Response Strategies of Financial Institutions to the FinTech Challenge

Description

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Over the past two decades, financial technology (FinTech) has transformed the established financial sector by introducing more efficient and innovative methods of providing financial services to consumers. The integration of technology into financial services has resulted in the development of new business models, products, and services that have disrupted conventional banking practices. All main functions of the financial industry have been affected, including payments, deposits and lending, capital raising, investment management, market provisioning (platforms), and insurance. This transformation is evident in selective FinTech statistics. For example, Fortunly (2022) reported that nearly half of consumers utilise exclusively digital banking for their financial requirements. Similarly, PwC (2020) reported that the emergence of new business models by fintech companies will pose a threat to up to 28% of banking and payment services. Finally, Technology has decreased the connection cost (cost/ megabytes per second) from $1245 to $23 and the storage cost (cost/ gigabyte of storage) from $569 to $0.03 between 1992 and 2012 (Deloitte, 2019).

To survive, traditional financial institutions were forced to adapt to these developments. They were compelled to allocate resources towards initiatives that would enhance their technological capabilities and knowledge, as well as preserve their competitiveness in terms of efficiency and cost. According to McKinsey (2020), traditional financial institutions have responded to the FinTech disruption in a variety of ways, including acquiring, partnering with, or participating in FinTech companies. According to Statista (2021), 75.3% of incumbents indicated that they prefer to collaborate with FinTech firms, 18.5% prefer to compete, and 6.2% prefer to engage in M&A. Interestingly, the existing literature has not yet sufficiently investigated whether transactions between traditional financial institutions and FinTech start-up firms create value or not. The results of the existing literature on strategic alliances and M&As in the general economy are inconsistent—showing that some of these transactions create value while others do not—so it would be interesting to examine if this is also the case with transactions involving Fintech firms and if so, why. Our study sought to address this literature gap by examining the three most popular response strategies of established financial institutions to Fintech companies—acquisitions, alliances and equity partnerships—in order to provide answers to questions such as: which of these response strategies create value for the incumbents and under what circumstances? What variables and factors influence how much value is created (or destroyed)? And how should smaller incumbents, with less resources than the big firms, respond to the FinTech disruption?

The research employed a sample of 85 acquisitions, 98 strategic alliances, and 64 equity participation investments undertaken by established firms in the period 2007-2019. The financial institutions involved in the transactions came from 23 nations but the majority of them came from developed countries, mainly from the US, Germany and the UK because they have the ‘right’ environment for startups to grow. The transaction activity picked up significantly after 2014, suggesting a possible bandwagon effect. Finally, the majority of financial institutions were banks rather than insurance companies or investment houses. This is not surprising since the banking industry has been more impacted by FinTech than the other industries represented in our sample.

We examined each strategy separately to determine if it created or destroyed value for the established firms in both the short and long term. In addition, we investigated whether the value generated varied by what type of financial institution was undertaking the investment—was it a bank, or an insurance company or an investment house? In addition, we investigated a number of variables that could potentially influence the variance in the value generated by these transactions.

Our research found that acquisitions created value in the short term, while strategic alliances destroyed value and equity participation investments had no impact. Banks were the least successful in creating value with their response strategies, while investment institutions were the most successful. In the long term, we also discovered that all three strategies destroyed value for the shareholders of incumbent firms. The value created (or destroyed) was influenced by the characteristics of the transacting parties, the characteristics of the transactions themselves, and other external factors, such as the macroeconomic environment. Moreover, the value generated varied significantly among the three strategies and within the same strategy. This variability can be attributed to a variety of factors, such as the disruptiveness of the startup relative to the incumbent, the value of the technology the startup possessed, the age of the FinTech startup, and the incumbent's experience in similar transactions.

The results of our investigation have several managerial implications. It is obvious that established firms must respond to the FinTech challenge, but our research indicates that there is no optimal, winning strategy when determining how to respond to disruption. Every institution should take into account its own particular circumstances, the particulars of the transaction, and the opportunities that arise from them. For instance, strategic alliances may destroy value *on average* but alliances with start-up firms that operate a disruptive business model or possess complex technologies actually create value. It is important to know what the average effect of a transaction is, but it is equally important to evaluate each transaction on its own merits. In this sense, managers should not approach FinTech firms as a threat; rather, they should regard them as an opportunity to enhance their client offerings, invest in innovation, and revise their strategies.

Doing nothing does not seem to be a viable response for incumbents. No matter how threatening the FinTech disruptions might appear, established firms should find ways to exploit them. The manner in which major pharma companies responded to the biotech disruption over 40 years ago should serve as a model for the manner in which established financial institutions should respond to FinTech in the present day. Our research can help them identify the major decisions they need to make to respond to disruptive FinTech and can also provide them with guidance on the factors they should consider prior to making a decision.

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