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Is it time to RE-INVENT BANKING

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Banks are the bloodline of any economy, and there is no denying their critical role in propelling societies forward.

As a consumer, irrespective of your level of affluence, you will have been approached by banks offering you everything from cash back to perks and promotions for you to become a customer. Moreover, while many banks provide terrible customer service, there are some that really go the extra mile for their clients.

So if banks are useful for the economy, and many offer good products and services to consumers, why does the title of this article suggest banks need to change?

To understand this, you'd have to comprehend how the inner structures of commercial banks work. Without getting into too technical an explanation on key bank management practices such as 'funds transfer pricing' or 'asset liability management', the gist of it is that consumers rank lowest in the pecking order of banks. At the top of this pecking order are large corporations to whom the bank lends money, often in the tens (or hundreds) of millions. A consumer's checking account earning zero interest is the cheapest money a bank can find, and it will be used to fund loans to large corporate clients who have the ability to negotiate the rate of these loans as close to zero as possible. This means that you have to earn zero for the bank to afford very low interest to large corporations. In essence, retail customers earn close to nothing on their savings so that the bank can compete for corporate borrowers who have bigger negotiating power. In aggregate the bank turns out well, as does the corporate borrower, but at your subsidy. Call it 'portfolio theory' if you want elegant jargon for 'rigged'.

This is one reason why the banking system is set up against consumers' best interests.

But there is more.

Even if you exclude large corporates, banking is a fairly complacent industry. Here again 'portfolio theory' applies. For every 100 customers who take a loan, say that 5 to 10 don't pay. This causes that the interest rate on your loan includes a risk premium to compensate the bank for those who did not pay. Like it or not, your loan or credit card interest is higher than it should be, because you provide the coverage for those who don't pay, so that in aggregate the bank is profitable. It's a bit like all drivers covering unpaid fines of other people caught speeding.

As you can gather, 'portfolio theory' is easy for banks but it can have far-reaching perverse consequences. One example is that if you a hard-working, ethical, person of integrity yet living in a community where non-payment of loans is above average, your loan rate will be higher because of other people around you: this creates a material barrier for you to finance your way to a better life. What you require as a consumer is that your probability of default be the decisive factor of the rate you get.

Complacency, deeply established in banks' DNA, is at play here: it's easier for banks to charge everyone a bit more than to refine their ability (through big data and analytics) to exclude with laser-sharp precision those to whom they should not lend. This requires learning new skills, new lending models, and new techniques to rise to this challenge: the opposite of complacency.

This is one area in which fintech companies can come to your assistance. Unlike banks, they are not complacent and, unlike banks, they are looking at increasingly sophisticated ways to predict who will not pay back the loan. The consequence is that good payers will benefit from lower rates. This is deeply driven by analytics, which was never a strong suit for most banks. Therefore, from now on you may be better suited taking a loan from a fintech company then from a traditional bank.

Yet not only on loans will this apply. The 'portfolio theory' we described above is also applied between bank products, which often subsidize one another. By way of example, international remittances: according to the World Bank, sending money abroad in Switzerland will cost on average 10.6%, in Germany 7.2%, in France 6.5% and in the US 5.8%, and in the UAE 4.2%. Even if these fat margins subsidized benefits for you (e.g., free checking) the model would not survive the arrival of companies like Revolut and TransferWise have made transfers virtually free.

And, for the record, these fat margins usually don't subsidize benefits for you, but help bloated banks cover the costs of large staff, buildings, layers of managers, lots of branches, et al.

This model can't survive.
Now, it is imperative that you separate good fintech from bad fintech. There are fintech companies lending at exorbitant rates (payday lenders, point-of-sale lenders, just to name two categories) and you should avoid borrowing from these no matter what. Any regulated bank or finance company will give you a better deal than companies that are essentially loan sharks with a polished digital look.

The fintech companies you need to look for are the ones who share in the emerging new ethos that technology and data can be used to give good people a fair deal and, with this, a better chance to prosper in life. These are the companies who are purpose-driven, and who inverted the business model of banks into first do well by clients, and next our revenues will follow.

Ethos-driven fintech companies, as the name implies, are purpose-driven in their mission to share back to consumers the benefits enabled by technology and data. They employ data scientists, cutting-edge risk models, and decades of collective talent in their loans management so they can really predict a good payer with much more accuracy then what banks can do today. Just for starters you already will get a lower rate if you qualify for a loan, as you are not subsidizing a significant number of non-performers in 'portfolio theory'.

If you follow the news on financial services, you will have heard a lot on banks embracing a "digital revolution", particularly as Covid-19 leads to more remote service delivery (everything from food to pharmacy) and consumers becoming ever more accustomed to app-driven commerce.

These banks are missing the point. A traditional and complacent bank, steeped in old traditions of pricing in aggregate, does not become "digital" by increasing the functionality of its app. The real "digital revolution" is to use technology to deliver financial services in completely new ways, using analytics and science to, genuinely and innovatively, act in the best interest of customers.

At Deem we call this the purpose fintech revolution, and it's on its way.