Brett King

Breaking Banks

The Innovators, Rogues and Strategists Rebooting Banking

WILEY

Contents

List of Illustrations

Breaking Banks

The Innovators, Rogues, and Strategists Rebooting Banking

Brett King

WILEY

Cover image: ©Tiero / 123RF

Cover design: Wiley

Published by John Wiley & Sons Singapore Pte. Ltd.

1 Fusionopolis Walk, #07-01, Solaris South Tower, Singapore 138628

Other Wiley Editorial Offices

John Wiley & Sons, 111 River Street, Hoboken, NJ 07030, USA

John Wiley & Sons, The Atrium, Southern Gate, Chichester, West Sussex, P019 8SQ, United Kingdom

John Wiley& Sons (Canada) Ltd., 5353 Dundas Street West, Suite 400, Toronto, Ontario, M9B 6HB, Canada

John Wiley& Sons Australia Ltd., 42 McDougall Street, Milton, Queensland 4064, Australia Wiley-VCH, Boschstrasse 12, D-69469 Weinheim, Germany

ISBN 9781118900147 (Hardcover)

ISBN 9781118915318 (ePDF)

ISBN 9781118900154 (ePub)

This book is dedicated to Matt, my son, who is learning to code and has more potential than he can imagine, and to the Italians who invented modern-day banking.

The measure of intelligence is the ability to change.

—Albert Einstein

Acknowledgments

There are a few people whose support made *Breaking Banks* and the ongoing disruption possible. First, thanks to Rachel Morrissey, who keeps me sane and keeps everything going, and to Randall and the team at Voice America for giving me the opportunity to run the *Radio Show* that led to this idea in the first place. Second, thanks to the amazing participants and interviewees who gave their time and support for the book, all of whom were very patient through rounds of edits and other unintended consequences.

Thanks to the team and supporters of Moven, who continue to give their incredible support in this tough, but amazing journey; to the tribe of bloggers, friends, and supporters who regularly tune in each week to my show, tweet, and amplify the message, including Sudu, Jim Marous, Dave Birch, Brad Leimer, Dave Gerbino, Serge Milman, Robert Tercek, Bruce Burke, Duena Blomstrom, Mike King (no relation), and cover artwork designer J. P. Nicols (no *h*), Ron Shevlin, Deva Annamalai, Jeff Stewart, Matt Dooley, John Owens, Bryan Clagett, Jason Cobb, Adam Edge, Jenni Palocsik, Matt West, Jay Rob, Lydia, and the crowd of other followers whom I'm sure I've missed; and to Uday Goyal, Sean Park, Sim, Pascale, Naoshir, Nadeem, Yann, and the team at Anthemis, who never cease to amaze me with their network and support.

Thanks to Nick Wallwork, Jeremy Chia, and the team at John Wiley & Sons for their support.

Thanks to Jay Kemp, Tanja Markovic, Jules, and the team at ODE, who support my efforts to keep the disruptor

message loud and clear on the road about 100 days of the year.

Finally, thanks to the disruptors, innovators, engineers, entrepreneurs, investors, and believers who are changing the world of banking every day.

About the Author

Brett King is an Amazon best-selling author, a well-known industry commentator, a speaker, the host of the BREAKING BANK$ radio show on Voice America (an Internet talk-radio network with over nine million monthly listeners), and the founder of the revolutionary mobile-based banking service Moven (Moven.com or search iTunes/Google Play for "Moven"). King was voted as American Banker's Innovator of the Year in 2012, and was nominated by Bank Innovation as one of the Top 10 "coolest brands in banking." His last book, *Bank 3.0* (available in seven languages), topped charts in the U.S., U.K., China, Canada, Germany, Japan, and France after its Christmas 2012 release.

King has been featured on Fox News, CNBC, Bloomberg, and the BBC, and in Reuters, *Financial Times, The Economist, ABA Journal, Bank Technology News, The Asian Banker Journal, The Banker, Wired* magazine, and many more. He contributes regularly as a blogger on Huffington Post.

Introduction: An Industry Being Reborn and Reinvented

The premise of *disruption* in financial services is relatively new. With the exception perhaps of the push for deregulation in the 1970s, banking is not known for huge leaps in innovation or significant shifts in the dynamic of the players involved. Sure, there have always been mergers and acquisitions, and some industry consolidation from time to time, but there's never really been anything that is akin to the level of disruption we've recently seen in the music or publishing industries, for example, or the dynamics of the communications sector with the shift from the telegraph to the telephone, and then from fixed-line to mobile.

In the midst of the financial crisis in 2009, Paul Volcker, the former U.S. Federal Reserve chief, berated the financial industry in respect to its track record on innovation:

> *I wish somebody would give me some shred of evidence linking financial innovation with a benefit to the economy.*
>
> **—Paul Volcker commenting at the *Wall Street Journal's* Future of Finance Initiative, December 7, 2009**

Volcker went on to claim that the last great innovation in banking was, in fact, the ATM machine. Volcker has a point. In all, banking hasn't really changed materially in hundreds of years. Ostensibly, the nineteenth-century form of the bank branch is still largely recognizable today. While we have had some so-called branch of the future concepts, the way we do banking has remained largely unchanged over the past hundred years.

At least, that was true up until a few years ago when the Internet emerged. Today, we see significant shifts in banking, consumer behavior, and bank product and service distribution methods. We have seen dramatic changes wrought by technologies like the Internet, social media, and mobile banking. The recent global financial crisis has undermined trust in bank brands collectively, and while that trust may start to return in the coming months, for now it is a cause for open challenges to the traditional banking approach. We have social media and community participation giving transparency to the discussion on bank effectiveness, customer support, and fees, like never before. We have new disruptive models of banking, payments, and/or near-banking that are taking off and challenging the status quo.

It is entirely possible that banks, with their heavy regulatory burden, high capital adequacy requirements, massive legacy infrastructure, and long-held conventions, may just have trouble adapting to these tectonic shifts. Think of Kodak, Borders, and Blockbuster as examples of companies in other industries that have succumbed to disruptive business models, changing consumer behavior, or technology shifts.

However, it is also possible that some banks may survive intact because they can direct their not-insubstantial resources to evolving the big ship that is their bank brand and operations, and can put a new layer of innovative customer experiences and technologies over the old core, creating something new, something dynamic and adaptive. Right now, however, the former looks considerably more likely, purely because the inertia in banking is fairly well embedded around risk and compliance processes, regulatory expectations and enforcement, and those 30-to-50-year-old legacy IT systems that can’t easily adapt to the always-on, über-connected environment we live in today.

In May 2013, when I established a podcast radio show[1] to tackle these concepts and questions, I set out with the intent of regularly interviewing the most disruptive players in the financial services space who are challenging the norms and attempting to turn traditional banking on its head, along with some of the most innovative leaders from within the sector trying to stay competitive. These two groups of disruptive innovators might represent different sides of the same problem, and while their approaches differ, the key takeaways or lessons they provide are extremely enlightening.

This book is not just a summary of those interviews; it is an examination of the new emerging business models, concepts, approaches, and constructs from a strategy, technology, and success point of view—what is working, and what isn't. More importantly, we look at what traditional players can learn from these innovators to kick-start their own projects or initiatives, and what they have at risk if they don't listen and learn. The interviews are insightful and take us in new directions, but also act as case studies of some of the techniques and models that are setting the tone for the next 20 to 30 years of banking. The data collected around these interviews and concepts is designed to give depth to understanding those models and providing statistical or quantifiable support for the various strategies.

In the chapters that follow, you will read about topics that include P2P lending, Bitcoin, and digital or cryptocurrencies, neo-banks or neo-checking accounts that challenge the basic bank account premise, social media's impact on major bank brands, banks that have had dramatic growth despite no branch network support, leading indicators of changing consumer behavior, sustainable banking, financial wellness and the tools that help people save, how campaign marketing is disappearing and customer journeys are emerging, and how technology is becoming elegant, highly usable, and more responsive to the end consumer. These are the new core competencies of retail financial services.

The secret sauce of these new innovative approaches, however, is really still down to the individuals driving that change on a day-to-day basis. This is not just about implementing the right technology or whether you integrate social media or mobile into your customer-facing strategy. This is about what drove these innovators to try something different, and where they see the industry going next.

In each chapter, I ask these industry leaders what the next 5 to 10 years will bring. In many ways, this is my favorite part of the dialogue, because it shows that potentially some of the revolutionary approaches to banking, lending, and customer engagement we are experimenting with today will be far more disruptive on a longer-term basis to banking than we can even imagine.

These are some of the most innovative disruptors in the banking scene today. Listen to what makes them and their businesses tick. Listen to what drove them to start these new approaches in the first place, to challenge the norm. Most of all, however, just imagine where this will take us next.

These are the *Innovators, Rogues, and Strategists rebooting banking*—perhaps even *Breaking Banks*.

NOTES

1 *Breaking Banks* is in its first year but is already in the top-five business shows on the Voice America/World Talk Radio network, which is in turn the most popular online

radio station and the most popular podcast channel on the Apple iTunes network.

Chapter 1
A New Take on Credit and Lending

The Global Financial Crisis saw the first decline in household debt in countries like the United States and the United Kingdom in over a decade, but in the past months we've started to see the lending business warm up again, getting closer to its pre-Financial Crisis levels.

When it comes to loan origination, traditional lenders increasingly are finding difficulty in competing with digital services and platforms that are providing more information and options in a more dynamic manner. Approval times have been slashed, built on newly designed processes with far less friction than the typical lender's loan application. As mistrust of the traditional banking system has increased and as lending has become more expensive, entrepreneurs have been turning to tools of the digital age to offer new solutions to those such as the unbanked, or to those looking for more transparent or cost effective options.

Lending has been around for a *very* long time. In fact, lending predates formal currency and the formalized banking system by thousands of years.

Archeological digs over the past 150 years or so have found literally hundreds of thousands of these tablets from as far back as 3000 BC. These tablets reveal that silver and barley (and sometimes gold as well) were used as the primary currencies and stores of wealth at the time. Mesopotamian merchants and lenders granted loans of silver and barley, at rates of interest fixed by law[1] to avoid usury. The yearly interest on loans of silver was regulated at 20 percent and on loans of barley at 33.3 percent.

Close to 4,000 years later, we're still using this same basic construct for lending purposes—a *principal*, a *term*, and an *interest rate*.

Access to lending has today become cheap and ubiquitous. Credit in the form of auto loans, student loans, payday loans, mortgages, and credit cards has sprung up across the developed world in increasing variety. Microcredit and lending systems, most recently popularized by the likes of Grameen Bank[2] in Bangladesh, and new online social platforms, such as Kiva.org,[3] have given broader access to credit in communities that have traditionally not had access to such.

Our dependence on credit and the way we use credit has also changed in recent years. In the early 1980s, U.S. household debt as a share of income was around 60 percent. By the time of the 2008 financial crisis, that share had grown to exceed 100 percent. In fact, at its peak just prior to the financial crisis, U.S. household debt as a share of income had ballooned to almost 140 percent, but in the United Kingdom that figure was almost 170 percent of household income. Today, U.S. household *credit card debit alone* averages $15,185 per household, but that is down from around $19,000 in mid-2008 (Figure 1.1).

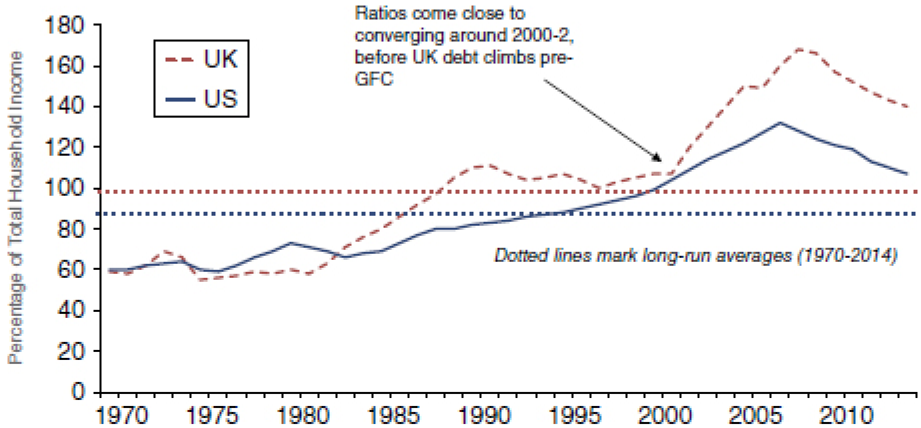

FIGURE 1.1 UK & US Household Debt as a % of Total Income

Source: Federal Reserve, BLS, Office of National Statistics (UK).

The good news (for consumers) is that after the financial crisis we're using debt less in countries like the United States and the United Kingdom. In fact, we've seen a roughly 20 percent decrease in household debt as a percentage of income since the financial crisis, bringing use of household debt back to around 2002 levels. The bad news is that with default rates skyrocketing during the financial crisis, this reduction is less about people saving money, and more about the fact that defaults increased dramatically.

At the heart of this increasing debt load we see in developed economies is a system that is built around lack of transparency on the real cost of lending, and lack of visibility on your money.

In the 1960s, when debt utilization was low, the bank account of the day was a Passbook, and there were no ATMs, credit cards, or debit cards. If you wanted to spend money, you had to take your passbook down to the branch, withdraw cash, and you would see very obviously how that withdrawal affected your overall financial position. You also couldn't generally spend more money than you had in your bank account. Overdrafts were uncommon, checks would bounce if you didn't have enough cash in your account, and the most common form of financing was a home mortgage (not a credit card).

Today, our use of credit cards and debit cards has actually decreased visibility on our velocity of spending. For the 68 percent of American households that live paycheck-to-paycheck,[4] this can be problematic. Try as we might to keep a rough estimate of how we spend our money on a day-to-day basis, most of us are just not that accurate in keeping track of our running bank balance. Inevitably, then, consumers end up in a store shopping for the week's groceries, they pull out that debit card, and the transaction is declined because they've simply spent more money than they were aware of. Or, worse, they suddenly are in overdraft and don't find out until they next go to the ATM and find their account $300 in the red due to overdraft fees.

The way we use credit in our lives is going to have to change. Visibility on the real-cost of debt, whether student loans, mortgages, credit cards, or things like medical loans in the United States, is going to face demand for greater transparency when it comes to consumer awareness on the real costs involved. At the same time, credit decisioning is going to go through a rapid change in the next decade as most of these decisions become real-time—no longer based on some application form you fill out sitting in a branch, but triggered contextually and based on a risk methodology built more from consumer behavior than historical default.

WHEN YOUR CREDIT SCORE BECOMES MORE IMPORTANT THAN ACTUAL RISK

In 2010, I moved to the United States, and despite a healthy income profile,[5] a spotless credit history outside of the United States, a healthy net cash position, a strong investment portfolio, and minimal ongoing credit exposure, I still couldn't get basic credit for love or money.

The problem is that the U.S. system has become so dependent on credit scores that good risk decisions can no longer be made without reference to that score. In the minds of many, credit scores appear to have become more about punishing borrowers for perceived bad behavior than actually providing access to credit.[6] Most credit scores often lag[7] 30 to 60 days behind consumer behavior (rather than accurately predicting the likelihood of default as they are supposed to), and consumers often see a markedly different credit score than what lenders see.[8]

With my income and risk profile I was a very safe bet for any lender or credit facility, but because I hadn't meticulously crafted a credit score history, I was a *nonentity* as far as lenders were concerned—and that translated to a false negative, a presumed "guilty," because I had what is known in the industry as a *thin credit file*. If a bank had examined my behavior, they would have seen that each month I save, and I spend considerably less money than I earn—and therefore my ability to service ongoing debt is very high. Additionally, my income has been improving consistently over the last four to five years, so that trend should mean that my ability to service debt is actually improving. None of that mattered. The logic of a sound credit decision based on actual risk had been replaced by another mechanism—a standardized score that was not a good predictor of risk without at least a two-to-three-year history or investment in building up that score specifically.

Now it is a fair argument that in a system that demands real-time or rapid access to credit facilities, perhaps even in-store at the time of a purchase, you need some sort of automated system that assesses credit risk. In the absence of a better system, maybe credit scores or credit agencies are the best approach we have? That might have been true back in the 1980s, but today the U.S. Public Interest Research Group has reported that the current system is generating erroneous credit reports 79 percent of the time.[9] In addition, the system is expensive, results in poor default management, and is designed primarily to protect the lenders, rather than positively facilitate the borrowers, even when they have a low or moderate credit risk profile. In the end, the best credit scores go to good, regular users of credit, rather than customers who choose to take credit only when they can't avoid it.

One accepted measure of overall credit risk management performance for lending institutions today is *default rate*, more specifically expressed as a *charge-off rate*. During the Global Financial Crisis (also known as the "Great Recession" or "GFC") banks like Bank of America (BAC) saw default rates on mortgages skyrocket to 24 percent in 2010[10] and credit card defaults of 13.82 percent in 2009.[11] Today BAC's default rate on mortgages stands at a nominal 6.7 percent,[12] and credit card defaults have also declined nationally. The Federal Reserve puts charge-off rates on mortgages/real-estate loans at 2.32 percent in Q1 of 2013, and 3.8 percent on credit cards.[13] Lending Club, the largest *peer-to-peer* (P2P) lender in the United States, has an effective default rate of 3 percent on its current portfolio, which is extremely competitive based on the current market.[14]

In the past two to three years, P2P lending has improved its viability as a new asset class and maintained respectable default rates. Lending Club has now surpassed $3 billion in total loans (Figure 1.2) and that has more than doubled the $1.2 billion in total loans facilitated that they recorded in just January 2013.[15] Considering they just passed $500m in loans back in March 2012, that is a phenomenally successful growth curve. Lending Club maintains an average annual interest rate of 13.34 percent, compared to the national 14.96 percent average APR on credit cards.[16] As of January 1, 2013, Lending Club had produced average total returns of 8.8 percent on "savings" over the previous 21 months of operation. During the same timeframe, the S&P 500 has had 10 negative quarters, and yielded average total returns of 4.1 percent.

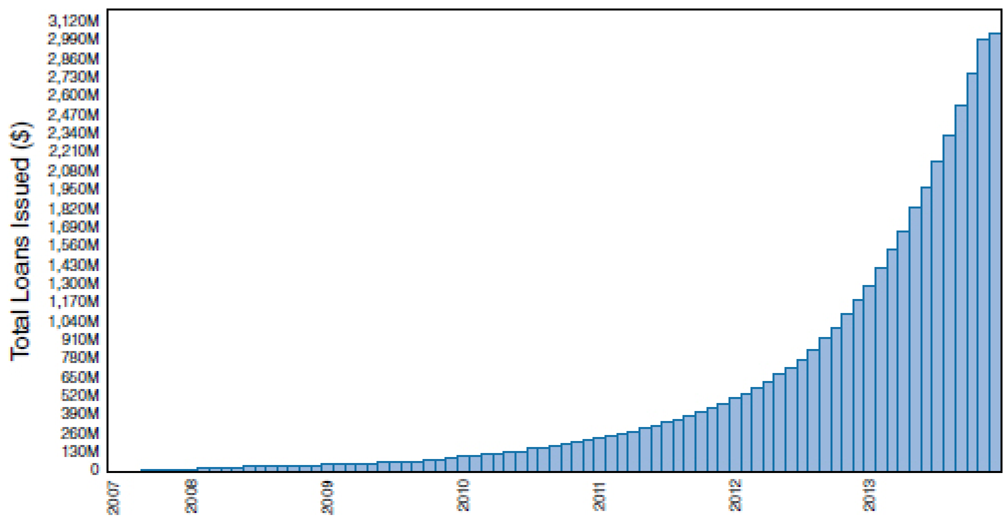

FIGURE 1.2 Total Loan Issuance (LendingClub.com)

> *For the high-credit-quality borrowers we serve, our risk-based pricing model often represents hundreds or even thousands of dollars in savings over traditional bank credit cards, which would charge them the same high rates as everyone else. Our rapid growth is being driven by those high-credit-quality borrowers who have been underserved by the traditional model.*
>
> **—Renaud Laplanche, CEO, Lending Club**[17]

P2P propositions in other markets are rapidly growing, too. Zopa in the United Kingdom has lent over £400m to date, and the total U.K. P2P industry now is approaching £800m (including the likes of Ratesetter and Funding Circle). But perhaps more interesting, Zopa’s growth is increasing with growth of 60 percent + year on year (YoY) and a recent run-rate of 90 percent YoY growth over the last 2 months, with £144m of their current portfolio having been lent in the last 12 months.[18] Zopa’s defaults are at 0.5 percent and with average loan rates of 6.7 percent,[19] which represents best-in-industry performance, and are around half the default rate of the top-performing banks in the United Kingdom.[20]

P2P lending now represents roughly 3 percent of the U.K. retail lending market (non-mortgage lending).[21]

TAKING A FRESH LOOK AT LENDING

Interviewing Giles Andrews, CEO and cofounder of Zopa, was a fantastic way to dive into some detail on why P2P is performing so well compared to traditional credit and lending methodologies, and why their default rates are a fraction of the big banks in the United Kingdom, particularly in Zopa’s case.

Brett: Giles, let me ask you, first of all, to tell us a bit about Zopa. What is Zopa? When did you start the business? What was the objective of Zopa, and where are you today?

Giles: Zopa was the first peer-to-peer lending business in the world. We launched it in March 2005. Peer-to-peer lending is a bit of a mouthful, but what we do is really simple. We connect people who have some spare money with people who want to borrow it. And, by doing so, cut out banks in the middle, so that both parties get a better deal. We had a simple aim, which was to provide greater efficiency in what we saw as a very inefficient financial sector—by providing better value to consumers on both the saving and the borrowing side of the trade.

Brett: You were the first in the space, so what led you to believe there was demand for a fundamentally different approach to lending in this respect?

Giles: I think the first thing we thought about was a question: "Why is it that consumers get a much worse deal out of financial services than big corporates do?" And our conclusion was, "Because a market had evolved (called the *bond market*), which distanced mediated banks, which provided greater efficiency and provided big corporates with better values. Large companies don't go to their bank to borrow money; they simply issue debt in the bond market. We wondered why that couldn't happen on a consumer level as well. The data exists, but marketplaces depend on trusted third-party data, and there is a lot of really useful consumer data, which allows informing positions. We thought we could replicate the marketplace model, but for consumers.

> ***Part of it is simply better modeling, better use of data, and some use of alternative data. We still use most of the traditional credit industry data . . . but I think we buy more of it, and we use it more intelligently. We've also begun to use some sources of alternative data.***
>
> **—Giles Andrews, CEO, Zopa**

Brett: On the matter of the lending model you've got, one of the things you and I have talked about in the past is how you assess risk. One of the things I've always been fascinated by is your robustness from a default perspective. After all, you're one of the best-performing institutions in the U.K. market, in respect to defaults in nonperforming loans.

Giles: And I think we've gotten better since we last spoke, Brett. We have the best-performing loan book in the United Kingdom. We have had default rates of below .8 percent in the last eight years. If you put that into context on an annualized basis, that means that credit losses are well below half a percent a year. And that plays against banks that are somewhere between 3 and 5 percent a year. We are in fact better (in terms of our default performance). I think part of that is from building credit models at a time when the world was increasingly over-indebted and worrying a lot about affordability, which might sound obvious now, in 2013, given the crisis we've been through. But in 2005, it didn't seem obvious—certainly not to banks that were still lending money to people on the basis of their previous track record without really wondering whether the loans were sustainable. Part of it is having the good fortune of building a credit model at a time when it was obvious to us that there was a problem looming.

We were not clever enough to see the subprime crisis that evolved two or three years later. But, we certainly did see that consumers were over-indebted. Part of it is simply better modeling, better use of data, and *some* use of alternative data. We still use most of the traditional credit industry data, and we still find that by and large to be the most predictive, so we are using similar data to banks. But I think we buy more of it, and we use it more intelligently. We have also begun to use some sources of alternative data. The other part of it is that with a peer-to-peer model, the fact that people borrow money from other people seems to make them behave better in that relative circle of influence. There's some evidence that consumers prioritize our debts, in some cases, over others because there are other humans at the end of the loans.

Brett: Very interesting psychology! So Giles, essentially, Zopa sounds like a social network in respect to the way it operates—a community of borrowers and lenders that you bring together. How much does the nature of social networking and community building factor into the success of Zopa from a business perspective?

Giles: It is really important to us to have an active community of engaged lenders. It might sound funny, but the community is really helpful as a sort of customer service tool. People actually respond really well to being given information by other customers. Often, they respond better to that than if it were given from the company itself. Putting all of your customer communications into discussion forums that live inside your website, on Twitter feeds, and on Facebook and things like that, and being prepared to share your customer service queries, says a lot about the transparency of your business and the fact that it is happy to have its dirty linen aired in public.

That is critical in the way the community has been a trust-builder. I think it would be fantastic to be able to leverage other peoples' social networks as a customer recruitment tool. We haven't really found any evidence of that happening. My conclusion is that people don't really want to talk about money via social networks. They're called social networks for a reason; they're not business networks.

Brett: You mean they're not going to share on Twitter, "Whoo-hoo! I just took a Zopa loan!"?

Giles: "That shiny car outside, I actually borrowed money to buy it." No, they are less likely to talk about that. Lenders are happier to talk about it because they feel that they are doing something clever. They are happy to share their insights on that and (beneficially for us) they are even happier to share their insights with other people.

Brett: Even with a good credit history, a good credit rating, doing all the right things in a tough economy, it is hard to lend money. Giles, are you guys going to be the knight on the white horse who comes in and just totally fixes the credit industry and maybe replaces the banks in terms of things like personal loans and debt consolidation?

Giles: I can think of two reasons why we will *not* replace banks. First, Zopa (and I could say the same about the peer-to-peer lending businesses in the United States) does not operate typically as a lender of last resort. Typically, we do not lend money to people who otherwise would not get finance. Second, we do use the data that banks use to analyze whether they should lend people money more intelligently. If you do qualify for a loan, you'll get a loan that's much cheaper. I think the challenge for anyone lending money is using the data