Bank to the Future II

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"BANKING IS NECESSARY, BANKS ARE NOT"

Bill Gates, 1994

Countless tech visionaries have talked about the potential for "disrupting" the banking industry. Some have even started companies which competed with traditional banks. (Despite his words, Gates himself never did so.) To date, none of these companies has had much impact on the incumbent banks, who have done a far better job of disruption by shooting themselves in the foot. (Honourable mention to Deutsche Bank, which since the GFC has managed to lose over 95% of shareholder value.) This is not to say that banking is immune from tech-based challengers, just that – so far – none of the challengers has succeeded.

Because the tech companies have always prioritized creativity, ingenuity, and speed to market, they have great difficulty understanding the mindset of industries where these characteristics are not virtues, but vices. Software developers who are creative build exciting new products. Bankers who are creative go to jail.

The essential features of all banking processes are security, privacy, and reliability. A bank which falls short in these areas will be disciplined by its regulators and deserted by its customers. Samsung could recall the fire-prone Galaxy Note 7 because phones are not bank accounts – any losses are minor and fixable. Microsoft could release the bug-ridden Windows Vista because users could find work-arounds or shells for the unsatisfactory operating system. A fire-prone phone, a dud operating system – these problems are nowhere near as serious as losing the contents of your bank account.

Banking also face high standards of regulation and compliance. In the wake of the GFC, regulators around the world tightened the tests and rules around bank balance sheets. In Australia, for example, banks must meet "unquestionably strong" benchmarks. In addition, growing concerns about tax evasion have combined with anti terrorism measures to impose strict new rules to prevent money laundering.

Earlier this month we reviewed what was known about Libra, Facebook's proposed new cryptocurrency. We concluded that there was a viable business model somewhere in all the hype, but that Facebook had badly underestimated the regulatory mountains it had to climb in order to get Libra approved in rich-country jurisdictions. In what follows we have broadened the scope of our review to look at the major threats to the traditional business model of Australian banks.

THE FOUR BIG THREATS FACING BANKS

There are four major threats to the business model of Australian banks. The first is whether they can improve their culture and operations sufficiently so as to comply with the **higher standards** resulting from the Hayne Royal Commission. We will not address this threat here, because it is under constant discussion in the media and because it is within the banks' own power to resolve.

The second threat relates to **cryptocurrencies and payment systems** such as Libra. Some commentators from the tech world have suggested that these currencies and systems will take over many of the functions which are currently performed by banks. On the evidence to date, we think this sort of change is unlikely, because banking is a highly regulated business in which reliability, privacy, and security are paramount. The tech industry has repeatedly demonstrated its inability to incorporate any of these features in its businesses, let alone all three features at once.

The third threat comes from new entrants who claim to have competitive advantages derived from new financial technology ("fintech"). New entrants who focus on a particular segment of the banking industry (such as factoring or mortgage processing) are likely to be acquired by a big bank long before they become serious competitors. "**Neobanks**" is the term applied to new entrants who compete head to head with the incumbents. Because they are starting from scratch, it will take several years before we see whether their competitive advantages can overcome those of the incumbents. In the meantime, the neobanks must keep raising capital in order to fund loan growth and pay for the regulatory and IT burdens.

The fourth threat is **ultra-low interest rates**. As we can already see in Europe and Japan, an economy where official interest rates and the yields on government bonds are close to zero or below it creates serious problems for the banks' traditional business model. Such an environment reduces bank profitability by compressing the net interest margin, which is the difference between the rate the banks lend at and their cost of funds. In addition, the low interest rates paid on deposits encourage depositors to look for non-bank alternatives with higher yields.

In our opinion, **ultra-low interest rates are the most serious threat** as well as the most urgent. A prolonged period of cash rates below 1.0% would not only reduce bank profits and dividends, it would also persuade many bank customers to switch from term deposits to non-bank alternatives, eroding a key competitive advantage for the banks.

WHAT IS LIBRA?

- Libra is planned to be a global cryptocurrency suitable for international transfers. Its value will be stable because it is based on a "Reserve" of high quality assets.

- There are many unanswered questions about Libra's regulatory status, particularly about its compliance with anti money laundering rules. It will not be accepted in developed countries until it satisfies each country's regulator.
- Libra can productively target remittances, which are an important segment of the global money transfer market. Remittances from rich countries to middle income and poor countries totalled USD $529 billion in 2018.
- The impact on Western banks will be modest until Libra changes its business model.

We analysed the issues surrounding Libra in the document "Libra: Star Sign or Tampon?" which was posted on the Arminius website earlier this month. We have subsequently updated our analysis with "Facebook Faceplant", which recorded Facebook's blunders in its initial dealings with US politicians and Swiss regulators.

HOW WILL LIBRA AFFECT AUSTRALIAN BANKS?

It is unlikely that Libra will have a material effect on Australian banks in the next five years, even if it were permitted to operate here. In some jurisdictions, foreign exchange dealing and international payments are important profit centres for banks. But in Australia these activities are well below the materiality level which would require them to be broken out for segment reporting.

More than three-quarters of bank profits come from the core business of lending, as represented by the Net Interest Margin. Wealth management used to be a major contributor to the remaining profit, until the Hayne Royal Commission. From now on, non-interest income will be mostly derived from loan-related fees, funds management, credit cards, and domestic payments.

THE NEW PAYMENTS PLATFORM

In February 2018 the New Payments Platform (NPP) was introduced for the Australian financial system. The NPP, which is owned by a consortium of financial institutions (including the Reserve Bank), is the electronic infrastructure on which payments systems and other overlays can operate, in much the same way as different trains can run on the same railtrack system. Whereas the old system restricted transfers to accounts specified by a BSB and account number, the NPP allows real-time transfers on a 24/7 basis, with address descriptions up to 280 characters long.

Most of Australia's financial institutions are now using the NPP. The first payment system up was Osko, run by BPay, which is owned by the Big Four banks. But so far not all participants have changed their operating protocols or upgraded their legacy systems so as to make full use of the NPP. (This means that certain banks had not increased or re-directed their IT spend to prioritize the NPP.) The Reserve

Bank recently scolded the laggards, threatening regulatory intervention by the Payments System Board if they didn't speed up their rollouts.

Last year's report by the Productivity Commission on competition in the Australian financial system criticised the NPP as being an oligopolistic arrangement which suited the incumbent banks and their payments systems. Among other issues, the report argued that the NPP's fees should be reviewed, that a formal open-access regime should be established, that the ePayments Code should be updated and applied to all participants in the system, and that merchants should be given the ability to use low-cost routes such as EFTPOS rather than high-cost ones such as Visa or Mastercard. At present the NPP allows the entry of new competitors, but does not encourage them.

The current situation may of course be altered by Reserve Bank regulation or by Federal Government legislation. Changes are unlikely to be rapid, however. Apart from the IT spend which any changes will necessitate, any payments system is composed of many organizations, people, and processes, and all of them have to consulted, re-trained, and revised in order to ensure that the system retains its key features of reliability, privacy, and security. The NPP did not begin operations until six years after the Reserve Bank's 2012 report on payments systems.

POTENTIAL NEW ENTRANTS

The most visible threats to the banks' business model are the fintech startups and the neobanks. They are the most visible because they are the noisiest. They need to attract customers and to keep raising capital, so they try to achieve and maintain high profiles in the media.

The fintech startups are usually focused on improving certain processes in the banking model, not on competing with banks. They are likely to be acquired by banks or by IT groups which provide services to banks. Some examples from the Australian incubator Stone & Chalk:

- Cloudcase claims to be able to cut the mortgage origination and approval process down to forty minutes. To date, its only user is the TSB Bank in New Zealand, which has a modest NZD 6bn in deposits.
- LoanDolphin offers mortgage seekers a free online platform where banks and brokers will bid for their home loans. It is one of seven similar platforms currently operating in Australia (so far).
- Butn has a suite of payment systems designed to simplify and accelerate transactions with customers and suppliers. Its intention is to increase the speed, capacity, and efficiency of the cash flow cycle.

- Priviti is targeting data management under the new "Open Banking" rules which will apply from Feb 2020. Its technology enables the bank customer to make online choices about what data is revealed and to whom.

The neobanks, by contrast, compete directly with the incumbent banks. They target the banks' customers and they may be able to market better, but they have the same funding needs and the same compliance obligations. The nearest comparison in Australia is the rise of the mortgage securitizers in the 1990s, who could offer cheaper mortgages because they had lower administration costs and their packages of mortgages were well received in wholesale debt markets. As soon as the GFC froze global markets for asset backed securities, however, the mortgage securitizers no longer had a business model.

Because lending is a business with immense economies of scale, the neobanks need to either find a profitable market niche or get big fast. Because of the upfront costs of building IT systems and developing marketing initiatives, neobanks usually face a prolonged period of high cash burn before they achieve cash flow breakeven (if ever). To the extent that they are "digital banks" – online only, no branch network – they have lower running costs, but they also need to set their costs of customer acquisition below those of the big banks.

The incumbent banks have the key advantages of customer inertia and the ability to copy good ideas. It is always cheaper for them to retain customers than to acquire new ones, which means that, provided they can identify wavering customers, they can undercut the neobanks. Often they can do so by starting their own digital banks, e.g. NAB with U-Bank, or by launching or reviving a niche brand, e.g. CBA with BankWest. They can also acquire or partner with successful competitors.



Even after the Hayne Royal Commission, the Big Four banks retain the trust of the public, in respect to security, privacy, and reliability (but not in financial advice), as the chart above shows. By contrast, technology companies have become notorious for their inability to protect their customers' data, whether by selling it, misusing it, or letting it get stolen. As many commentators have observed, if you don't trust Facebook with your phone number, why would you trust them with your money?

OPEN BANKING

The success of the neobanks relies heavily on the introduction of "open banking" in Australia, which is due to start in February 2020. Under the new regulatory regime, bank customers will have the right to share their banking data – transactions in mortgages, credit cards, debit cards, savings accounts, etc – with any third parties that they choose.

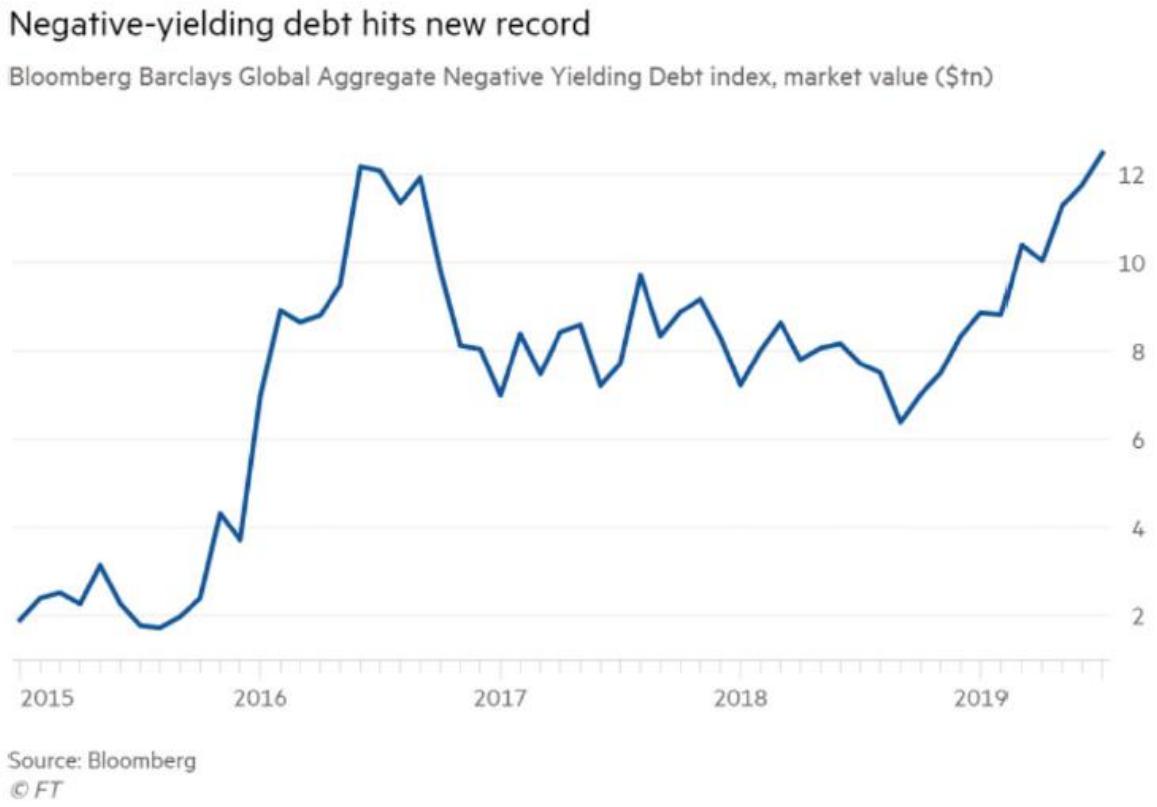
This visibility of data will make it easier for customers to switch banks and shop around for products, just as the introduction of number portability made it easier for phone users to change service providers. It will also result in wider variation in the interest rates and fees charged, because banks and neobanks will both be better able to differentiate good customers from bad. The website of the neobank Symple Loans, for example, mentions interest rates between 5.99% and 25.99%, as well as loan establishment fees between 2% and 5%.

A change of bank or bank product, however, is more laborious for the consumer than a change of phone company, so the switching effect may well take time to build up. Switching health insurers, for example, is a fairly simple process, but the rate of switching between funds had only reached 4.3% per annum in the year to March 2019, after doubling over the last decade.

THE RISK OF ULTRA-LOW INTEREST RATES

Probably the biggest single threat to the Australian banking model is the continuing fall in interest rates. Ultra-low interest rates impact the banks' main profit source, their Net Interest Margin (NIM). Even if official cash rates remain above zero (as in the US, but not in Japan), lower rates tend to compress the banks' NIM, which in turn reduces their after-tax profits and the level of dividends which they can pay. Every 25bp cut reduces the profits of Australian banks by up to 4% (provided that it is fully passed through). Futures markets are currently expecting two more cuts this year, i.e. an official cash rate of 0.75%. This implies an 8% fall in Australian bank profits.

Ultimately, falling interest rates may lead to negative interest rates, which have been widespread in Europe and Japan since 2016. The ECB and other European central banks had cut their policy rates into the negative in 2014, but bond yields and deposit rates generally stayed above zero. In January 2016 the Bank of Japan started charging banks 0.1% per annum on their deposits with the central bank, instead of paying them interest. The intention was to force the banks to increase their lending so as to stimulate the economy and lift CPI inflation to 2% per annum. To date, the policy has been a failure. The yield on the benchmark 10-year Japanese Government Bond (JGB) went negative in February 2016, then crawled back into positive territory (but never above 0.20% per annum) before relapsing below zero in January 2019. This year, the amount of debt with negative yields reached a record USD$ 13 Trillion, and German and Danish mortgage lenders started offering negative-rate mortgages.



The benchmark 10-year Australian Government Bond yield was 2.62% a year ago, but it has recently hit an all-time low of 1.28% per annum and is forecast to go below 1.0% soon. Ultra-low interest rates are very painful for banks, as is already evident in Europe and Japan. Depositors become unhappy with the returns from instruments such as term deposits, and remove their money in search of higher-yielding alternatives. This trend would erode a key competitive advantage in funding costs which the Big Four Australian banks have over their smaller or newer competitors – a huge pool of very sticky, low-cost money.

It is possible for banks to offer higher-yielding alternatives to the traditional term deposit, or to add on non-financial inducements such as bonuses or free trips. Besides the inertia factor, bank deposits do have the important advantage that, like government bonds, they are effectively risk free. The ordinary bank customer may lack investment expertise, but still understands that “money in the bank” is much safer than money in shares, money in property trusts, or money in bank hybrids. The ordinary retiree, however, may be compelled to take on more risk in order to achieve a liveable income.

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