive funds through Pay Now, they need to register and link one mobile number with their respective participating banks' accounts. Nineteen banks in Singapore already offer free and 24*7 inter-bank transfers through Internet banking, running on a system known appropriately as FAST (fast and secure transfers).

Pay now runs by allowing the seven banks - which process 90% of the retail transaction volume - to move fund transfer service onto mobile devices. This service now effectively turns the mobile number into a unique identifier of a banking customer, which is more efficient than using a bank account number as an identifier. Banks are now expected to integrate the Pay Now service into their existing P2P service, or launch them separately as a new application. Most banks are expected to keep the mobile transaction threshold to about S$1,000 a day. Plans are for the service to be extended to business and digital P2P payments which are cheaper than cheque payments in Singapore.

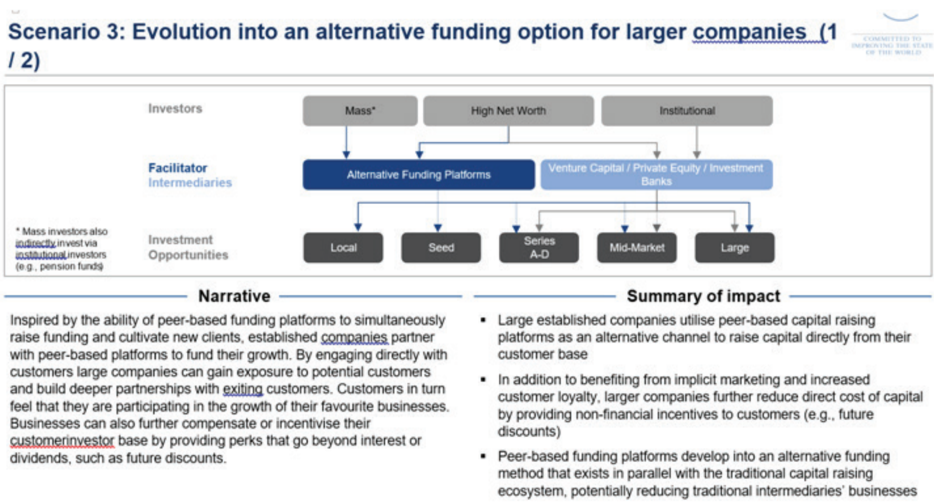
Financial Integration under BRI

Regional economic integration and urbanization could further boost APAC including ASEAN-5's growth momentum. The implementation of the AEC Initiative, the Chinese- led BRI comprising the revival of the land-based Silk Road Economic Belt and the sea-based 21st Century Maritime Silk Road initiative and other regional economic integration groupings could significantly expand trade and investment and unleash powerful forces of competition in the region. These initiatives are aimed at raising productivity levels and infrastructure growth in the BRI participating countries. To seize the opportunities associated with BRI and FinTech- led digital financial services, banks in the APAC region need to:(a) Invest in digital channels to meet customer needs - but not necessarily at the expense of personal interaction with customers:(b) Focus on areas of strength and specialist areas of expertise - and withdraw from business lines

[24]http;//www.businesstomes.com.sg/openion/banking Fintech/tie-ups-represent a potent force-26/7/2017

and markets where scale or competitive advantage is lacking. International banks, in particular, have begun to re-assess what is core versus non-core for their business in the region. The BRI listed infrastructure projects in 65 participant countries are preparing for financial integration strategies to provide joint financial services to BRI listed large scale infrastructure projects that are taking place in South East Asia, South Asia and Central Asia in phase I. Similarly, the newly emerging micro and small and medium enterprises are seeking cross border retail finances form host countries as well as from BRI participant countries. Banks in Sri Lanka are yet to explore business opportunities in these regional initiatives or seek opportunities to expand cross border retail business. BRI financial integration is a great opportunity not to be missed by banks in Sri Lanka. Now it is time for banks to raise their heads from the sand. As expected, China–led BRI is going through geopolitical resistance, but BRI alone seems to be a novel initiative to the Asian region and potential benefits appear to be enormous. Crowd funding platforms are widening access to capital raising activities, making the overall ecosystem richer. As regards implications for banks, they should note that access to more diverse funding options allow ancillary service providers and new companies to grow at a quicker pace and shorten the average time between early funding stages, which is being promoted under BRI financial integration.

Fig 8.Alternative funding options for large companies



Source: Deloitte, FinalReport, June 2015

Observations and Concluding Remarks

The current shape and makeup of the banking industry is inevitably going to change. The question is in what ways and by how much? The sheer scope and speed of evolution in regulation, customer behaviour and technology – coupled with changing market dynamics and aggressive non-bank competitors – mean banking in the future cannot simply be a continuation of banking in the past. This creates a real risk that they will be left without a clear strategy and business model to execute the degree of transformation required if they are to maintain their central role in the delivery of banking services. Corporate history is full of cautionary tales about incumbency advantage being lost at the turn of technological cycles.

As the digital revolution evolves, much of the financial terrain in which technology companies are making the deepest inroads will come into much sharper regulatory focus. This will favour the established banking players. As a result, the digital revolution's assault on the traditional banking industry is by no means overwhelming. In finance, at least, technology firms should not be viewed simply as a threat, but as a source of productivity-boosting innovation. Emerging alternative lending models create both competitive threats and evolutionary opportunities for financial institutions, making it important for incumbent institutions, especially banks and alternative platforms to develop more integrated partnerships and learn from and share each other's capabilities. It would be premature to conclude that traditional banking is withering away. Many of the new entrants with limited scale as well as data and information on customers have now realized that they alone cannot cause damage to the centuries old banking industry. By steering clear of services that might draw the scrutiny of financial authorities, digital start-ups face a natural limit to the size of their market.

No doubt, Fintechs are spreading fast, but they tend to boast a little too much. Fintechs are clearly in the process of making inroads into the retail business of banks in a more systematic and cost efficient way, thereby pushing banks to look after their large and money market customers. If banks are still interested in saving their retail business, they have no choice but to adopt to the innovative changes that are required by the new wave of digitization. In South Asia, except India, countries are yet to prepare their digitization strategy of banking services and the orderly manner in which banks would proceed. By 2025 to 2030, could the market economy exist without banks? Banks are strong and robust in their structures particularly in the post financial crises period. Their brands and reputation remain potentially powerful, while alternative banking providers still suffer from a lack of trust. There is no chance of banks withering away in the near future. Against this background, today's banks must press ahead on several fronts: they must continue to adapt to regulatory changes and be strong and stable; work through the legacy of underperforming assets; change their organisation's culture and behaviours and demonstrate to society that they deserve a renewal of trust; and invest in customer service and operational innovation. Managing a transformation programme of this scale will be a challenge – but a comprehensive transformation will be held in good stead.

All of these call for banks and regulators to accept the inevitability of change, and develop a new vision for the future of banking services. Turning that vision into reality will not be quick or easy. But unless both banks and regulators embrace and embark on this journey today, they face a real risk of being left behind on the hesitancy. Many professional and scientific surveys reveal that about half of the respondents would be willing to switch to a bank that could address these concerns and offer online features that meet their needs. To overcome this inertia, banks must find ways to increase the online value offered to consumers at critical stages of purchasing decisions, for example, by making transactions less complicated.

Stories and assertions about banks' demise are premature but are not entirely baseless. Banks have had tumultuous times, survived many financial crises and are now looking forward to survive in the new digital world. After each financial crisis, due to their own restructuring plans and toughened regulatory requirements, banks looked very different to what they were prior to the crisis. Although diminished, banks' trust and brands remain powerful assets as well as their customer relationships. Financial service consumers are becoming more sophisticated and are ready to take advantage of digital banking, especially the young and affluent. It is hard to predict the future of the banks which resist or avoid change or those banks which would like to continue in their comfort zones, keeping their heads in the sand until they confront a danger. They may not be banks in the future.

It is imperative for regulators to change their mindset and approach today. In many instances, dynamism of banks has been stifled by draconian regulatory structures. Currently, banking regulators worldwide appear to be focused on tactical responses to avoid bailing out weak or insolvent banks in future despite pressures from political circles on grounds of 'too big to fail". However, there is a need for greater certainty around the regulatory agenda, and for policy to focus on the role of banking as a positive contributor to economic growth. At the same time, regulators need to be vigilant on FinTechs and other aggressive ancillary service providers who can rock the financial system stability for want of entry into the banking industry. A light touch regulatory framework is essential to avoid potential disruptions to financial system stability by non- bank financial service providers, i.e. mobile operators, ancillary service providers and FinTech and start-ups. As many such players plan to partner with banks and move onto the dynamic digital world, viability and stability of these constituents and the robustness of their systems are equally important for the financial system. Banks would then be more comfortable to partner with lightly regulated entities and move to the new world of tomorrow.

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