Journey to the Center of the Matrix

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Managing Partner, QED Investors

QED Investors has invested in 40+ FinTech disrupters over 9 years

I've been blessed with four distinct stops in retail financial services

1985

Strategic Planning Associates
Principal

1988

Signet Bank Card
Executive Vice President

1994

Capital One
Co-Founder, President, COO

2004

QED Investors
Managing Partner

We began QED Investors over nine years ago to help the disrupters

- Leverage over **120 years of collective experience** in building financial services businesses
- Invest in **breakthrough disrupters** attacking the incumbents and leveraging next generation propositions in retail financial services (**40+ FinTechs to date**)
- Play **active, hands-on consigliore roles** with leaders leveraging our operating, credit, and marketing experiences to profitably scale quickly and soundly

We contemplated what a blank slate bank might look like…

- ✓ Delight your customers in service and product design
- ✓ Embrace digital channels and avoid creating technical debt
- ✓ Develop a culture of discipline and consistency
- ✓ Attract and retain top talent
- ✓ Don’t get sideways with the regulators
- ✓ Manage out rogue employee behaviors
- ✓ Don’t try to be all things to all people all the time

All of this is true but obvious – and doesn’t provide a roadmap for existing companies

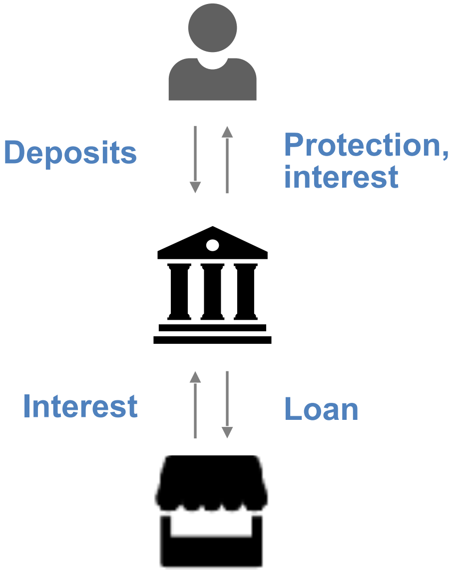
How must new and existing institutions evolve?

- We propose that the answer requires striking the right balance along two dimensions:
  - **Resilience**
  - **Flexibility**

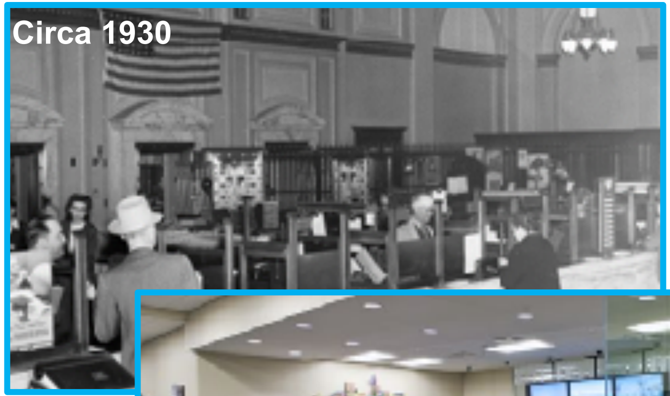
- While important, this is devilishly difficult to do…
  - "Extremes" create vulnerability, while balance allows institutions to reap the best of all models
  - Organizational change is challenging and slow – and typically faces multiple sources of resistance

The basic retail banking model has been the same for decades

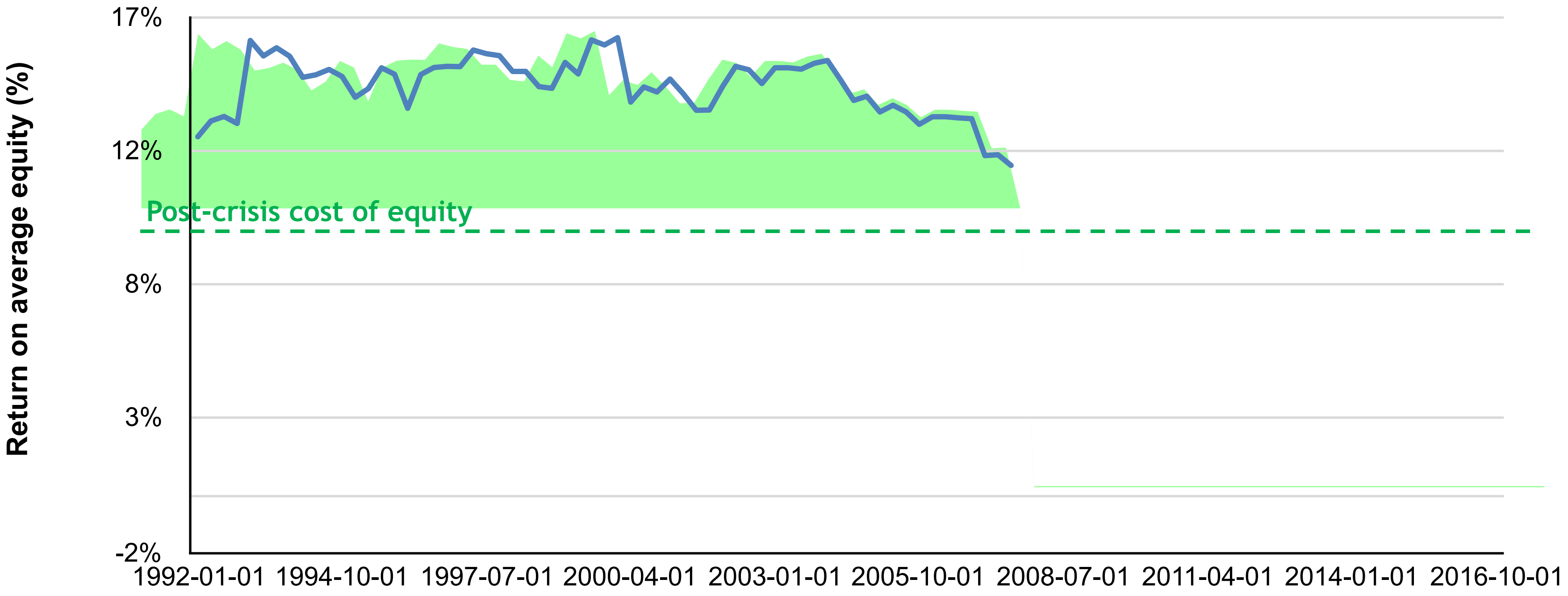
Retail banks have engaged in a largely similar business model for decades



Even the execution of this model is not dramatically different today

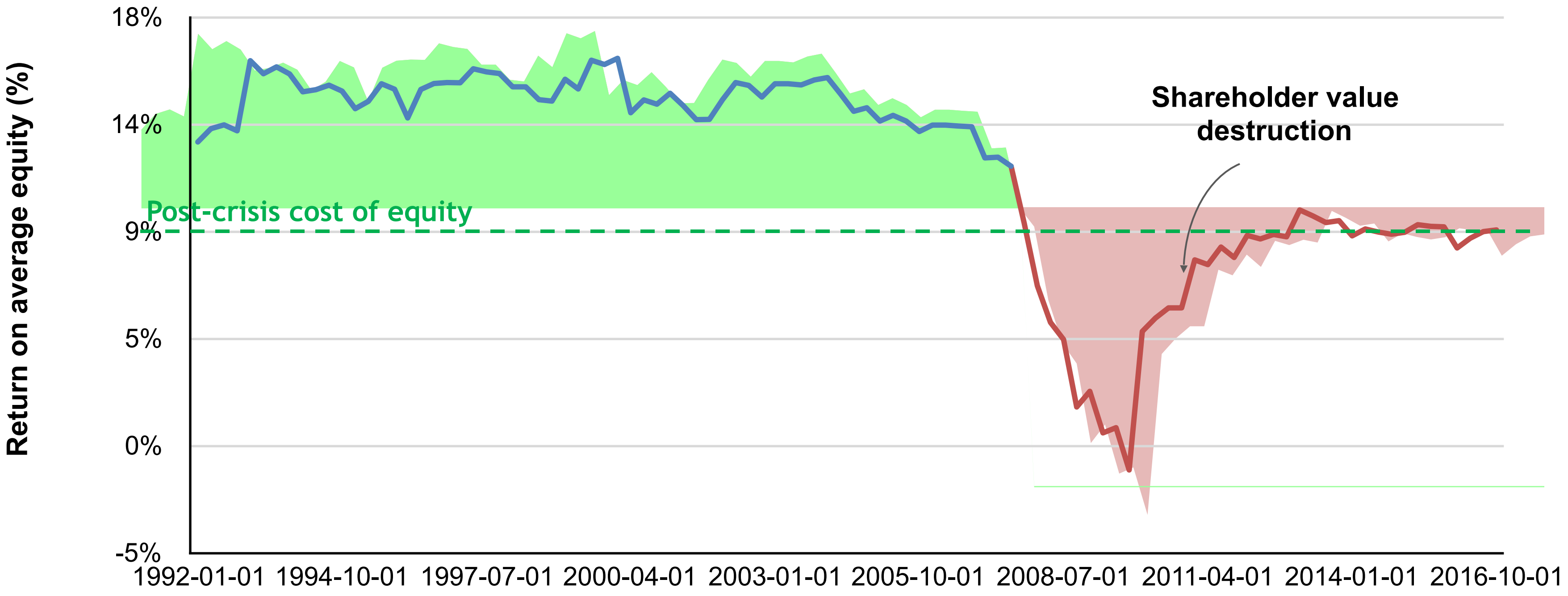


That model worked when banks averaged ~15% ROE…



Source: Federal Reserve Economic Data. Return on Average Equity for all U.S. Banks, Percent, Quarterly, Not Seasonally Adjusted. Shareholder value shading assumes constant cost of equity

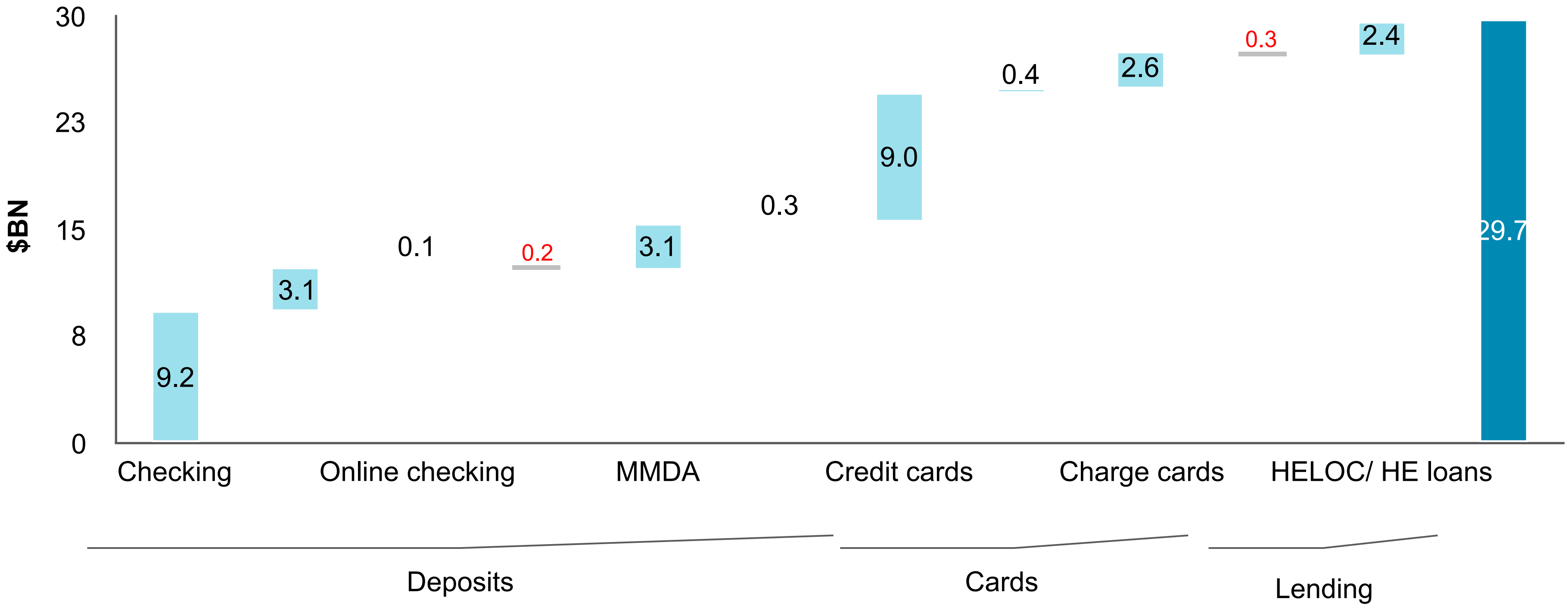
…but banking economics have weakened since the crisis



Source: Federal Reserve Economic Data. Return on Average Equity for all U.S. Banks, Percent, Quarterly, Not Seasonally Adjusted. Shareholder value shading assumes constant cost of equity

Banks have not focused on what the key profit pools are, attempting to be all things for all people…

Annual post-tax economic profit, 2015



Source: Oliver Wyman analysis

…while disrupters have attacked deep profit pools and atomized the retail banking model

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	FinTech disruptors	
Consumer lending	LendingClub, SoFi, loanDepot	loanDepot has funded $100 Bn in loans since 2010
Payments	stripe, PayPal, Klarna, Square	Square's $50 Bn in 2016 transaction volumes marks a 39% increase from 2015
Wealth management	SIGFIG, wealthfront, Betterment	Betterment and Wealthfront manage over $10Bn in assets
Small business lending	OnDeck, quarterspot, Funding Circle	Chase, BBVA Compass, and CommBank (Australia) have partnered with OnDeck
Deposits	SIMPLE, monzo, Atom	Atom works with 800 mortgage providers to provide digital mortgages

Regulatory pressure, low rates, and evolving technology have squeezed bank profitability…

FED'S WILLIAMS SAYS HISTORICALLY LOW INTEREST RATES WILL PERSIST

February 21, 2017 — Bloomberg

WORLD'S BIGGEST BANKS FINED $321 BILLION SINCE FINANCIAL CRISIS

March 2, 2017 — Bloomberg

THE COST OF NEW BANKING REGULATION: $70.2 BILLION

July 30, 2014 — WSJ

CITI WILL HAVE ALMOST 30,000 EMPLOYEES IN COMPLIANCE BY YEAR-END

July 14, 2014 — MarketWatch

+

High costs of technical debt that burden traditional banks

Reduced value of bank branch footprint due to mobile

Cheap computing that lowers barriers for new entrants

…and much of the talent arriving at these disrupters has come from banks

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Many FinTech founders left leading banks…

Mike Cagney

SoFi

CEO, Co-Founder

WELLS FARGO

Justin Basini

ClearScore

CEO, Co-Founder

Capital One

Deutsche Bank

Sasha Orloff

LendUp

CEO, Co-Founder

citi

…and grow their teams with bank talent

LendingClub

1,363 employees on LinkedIn

Past employers	
94	Wells Fargo
48	Capital One
45	Bank of America
41	JP Morgan
36	Charles Schwab
264	

Atom

213 employees on LinkedIn

Past employers	
22	Northern Rock
19	Barclays
18	Virgin Money
18	Lloyds
10	HSBC
87	

Source: LinkedIn

Traditional banks and FinTechs operate at fragile extremes

- Slow adoption of digital channels
- Legacy technology infrastructure
- Conservative use of alternative data
- Organizational inflexibility
- Culture of “no” and regulatory overhead
- Struggle to launch new businesses
- Weak talent attraction/retention
- Poor net promoter scores

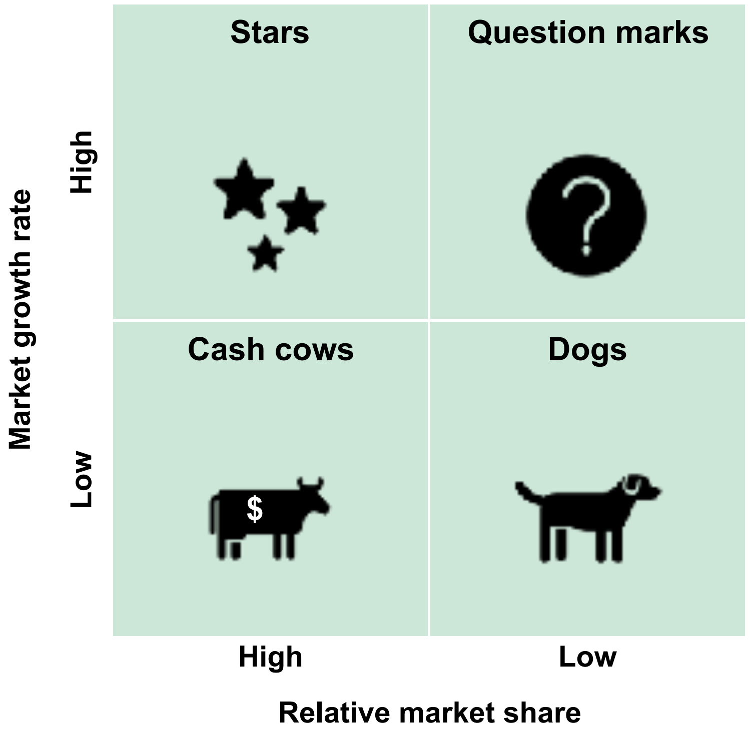
Risk of being a utility

- Monoline / narrow product suite
- Lack of built-in physical distribution
- Scarcity of customer data
- Sub-scale, millennially-focused business
- Struggle to scale new businesses
- High cost of capital and debt
- Lack of capital reserves
- Minimal compliance / capital mkts. infrastructure

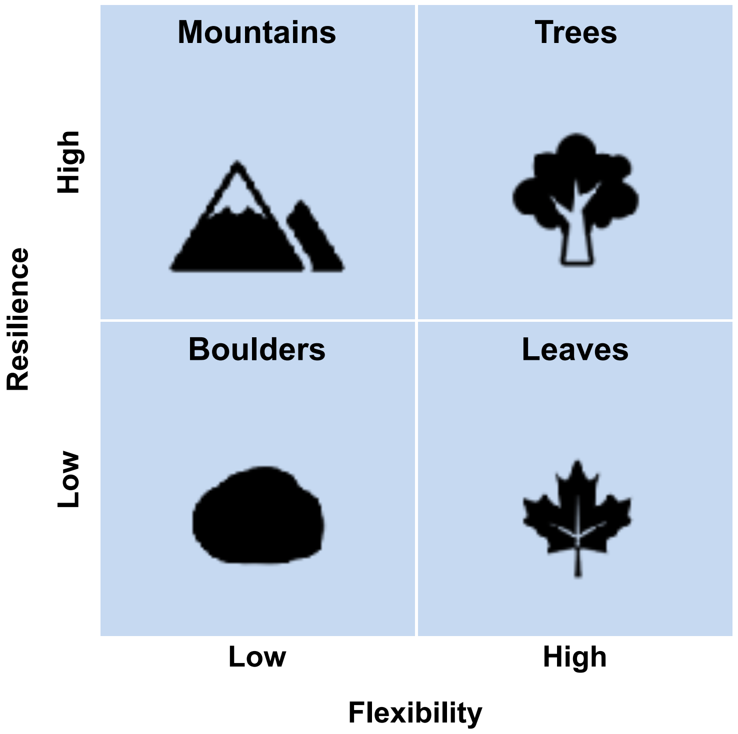
Risk of extinction for numerous reasons

Similar to BCG's framework for analyzing business units, we need a framework to discuss banking model trade-offs

BCG Growth-Share Matrix (1970)

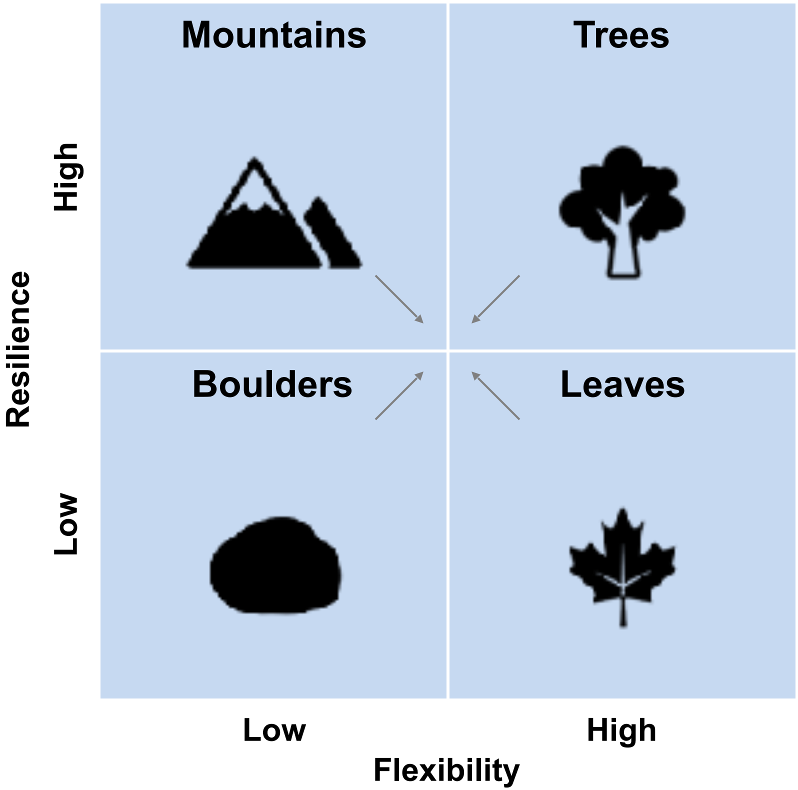


QED Matrix (2017)



Each quadrant has its shortcomings, so institutions close to the center tend to be best positioned

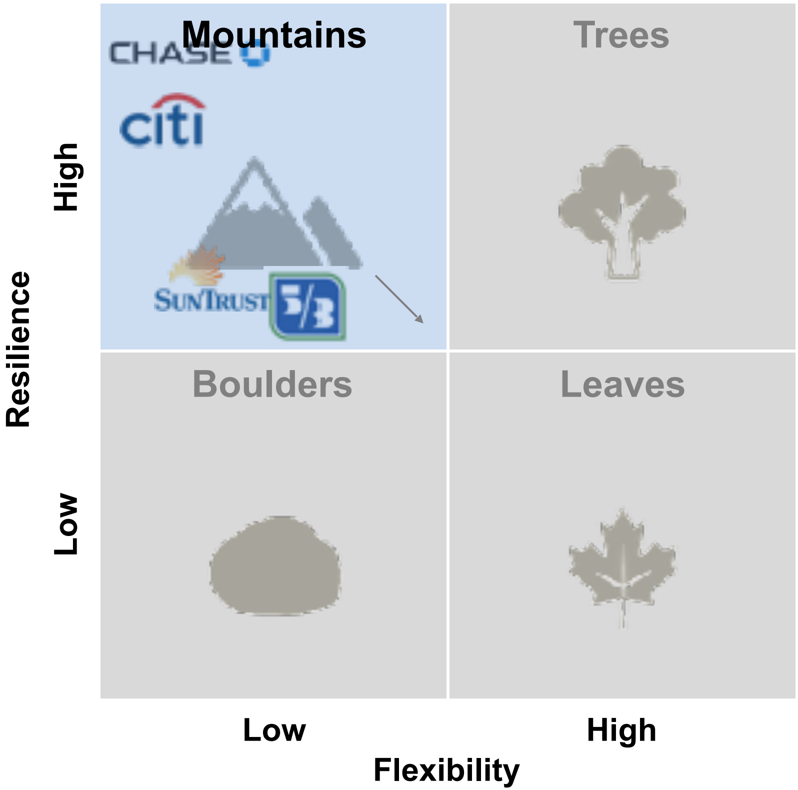
QED Matrix



- Distinguishing between banks and FinTechs on a **single dimension is insufficient**
- The QED Matrix reflects **trade-offs** in the design of financial services institutions
  - **Resilience** is a function of factors like brand, capitalization, and product suite diversification
  - **Flexibility** concerns both infrastructure and decision-making – and spans organizational design, technology, culture, talent, and more
- Each quadrant has strengths and drawbacks, so our thesis is that **entities should move towards the center of the matrix**

QED Matrix: Mountains

QED Matrix



Characteristics

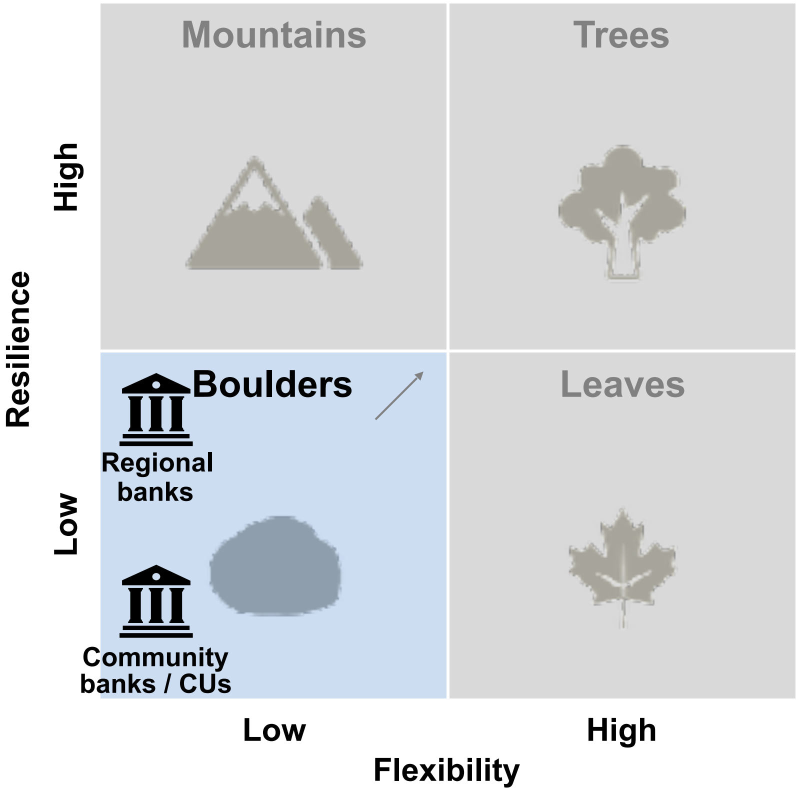
- **High resilience** due to product diversity, brand, capital reserves, distribution networks, and low cost of capital
- **Low flexibility** due to institutional inertia, low growth, technical debt, & focus on regulation and cost reduction

Pros / Cons

- \+ Very strong distribution, including massive physical networks and more investment in digital than Boulders
- \+ Efficient at competing in “national” businesses
- \+ Able to test new models easily on existing customers through partnerships with and acquisitions of Leaves
- \- Decision-making process, infrastructure, and regulatory pressures lead to poor ROE and limited innovation
- \- Sourcing and retaining talent remains challenging

QED Matrix: Boulders

QED Matrix



Characteristics

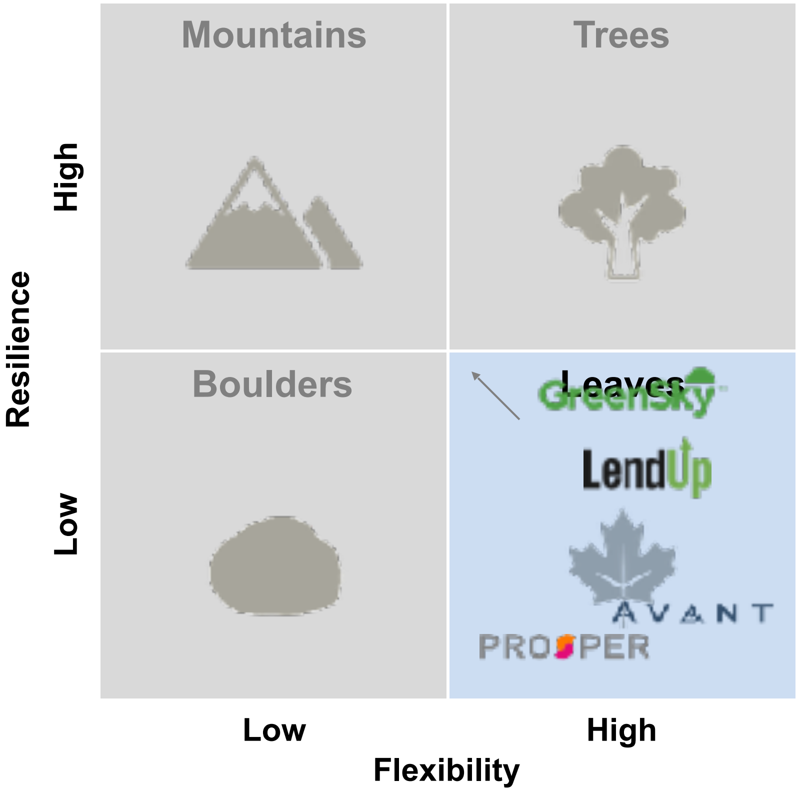
- **Low resilience** due to lack of capital reserves or product diversification of larger banks (Mountains)
- **Low flexibility** due to legacy infrastructure, weak talent pipeline, and dearth of ideas or comparative advantage

Pros / Cons

- \+ Low cost of capital and strong advantage in "local" businesses (e.g., deposits, CRE)
- \+ Partnerships with Leaves and even Mountains can be particularly material due to smaller size
- \+ Developed risk and compliance capabilities
- \- Vulnerable due to more limited capital reserves and capacity to innovate (given talent, digital capabilities)
- \- Sub-scale operations force a trade-off between profitability and proper resourcing

QED Matrix: Leaves

QED Matrix



Characteristics

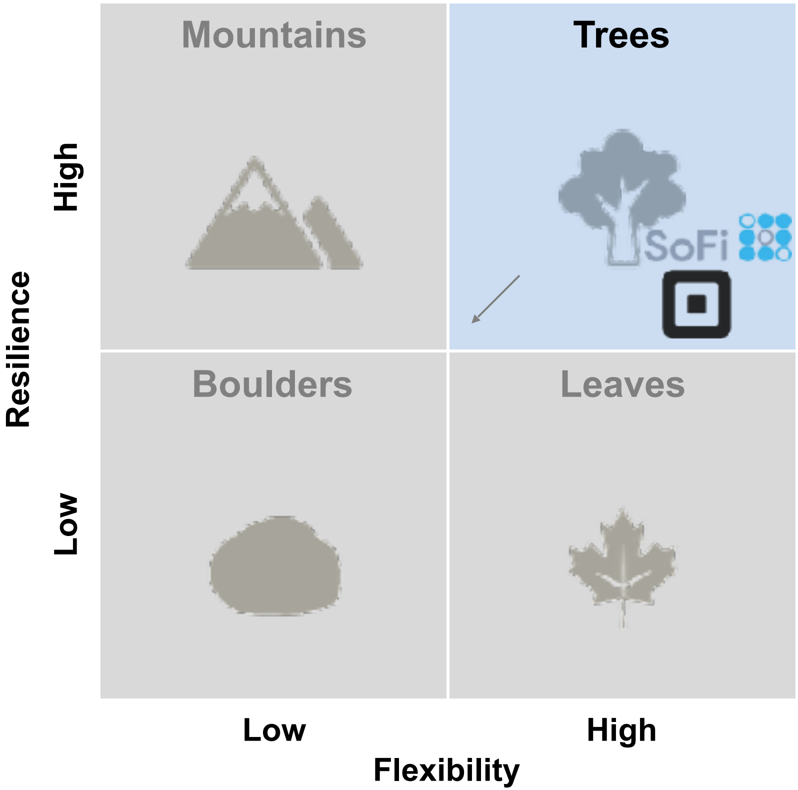
- **Low resilience** due to product concentration (often monoline) and lack of stable, low cost capital (deposits)
- **High flexibility** due to simple organizational structure and technology infrastructure, access to talent, etc.

Pros / Cons

- \+ High degree of focus makes it easier to excel in a specific part of the market (e.g., franchise lending)
- \+ Focus facilitates partnerships with Mountains/Boulders
- \+ Very flexible model with minimal regulatory and organizational overhead, good talent, etc.
- \- High cost of capital and customer acquisition
- \- Too much flexibility can lead to oversight of edge cases and compliance issues that create extinction risks

QED Matrix: Trees

QED Matrix



Characteristics

- **High resilience** due to factors like product diversification and robust / loyal customer base
- **High flexibility** due to simple organizational structure, minimal technical debt, and strong access to talent

Pros / Cons

- \+ High net promoter scores from customers due to range of product offerings and focus on the customer
- \+ Strong growth potential that creates access to talent
- \+ Lack of severely bloated organizational structure or technical debt enables further innovation
- \- Minimal regulatory experience or capital relative to full service banks that have a similar model
- \- Risk of losing customer focus and agility in growing too large and reorienting around SBUs

QED Matrix: How to move to the center

Mountains

- Partner and invest in Leaves to experiment with new models
- Shed (or scale back) low ROE businesses
- Shift towards platform model, strong distribution model
- Hire, retain, and empower talent

Boulders

- Focus efforts on local businesses (deposits, CRE, agriculture loans)
- Partner with Mountains / Leaves on national businesses

Leaves

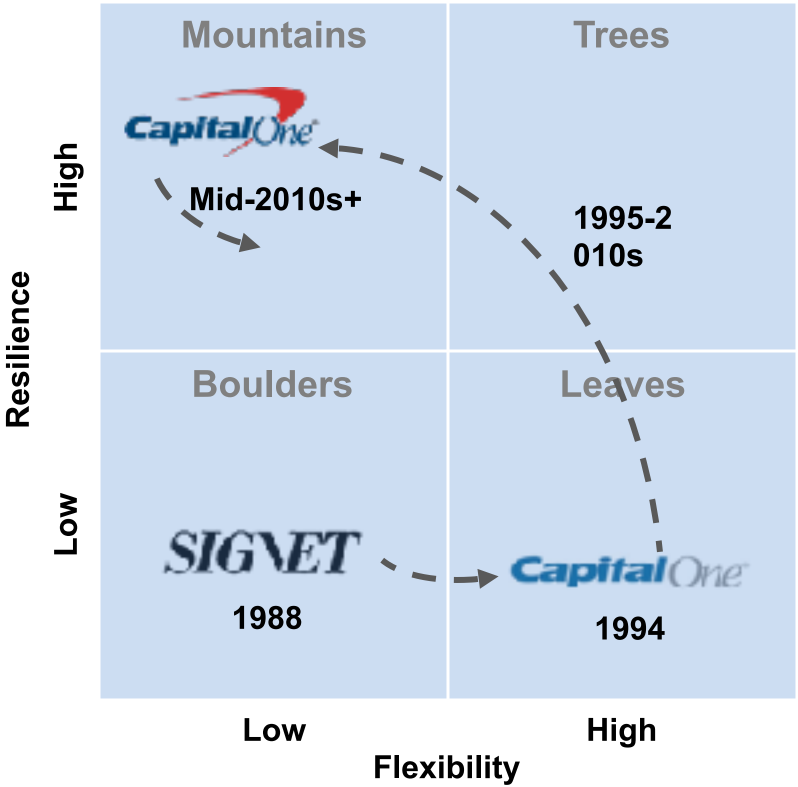
- Diversify offerings to reduce risk and expand customer base
- Partner with Mountains and Boulders to improve distribution

Trees

- Develop bank-like capabilities in deposit-taking and risk
- Avoid organizational bloat, technical debt, silo-ing by SBU, etc. common in banks

QED Matrix: How companies evolve over time

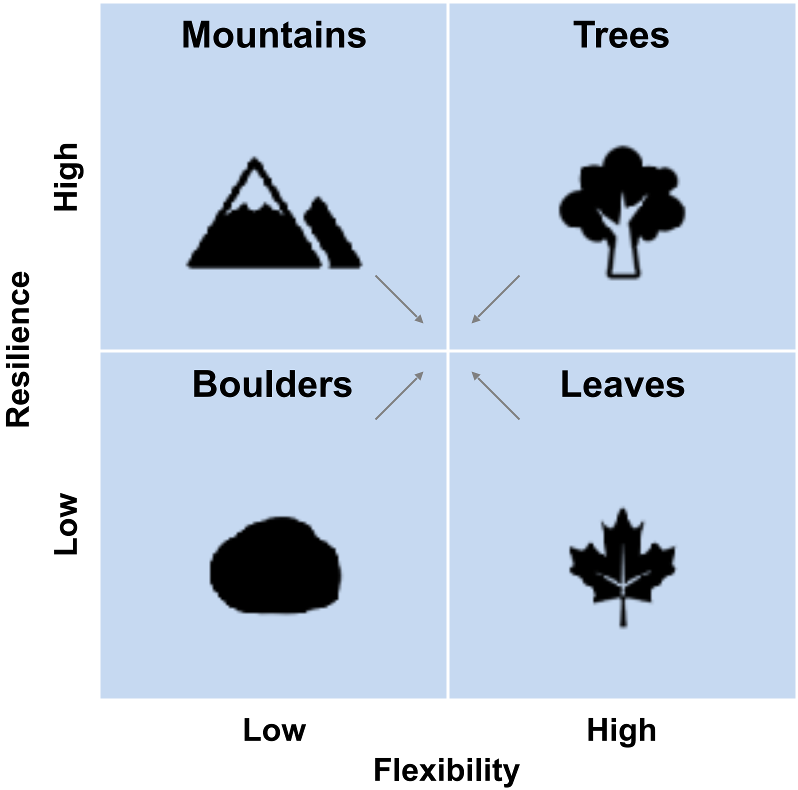
QED Matrix – Capital One example



- **1988:** Signet Financial Corp card business and adopted Information Based Strategy (IBS)
- **1994:** Signet Financial Corp announced spin off of its credit card division, which became Capital One
- **1999**: Capital One announced expansion beyond credit cards to additional products (e.g., lending)
- **Starting 2005**: Capital One acquired several retail banks to expand capabilities and scale (including Hibernia, ING Direct)
- **Starting 2010s**: Capital One began to reduce branch footprint, experimented with banking “cafés,” and launched Capital One Labs

QED Matrix: Where is your company and how has it moved?

QED Matrix



- We will explore themes around the QED Matrix more deeply in the coming months
- As part of this effort, we are gathering perspectives on the placement of banks and FinTechs in the QED Matrix
- We also will analyze how these institutions have evolved (some have occupied several quadrants)
- Visit **qedmatrix.com** to sign up for an email notification when we begin to collect data