Knowledge

# Fintech Versus Banks: Déjà Vu?

By Jean Dermine , INSEAD Professor of Banking and Finance

**Those sounding the death knell of the banking industry at the hands of fintech start-ups are underestimating the resilience of banks to disruptions.**

The recent dismissal of Lending Club CEO, the charismatic French entrepreneur Renaud Laplanche,for allegedly miss-selling loans to a Wall Street bank, caused a media circus about the future of fintech, raising concerns whether these ambitious start-ups had the right controls in place to keep up with their growth. But the fintech industry was already on shaky ground before this news broke.

Initially dubbed peer-to-peer lending (individuals financing individuals), it has evolved into “marketplace funding” with large institutional investors such as pension and hedge funds, and even banks, making the loans to individuals. After the initial euphoria of its public listing in 2014, Lending Club was trading well below its issue price by January 2016 as it started to lose the interest of institutional lenders due to increasing default rates. Regulators

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also began paying more attention to the information “investors” were getting about their investments and whether consumers were borrowing  at usury rates.

Many claims have been made that mainstream banks could be displaced by peer-to-peer and market place lenders, but in a recent paper for **Banque de France’s 2016 Financial Stability Review**, I point out that it is far from clear that these new players have the expertise and infrastructure to replace the work banks do.

Lending, for example, is more than just matching investors and borrowers. It involves the control of risk after lending has taken place, the trading of claims if investors need to access liquidity, and the crucial management of non-performing assets or the restructuring of loans if required. Marketplace lenders in contrast, hold no loans of their own, nor do they hold any of the credit risk. Thus far they have benefited from a low interest rate environment, minimal regulatory oversight and a revival of the US economy: three advantages that are likely to be short-lived.

## Disrupt this

The recent surge of fintech is just one part of a long series of innovations in the banking sector that includes telephone banking, payment cards, the development of capital markets, internet banking, smartphone apps and cloud computing.

In fact, predictions of banking's slow death began 35 years ago when phone banking emerged sparking fears that telephone companies would enter the industry. That didn’t happen. Instead, banks started offering telephone services. We’ve also seen payment cards emerge, such as the “Octopus” card, a top-up transit card used by commuters in Hong Kong, which, given its widespread use, seemed well-placed to perform other services. That didn’t materialise either. Banks now have payWave credit and debit cards that also double as subway cards in Singapore for instance.

## Why we still need banks

Why have banks survived these threats? For the past 600 years, they’ve played a crucial role as intermediaries in financial markets able to balance and manage interrelated services and bridge gaps between short-term deposits and long-term loans. In my paper, I identified six major functions of

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banks that provide a host of services, many difficult to compete with. To simplify, we can group them into three categories.

1. Data processing: The payment service involves the debit and credit of accounts. Brokerage of shares or bonds involves a change in ownerhip. As banks do not have a competitive advantage in data processing, it is no surprise that fintechs, such as PayPal or TransferWise, are very active in this area.

2. Data analysis. Lending involves not only matching investors and borrowers but monitoring risk and collateral and restructuring when needed. Advisory work for corporations in the field of risk management or corporate restructuring or advice in asset management require a degree of financial expertise that can only be acquired at significant cost.

3. Finally, banks have a unique balance sheet structure not available to fintechs. By transforming short-term deposits into long-term loans they provide liquidity to the economy.

The entry of fintechs in the last two categories of banking services will not be easy.

**They’ll respond, you can bank on it**

In many cases, banks have been able to respond. In France, they joined forces to introduce Paylib for online payments and others have collaborated with Apple. This has indeed meant reduced revenue and banks are facing pressure to reduce operating costs, which they respond to with omni-channel distribution and closing of branches. A useful distinction should be made between ‘old’ countries already overbanked and emerging markets where there is still a significant unbanked population. In the last case, agile fintechs could reach the unbanked population more rapidly.

Regulation is also likely to catch up with fintechs. As I recommend in my paper, public policy should ensure a minimum level of transparency for borrowers and investors. It must identify and control shadow banking with maturity mismatch, a major cause of a liquidity crisis. Banks still have a unique role to play in providing liquidity and funding higher credit risk assets, which are often opaque. Digital technology, in my opinion, does not represent a fundamental disruption to these two banking services. Just as banks have adapted to new technology in the past with the development of

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omni-channel distribution, there is no reason why this would not be the case again.

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