

Wiley Finance Series

CREATING
Strategic Value

— THROUGH —
**Financial
Technology**



JAY D. WILSON, JR.

WILEY

Creating Strategic Value through Financial Technology

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*To Becky, my supportive wife, who inspires me to be
better each day.*

*To Connor and Sadie, my two children, who bring so
much joy and keep us entertained.*

Preface

As the financial crisis and Great Recession illustrated, the health and vibrancy of the banking industry is an important ingredient in a healthy economy. In the United States, community banks play a special role in the economy as they constitute the majority of banks, are collectively the largest providers of agricultural and small business lending, and are often key employers and providers of financing in their local communities. While conditions have improved since the depths of the financial crisis, community banks face difficult market conditions with intense and growing competition from both larger banks and non-bank lenders, a relatively difficult interest rate environment that places pressure on margins, and a heightened regulatory and compliance burden.

Community bankers are also increasingly facing an additional challenge with the rise of FinTech and its vast array of emerging companies and technology innovations in different areas of financial services. FinTech is a challenging strategic threat to assess for banks since competition is coming from startups focused on addressing a number of core banking services. While many bankers view FinTech as a potential threat, FinTech offers the potential to improve the health of community banks for those banks that can selectively leverage FinTech to enhance performance and customer satisfaction and improve profitability and returns. FinTech can also help level the playing field for community banks to compete more effectively with larger banks and non-bank lenders.

This book seeks to illustrate the potential benefits of FinTech to banks, both large and small, so that they can gain a better understanding of FinTech and how it can create value for their shareholders and enhance the health and profitability of their institutions. We provide a map of the FinTech industry and present guideposts for navigating the sector so that different parties (investors, entrepreneurs, and traditional financial services companies like community banks) can enhance customer/product offerings, improve efficiency/cost structure, and ultimately profit by creating strategic value as financial services and technology increasingly intersect.

Section One introduces the reader to FinTech and discusses the reasons behind the excitement and interest in the sector globally and, more specifically, for financial services in the United States. Additionally, we examine how FinTech can help community banks close the performance gap with

larger banks and enhance customer services offerings, efficiency, profitability, and valuations in a challenging operating environment. Lastly, we delve into the history of FinTech to determine themes and trends from some of the more mature FinTech companies. For those bankers still skeptical of the power of FinTech, consider the time and money saved by both customers and bankers through the use of the ATM, an earlier FinTech innovation that we discuss in Chapter 3. Imagine the lines at banks before a long holiday weekend if that were the only place to go and get cash, as well as the inconvenience of being unable to obtain cash on a Sunday or holiday because all of the bank's branches were closed.

Section Two discusses several FinTech niches that have great potential for banks. Each chapter focuses on a particular niche (Bank Technology, Alternative Lending, Payments, Wealth Management, and Insurance). We provide an overview of emerging trends in each particular FinTech niche and highlight certain FinTech companies that have developed in these areas. Finally, we discuss key insights that can be gleaned from the successes of these emerging FinTech companies. The case studies presented hopefully provide guideposts for bankers as they assess the vast array of companies in the FinTech ecosystem and that particular niche.

Despite the potential benefits of FinTech for community banks and vice versa, significant challenges exist for community banks considering FinTech opportunities. Community banks typically operate with a leaner technology staff and the appeal of FinTech can often be overshadowed by the breadth of the landscape. Lastly, there can be significant cultural, valuation, and risk differences between banks and FinTech companies, which can make partnerships and mergers between the two difficult.

Consequently, **Section Three** attempts to address some of these issues in greater detail and illustrates how both financial institutions and FinTech companies can create strategic value from improving one or some combination of the three primary valuation elements of cash flow, risk, and growth. For those interested in pursuing FinTech opportunities, they present traditional financial institutions with a number of strategic options, including focusing on one or some combination of the following: building your own FinTech solutions, acquiring a FinTech company, or partnering with a FinTech company. While we do not yet know which strategy will be most successful, we do know that discussions of whether to build, partner, or buy will increasingly be on the agenda of boards and executives of both financial institutions and FinTech companies for the next few years. In Section Three, we discuss a range of topics that should assist banks with analyzing these strategic options, including how to value a FinTech company and the pros and cons of partnership and acquisition strategies, and provide an introduction to the frameworks and return analyses banks can use to analyze and structure potential FinTech partnerships and mergers.

FinTech is an increasingly important topic for bankers seeking to navigate complex and difficult market conditions. As FinTech continues to spread across the financial landscape, banks of all sizes are beginning to craft their responses and prepare to either embrace future innovations as an improvement to their business models or attempt to shield their business models from potential disruption. Banks are starting to realize that they must develop a strategy that considers how to evolve, survive, and thrive as technology and financial services increasingly intersect. For these reasons, a number of banks are seeking to engage in discussions with FinTech companies. The right combination of technology and financial services through a partnership has significant potential to create value for both FinTech companies and traditional financial institutions.

FinTech presents the financial services industry with a unique opportunity to both increase revenue, particularly non-interest income, while also lowering costs and improving efficiency. In order to harness the potential of FinTech, bank managers and directors need to understand which FinTech niches best suit their business model and also how to prioritize FinTech initiatives and compare their potential to other strategic initiatives in order to focus on those areas that generate returns and enhance valuation. Similarly, FinTech entrepreneurs need to understand the financial services and banking landscape to be able to discern whether they should approach the industry as a partner, disruptor, or some combination of the two. Therefore, this book should also benefit FinTech companies and entrepreneurs who will gain a greater understanding of the challenging conditions facing banks, how their innovations can create value, key valuation drivers, and how to structure mergers and partnerships with banks.

Globally, banks face many of the same difficult market conditions and challenges currently affecting U.S. banks. However, it is an exciting time to be in financial services. Similar to innovations like the printing press or the steam engine or assembly-line manufacturing that led to significant changes in their respective industries, FinTech offers a unique opportunity to transform the financial services industry while also improving the greater good and providing better and more efficient services for customers, including many un- and under-banked people around the globe. FinTech also offers those countries with a weak financial infrastructure the opportunity for greater financial inclusion by providing financial services like banking, insurance, and wealth management at lower costs through digital channels. This can have a profound impact on people's lives and create profitable business models for banks and innovative FinTech entrepreneurs.

We are still in the early stages of development of a number of FinTech niches and innovations. For example, an innovative development in banking the last few years has been the use of mobile check deposit, which entails writing a physical check and snapping a picture on the phone. As a user of

this product, I must admit that it is very convenient and something that I use often as it saves me a trip to my local bank branch. While this is innovative, it is not a fully digital deposit system as it still requires a paper check and doesn't reduce the time spent writing the check or replace the inconvenience when you are out of paper checks.

As the FinTech industry evolves, it will be interesting to see whether idiosyncrasies like depositing a check persist and also whether this dichotomy continues to exist between FinTech, its many niches, and traditional financial services. One can certainly envision a financial services industry in the future where the remaining successful companies combine the best elements of both traditional financial services and FinTech and the two industries converge.

Thanks for taking the time to read this book and please feel free to reach out with comments or questions. In addition to having a keen interest in community banking and FinTech, I am also an avid tennis player. As such, I forewarn the reader to expect a few tennis analogies and stories in different sections of the book.

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One

Section One of this book introduces the reader to FinTech and discusses the reasons behind the excitement and interest in the sector globally and more specifically for financial services in the United States. Additionally, we examine more specifically how FinTech can have a significant impact on community banks through opportunities to enhance customer service offerings, efficiency, and profitability in a challenging operating environment. Lastly, we delve into the history of FinTech to determine themes and trends from some of the more mature FinTech companies.

Chapter 1 is titled **What Is Financial Technology?** We answer that question and present an overview of current trends in the FinTech industry. We also provide perspective on why FinTech is important and receiving significant attention from investors, regulators, entrepreneurs, and management/boards of traditional financial services companies.

Chapter 2, Community Banks and FinTech, discusses traditional bank valuation trends and drivers and shows how incorporating FinTech into your bank's existing strategy can help improve the profitability and valuation of your community bank. This chapter is also important for FinTech entrepreneurs as it demonstrates the potential value proposition for FinTech companies in the community banking sector. Successful FinTech companies need to be able to demonstrate their potential to improve the profitability and valuation of banks in order to attract them as customers or partners.

The Historical Context for Fintech is presented in **Chapter 3**. This chapter walks through the history of FinTech, including ATMs, electronic stock exchanges, and core vendors. We also look at the largest IPOs in the industry's history. This history lesson should help the reader understand what might be important in today's FinTech environment.

What Is Financial Technology?

TECHNOLOGY'S IMPACT ON FINANCIAL SERVICES

Tennis was invented a long time ago. How long ago? Well, it depends upon whom you ask. Similar to a number of other sports, the origins of tennis are unknown. The earliest records of the sport include paintings of European commoners and royals batting a ball around. However, the history of modern (lawn) tennis is clearly documented, as it was first publicly announced in March of 1874 by two British papers. The announcement included a patent for “A Portable Court of Playing Tennis,” which included a history of the sport, instructions for how to set up the court, and rules of the game.

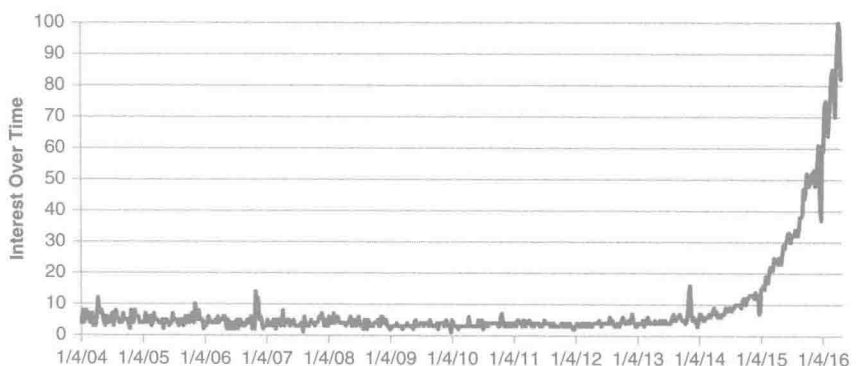
While basic tenets and elements of the game have remained similar over the years, tennis continues to evolve with changes to scoring, court surfaces, equipment, and playing styles. A key driver of these changes is the influence of technology. The development of stronger and lighter materials for a variety of industrial purposes would not at first glance be noted as a key driver of change in tennis, but these changes had a significant impact on the game. Graphite and other stronger, lighter synthetic frames are commonplace in the game today. The last wooden racket appeared in a major tournament in the 1980s. The confluence of technology and design affects balls, court surfaces, and even the pristine grass of Wimbledon. Many players now regularly use high-tech training tools to improve their fitness and stroke mechanics.

Despite these significant advances in the game over the years, tennis is not a sport that is linked with technology and a spectator at Wimbledon today would still recognize the sport if shown images from the tournament in the early 1900s. For these reasons, tennis is often referred to by pundits as being “steeped in tradition” and viewed by outsiders as a game that is slow to evolve. They can point to certain things like players still hitting the same basic strokes and the biggest tournaments still being held at some of the same venues (Wimbledon has had a tournament since 1877).

While we do not foresee those in financial institutions like banks, wealth managers, or insurance companies picking up tennis rackets anytime soon, there are a number of parallels between the evolution of tennis and the evolution of financial services. Like tennis, certain basic tenets and activities of financial services (such as depositing money, paying for goods/services, and borrowing/lending funds) have existed in some fashion for many centuries and are not expected to change in the future. However, a number of changes have occurred in the past and will continue to occur within financial services as technology increasingly intersects with financial services.

There is much excitement around technology and its potential applications within financial services as a number of pundits and analysts foresee a growing number of applications and improvements for the sector. Consumers are also increasingly asking for and adopting new technology applications. While the term *TenTech* (short for *tennis tech*) has yet to grace magazine covers and TV headlines, *FinTech* (or *financial technology*) has become commonplace in major magazines, newspapers, and TV stories within the financial services sector. The excitement around FinTech is difficult to gauge but the expansion in Google searches of the term *FinTech* and the global dispersion of those searches provide some benchmarks and evidence of the growing level of excitement. (See Figure 1.1 and Table 1.1.)

Given the growing interest in FinTech, let's address a few questions about FinTech: "What is financial technology and who are the players?," "Why is there so much excitement about FinTech?," and "Why is FinTech potentially so important for society?" By examining these key questions, we can gain a keen understanding of the topic.



Numbers represent search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. Likewise a score of 0 means the term was less than 1% as popular as the peak.

FIGURE 1.1 Google Search Trends for "FinTech"