The Quiet Revolution Begins

By Mohamed A. El-Erian *Thu, Jun 11, 2015*

The chief economic adviser at Allianz analyzes the clash between traditional and "robo" financial service providers, and recommends 'institutional partnerships that combine the more agile existing platforms with exciting new content and approaches.'

Steadily and indisputably, the financial services industry – with which we all interact, whether as borrowers, savers, investors, or regulators – has embarked on a multiyear transformation. This process, slow at first, has been driven by the combined impact of two sets of durable forces.

On one hand, top-down factors – regulatory change, unusual pricing, and what Nouriel Roubini has cleverly termed the "liquidity paradox" – are at work. Then there are disruptive influences that percolate up from below: changing customer preferences and, even more important, outside visionaries seeking to transform and modernize the industry.

Beginning at the top, the regulatory pendulum is still swinging toward tighter supervision of traditional financial institutions, particularly large banks and insurance companies deemed "systemically important." Moreover, re-designed regulatory frameworks, phased implementation, and stepped-up supervision will gradually extend to other segments, including asset management. This will contribute to further generalized de-risking within the regulated sectors, as part of a broader financial-sector movement toward a "utilities model" that emphasizes larger capital cushions, less leverage, greater disclosure, stricter operational guidelines, and a lot more oversight.

The pricing environment compounds the impact of tighter regulation. Like utilities, established financial institutions are facing external constraints on their pricing power, though not of the traditional form. Rather than being subjected to explicit price regulations and guidelines, these institutions operate in a "financial repression" regime in which key benchmark interest rates have been held at levels below what would otherwise prevail. This erodes net interest margins, puts pressure on certain fee structures, and makes certain providers more cautious about entering into long-term financial relationships.

As a result of these two factors, established institutions – particularly the large banks – will be inclined to do fewer things for fewer people, despite being flush with liquidity provided by central banks (the "liquidity paradox"). And banks and broker-dealers can be expected to provide only limited liquidity to their clients if a large number of them suddenly seek to realign their financial positioning at the same time. But this is not just about them. The fact is that providers of *all* long-term financial products, particularly life insurance and pensions, have no choice these days but to streamline their offerings, including a reduction of those that still provide longer-term guarantees to clients looking for greater financial security.

The impact on the financial-services industry of these top-down factors will gradually amplify the importance of the bottom-up forces. Over time, this second set of factors will fuel more direct and efficient provision of services to a broader set of consumers, contributing to a reconfiguration of the industry as a whole.

For starters, customer expectations will evolve as the millennial generation increasingly accounts for a larger portion of earning, spending, borrowing, saving, and investing. With many of these newer clients favoring “self-directed” lives, providers of financial services will be pressed to switch from a product-push mindset to offering more holistic solutions that allow for greater individual customization. Market-communication functions will also be forced to modernize as more clients expect more credible and substantive “any place, any time, and any way” interactions.

Then there is the influence of outside disruptors. Jamie Dimon, the CEO of JPMorgan Chase, expressed it well in his 2015 shareholder letter, observing that “Silicon Valley” is coming. These new entrants want to apply more advanced technological solutions and insights from behavioral science to an industry that is profitable but has tended to under-serve its clients.

Airbnb and Uber have demonstrated that disruption from another industry is particularly powerful, because it involves enabling efficiency-enhancing structural changes that draw on core competencies and strategies that the incumbent firms lack. Many other companies (for example, Rent the Runway, which provides short-term rentals of higher-end fashion) are in the process of doing the same thing. Be it peer-to-peer platforms or crowd-funding, outside disruptors already are having an impact at the margin of finance, particularly in serving those who were previously marginalized by traditional firms or had lost trust in them.

The end result will be an industry that serves people via a larger menu of customizable solutions. Though traditional firms will seek to adjust to maintain their dominance, many will be challenged to “self-disrupt” their thinking and operational approach. And, while emerging firms will offer better services, they will not find it easy to overcome immediately and decisively the institutional and regulatory inertia that anchors traditional firms’ market position. As a result, a proliferation of financial providers is likely, with particularly bright prospects for institutional partnerships that combine the more agile existing platforms with exciting new content and approaches.

© 2015 Project-Syndicate.