

'Manufacturing' vs distribution: where is digital banking going?

*The role that banks will play in the future remains uncertain. The core activities of creating, moving, and transforming money are critical to the modern economy, and make up the "manufacturing" side of the banking business. The separate competitive demands of manufacturing and distribution will drive a separation of these activities within individual banks. **Duncan Knowles** writes that the future of banks will lie primarily in manufacturing, while the distribution side will be overtaken by smaller, nimbler competitors.*

Bank customers have grown accustomed to being able to access services on demand, through their mobile phones, with largely frictionless experiences. These expectations translate across industries, with frustrations mounting whenever a legacy process requires a form to be filled, a signature to be provided, a conversation to take place, or a physical meeting to happen.

New entrants have identified pain points in customer experiences, such as account opening and transaction authorisation, and have developed simpler, more intuitive approaches to ease these. In response, incumbent banks have invested heavily in improved mobile banking apps, both for individual customers, and for the employees of corporate customers.

However, digital disruption in commercial banking is still at the stage of digitising traditional products, services and experiences. Just as early digitisation of music saw digital stores on which albums or single tracks could be purchased, digital banking now offers digitised versions of current accounts, credit cards, payments and personal loans. However, truly digital banking has yet to evolve; the analogy of the streaming services that have largely taken over music distribution.

The music industry used to rely on revenues from the sale of physical recordings, through large scale physical distribution networks. The digitisation of music, and even more so the introduction of streaming services, led to the collapse of these networks into bankruptcy. Fundamentally though, artists continue to record music, and consumers to listen to it.

The shape of the music industry changed, but the core activity remained the same. In the same way, digital disruption is unlikely to result in material changes to the core activities of banking. This is not to say that banking will not change; it has already changed significantly and will continue to do so. However, the role that banks will play in the future remains uncertain.

The core activities of commercial banking

Most people are familiar with banks through the products they offer to their customers, mainly deposit accounts, credit cards and loans. More fundamentally though, banking is the creation, movement and transformation of money. These core activities are critical to the modern economy and take place primarily through commercial banks.

Banks create most of the money in the economy through their lending. The reserve accounts they hold with central banks sit at the heart of the payment system. They enable long-term projects to be funded by depositors with short-term horizons ("maturity transformation"). By acting as intermediaries for credit, they enable risk averse investors to place funds into high-risk commercial activities ("credit transformation"). By providing finance against long-term assets, they allow investors to access short-term funds ("liquidity transformation").

These core activities are the "manufacturing" of banking. The banking products we are familiar with, the deposits and loans, allow individuals and firms to access these services, and are the "distribution" of banking. Someone wanting to buy a house does not need a mortgage; that individual needs to exchange their own long-term cashflow for short-term liquidity at a scale sufficient to pay for the house. It is the liquidity the individual needs, not the mortgage; the mortgage is simply a way to deliver this liquidity.

Manufacturing banking is complex, risky and capital intensive, with significant economies of scale. It is also tightly integrated with banks' distribution activities. This creates significant barriers to entry for new competitors. As a result, many banking markets are dominated by a small number of large banks. This has the advantage of simplifying regulation of these banks. However, such market concentration is understandably of significant concern to competition authorities.

Open finance

To address this, authorities in various countries are now experimenting with "open finance" initiatives, which have the potential to disentangle manufacturing and distribution in banking.

Under such initiatives, customers can ask their banks to share their financial data with other providers. Banks are then obligated to do so, using standardised application programming interfaces (APIs), whose specifications are open to developers. This enables other providers to develop services that make use of a customer's financial data across all their banks.

At its simplest, open finance allows balances and transactions to be shared. This enables other providers to aggregate accounts, categorise transactions, and provide simple financial analysis tools. Extending open finance to payment initiation allows customers to make payments from their accounts using third party interfaces. At this point, a bank's customers are effectively able to use the mobile app of another provider to access their finances; and providers can offer aggregated account management across all of a customer's bank relationships. This is where the UK is today.

A further extension of open finance permits account origination, such as applying for credit or opening new current or saving accounts, through third party interfaces. This allows new providers to offer market comparison services for customers to help them choose the offer that best meets their needs. Australia is experimenting with this approach.

Provided identification of a customer is sufficiently robust, authorities may ultimately allow the providers to rely on the customer due diligence performed by others, allowing instantaneous account opening. By this stage, new providers could offer a simple automated cash management solution for customers, with sweep accounts for deposits, automatic refinancing of loans, and other similar services. Digital identification regulations in Canada may be moving towards this.

A final scenario for open finance is the provision of banks' manufacturing services to distributors who would develop products for customers. Examples could include APIs for credit decisioning, customer due diligence, transaction monitoring, funding, fraud checking, and many others. This would enable new providers to move beyond the digitisation of existing banking products, and into the creation of genuinely new offers for customers.

By effectively separating the distribution of banking from its manufacturing, open finance allows robust regulatory control over financial stability to be maintained without impeding vigorous competition over distribution. As a result, there is a strong policy imperative that will lead to continued development of open finance initiatives. Unfortunately, open finance also has the potential to introduce significant new risks, particularly of fraud and cyber-attacks. These will slow both its implementation by regulators and its adoption by individuals and firms.

Impact of open finance on the competitive environment

Over time, it is unlikely that banks will be able to maintain tightly integrated businesses; the separate competitive demands of distribution and manufacturing will drive a separation of these activities within individual banks. Large corporates will continue to purchase the banking services they need on a wholesale basis direct from banks, but smaller firms and individuals will source theirs from a developing ecosystem of distributors, each providing offerings tailored to particular competitive niches.

Banks will struggle to provide sufficient customisation to compete effectively with this ecosystem, and will gradually cede ground, focusing their own distribution offering around the largest and most profitable segments they are able to identify. For other segments, banks will need to cultivate the distribution ecosystem to drive their manufacturing business.

Freed from the need for distribution, banks will look to capture value up and down the manufacturing value chain. Some will focus on becoming the most efficient manufacturers, driving scale at the cost of increased capital requirements and ever tighter regulation. Others will seek to orchestrate distribution ecosystems, acting as intermediaries between these and the large manufacturers, supplemented with advice and support for both distributors and their customers.

The future of banks will lie primarily in manufacturing, where they will continue to leverage their critical role in the economy to generate returns for their investors. At the same time, the distribution of banking will continue its evolution towards a truly digital business; albeit one supported by face-to-face interactions for complex situations requiring human empathy.

Digitally native banking

Manufacturing banking services involves significant risk, and managing that risk entails significant complexity, which in turn leads to significant expense. To reduce complexity and cost, banks have built products and services around aggregated balances in their customers' accounts. From a bank's perspective, the balance is the fundamental unit of banking.

For an individual or a firm, however, what is essential is certainty that sufficient liquidity will be available at the moment it is needed. Banks' customers maintain savings balances to provide themselves with liquidity reserves; and borrow large fixed balances over extended periods to supply additional liquidity. From the customer's perspective, the transaction is the fundamental unit of their finances.

Digitally native banking will need to break commercial banking down into the fundamental elements that its customers need, then reassemble these into whatever form best serves those customers; whilst at the same time maintaining financial stability and allowing banks to continue to perform their critical economic roles.

For example, rather than a customer holding idle funds on deposit in case of need (possible funded through borrowing a large fixed balance), funds could be automatically swept into accounts of various maturities to maximise returns for the customer. If there is a shortfall, credit decisions could be taken automatically at the transaction level, extending exactly the amount of liquidity needed. If a significant excess, funds could be swept into investments commensurate with the customer's risk profile.

Such transaction-based banking services are unlikely to be provided by incumbent banks fearing loss of net interest income from reduced balances and increased risk due to reduced stickiness of funding. The sheer complexity of building interfaces and algorithms to address a huge range of different customer situations reduces the likelihood further.

However, complex challenges can often be addressed by complex ecosystems more easily than by single entities. Open finance allows for the challenge of transaction-based banking to be broken down into manageable pieces, with different distributors meeting the needs of different customer segments; and customers self-selecting the appropriate provider in a competitive marketplace.

At the same time, open finance allows banks to supply liquidity, funding and safe assets into this ecosystem. Funds and liquidity needs can be aggregated by distributors, with decisioning provided by banks as a digital service. Banks can retain their role in manufacturing, and as the gatekeepers of the financial system.

This is just one of many possibilities for digitally native banking. Whatever the eventual shape of the industry however, it must, like transaction-based banking, improve outcomes for individuals and firms whilst preserving the soundness and integrity of the financial systems on which our economies depend.

Banking in an age of disruption

As banking transforms, it is more important than ever that those working in and around banking, and those seeking to disrupt banks, understand the role of banks in the economy, their business models, the risks they create and manage, and how they support individuals and firms to grow their prosperity. My [book](#) provides a comprehensive overview.



Notes:

- *This blog post is based on “[Banking Matters: An essential guide to commercial banking in an age of disruption](#)”.*
- *The post expresses the views of its author(s), and do not necessarily represent those of LSE Business Review or the London School of Economics.*
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