A BANKLESS FUTURE?

BRACING FOR THE UNBUNDLING OF BANKS

BARRIE WILKINSON

It is the year 2115 and my great-grandson, Barrie Wilkinson IV, walks into a real estate agent's booth on New York City's Upper West Side.

Barrie: *"I'm looking for a one-bedroom apartment. Do you have anything for $20 million or less?"*

Real estate agent: *"You are in luck, sir. Such a property came on the market today."*

Barrie: *"Can I take a look?"*

Real estate agent: *"Of course. Put on these i-goggles and I'll take you on a virtual tour."*

Five minutes later...

Barrie: *"It looks great. I'll take it."*

Real estate agent: *"Wonderful! I'll just need you to sign the contract and confirm means of payment."*

Barrie lifts his arm and starts speaking to his Apple Watch: *"Update on my financial situation, please."*

Watch: *"I'm opening your Amazon money manager account. You have $3 million in liquid bonds and $4.5 million in your equity portfolio."*

Barrie: *"Liquidate my bond portfolio and set aside funds for a deposit on the house."*

Watch: *"Transaction complete."*

Barrie: *"Now I need a mortgage for $17 million."*

Watch: *"Your Experian credit rating has expired. Would you like me to get it renewed?"*

Barrie: *"Yes. And share all available information so I get the best possible rating."*

Watch: *"Done. You have received a B2 rating. You now need to upload the information on the property and legal documents. You have received five mortgage offers. How should I rank them?"*

Barrie: *"By price please, and filter for offers that cannot deliver the funds today."*

Watch: *"The best offer is from Vodafone Finance at 2 percent for a 30-year fixed-rate mortgage. Would you like to proceed?"*

Barrie: *"Yes, that sounds great."*

Watch: *"I can confirm that the mortgage funds have been transferred to a custodial account awaiting confirmation of receipt of the property* deeds."

Real estate agent: *"I just need a fingerprint signature on the contracts, and I'll release the deeds."*

Barrie presses his finger on the screen of his watch.

Real estate agent: *"Excellent. Here are the keys to your new home. Congratulations."*

Banks need to adopt much of the technology used by their upstart competitors

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UNBUNDLING BANKS

While it may seem unlikely, the scenario above is already possible using technology currently in existence. Most readers will be struck by how quick and hassle-free buying a house could technically become. But bankers should be struck by something else: Namely, the absence of any party in the story that resembles the banks of today. Each activity involved in the financing of Barrie IV's house purchase is performed by a separate firm. When his great-grandfather recently bought a house, they were all performed by one bank.

Fintech firms are already using advanced information technology to compete with banks in various parts of their "value chain." Thus far, the competition has been restricted mainly to the payments space, but they are moving into other areas. Investors are enthusiastic about their prospects.

Tens of thousands of bank employees spend their days concerned with credit risk, market risk, cybersecurity, and a plethora of other menaces. Yet these threats are trivial compared to the prospect of being rendered irrelevant by technology.

Is the multi-function, one-stop-shop banking model doomed?

To answer the question, we need to look at what banks do. Is there any function performed by banks that couldn't be done better by stand-alone competitors using new technology? Or is there some advantage in combining these activities within a single firm?

THE RISE OF PURE-PLAY PROVIDERS

Banking involves four basic activities: deposit taking, maturity transformation (using short-term liabilities to fund long-term assets),

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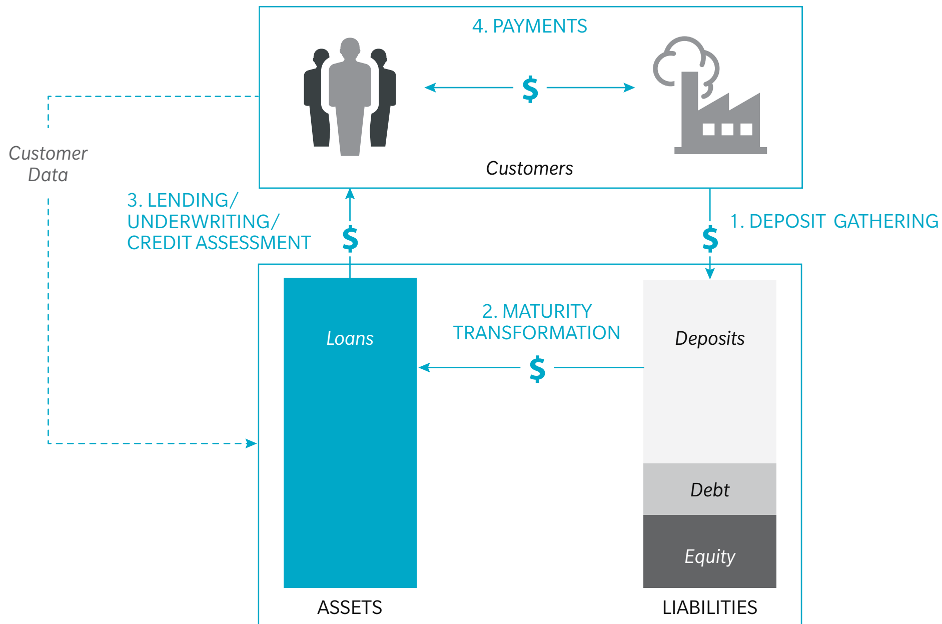
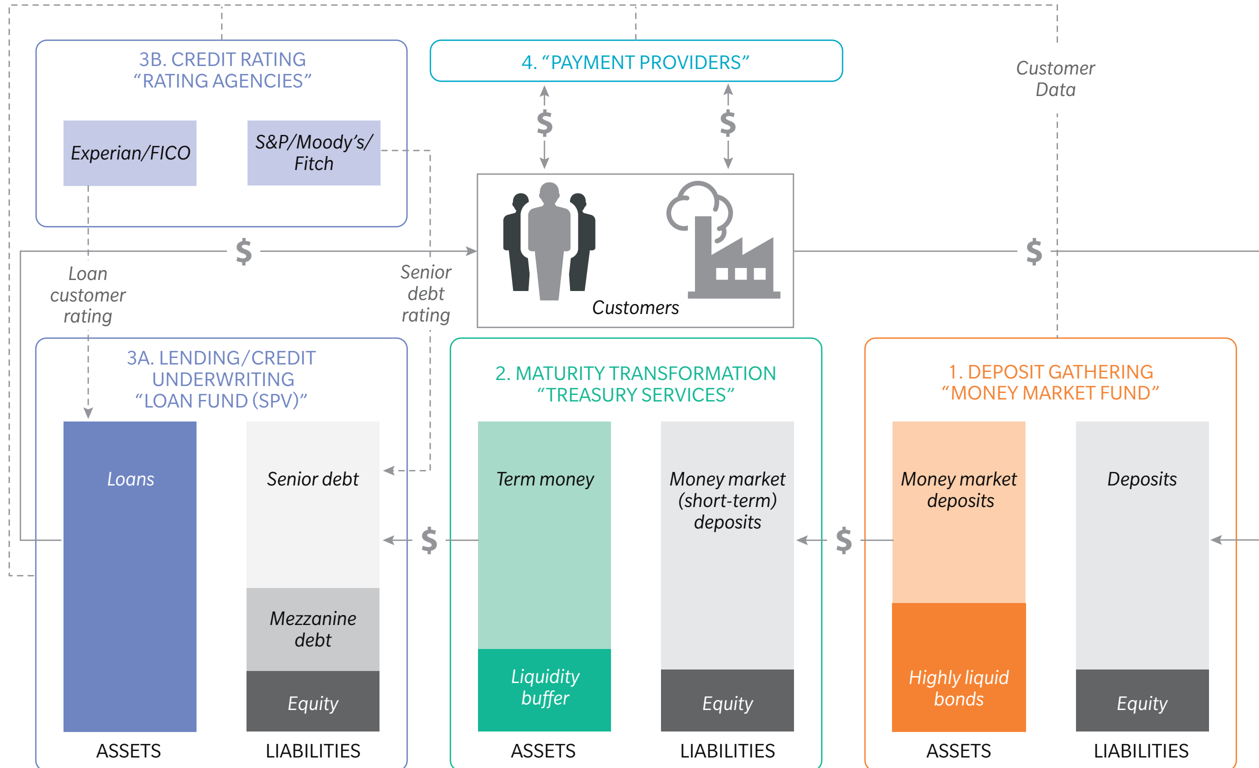
EXHIBIT 1: UNBUNDLING BANKS

TRADITIONAL BANK (ONE-STOP-SHOP FOR ALL BANKING SERVICES)



AFTER UNBUNDLING



$ Money flow ----- Information flow

Source: Oliver Wyman Analysis

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lending (including credit assessment), and the provision of payments. These activities have traditionally been bundled together in a single firm. But they need not be. Each function could instead be performed by pure-play providers. (See Exhibit 1.)

Some such pure-play firms already exist. Non-bank payments providers, such as PayPal, are familiar and growing in number. In an unbundled world, they could extend their activities to include direct debits, standing orders, and other payments still dominated by banks.

Today's money market funds resemble the pure deposit takers. Though they must invest to pay interest to their depositors, they greatly reduce the risk of doing so by buying only high-rated, liquid securities in an unlevered model.

Loan funds and securitization vehicles already resemble pure-play lenders. They fund their lending by issuing securities backed by the loan assets. In a mirror image of money market funds, they reduce the liability side of their business to a formality. And, of course, stand-alone credit assessors, such as Experian and Moody's, have been around for decades.

The notable exception is maturity transformation. No firm provides maturity transformation as a stand-alone service, taking the short-term assets of investors and providing lenders with long-term funding.

How come?

MITIGATING DEPOSITOR RISKS

In his seminal 1937 paper "The Nature of the Firm," British Nobel Prize-winning economist Ronald Coase argued that the scope of a firm's activities is determined by transaction costs. A firm will buy from an external supplier unless transaction costs make it cheaper to do things in-house. These transaction costs arise mainly from contractual uncertainty and the difficulty of getting information.

Standardized contracts in financial markets (most notably, for exchange-traded securities) and advances in information technology have dramatically reduced market and transaction costs. So we should not be surprised by the emerging unbundling of banks.

But what about maturity transformation? Why haven't external providers emerged when the transactions required have also become cheaper?

The answer is government policy.

Maturity transformation creates a risk for depositors. If too many depositors ask for their money at once, the bank (or an alternate provider) may not be able to hand it over because it cannot liquidate its long-term assets. To protect depositors from this risk, and the economy from the systemic risk created by bank runs, governments now guarantee retail bank deposits. Emergency access to central bank support also helps banks to mitigate the risk of a run on wholesale deposits. These mechanisms effectively, if unintentionally, subsidize the short-term borrowing performed by deposit-taking institutions. Unsubsidized pure-play providers cannot compete.

> Banks will continue to lose big chunks of what they do now

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Of course, governments attempt to reduce the extent of this subsidy by requiring deposit takers to hold liquid assets sufficient to prevent the need to call upon these mechanisms. But the non-existence of pure-play providers suggests that this is insufficient to eliminate the subsidy.

REVAMPING BANKS

So long as these implicit subsidies are worth more than the burden of liquidity and capital rules, banks are unlikely to completely unbundle in the way envisaged above. But they will continue to lose big chunks of what they now do. And in response, they will find themselves adopting much of the technology of their upstart competitors.

There will probably still be banks around when my great-grandson begins to look for a London residence, but they will not exist in the same form that we know them today. And, as Barrie IV will testify, banking will be better than we now know it, whoever supplies it.

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