Narrowing the gap

Richard Tomlinson *reports on how the pandemic could trigger regulatory policy changes that will help fintechs to enter the financial services mainstream*

There are currently two apparently conflicting views on the regulation of fintechs. In the first, fintech banks are still hindered by a regulatory regime that unfairly favours the incumbents. In the second, Covid-19 has triggered a decisive policy shift that will enable fintechs to enter the financial services mainstream. But there may be truth in both, suggesting a rather more tangled plot.

This complexity was highlighted in August, when it emerged that the Bank of England had raised capital requirements at digital bank Monzo from 9 per cent to 13.65 per cent of risk-weighted assets, plus a fixed amount of £21m.

> *Regulators should remove barriers to allow successful start-ups to grow and compete with the incumbents*

That came just as Monzo embarked on a fundraising round. Superficially, the story lent weight to the charge that fintechs are constrained by unduly stringent capital requirements compared with the incumbents. Yet the case made by the fintechs is more nuanced, focusing on how regulators and policymakers can do a better job of monitoring and supporting digital lenders once they progress beyond the start-up phase.

"What we would like to see is a journey that moves in stages in a more manageable, sustainable way," says Iana Vidal, head of policy and government affairs at Innovate Finance, the UK fintech sector's industry association.

At the heart of this case is what happens when early-stage fintechs leave the security of the Financial Conduct Authority's (FCA) regulatory "sandbox" for start-up firms. The FCA created the sandbox in 2014 as a safe space for start-ups to test whether their business model was robust enough to survive on a fully regulated playing field.

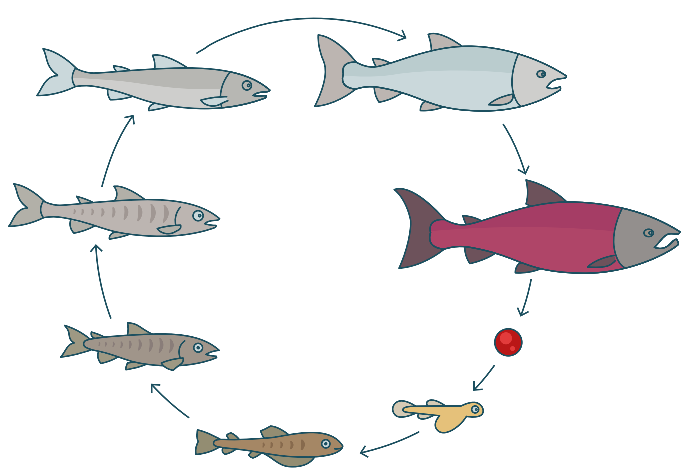
"The UK has been a fantastic environment for fintech start-ups to get established," says Nick Lee, head of regulatory affairs at OakNorth Bank, a digital-only UK bank that specialises in lending to smaller mid-market companies. "The policy focus now for regulators should be on removing barriers to scaling to enable successful start-ups to grow and compete successfully with the incumbents."

OakNorth illustrates Lee's point that there is a cohort of mid-stage UK fintech lenders, including Monzo and its rival Starling, that occupy an intermediate space between the digital start-ups and the big high-street banks. Launched in 2015, OakNorth nearly doubled its pre-tax profit in 2019 to £65.9m while attracting deposits from 144,000 savers, up from 28,000 in 2018. It's not a banking minnow, yet nor is OakNorth (or Monzo or Starling) anywhere near the scale of an incumbent such as Lloyds Banking Group, which registered pre-tax profit of £4.39bn in 2019.

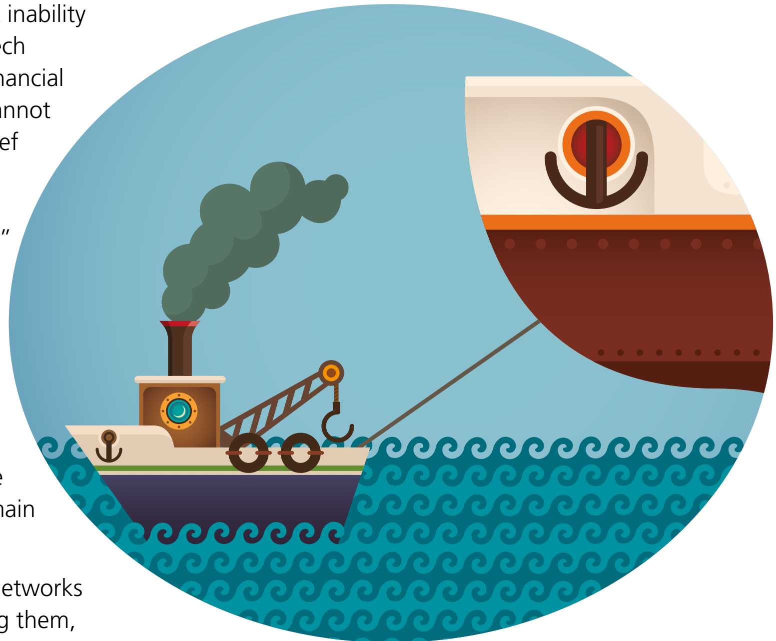
Lee was previously responsible for the authorisation and supervision of new banks at the Prudential Regulation Authority before joining OakNorth in 2017. He suggests that precisely because of their smaller scale, established fintech lenders such as OakNorth "don't pose the same risk to the banking system as one of the incumbents and therefore we feel some of the regulations should be more risk-based and proportionate".

The policy shift that Covid-19 built

It's here that the second storyline surfaces. For, while there is no evidence that the FCA is minded to set up an intermediary sandbox for established digital lenders, there are increasing signs that regulators and the Treasury see fintech challenger banks as integral to building UK financial services "back better" in the wake of the pandemic.



To some extent, this is a story about the persistent inability of the incumbents to use the full potential of fintech innovation to improve customer service. "Large financial services firms are like huge battleships and they cannot pivot quickly," says Holly Mackay, founder and chief executive of Boring Money, a personal investment advisory company. "They need nimble fintechs to show them what good looks like at the front end."



In addition, the perception of fintech lenders as serving a social purpose received a boost at the start of the Covid-19 crisis because of the failure of the incumbents to fulfil an urgent mandate. In March, when the government launched its Coronavirus Business Interruption Loan Scheme (Cbils) for small and medium-sized companies, the cash was at first distributed entirely through the main high-street banks.

It rapidly became apparent that the incumbents' networks could not reach many of the smallest firms, among them, ironically, traditional high-street businesses. The fintechs that covered this market began lobbying to fill the gap. In April, OakNorth and Starling were added to the list of authorised Cbils lenders, to be joined over the summer by other digital challengers such as ThinCats, based in the Isle of Man, and the UK-German bank Iwoca. "The fintechs demonstrated they had a really key role to play, in using their technology and credit analytics to get the money out of the door," says Vidal.

A new "digital" sandbox

Despite the Treasury's false start with the Cbils programme, Covid-19 has in fact added urgency to efforts by regulators and policymakers to improve the chances that the best fintech start-up lenders will evolve into robustly competitive banks, in a market where the pandemic is accelerating the permanent closure of physical branches.

In July, the FCA announced a partnership with the City of London Corporation to develop a new "digital sandbox" that would enable participants to test their latest technology services in a safe regulatory environment before full market launch. This initiative – in effect, a focused, high-tech version of the existing sandbox – aims to establish "a platform to tackle the challenges that will face the financial services sector in the recovery from Covid-19," said Christopher Woolard, the FCA's interim chief executive at that time.

The same month, the Treasury launched an independent review of the UK's fintech sector, postponed from March because of the lockdown. Headed by Ron Kalifa, the former chief executive of Worldpay, a payments processing company, the review will explore how the state can help the sector maintain its "global reputation".

In September, Tech Nation, the government-backed networking platform for digital entrepreneurs and investors, launched a "Fintech Pledge" to prompt wider collaboration between incumbent banks and the sector. Barclays, HSBC, Lloyds Banking Group, NatWest Group and Santander were among the early signatories.

> *"The Fintech Pledge sets out what fintechs can expect from banks and how to create productive collaborations*

"Fintechs regularly cite partnerships with financial institutions as both one of their greatest opportunities but also the biggest challenge," says Victoria Roberts, director of Tech Nation's Fintech Delivery Panel. "The Fintech Pledge should bring a welcome clarity, setting out clear commitments about what fintechs can expect from banks and how best to create productive collaborations."

It's easy to dismiss such initiatives as window dressing by the incumbents. Regardless of Covid-19 and Brexit, fintech lenders face the same routes to failure or success they have always done. They can fail principally because they are too small to succeed; they can be acquired by a larger fintech or one of the incumbents; or they can continue to operate as specialised lenders targeting usually smaller businesses and personal customers whom the incumbents ignore or cannot reach.

As for Brexit, fintech lenders confront the same uncertainties about the post-EU future as the rest of the UK's financial services sector, with similar divisions of opinion. A good illustration is whether liberation from the EU's Second Payment Services Directive (PSD2) represents an opportunity for fintechs or a headache. According to Vidal, some digital lenders sense a potential benefit if they can propose a credible, innovative technology-based alternative to the current rigid PSD2 rule that online account holders must be "re-authenticated" every 90 days. But other fintechs see the 90-day rule as providing necessary security, with no common sector-wide position.

Amid the uncertainty, what is clear is that Covid-19 and Brexit are speeding up the erosion of regulatory distinctions between fintech lenders and incumbent banks, all of which have fast-growing fintech divisions and businesses. The fintechs might not be too big to fail (and many will), but they have shown their social importance in helping get money to where it is needed. They are no longer niche.

"Over the last five years, brand awareness in financial services has overtaken the idea that this is my bank or my insurer," observes Vidal. "At some point, we will stop talking about fintech and the rest of financial services because they are intertwined and connected." And then, we may know as well whether any of the current crop of fintech challenger banks have what it takes to become incumbents themselves. ■

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