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Mutually Assured Disruption

Why established companies should join forces with upstart competitors.

BY RAMESH NAIR AND KEN FAVARO

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by Ramesh Nair and Ken Favaro

In June 2014, Spanish bank Santander and online business lender Funding Circle announced a customer-sharing agreement in the United Kingdom. When Santander turns down a loan applicant, the company refers the borrower to Funding Circle. In exchange, Funding Circle sends some of its customers to Santander for cash management and other services. The relationship involves only referrals; there are no fee splits, risk-sharing provisions, or operational interactions.

In a different type of arrangement, in April 2015 Citigroup agreed to fund US$150 million in loans to lower-income borrowers through Lending Club, an online consumer lender. Lending Club finds and evaluates borrowers, and a state-chartered bank in Utah makes the loans, which are then sold to a private equity firm through a credit facility provided by Citigroup.

Financial services is just the latest sector to witness the forging of such partnerships between innovative online companies and incumbents. Across industries, the latter often face swarms of well-funded startups. Armed with next-generation technology capabilities in areas such as big data, social media, cloud-based computing, and data analytics, these startups can offer customers a better value proposition: lower prices, greater convenience, and highly customized products and services. Unlike the traditional players, they are not encumbered by legacy IT systems. They build platforms that are far more advanced than incumbents' systems in flexibility, speed, and efficiency.

Many incumbents respond to these threats by trying to compete head-to-head, acquiring startups, setting up their own separate digital shops and venture funds, outsourcing, or becoming partners in joint ventures. And although some of these efforts may succeed in their own right, ultimately they fail to enable incumbents to commit to the kind of major rethinking of their business model that is demanded by disruption. To do so, companies need to engage their disruptors by entering into a new type of business relationship — what we call *collaborative reinvention.*

These relationships aren't necessarily based on an exchange of monetary value, though sometimes the incumbent will become an investor in the disruptor. Nor are the relationships set up to make a company's existing capabilities less expensive or more efficient. Instead, collaborative reinvention involves the sharing of capabilities, through which each party benefits from the technology, know-how, resources, and experience of the other. A well-crafted collaborative reinvention also opens up new revenue streams for each player. For example, the parties might decide to provide access to one another's customers, as in the cases of Santander and Citigroup above.

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The startups share access to their proprietary platforms and processes, but they have much to gain in return. Large, established companies have the structures and processes needed to operate at scale and manage critical functions such as regulatory compliance, customer service, and fraud prevention. Perhaps more important, they possess long-standing customer relationships and have vast troves of customer profiles and other data, including their preferences, transactions, and behavior over time. Next-generation startups can't make the most of their data-crunching talents without access to this data. The customer algorithms that disruptors use to personalize transactions are mostly the output of proxy data from social media and other Internet sites.

For example, industrial manufacturers such as General Electric, Caterpillar, and Deere & Company have equipped their products with sensors, and now control streams of data on customer usage patterns and machine performance. The disruptors have the capabilities to turn such information into new service offerings. In 2014, Caterpillar and the Chicago-based data analytics firm Uptake announced a partnership through which the young firm is helping the 90-year-old equipment maker compile, organize, and analyze sensor information from its bulldozers, backhoes, and other industrial machinery. Caterpillar, for its part, has taken a minority stake in Uptake.

Similarly, in other industries, collaborative reinvention has resulted in new offerings that use technology to better serve existing customers (or to reach new ones). Carena, a healthcare technology firm, has partnered with several large hospital systems to provide both the technology platform and the associated operational support for low-cost telemedicine services. Online education company edX has partnered with universities including Harvard, Columbia, and MIT to provide the technology for online education; the schools bring their professors and curriculum into the venture.

Illustration by Kotryna Zukauskaite

The Fintechs Are Coming

In the financial-services sector, startup funding soared to $12 billion in 2014 from $4 billion in 2013, according to the venture capital database CB Insights. New "fintechs," as they're called, are born every day. They offer innovative new products and services with streamlined application processes that bypass traditional financial institutions. They leverage digital technology and analytics to keep costs low, and benefit from the increasing willingness of consumers to take their financial transactions online.

Hundreds of fintechs are now targeting the most profitable, least complex segments of the market, such as international payments and consumer loans. For example, consumer lender Affirm finances consumer purchases with point-of-purchase loans, using personal data from social media to evaluate credit risk and offer interest rates and repayment terms tailored to individual borrowers. Payments specialist TransferWise offers low-cost international money transfers by using a peer-to-peer model that matches the transfer requests of various customers. And student loan company PYT Funds — PYT stands for "pay your tuition" — helps banks transform their "turndown pool" of student loan applicants into profitable customers by helping the applicants crowdsource the collateral required for bank approval.

Fintechs provide the technical capabilities needed to reinvent incumbents' back-office systems and processes at minimal cost, as well as contributing advanced front-office skills. "Fintechs have what banks want: superior underwriting engines with models and access to troves of big data, modern and relevant front ends aligned to customer expectations and preferences, and software architecture that has been developed from the ground up based on modern technologies and principles," says PayPal cofounder Max Levchin, who recently launched Affirm.

Yet Levchin also acknowledges that fintechs can't keep growing larger without developing many of the resources of a traditional financial institution. As they scale up, fintechs will attract greater scrutiny from banking regulators, which have largely ignored them so far. This means these new firms will require full-fledged regulatory compliance and customer servicing capabilities — the bank charters, licenses, and compliance systems needed to meet regulatory requirements and operate within "industry guardrails" such as automated clearing house (ACH) payment networks — that banks have refined over generations.

Although banking systems and platforms are not always cutting-edge, they most certainly have the controls, audit trails, scale, balance sheet, and fail-safe features required for large-scale lending and deposit taking. Already, major banks are lending their balance sheet strength to fintechs by purchasing securitized loans from online players. And as their lending activities grow, fintechs will need organizations, processes, and technologies for managing frauds, claims, and collections. Again, major banks can do all this.

As Levchin puts it, fintechs "will soon be subsumed within the same things they were trying to solve." He believes fintechs would be willing to share their distinctive capabilities with banks as long as the banks are willing to take on traditional banking functions for which the fintechs have no real aptitude or affinity. Levchin foresees a business model in which banks might become the gatekeepers to the guardrails — that is, regulatory compliance, funds transfer, and other traditional capabilities — and take a fee from the business that comes into their ecosystem from the fintechs, giving as an example a "start-up service for ACH transfers." He thinks fintechs would consider such capabilities a fair trade for helping banks reinvent their established, last-generation business models.

Getting Started

Collaborative reinvention can work anywhere that new players are using leading-edge technologies to attack profit pools controlled by incumbent companies. But to succeed, companies need to start by asking themselves four questions.

• **What part of our business needs reinvention?** Companies should prioritize the business lines, market segments, or parts of the value chain most in need of new capabilities. Wholesale transformation is usually a bad idea.

• **With whom should we collaborate?** The logical choices are digital disruptors focused on the segments identified in the answer to the first question. Because companies in this sphere may come from very different backgrounds, make sure both parties are like-minded players looking for a true collaboration based on mutual respect and appreciation.

• **What exchange of value will govern the relationship?** Decide which capabilities each party will contribute — the answer will depend on what each party needs. A tech startup, for example, may need access to an incumbent's balance sheet or customer base, whereas an incumbent may need to upgrade legacy technology architecture or accelerate product development.

• **How do these collaborative efforts support our broader enterprise strategy?** Your reinvention must align with the fundamental choices you have made about which businesses to compete in, as well as your differentiating capabilities and value proposition. It takes more than a transitory relationship to facilitate a marketing campaign or build a mobile app.

Answering these questions will lead to collaborations that offer opportunities for incumbents and disruptors. By bringing together their respective skills and technologies, both can do things neither could have achieved alone. ✚

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