New entrants have been nibbling at the banking value chain since before the global financial crisis (Figure 1). This has intensified following the crisis as trust in traditional banks has eroded and customers have turned to other organizations to meet their borrowing and investment needs. Some of these organizations have been welcomed by governments and regulators, particularly as a source of finance for small and medium-sized businesses. Banks must respond to defend their position.
We believe it is highly unlikely that these new competitors will be able to completely disintermediate traditional banks. It is currently unclear how far the organizations can expand their business models, and how they would deal with the inherent (and often little understood) risks in new intermediary models that have not withstood a crisis of their own. Nor is it clear that these organizations want to expand their operations so far that they attract significantly greater regulatory attention. The G20 recently announced that it would focus on addressing shadow-banking risks during the coming year and, over the coming decade, we expect increased regulatory scrutiny will lead these organizations to face their own compliance problems.

However, despite the challenges they face, many of these new competitors have shown themselves to be better than banks at using customer information to deliver improved services to clients. Furthermore, greater regulatory scrutiny may even lead to greater trust in these firms, and although some new competitors may exit the marketplace, those that remain are likely to be much stronger. Banks must work out how to adjust to this new competitive environment.

Competition in retail banking

In retail banking, some of the greatest innovation in the past decade has been in payments. Alongside PayPal, which has grown into one of the world’s largest financial services organizations, a host of new innovators have emerged. Payments to small business that used to require a check can now be made by card if the business person carries a smartphone and a dongle. A number of mobile wallet applications for smartphones have been launched in recent years, allowing direct payment to individuals with only a mobile phone number.

Although mobile payments have only recently started to gather momentum in the developed world, they have long been popular in a number of emerging markets that have lacked traditional payment infrastructures. Across these markets there are 251 live and 102 planned deployments of mobile money services for the unbanked, of which only 85 are financial service company initiatives.1

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In lending and investments, a number of peer-to-peer (P2P) lending firms have emerged (Figure 2). Without the infrastructure and higher operating costs of traditional banks, including expensive branch networks, these P2P lenders are able to offer greater rates of return to investors and lower interest rates to borrowers.

Figure 2: Cumulative lending by major US and UK P2P organizations (US$m)

Source: Peer-to-peer finance association (UK), LendStats.com

There is also increased competition from full-service banks. For example, in the US, we have seen examples of direct banks offering services to customers while using the core banking systems of traditional banks. New bricks-and-mortar banks have also been launched, with a small number of full-service branches in areas with high foot-traffic. These banks have tried to differentiate themselves by offering higher standards of customer service — for example, extended opening hours or faster product application processes — even if they cannot compete fully on price.

This array of new entrants into retail banking is already forcing traditional banks to respond, whether by investing in improved customer service or the technology to deliver some of the services these new players are offering. Although we expect some consolidation of new entrants over the coming decade, they have already transformed customer expectations. We expect this to continue, with customers demanding better pricing and service. Banks will need to make the investments to meet these demands or risk losing business.

**Competition in corporate and investment banking**

Competition among investment banks is also increasing. With more products like derivatives becoming increasingly commoditized as the over-the-counter market shrinks, institutions face greater margin compression. There is a technology “arms race” too — for example, as banks invest to reduce latency in their order management systems. Ultimately, the expense of competing, combined with declining margins, will lead to companies withdrawing from certain businesses. Only those with sufficient scale will survive.

Additionally, the demutualization of traditional exchanges has created additional competition. In response to what banks saw as increased fees, some investment banks established their own platforms to provide dealing services at lower rates than the traditional exchanges. In response, the traditional exchanges have sought to provide direct access to some investors, disintermediating the banks.

Beyond sales and trading, we expect banks also to face further erosion of their corporate banking business. As banks with constrained balance sheets struggle to lend to large corporates, we expect some funds to be ever more willing to fill this gap.

Although threatened by these new competitors, we believe banks can respond by building partnerships or making acquisitions. They can also become more effective at competing directly. Only in extremis, when they are unable to fund the investments to address this new era of competition, might they have to exit certain business lines.
Over the coming months, our Transforming banking series will explore why customers are increasingly attracted to new intermediaries, where we see leading practice among these institutions, and the investments that banks should make to compete with them effectively.

To contact a member of the banking team or to keep up to date with EY’s insights and analysis, go to ey.com/transformingbanking.