Fintechs have advantages over established banks, but regulation is a major challenge

blogs.lse.ac.uk/businessreview/2017/03/14/fintechs-have-advantages-over-established-banks-but-regulation-is-a-major-challenge/

3/14/2017

Fintech firms may have many advantages over established banks in entering the new market of digital banking. For example many well-known banks have outdated and cumbersome computer systems while new start-ups can start from scratch and develop new and fast systems in only months. The question for large financial institutions is whether to buy firms or build the new start-ups internally.

To overcome these shortcomings, a growing trend is for existing financial services firms to acquire fintech firms. For example, the Spanish multinational banking group BBVA has purchased a number of start-ups, such as a 29.5 per cent stake in Atom, the UK's first mobile-only bank. Barclays Bank has developed an accelerator program which provides funding and infrastructure to new start-ups. Acquisitions remain a dominant theme in the fight for market share and new technologies.

In order to succeed in the digital banking market, start-ups should note that they will face five key challenges accessing the financial services market:

1. *Technology and cyber security* – technology is at the core of any digital banking start-up. Any new firm needs to ensure the successful integration of systems and interfaces across multiple media. Cyber security is a growing threat, and no fintech firm can afford to treat this issue with anything less than the utmost seriousness. Over $1 billion was stolen in cyberattacks in 2015 alone, and the FCA has strict rules and guidance on how firms should approach this issue
2. *Marketing* – new fintech firms are likely to need to spend a great deal on marketing. Established firms may have an advantage here as they have the option of accessing their existing customer base through a number of channels
3. *Capital* – all new firms need capital to get their business off the ground, but fintech firms are often extremely

attractive to venture capital and private equity investors. Around 18 billion euros were invested in financial services in 2015, a year-on-year increase of some 70 per cent, so capital is readily available for new entrepreneurs, in particular in London

4. *Legal framework* – all firms need to comply with relevant legislation, as well as with the rules of their regulator. Firms need to have the right legal framework in place to ensure they comply with the law. This challenge can easily be managed as London offers one of the best ecosystems for law firms which now specialise in providing assistance to digital banking firms
5. *Compliance and regulations* – these are the most critical success factors for a new digital banking firm, and there are a number of issues to consider:

- The regulator will not approve any application from a firm that fails to demonstrate it can meet the necessary governance, technological and operational requirements
- Regulators have the power to withdraw authorisation from any firm that commits a serious breach of the rules.
- For less serious offences, it can impose fines, warnings and other sanctions, which may cause significant reputational damage to the firm
- Firms operating in more than one country may need to comply with more than one set of regulatory rules
- Firms need to remain alert to changes in regulatory requirements, and adapt their processes accordingly

Fintech companies have to be authorised to conduct regulated business

The process of obtaining authorisation from the FCA can be onerous, and the process can take up to one year. Nevertheless, it is illegal to conduct regulated activity in the UK without holding the necessary regulatory permissions.

Fintech start-ups should therefore be aware of two alternative ways of being regulated, and should consider if either of these options is right for them:

1. Becoming an appointed representative (AR) – essentially the AR firm does not hold an FCA authorisation, but is supervised by another firm which does, known as the 'principal firm', or just the 'principal'. The AR is an agent of the principal. The regulator will hold the principal accountable for failings in the AR's activities, and will also set out what activities the AR can and cannot undertake. The registration process for becoming an AR can take as little as 3-4 weeks, and the principal firm takes care of all compliance issues, thus reducing the AR firm's costs.

2. Using third-party providers – here the new firm opts to 'buy-in' certain regulated activities from third-party providers. For example, a firm may not require permission from the FCA to hold client assets if it can find a third party willing to carry out this function on their behalf. Other firms choose to outsource the compliance function, although here firms should note that they can never outsource responsibility, and that the FCA will still hold the authorised firm accountable if an external compliance provider fails to provide a good service. With specific relevance to fintech, some firms use third parties to provide services on their behalf.

How does the FCA help?

The Financial Conduct Authority has developed a number of initiatives which provide a breeding ground for new fintech businesses and make London the capital for fintech.

A digital banking start-up, or any start-up financial services firm intending to make significant use of technology, should be aware of two very important FCA initiatives:

2. Regulatory sandbox – an initiative that allows firms (those that are already authorised) to apply to the FCA for special permission to test a new technology-based business model. Examples of Sandbox applications approved by the FCA include: an advice tool developed by Citizens Advice which allows key features of debt solutions to be compared or an app developed by HSBC which helps customers manage their finances.

The outlook

The total value of global investment in fintech in 2016 was £25.1 billion, which represents a rise of more than 50 per cent in just one year, and a sevenfold increase in just four years. There is no reason to believe that this significant growth will slow in any way in the coming years. Fintech is unquestionably a very exciting area to be involved with, but firms in this sector need to be aware of the challenges they face and ensure they continue to meet changing regulatory requirements.

♣♣♣

Notes:

- *This blog post is based on the author's paper How to ensure that your digital banking start-up is fully compliant: New entry strategies to regulated markets from a UK perspective, in Journal of Digital Banking, Volume 1 / Number 3 / WINTER 2016/2017, pp. 222-230(9)*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics and Political Science.*
- *Featured image credit: Spotlight Fintech Hackathon, by Webmontag Frankfurt, under a CC-BY-SA-2.0 licence*
- *Before commenting, please read our Comment Policy.*

Gerhard Grueter is a co-founder and managing director of Lawson Conner, a compliance and regulations firm providing operational infrastructure, outsourced compliance services and technology solutions to financial services firms worldwide. He oversees global business operations, helping clients launch digital banking businesses and assisting with the navigation through the ever-evolving regulatory landscape in Europe. In addition to this, he has the external responsibility for engaging with the regulatory markets. He is a former partner of a US$500m distressed debt fund, a former senior credit analyst of a multi strategy hedge fund (US$3bn) and a former Vice President in Investment Banking at Merrill Lynch in London. Gerhard is a frequent panelist and speaker at conferences and has authored a number of publications around Alternative Investment Fund Managers Directive (AIFMD), financial services, hedge funds, risk management and compliance and regulations. He holds a BA in Business Administration and an MBA from Cornell University/ London Business School.