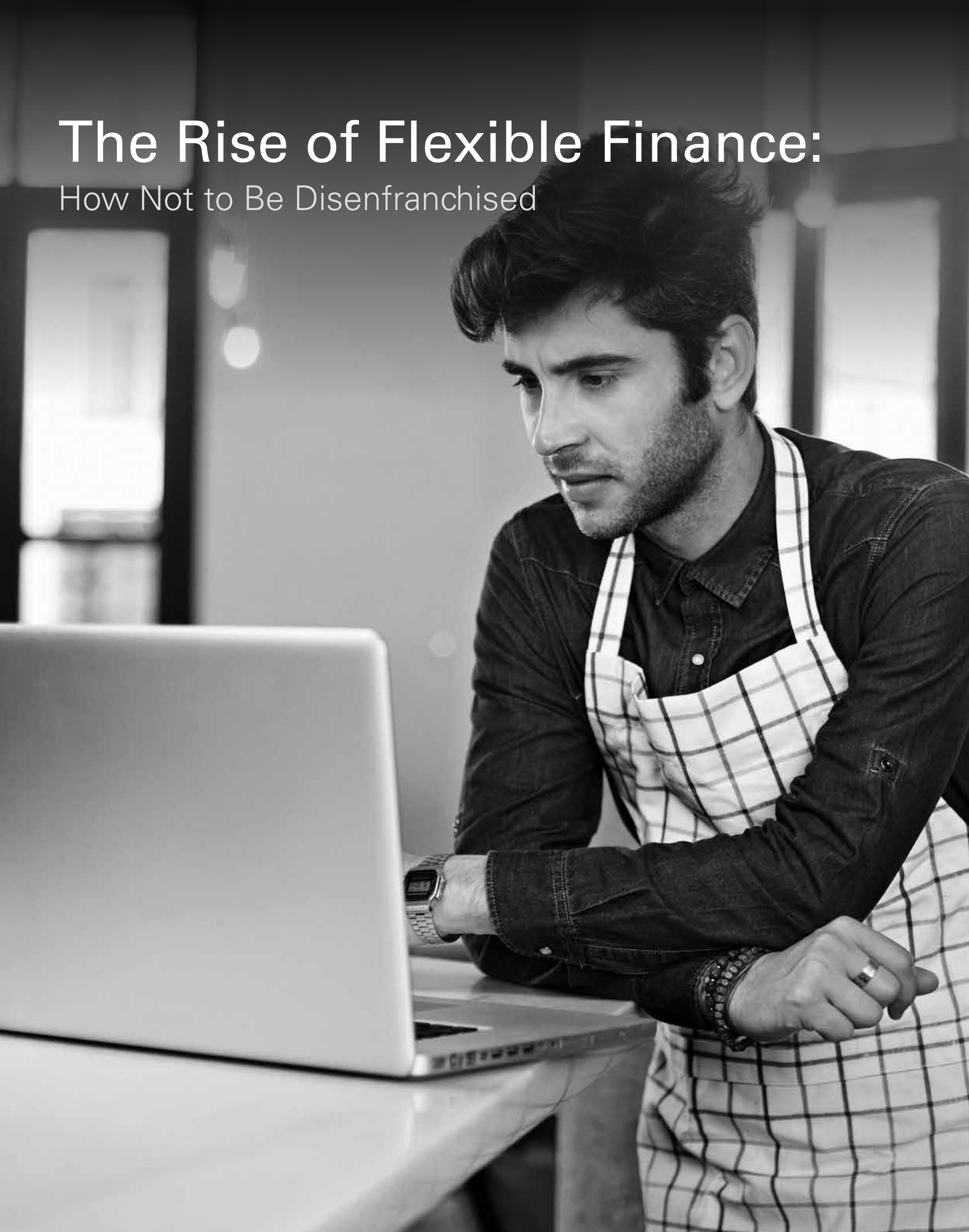
The Rise of Flexible Finance:

How Not to Be Disenfranchised



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The rapid rise of flexible finance offered by challenger entities poses the very real threat of disenfranchisement for many banks. At the same time, the COVID-19 pandemic is likely to increase demand for credit, which will further accentuate the need for banks to make the most efficient possible use of their balance sheets. Pete Tobin, Vice President Product Solutions, at Fiserv and Barry Tarrant, Director Product Solutions, at Fiserv, explore this connection and how both challenges can be successfully addressed.

Consumer payment and financing products have historically evolved in a highly-siloed, and product-centric manner, typically within separate business lines of a bank. Under this model, customers were obliged to select how they would fund a purchase (pay now or later) pre-transaction. This is now changing rapidly: new players are already in the market offering consumers a range of flexible financing options and innovative customer experiences before, after and most importantly at the point-of-sale (POS).

This presents a competitive threat far greater than the disintermediation created over the last 10 years or so by mobile payments and wallets such as PayPal, Apple Pay and Google Pay. While these solutions sacrificed a certain amount of transaction and customer data, the new flexible financing players are directly threatening the entire customer relationship by taking the entire transaction.

The challenge for many banks is now shifting from one of disintermediation to one of outright disenfranchisement, so they now risk:

- Losing the P&L benefit of the transaction
- Greater erosion and possibly complete loss of the customer relationship
- Losing all data associated with the transaction (which is also becoming increasingly granular and valuable)

The Funding Transition Threat

So how has this threat to the status quo arisen? 20 years ago, consumer payment choices were relatively limited – debit/credit card, cash or perhaps point-of-sale consumer finance. Then the range of payment options gradually started to increase with the introduction of mobile phone payments and methods specifically intended for online transactions.

These additional payment methods created a degree of disintermediation. The bank card was still the funding source, but the customer experience was now owned by another party. The consumer was no longer thinking about paying with their bank credit/debit card but instead began paying with a mobile or digital wallet like Apple Pay or PayPal.

The latest development – and one which poses a far more substantive challenge to many banks' business models – is the emergence of a choice of multiple types of funding for payments at the point-of-sale, combined with innovative customer experiences and dynamic financing flexibility that transform the buying experience. In this approach, part of the revenue derives from the consumer's financing charges and part from the fees charged to the retailer.

When consumers start using language like "to Klarna it" for buying online – with the company name being denominalised – the implications for banks become very clear.

This choice and flexibility has the potential to disenfranchise the consumer's bank or card issuer almost completely. They are not just losing a degree of customer engagement, but the entire relationship and transaction. So a credit card issuer will no longer see those receivables and a debit card issuer won't see the transaction cross its books. The customer's bank account is relegated to, at best, being used to repay another party with which the customer has now formed a relationship. The bank itself is left with no idea what or where the customer bought and without any revenue from the transaction.

This transition is a global phenomenon, and there is evidence that it is fundamentally changing consumer attitudes to credit. In doing so, these new flexible financing players are not only capturing existing consumer funding demand from banks, they are also creating new demand and capturing that as well. A good example of this is Germany, which has traditionally been highly averse to credit, instead preferring to use current accounts and overdrafts to support payments where borrowing was required. Now, challenger providers of flexible finance are issuing their own branded cards there and gaining traction. For one prominent provider, Germany is now its largest market in terms of web sites offering its financing solutions.

There is also a sense in other countries, such as the U.K., that consumer sentiment (especially among millennials) is moving away from traditional credit sources towards more personalised, targeted and relevant finance solutions. Possibly an even bigger concern for banks is that there is evidence to suggest that some of the most affluent households (with more disposable income and thus representing a greater cross-selling opportunity for other financial products) are more willing to shift to new providers. A 2018 survey by Forbes[1] showed that those aged 55 or younger with an annual household income of at least £55,000 exhibited this tendency, with 65 percent of them also open to sharing their personal data with other banks or non-banks in order to get better products or services. Whilst this segment is estimated to represent 15–20% of the total customer base, it accounts for some 45 percent of existing U.K. bank profits, so they represent a disproportionately large portion of profit that could be at risk.

[1] forbes.com/sites/baininsights/2018/03/15/why-big-uk-banks-are-worried-about-open-banking/

Urgency and Opportunity

This situation alone clearly demands some form of response, but there are two further important considerations for banks. The first is that this market is evolving extremely quickly so there is a strong time-to-market imperative. A multiyear internal project to deliver a competitive flexible financing solution will be impractical, as the competitive advantage lost in the interim will be too great.

The second consideration is that there is also an important opportunity here in the form of regulatory capital. Credit in forms such as overdrafts and credit cards is expensive in terms of regulatory capital, as the full amount of the credit limit has to be provisioned for, even if it is not actually drawn down. A bank that is able to offer integrated multi-option consumer finance before, at or after the point-of-sale also has the opportunity to promote more efficient alternatives from a regulatory capital perspective, such as fixed term loans.

This opportunity would be important at any time, but the response of central banks around the globe to COVID-19 makes it clear that they anticipate a greater need for credit (including consumer credit) so there is also an opportunity here to grow the lending book efficiently in terms of regulatory capital.

Strategy

There are two very clear strategies that banks can consider in responding to this challenging situation:

- Going head-to-head with the challenger providers of flexible finance by developing technology and customer experiences that enable them to integrate with merchants POS systems and compete directly with these competitors
- Building on the relationship they have with consumers and developing a suite of truly customer-centric, dynamic and flexible finance propositions that meet the customer's requirements, thus negating the need for the customer to even consider a challenger's service

Achieving the first of these options involves significant development of new capability to integrate with merchants' POS to enable sales and full/partial return processes, as well as providing the merchant with management and reporting tools. This may require different models with an off-the-shelf approach being required for multiple smaller merchants, whilst larger merchants demand a more bespoke retail partnership model. And whilst the revenue opportunity is broader, with potential for revenue from both the retailer and the consumer, it is a space that is gradually becoming more crowded. This will probably increase competitive pressure, which in turn is likely to reduce margins, whilst also raising the bar to improve the underlying customer experience and proposition.

The second option may by comparison appear to be a more defensive play as it just relies on enhancing the existing relationship. However, it too will require the development of a range of dynamic and flexible financing propositions, with innovative customer experiences that are clear and compelling enough to compete with the threat of the alternatives. It also has the very considerable additional advantage of enabling more efficient lending from a regulatory capital viewpoint.

Why PaaS Not DIY?

While banks undoubtedly need to respond to the challenge posed, they are suboptimally positioned to do so in-house, whichever strategy they choose to follow. As mentioned above, banks' existing lending products have typically evolved in completely separate siloes within individual business lines. Unfortunately, the same can also be said of their underlying technology, which is often similarly discrete. Therefore, for banks to consolidate all their various funding products and systems to deliver a similarly polished flexible finance offering to the disruptors, is not trivial. As with any implementation project, the usual cost and risk hurdles apply, but legacy architecture and applications are likely to increase them, possibly unpredictably.

It therefore seems likely that some will be seeking an alternative such as a payments as a service (PaaS) solution. Such services are already available and can deliver all the necessary capabilities and customer engagement to compete effectively with the challenger providers of flexible finance, but without all the risks and costs of an internal implementation. Examples of some of the integrated funding types a sophisticated PaaS solution can provide include:

- Deferred debit capabilities that enable a transaction to be temporarily pay now or pay later (such as for goods bought subject to approval)
- Equal Payment/Instalment Plan solutions that allow for equal payments over a set period of time, to facilitate budgeting for large or unexpected purchases
- Personal Reserve type propositions that provide a flexible line (or lines) of credit that sit alongside a current account
- Revolving lines of credit both with and without separate plastic that offer customers a high degree of flexibility to manage their finances
- Structured personal loans that provide lower flexibility, but a higher level of debt control

The consolidation of customer data in a modern PaaS flexible financing solution not only addresses the immediate challenge, it also opens the door to adjacent revenue opportunities and future innovation. For instance, understanding what a customer has purchased can drive cross sales, whether they are directly related to the article purchased or related to the demographic data that changing customer behaviour may indicate.

In the future it may not be beyond the bounds of imagination that data about consumer purchases of items with a predictable lifespan could be used by artificial intelligence or machine learning to make highly targeted, relevant and proactive financing offers as an item nears the likely end of its useful life. In effect, the bank would be in a position to know what a customer's likely financial needs were before they even arose.

Conclusion

The old adage of a challenge also being an opportunity certainly seems to apply to flexible finance. Banks that respond swiftly will not only be protecting their existing franchise. They will also have the opportunity to participate in a growing market segment, as well as to optimise the use of their regulatory capital and the return on that capital.

From a practical perspective, the need for a rapid response makes it probable that those who succeed will be those who adopt a PaaS solution, as opposed to building one in-house.

Assuming the right provider is selected, future-proofing, extensibility, lower risks and improved costs, along with consistent multi-country and multi-region implementation are all achievable.

Connect With Us

For more information about payment solutions, email Barry.Tarrant@fiserv.com or Peter.Tobin@fiserv.com or visit fiserv.com.

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