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Digital Disruption in Financial Markets – Note by BIAC

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More documents related to this discussion can be found at
http://www.oecd.org/daf/competition/digital-disruption-in-financial-markets.htm

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1. *Business at OECD* welcomes the opportunity to provide its views to the OECD Competition Committee for its roundtable on FinTech and Disruptive Innovation in Financial Markets. The financial sector is facing substantial changes not only because of the entry of new players and new business models (FinTech) but also because large technology companies (BigTech) are starting to offer financial services. Generally, regulators are faced with the unenviable task of attempting to achieve a level of equilibrium between the benefits of regulation and free market innovation. They also have to consider the possible effects that such innovation might have on financial stability.

1. Introduction

2. Innovation in financial services is not a new phenomenon. Over the past few decades innovations have included credit cards in the 1960s, debit cards and cash dispensing machines (ATM's) as well as telephone banking in the 1970s and 1980s. More recently, internet banking has brought the benefits of branchless banking and the ability to conduct banking activities remotely. What is different today, and hence the use of the term "disruption," is the speed of change, the number of new entrants, and the introduction of services and business models that are bringing radical changes to the market. One of the key factors for such evolution has been the increase in the use of smartphones and of the internet.

3. In June 2015, at the OECD hearing on disruptive innovation in the financial sector, *Business at OECD* considered specific issues concerning payment systems, crowdfunding and P2P lending. *Business at OECD* also considered the role of regulators and their struggle to achieve an ideal balance between innovation and regulation.[1] In this paper, *Business at OECD* will consider issues relating to FinTech in general, the role of regulation and of regulatory sandboxes, the entry of large players from the retail, technology and telecommunications industries, such as PayPal, Amazon, Google, Facebook, and Apple, and the potential impact of all these services on financial stability.

2. Financial Technology (FinTech) in General

4. FinTech is a global phenomenon which is disrupting and changing the worldwide financial landscape. The term FinTech is used to describe a variety of products and services delivered through the use of technology, using specialised software and algorithms on computers and, increasingly, smartphones. FinTech can be defined as "technology-enabled innovation in financial services that could result in new business models, applications,

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[1] OECD, Hearing on Disruptive Innovation—*Note by BIAC*, DAF/COMP/WD(2015)48 (June 12, 2015), *available at* www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/COMP/wd(2015)48&docLanguage=En.

processes or products with an associated material effect on the provision of financial services."[2]

5. FinTech start-ups are emerging with new technologies and innovation which aim to compete with traditional financial models in the delivery of financial services. The innovation or disruption brought by FinTech start-ups is taking market share away from traditional financial institutions and is starting to provide more options to consumers and commercial customers that may be either less expensive, faster or more personalised.

6. The first sector in which start-ups have successfully challenged traditional banks is payment systems. The fact that payments have been the first area to be developed is not surprising since technology allows for the achievement of economies of scale to provide more efficient payments services, in terms of price, speed and security. One need only think of the linking of PayPal to eBay which allows small payments to be made instantly (at no cost) to customers all over the world.

7. Companies such as Monzo, TransferWise, Stripe or HiFX have quickly gained market share for local and international payments offering low or no transaction fees. These new services have obliged banks to adopt new digital strategies to remain competitive or in some cases to ally themselves with new players.

8. Other sectors where startups and digital platforms have now stepped up their efforts are deposits, lending and capital raising, insurance and wealth management. One can observe different models: one where the FinTech replicates what is done off-line (and deposits are one example); one where they introduce innovation in traditional sectors (such as the recent introduction of PayPal credit in the UK that has been offering 24 months payments interest free or 4 months interest free for acquisitions on eBay over £99[3]); and one where they introduce new and innovative services.

9. The speed at which FinTech can grow is astonishing. Today, one of the biggest financial firms in the world is AntFinancial. Its origin lies in Alipay which was set up by Alibaba in China in 2004 to make payments easier. It was spun off in 2011 and now provides not only payments and other financial services but also funds consumer and small-business loans.

10. The most innovative business models in FinTech relate to lending services. They are known as crowdfunding and P2P lending. These are having significant impact allowing companies and people that before might have struggled to get a loan or funding to raise money successfully.

11. Crowdfunding, for example, is a way of raising finance by asking a large number of people each for a small amount of money. Traditionally, loan-financing a business, project or venture involved asking a few people for large sums of money. Crowdfunding switches this idea around, using the internet to talk to thousands—if not millions—of potential funders. Typically, those seeking funds will set up a profile of their project on a website. They can then use social media, alongside traditional networks of friends, family and work acquaintances, to raise money. The market in which these types of lenders operate

[2] FIN. STABILITY BD., FINANCIAL STABILITY IMPLICATIONS FROM FINTECH–SUPERVISORY AND REGULATORY ISSUES THAT MERIT AUTHORITIES' ATTENTION 7 (June 27, 2017), *available at* www.fsb.org/wp-content/uploads/R270617.pdf

[3] *See Three Ways to Use PayPal Credit*, PAYPAL, *available at* www.paypal.com/uk/webapps/mpp/paypal-virtual-credit/existing.

is also a key factor: where you have low approval rates through traditional loan financing (i.e., SME financing through a bank) you may see more active crowdfunding and P2P market.

12. P2P websites, on the other hand, work like marketplaces. They bring together people or businesses that want to lend money with those that want a loan, creating a way for borrowers to get funding without going to the banks. On some platforms, any money lent out is automatically divided between lots of borrowers, but with others, the lender can choose who to lend money to.

13. If one considers FinTech in general, several trends can be observed.

2.1. User Experience is Key

14. Traditional banks have been perceived for some time as all offering the same kind of services. Since the product and service is similar, competition authorities have observed that customers tend to be "sticky" and not change their current account unless they are unsatisfied with the customer service they get. Banks have been carrying out surveys of their customers for a long time to determine their overall satisfaction and how likely they are to recommend that bank (the so called NPS, Net Promoter Score). But nowadays, when changing banks is just a few clicks away,[4] keeping customers happy is crucial. Customer experience and satisfaction are becoming the key competitive differentiator.

15. While reputation can be a barrier to attaining success, new start-ups can easily build quickly a reputation for excellent services. In the UK, for example, smartphone bank Monzo has topped a survey from Which?, the UK consumer association, into how satisfied people are with their accounts. Challenger brand Monzo describes itself as "a bank that lives on your smartphone."

2.2. Users are also Starting to Multihome for Their Financial Services

16. Consumers nowadays use a variety of payment systems but also a variety of financial services. Somebody could have a mortgage through a bank and a loan through a P2P network. The days when a customer used a single bank for all their financial transactions are certainly over.[5]

2.3. The Increased Use of APIs (Application Programming Interfaces)

17. APIs provide the backbone for integrated ecosystems. Open bank initiatives will continue to be rolled out globally with APIs enabling the integration of third-party services and traditional providers.

[4] The UK, for example, has introduced a 7-day switching service where customers can change current account seamless and all their direct debits will be automatically switched to the new bank. *See* www.currentaccountswitch.co.uk.

[5] In Korea, for example, the average adult has 5.2 bank accounts and 3.6 credit cards. *South Korea is Trying to Makes Banking Fun*, THE ECONOMIST (May 4, 2019), *available at* www.economist.com/special-report/2019/05/02/south-korea-is-trying-to-make-banking-fun.

2.4. Cyber Risks are Mounting

18. New entrants as well as traditional banks are at high risk of cyberattack. While the traditional banks might have a legacy system which requires constant updating, a new entrant might not have invested sufficiently on security. *Business at OECD* will discuss the connection between this issue and financial stability later in this document.

2.5. FinTech Disruptors are Now More Willing to Work with Traditional Providers and Banks are Starting to Think Like FinTech

19. In a similar way to what has been happening in the technology sector, we see start-up companies becoming quite successful and grow on their own or, in other cases, starting to work with traditional providers. We also observe start-ups being set up or purchased by traditional financial institutions to complement their current offerings. Very recent examples are online banking operations Bo` and Mettle set up by RBS and the acquisition by Mastercard of Vyze, an application that connects merchants with multiple lenders, allowing them to offer the customers a wide range of credit options online and in-store.

20. FinTech services have a major impact on the financial industry by lowering barriers to entry, by eliminating physical branches or large organisational structures, by disintermediating current value chains, and by introducing new business models based on platforms and sharing economies.

21. FinTech start-ups are generally able to offer financial services for lower costs than the incumbent due to the lack of legacy infrastructure. Their acquisition costs are also much lower than traditional banks. But they have some disadvantages: lack of name recognition (at least initially) and lack of customers' trust.

22. Incumbent banks enjoy considerable competitive advantages vis-à-vis new entrants: a large customer base, proven experience and reputation, etc. They also have access to cheaper capital funding.

3. The Role of Data for FinTech

23. New entrants that would like to offer loans may not be able to compete effectively for borrowers unless they have access to the credit history of the beneficiary.

24. The EU Payments Service Directive 2 (PSD2)[6] has dramatically changed the status quo in Europe in an attempt to drive innovation and enhance competition. Banks now have to allow authorised third-party providers access to customers' account information and make payment from customers' accounts. These amendments will allow the new participants to use information and payment infrastructure and to initiate payments, taking advantage of the fact that banks, after having invested to comply with the new regulatory requirements, will have developed infrastructures to maintain a payment account and to process payments.

[6] Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC, 2015 O.J. (L 337) 35.

25. Solutions integrated with the APIs of other financial services firms allows start-ups to offer consumers secure and convenient access to a range of financial information. One platform aggregates user's current account, credit cards, and pension balances into simplified format. This gives the consumer the ability to access a range of financial services directly through one platform, improving their understanding of their own financial position and resulting in a more convenient user experience.

26. One example of such increased data sharing is the UK Open Banking initiative which requires the nine largest banks in the UK to make certain information accessible to other approved companies in a standardised, straightforward and secure way with explicit consent of the customer.[7] Open Banking was introduced in order to make it easier for new financial service providers to offer new products, services, and a better choice for customers.

4. The Role of Regulation and FinTech

27. Over the past few years, banks and other financial institutions have been faced with intense and increasing regulatory scrutiny, compliance with which has necessitated significant investments, potentially at the expense of innovation and growth. New regulatory requirements have attempted to level the playing field for the largest traditional players; however, the significant overhead and operational implications associated with implementing and enforcing these measures has not flowed equally downstream to smaller financial services players. It is not unreasonable to argue that the banks are disproportionately encumbered by a large amount of regulation that does not apply to smaller FinTech companies which can avoid capital ratios funding requirements, liquidity and anti-money laundering regulations.

28. Financial regulators have been considering how to reduce misconduct and ensure financial stability by applying rules to FinTech start-ups without hampering innovation.

29. Financial regulation, if badly designed, might become one of the primary entry barriers for new services. This is particularly true if the regulations are not technology-neutral or if they are overly proscriptive. Onerous requirements could hamper innovation. Regulators will have to consider new tools to facilitate the delivery of risks and compliance functions. Heavy-handed or poorly designed intervention can stifle innovation and exert a chilling effect on economic growth. This applies not only to FinTech start-ups but also to traditional banks where certainly prudential rules might hamper, make it more difficult or costly for them to invest in innovation, or to acquire and expand a FinTech offering.

30. In the context of FinTech, the degree of technical complexity is an issue. Regulators are confronting issues for which existing rules might be ill-equipped or where there is not yet a full understanding of the possible consequences. Coordination between regulators would be beneficial as it would avoid the possibility of gaming the international regulatory system.[8] This is increasingly important in a sector where economies of scale for FinTech

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[7] *See* www.openbanking.org.uk/.

[8] A controversial example in FinTech is the recent granting of a banking licence in Lithuania to London-based Revolut. The Bank of Lithuania is keenly promoting itself as the place to go for FinTech companies, promising "smooth authorisation," "cooperative attitude" and no sanctions for

start-ups are encouraging growth outside its national borders. N26, launched in Germany and Austria in 2015, is now in 24 European countries and planning to enter the U.S. and several countries in Asia. Ant has stakes in, or partnerships with, digital payment firms in several countries.

31. In such a fast-moving environment, there are efforts by regulators to understand better the evolution of the market. Some authorities, and in particular the UK Financial Conduct Authority (FCA), have responded by creating the so called "regulatory sandbox."[9]

32. The word sandbox originally referred to the small box filled with sand where children play and experiment in a controlled environment. The term regulatory sandbox refers to testing grounds for new business models.

33. The regulatory sandbox allows firms to test innovative products, services and business models in a live market environment, while ensuring that appropriate safeguards are in place. It was established in November 2015 to support the FCA's objective of promoting effective competition in the interest of consumers.

34. Its potential benefits are:

- reducing the time and, potentially, the cost of getting innovative ideas to market;
- enabling greater access to finance for innovators, by reducing regulatory uncertainty;
- enabling more products to be tested and, thus, potentially introduced to the market; and
- allowing the FCA to work with innovators to ensure that proper consumer protection safeguards are built into new products and services.

35. Applicants are assigned a case officer to support the design and implementation of the test. This enables case officers to help firms understand how their business model fits within the regulatory framework. It helps the authority to understand better new services and offerings. It also ensures that appropriate safeguards are built into innovative products and services during and after testing.

36. Interestingly, the regulatory sandbox is open to all players. Large authorised firms have tested innovations in the sandbox that, following successful testing, they have made available to the wider customer base.

37. Sandboxes are now being used by several other authorities across the world as they are proving an effective development in which businesses can try innovative ideas in a controlled environment.

38. The ability to innovate is essential to a healthy economy. It is therefore incumbent upon regulators to ensure they help businesses find opportunities to grow safely and fairly. Financial regulators will need to explore using new technology such as AI to enable them to make more timely analysis and assess data with greater efficiency. Moreover, regulators may need to develop a better understanding of new and emerging technology that financial institutions are leveraging to provide services and/or analyze data. Interestingly however,

the first year. This would not be a problem if it concerned only Lithuania but on the basis of EU rules on passporting, they can now operate across the entire EU.

[9] *See* www.fca.org.uk/firms/regulatory-sandbox.

the considerations behind the sandbox are consumer protection and fostering innovation, but financial stability does not seem the key driver.

5. Financial Stability

39. It is generally accepted that increased competition might lower stability, but that its effect varies across banks depending on the underlying financial health of the institution. Competition might encourage certain players to increase their risk appetite, weakening their stability.

40. An assessment of the financial implications of FinTech and its impact on financial stability is challenging given the limited availability of data. In addition, many FinTech start-ups are still small companies and therefore not yet systemically important.

41. This does not mean that there are no issues for financial stability. Systemic importance could emerge quickly from a number of sources including from greater concentration in some market segments. Reputational contagion is also a potential concern. For example, significant and unexpected losses incurred on a single FinTech lending platform could be interpreted as indicating potential losses across the sector.

42. Many innovations are designed to be fast in nature which may mean they are more likely to create or exacerbate excess volatility in the system. A run on a bank in the past usually involved queuing at a branch to collect the money. Nowadays, much could be done quickly just by clicking on a phone or on the internet.

43. One must also not forget the risks of cyber-attacks mentioned before. Cyber-attacks from certain countries are increasing in complexity and number. A cyber-attack that might bring down the financial system or key institutions is not entirely inconceivable.

6. Issues raised by BigTech

44. One of the most notable developments in recent years has been the entry of large technology companies (BigTech) into the financial services arena offering payment services, credit, insurance, and even wealth management, to retail and small business clients. The names of Amazon, Apple, Google and others are usually cited.

45. The entry of BigTech into online banking may have a much more significant impact on competition than FinTech. These platforms have large installed consumer bases, established reputations, powerful brands, substantial earnings and unfettered access to capital markets. In addition, they can leverage superior information about consumer preferences, and they can exploit the massive data gathered from their business lines to enable them to tailor their offerings to the customer.

46. Combined with strong financial position and access to low-cost capital, BigTech firms could achieve scale very quickly in financial services. The Financial Stability Board (FSB) in a study published in February 2019 states that “[c]ross-subsidisation could allow BigTech firms to operate with lower margins and gain greater market share[s],” even

conceivably resulting not in a more competitive market but rather increased concentration.[10]

47. While big banks have to provide their customer data to others (at least in Europe, as seen with PSD2 and Open Banking), BigTech platforms will de facto retain their unique access to the data of their customers and be under no obligation to share their data.[11]

48. In contrast to banks, BigTech firms do not have a traditional branch network. Decisions on whether or not to lend are based on predictive algorithms. This is in contrast to traditional banks, which commonly rely more on human judgement to approve or reject applications.

49. In its study, the FSB has warned that banks have more to fear from the competitive impact of BigTech firms in financial services than the disruptive threat posed by cherry-picking FinTech start-ups.[12]

50. While welcoming the improvements in service quality promised by competitive new entrants, the FSB believes that a disruptive shake up in the market "could materially alter the universe of financial services providers."[13] Competition from large established technology companies could put pressure on the profitability of financial institutions and lead them to take on more risks to protect their margins.

51. The rapid growth of BigTech has undoubted upsides, but these must be balanced against the potential downsides. BigTech firms may improve competition and financial inclusion. However, such firms may increase market concentration and give rise to new risks, including systemic risks due to market concentration and to the way they interact with the broader financial system. It is therefore important to understand how BigTech firms fit within the current regulatory framework and how regulation should be organised.

52. BigTech entry into banking may be facilitated by the more limited regulation applying to non-banks. Regulators have to provide a secure and level playing field for all participants, incumbents and new entrants alike. At the same time, they have to foster innovative and competitive financial markets. Firms providing similar services or taking similar risks should not operate under different regulatory regimes. As noted previously, banks are currently encumbered by a large amount of regulation that does not apply to smaller FinTech companies relating to capital ratios, funding requirements, liquidity and anti-money laundering regulations.

[10] FIN. STABILITY BD., FINTECH AND MARKET STRUCTURE IN FINANCIAL SERVICES: MARKET DEVELOPMENTS AND POTENTIAL FINANCIAL STABILITY IMPLICATIONS 2 (Feb. 14, 2019), *available at* www.fsb.org/wp-content/uploads/P140219.pdf [hereinafter FSB 2019].

[11] Telco operators like Orange develop banking services building on expertise of experienced players of the banking sector and offering a middle way between a FinTech start-up (good performer but unstable) and a BigTech company. Thus, it offers a way for some other industries to diversify and valorize their assets and customers.

[12] FSB 2019, *supra* note 10, at 11-16.

[13] *Id*. at 1.

7. Conclusion

53. As *Business at OECD* suggested in our paper in 2015, the financial markets and consumers are greatly benefiting from a dynamic financial environment. For this to be the case in the long-term and to maintain a stable financial system, regulators and lawmakers have an important contribution to make to ensure regulation is extended to all aspects of financial services, regardless of the provider, and to create an environment where the right sort of innovation can flourish. For example, the PSD2 brings under EU legislation various types of payment service providers which were previously unregulated. That achieves the important objective of creating a level playing field amongst players while protecting the consumer and ensuring security in this area. But further steps are necessary across the world to ensure such level playing field.

54. To be truly effective, financial policy regulation must be forward-looking and prepared to accept the challenges of keeping pace with innovation, including the rapid changes to the competitive landscape brought by the entry of FinTech start-ups and BigTech. In *Business at OECD*'s view, the new financial technologies should be brought into the financial framework in a manner that does not neuter their creativity or lower the potential to revitalise the economy. But at the same time, regulation should take into account the objective of mitigating systemic risk and ensuring the stability of financial systems.

55. To create a good competitive environment, policy-makers should regulate activities rather than financial institutions. In the past, there has sometimes been a tendency to look at and regulate primarily only big banks. The innovation in the banking sector and the entry of BigTech should force a rethink of this approach.

56. Finally, many of the FinTech start-ups and BigTech companies have the ability to operate in several countries or are planning to operate in several countries. Better coordination between the regulatory authorities would be welcomed.