eBOOK

The Age of Abundant Banking

How to stay innovative when every company offers a debit card

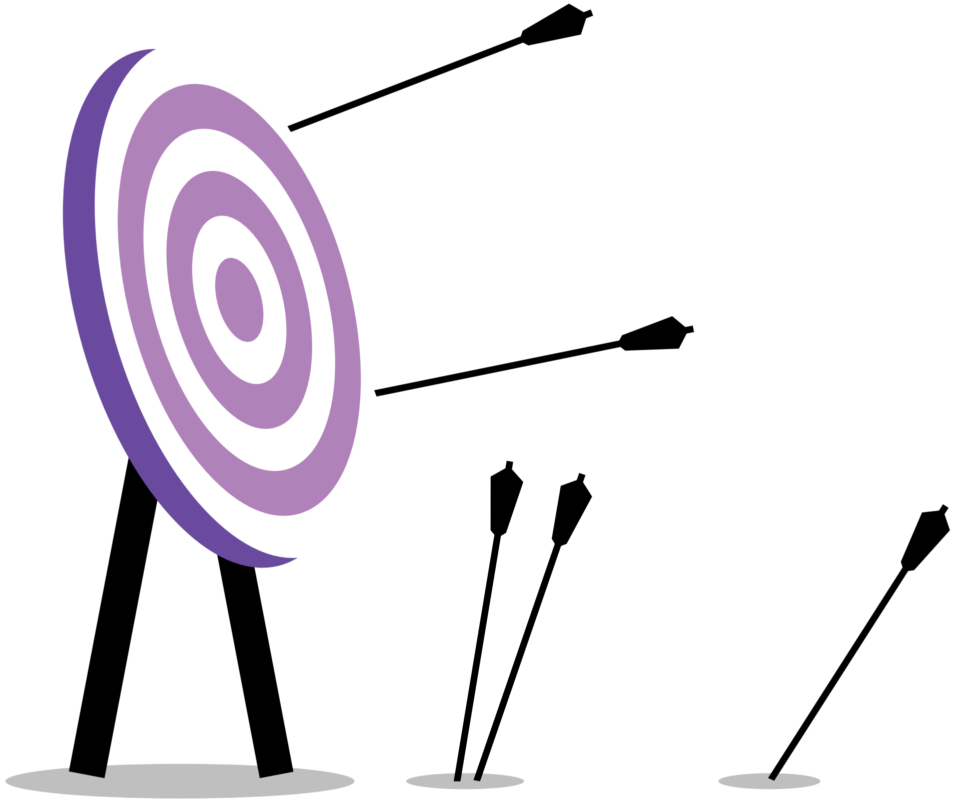
Q2

Introduction: Accelerating toward the next normal

Financial services is entering a new age: *The Age of Abundant Banking*. Traditionally, banks and credit unions have played a central role in everyone's financial world. "Ask your banker" used to be the typical response to every financial question. But the relationship between banker and consumer is changing. We're seeing a range of companies, from payments to payroll, take over traditional banking relationships by offering banking services with greater advantages than most banks can offer alone.

In this paper, we will:

- Explore the reasons behind this change.
- Take inventory of the present situation.
- Discuss the consequences of a shifting landscape.
- Outline what it means to be an innovative company in this new age.



Banks have a branding problem

First of all, bankers and consumers aren't on the same page. In a 2018 report by Celent, 73 percent of financial executives agreed with the statement: "Customers would say 'my bank knows me'," but only 43 percent of consumers agreed.

How did this disconnect happen? It started about 10 to 15 years ago when many banks began to disregard customers' needs and expectations, and tolerance of financial institutions (FIs) started to erode.

Anti-consumer Practices

Remember when banks could charge you a $30.00+ overdraft fee per transaction, and you didn't even have the option to have your card declined instead of over drafting? Many families have horror stories from this period, and as a result, their children formed skeptical opinions of banks in general.

The Great Recession of 2008

The court of public opinion blamed the financial crisis squarely on reckless profit-seeking financial executives. This created a public relations abyss that many banks are still trying to crawl out of.

On the other hand, technology companies have been able to successfully brand themselves as having a higher purpose than pure profit.

Tesla wants to accelerate the world's transition to electric transport, and they've walked the walk by opening their patents up.

Amazon strives to be the Earth's most customer-centric company. They've had some controversies around employees, but 1- to 2-day delivery for, well, anything has improved the lives of millions.

Gusto, the innovative payroll and financial wellness company, has made it their mission to help companies put their people first. And they offer many free financial services to back that up.

When banks lose, do tech companies gain?

While no company can stay in the game without profit, branding is clearly important: consumers feel better about giving their money to companies that look out for the world's and their welfare. Unfortunately, many consumers have come to see FIs as solely fixated on making money. All the while, many tech companies have escaped the same judgment.

According to a 2018 Bain & Company survey, those who trust technology companies are more interested in opening a bank with them. And a great many people fall into this category.

46%	29%
Americans who trust at least one tech company more than banks in general	People worldwide who trust at least one tech company more than their primary bank

Source: Bain & Company

Clearly, many consumers don't see their banks operating in response to their needs. And if consumers don't trust their bank, it means they're more receptive to having other types of companies take over some or all of their financial matters.

Relevant players—investors and tech companies—have taken notice. That's why we've seen a massive increase in venture funding for fintechs, which has risen from $9 billion in 2010 to $135.7 billion in 2019. This trend should continue: a Business Research Company report notes that the global fintech market was valued at $127.66 billion in 2018 and is expected to grow to $309.98 billion through 2022.

So when banks lose, do tech companies gain? Yes and no. While consumers feel neglected by banks and are searching elsewhere to satisfy their financial needs, banks still have a substantial role to play in the new system for meeting customer needs: banking as a service, or BaaS.

Innovation requires symbiosis between banks and technology companies

Companies across the board are encroaching on the once sacred (and nearly impossible to enter) financial services space, which was previously only available to chartered FIs. Accounts, debit cards, controls—all of these products are now available to virtually any company who wants to offer them, but in order for this to happen, FIs still need to be involved.

Here are just a few business sectors that are beginning to offer banking services:

- Investing
- Payroll
- Lending
- Personal financial management (PFM)
- Gig economy

What does this mean for FIs?

While tech companies have the product development talent to build exceptional banking products, their knowledge of the financial regulatory system is miniscule compared to an FI's. FIs know the compliance process inside and out, and they can provide FDIC insurance for accounts.

Together, banks and any company engaging in fintech (which we'll just call "fintechs") are the perfect pairing, and given the right infrastructure arrangement, they can work together well to solve the specific needs of consumers.

What does this mean for consumers?

Through a partnership between banks and fintechs, solutions for the previously underbanked now exist. A whole new consumer segment has emerged as a viable market because fintechs are able to provide targeted products that weren't financially viable for traditional FIs to build. For example, payroll companies can now offer Early Pay functions that give a paycheck advance with zero interest, which saves millions of people from predatory lending companies that capitalize on people who are in tight financial situations.

What is banking as a service?

A system of collaboration between a bank and a non-bank company—often facilitated through a third party like Q2—to bring new financial solutions to customers. This system enables the non-bank company to offer banking services, such as DDA accounts and debit cards, without becoming a bank.

Q:

With all that's changed, perhaps a better question is, what hasn't changed?

A:

The desire for convenience in the heart of every consumer.

The dawn of a new age of banking

No consumer wants to log on to four different apps every day in order to stay apprised of their financial situation. Once better financial services become available elsewhere, consumers likely will switch their personal banking from traditional FIs to different companies, as in the following case examples:

Case 1: Investor

If you spend most of your time managing your investments, and your broker starts offering banking services, it's easier to just manage your bank account there. So, you switch.

Case 2: Middle-class American

As in our Early Pay example, if you're a middle-class American who sometimes needs an advance on your paycheck, and your payroll company starts offering that service, it could be all the incentive you need to just cancel your direct deposit and start banking through them.

Case 3: General contractor

If you're a contractor using a lending company for a revolving line of credit, and suddenly it offers banking with access to better rates, why not switch your direct deposit and simplify your life?

On the horizon, Q2 sees a world of abundant banking services where people can choose to have primary banking relationships at banks or at other types of financial services providers. And within that new world, Q2 is ready to provide the fundamental technological infrastructure, the expertise to bridge the divide between technology and financial services, and unsurpassed support for innovation.

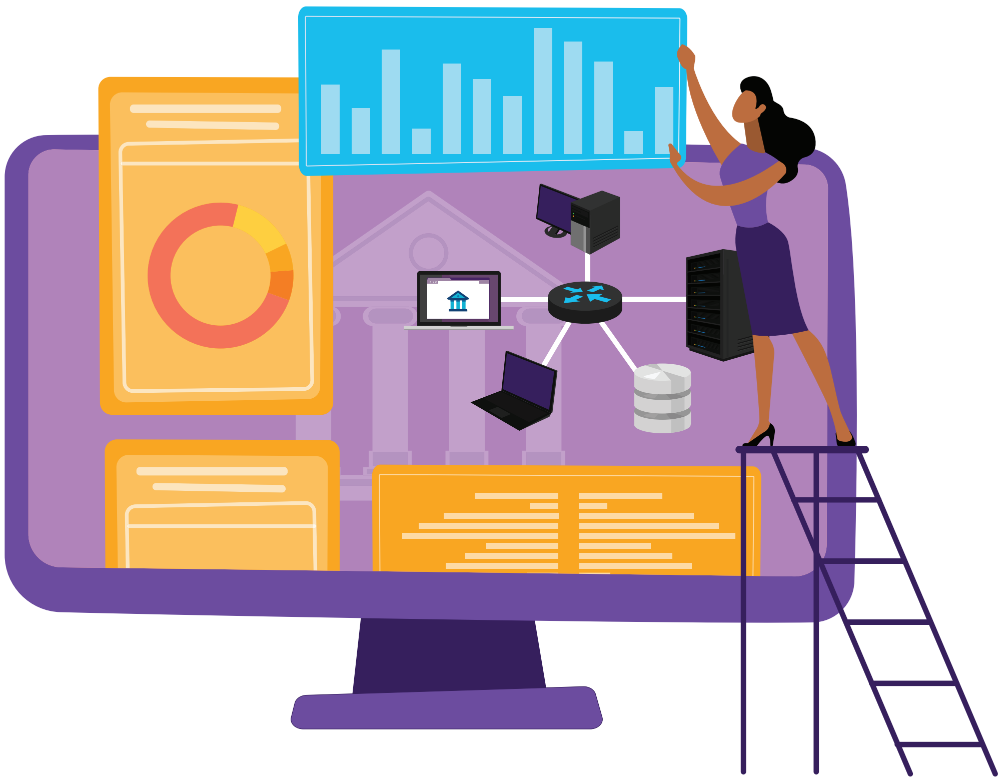
That's not to say that the future won't involve personal banking at actual FIs. But just as electricity flows through the path of least resistance, people will seek to maximize their convenience by consolidating their financial activities as much as possible. Fortunately, everyone wins in an abundant banking system like BaaS. Even if consumers decide to switch their direct deposits to fintechs, traditional FIs will always have a critical role to play—and plenty of new benefits to reap in the form of deposits, non-interest fee income, and more.

The role of traditional FIs in this new age

Other BaaS platform providers often fail to emphasize a key point about this new age of abundant banking, which is the substantial role that traditional FIs will play within it. Granted, FIs could lose banking relationships, but those FIs that accept BaaS as inevitable will adapt. They'll work with emerging companies to offer much-needed financial services and provide an invaluable connection to the existing financial system—in fact, the only truly viable fintech model depends on bank partnerships.

While it's possible for fintechs to become banks themselves, most don't want to—they just want to offer banking services. Becoming a bank has enormous implications on a company's level of regulation. It's like running in soft sand, and it can significantly impact growth and future plans.

So banks need fintechs, and fintechs need banks. But working directly with banks (i.e., not through a BaaS platform) introduces a whole new set of hassles for fintechs: primarily, plugging into old core technology (that differs from one bank to another) limits the agility that makes product development feasible. Rapid product iteration cycles are necessary, and back-end financial matters are onerous, making it important to outsource them.



This is where Q2 comes in:

- We provide the technological infrastructure that makes it possible for technology companies to leverage banking relationships to create targeted financial products.
- We forge deep relationships between FIs and companies offering innovative, sought-after services through an intricate matching process that weighs product goals, bank expertise, mission alignment, and more.

Both are equally important. But remember, between the various BaaS platforms, not all technological infrastructure is the same, nor are all banks and bank partnership networks.

In Q2's case, we don't add another middleware layer of technology. We've actually replaced the old core technology with a new, flexible cloud-based core, which has advantages such as instant core updates and fewer points of failure compared to middleware systems.

Inferior and superior technological infrastructure

Most BaaS platforms run on technology called "middleware," which is an additional layer of technology that facilitates transactions by communicating with the legacy core technology running at most banks.

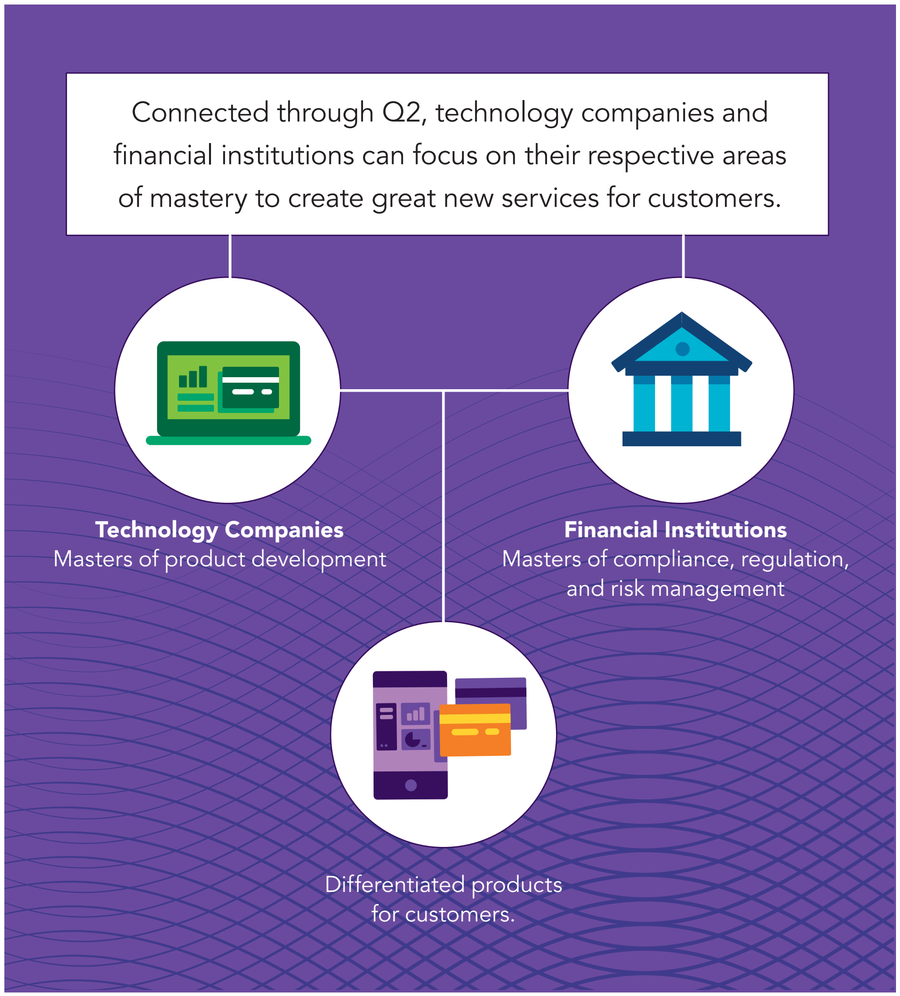
There are two primary problems with middleware systems:

Points of failure – With each additional layer of technology comes additional "hoops" for financial information to pass through. And because each layer is capable of malfunctioning, more layers mean more possibilities for the system to fail. This system is especially vulnerable when one tech layer—such as the legacy core—updates and the middleware must accommodate the changes. If it doesn't, incompatibilities result.

Lack of instant updates – Legacy core technology can only handle batched updates, and only a few batches per day. Unfortunately, because transactions are happening all the time, this batch system forces the middleware to make guesses about the information that will be present in the core after the next update. These guesses can be wrong. For example, an incorrect KYC approval could be made using "guess" data that will later have to be rolled back. And in addition to incorrect guessing, batch updates also limit a fintech's ability to display accurate, real-time information about a user's funds.

Stay innovative over time with the right bank partnership

The partnership between the fintech offering financial services and their partner bank is critical to the entire system. Here's how it works:



As with any partnership, problems can emerge immediately or over time. The concept of scale is important here. While a fintech and a bank could work well together when a product is in beta, by the time they grow to the national level, the partnership could cease to be a good fit. For example, if a young fintech sees rapid user adoption, they may generate more deposits than their partner bank is able or willing to handle.

While switching banks is never ideal, sometimes it is necessary. Therefore, it's important for a BaaS platform to provide the option to switch (otherwise, a painful data conversion could be necessary) as well as to offer a variety of FIs to partner with. The bank partner should be familiar and comfortable working with the fintech's line of business, and having multiple bank options increases the chance of finding that perfect match.

Even more important than the option to switch banks is the option to become a bank. With Q2, our CorePro platform permits this if a fintech's business model requires it down the road, and it part of why we're such a flexible platform. Making this important platform decision from the outset will lock in a truly scale-friendly technology stack, where choosing wrong can limit options down the road.

With the right partnership, fintechs can flourish and FIs can contribute beyond their immediate communities, potentially reaching the national or even global scale.

Conclusion: Obsess over your rate of innovation

Everyone wants simpler, more effective financial services, and BaaS has opened the door to a new set of experiences, for new customer segments. This especially matters to the underbanked—which represented 16 percent of American adults in 2018—for whom it's now possible to create profitable financial services. Historically, banking has been the worst for those with the least amount of money because it hasn't been financially viable for FIs to create services for them. As a consequence, FIs' impetus for growth has been on the commercial side, and consumer services have suffered.

Q2 believes BaaS is the way to bring more services to the underbanked, bring a better system to FIs, and grow communities.

Flexible cloud-based core technology means it's possible to drop the cost basis of banking low enough to profitably serve these underbanked users. The winners in this system will be companies who are innovative enough to capitalize on these new economics and combine the simple tools of banking—cards, accounts, and data—with their existing service offerings, as well as banks that are nimble enough to adapt to their new role.

Plain and simple, optimizing for innovation in The Age of Abundant Banking means dedicating as many resources to product development as possible. Anything that distracts from this task is a compromise on innovation and slows the charge toward offering industry-leading banking services—and great products in general. Quick movement, quick mistakes, and quick problem solving are what's necessary, and a flexible platform with a built-for-scale economic model is the golden ticket.

We at Q2 agree with Angela Strange of the venture capital firm Andressen-Horowitz: every company will be a fintech company. The spoils will go to those companies who pull this evolution off with speed and grace, and collapse will ensue for those who are late to the game.

For more information, go to Q2.com/fintech/banking-as-a-service or call (833) 444-3469.