THE one BRIEF
AON EXPLORES THE WORLD'S MOST PRESSING BUSINESS ISSUES

CAPITAL & ECONOMICS

Cooperation And Competition In The Age Of Fintech

OVERVIEW

From online banking, to cryptocurrencies, to powering the financial infrastructure of the sharing economy, fintech is transforming our economic world. But at the same time it opens new opportunities, it's also disrupting industries and challenging regulatory frameworks.

For financial institutions in particular, fintech represents both a threat to business-as-usual and significant opportunity, promising new markets, improvement of internal processes, and even the delivery of more cutting-edge products and services to customers. Meanwhile, regulators must rise to the challenge of adapting current regulatory frameworks or creating new ones to better manage such new industries. Essentially, institutional finance must either compete head-to-head with these new, agile, and dynamic startups firms, or learn to co-operate with them.

IN DEPTH

Emerging Financial Technologies

Over the last decade, technology has brought profound disruptions to traditional finance. The blockchain is still little-understood by many, but its core value lies in the fact that it can secure any transaction without the need for a third party intermediary to authenticate it. While currencies like Bitcoin are not yet mainstream, it is a technology that could in theory disrupt the $586 billion transfers market currently owned by traditional banks.

Meanwhile, peer-to-peer lending cuts banks out of the entire loan process, by enabling individuals to lend directly to other individuals or businesses. Crowdfunding is the most public example of this, but there are also a range of other peer-to-peer investment services removing banks from the equation.

And higher up the investment banking chain, automated robo-advisors are replacing trained analysts in picking and trading stocks. According to the most recent (2012) figures, algorithmic trading accounted for 50% of all US equities trading. Currently banks are safe in this area, as they own the fiber-optic infrastructure that underpins algorithmic trading. But the next five or ten years, as internet services get faster and smartphones get smarter, could see this change. Small scale robot-advisors are already letting non-specialists engage in low-level stock trading with no financial intermediary aside from the app itself. Acorns, for instance, automatically rounds up retail purchases and makes automated investments with the difference.

However, amidst newer technologies and increasing competition, the future for banks isn't too ominous. Jacqueline Geiger, Financial Institutions Practice Leader, Aon Risk Solutions, states that some traditional financial institutions view fintech as more of an opportunity than a threat. "Broadly speaking, fintech startup activity should create new opportunities and sources of innovation for institutional finance. This type of innovation is positive for the industry and embracing it can actually help financial institutions prosper in an increasingly competitive environment."

The Showdown

Even when direct competition between fintech and institutional finance is happening, the degree of that competition varies by geography and the relative maturity of local financial institutions. For instance, in the US, the relationship between fintech startups and large financial institutions is competitive, with both pursuing similar markets. Enrico Nanni, Chief Commercial Officer Aon EMEA Specialty,phasizes the pressure felt by large banks amidst the current changes, "there is considerable pressure to innovate whilst having to deal with a rigid cost structure, a declining business model and shareholders' expected returns."

Jeff Hanson, Director, Aon Limited, sees Silicon Valley as both a possible competitor to traditional Wall Street firms as well as an agent for facilitating change. "Over the next decade, startups or even the well-established Silicon Valley firms might emerge as major financial players as traditional financial institutions are still trying to adapt to the growing demand of digital currency." At the same time, he states, "Silicon Valley might also become a facilitator and provide the necessary infrastructure for the more traditional banks."

In areas with less developed financial institutions however, big banks and fintech players are working hand-in-hand to cater to local needs. For example, Sub-Saharan Africa is home to some of the world's most forward-thinking bitcoin remittance startups like Mpesa and BitX. Some of these are developing under incubation programs developed by banks themselves. Barclays, for instance, runs a fintech accelerator in Cape Town, South Africa. These locations have the advantage of having populations used to mobile banking and the pressing need of better access to different kinds of finance.

Regulatory Infrastructure & Risks

It's almost impossible to completely anticipate the full extent of the effects that new technologies will have in the wider economy. How many observers in 2007 could have guessed that the newly released iPhone would redraw the map of mobility services within a few years of its release? But that's what happened, seemingly overnight, as people embraced the idea that their mobile device could make hailing and paying for a taxi simpler than ever.

As with all new technologies, things move fast. Regulation, on the other hand, doesn't. Digital currency is still in its infancy and currently unregulated. Hanson states, "we're seeing uncertainty around who will ultimately have regulatory responsibility and what the impact can – and will – be."

An important first step for regulators is to find a balance between maintaining a stable financial sector while keeping up with evolving consumer preferences. Geiger explains that new regulations will be put in place and existing regulations will have to be updated based on how this new financial world evolves. In such new markets, there's complexity from all parties involved: regulators, fintech firms, institutional finance and consumers. "There are several challenges," she says, and "creating a framework for regulation that does not unreasonably limit innovation or make it cost prohibitive is crucial to not constrain the competitiveness of traditional, established institutions."

One specific difficulty will be building new regulatory frameworks for the more niche services that fintech startups offer. There is added complexity when different organizations are part of the same service – for example, a firm that provides the payment service to a car-sharing technology. "Regulators will have to assess the different services provided by everyone in the fintech supply chain, as startups often focus only on one of the activities, or even part of the activity, traditionally carried out by a large "one-stop shop" financial institution," says Nanni.

The very nature of disruptive technology is how quickly it moves – typically much faster than laws and regulations. Regulators are then left playing catch up to modify current regulations or create entirely new ones. This is something regulators in fintech will also need to come to terms with, says Nanni. "Regulators have been traditionally slow to capture change in many industries that have suffered disruption by tech companies and often had to 'acknowledge a new *status quo*' rather than being able to regulate in advance of entry to markets by tech disruptors."

Sometimes this strategy doesn't work for the startups. Firms caught skirting certification and licensing regulations in the insurance sales industry have suffered very public and damaging scandals. But an unreactive regulative body could end up letting firms enter the market that are not only dangerous to incumbents but to customers as well.

Ironically, tech could be the solution here – regulation tech, or regtech, could use big data and analytics to identify holes in current models and help regulators formulate appropriate strategies.

Innovating Amidst Uncertainty

The relationship between emerging financial technology and the financial players it potentially disrupts isn't always confrontational, and there are plenty of examples of collaborative development.

"All the major banks have digital currency teams working on providing solutions for their respective institutions," says Hanson. "For example, the potential cost savings provided by digital currencies like Bitcoin to transfer funds overseas has created significant pressure on larger established money transfer companies to be much more competitive."

Geiger also highlights the various forms collaboration between banks and fintech, "it's interesting to note where and how institutional money is 'supporting'" startup activity. In particular, whether that support comes via an institution creating its own incubator or accelerator, whether through funding others, or whether through partnering with VC".

Santander can be considered a good example of how a bank has taken a strong pro-tech approach to dealing with new financial innovation internally. It has been developing blockchain-enabled transfer methods, which it completed earlier this year. Santander also runs the Innoventures fund, a venture capital arm that has invested in 12 fintech funding rounds since launching in 2014. While Santander's exact contribution is unclear, the funding totalled nearly $0.5 billion, and included rounds to fintech heavyweights like contactless payments firm iZettle. Also taking a pro-active interest in fintech is Standard Bank, which has partnered with Microsoft's Bizspark to open the Ignitor tech incubator in Johannesburg, South Africa. What's interesting about this collaboration is that Standard does not take an equity position in the startups going through its program. It's also a good example of tech and high finance players operating together to develop transformative technology.

Also looking into Bitcoin development is R3, a consortium of 45 (and growing) global financial institutions dedicated to researching and implementing blockchain technology. Its members include major players such as Barclays, Goldman Sachs, JPMorgan and Credit Suisse, among others. Of course, the blockchain technologies being pursued by big banks are those that cut down on internal costs, rather than a cryptocurrency that replaces the whole sector.

In other instances, rather than posing a threat, new financial technology opens up markets that banks previously wouldn't have entered, particularly in the developing world. The rise of mobile banking, microfinance, and data-driven credit ratings are expanding institutional financial services to the 2 billion unbanked adults in the world.

The Road Ahead

Ultimately, it's co-operation, rather than outright disruption that may end up being most accurate vision of the future of finance. Big banks are too integral to the global economy to make takeovers by fintech startups likely. But at the same time, the value offered by fintech to both customers and financial operators is too big for either to ignore. According to Nanni, the future of financial institutions is likely to be "collaboration between regulators, traditional financial institutions and fintech. Things will continue to move quickly and this type of 'continuous innovation' brought by fast-moving startups will alter the risk profile of the industry."

TALKING POINTS

"I don't think that the banking industry has any intent of developing everything in house, we are not as nimble and we are spending huge amounts on compliance and meeting regulators requirements. Certainly we are looking for innovation outside of the bank walls so we need to partner because over the last 10 years we worked with a lot of start-ups to provide technology solutions and starting of as a partnership works very well." – Cindi Murray, Head Of Digital Transformation, Bank of America Merrill Lynch

"Investment banks, through their accelerators and labs, have started to engage with FinTechs to understand how to work better together... [but there is] more innovation going on outside of an institution's four walls than inside, and the investment in participating in that innovation is low relative to the risk of not being abreast of the FinTech landscape and players." – Lawrence Wintermeyer, CEO Innovate Finance

FURTHER READING

- The Coming "FinTech" Revolution – The Brookings Institution, September 20, 2016
- Banks Warned Over Fintech Payment Firms – CityAM, September 26, 2016
- Fintech To Drive Transformation Rather Than Disruption – Moody's, May 18, 2016
- Regulating The Fintech Revolution – The Lawyers Weekly, September 30, 2016
- 25% Of Banks Would Buy A Fintech Company – Business Insider, September 16, 2016
- Fintech: Are Banks Responding Appropriately? – EY, 2015