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FINTECH – THE FUTURE FOR FINANCIAL INSTITUTIONS

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Fintech companies, using cutting edge technology, are disrupting traditional banking and finance and competing for their business. Their aim is to be better, faster and cheaper. Financial institutions will either need to compete or collaborate with these challengers. Here Clifford Chance experts look at the legal issues banks face as they move towards generating revenue from their own technology.

Fintech firms are growing fast. The Economist magazine estimates that Silicon Valley firms alone, attracted US$12 billion in investment in 2014. They are particularly active in payments, foreign exchange, peer-to-peer lending, data, investment services, wealth management and infrastructure. While regulation makes it difficult for non banks to provide account and deposit-taking services, recent regulatory activity is aimed at breaking down these barriers and leveling the playing field for new entrants.

Peter Chapman, a senior associate in financial regulation at Clifford Chance says: "Consumers want a range of financial services providers and they want the market to be competitive on price and service. They also want accessibility, not just in terms of the amount of services available, but also in how they receive those services, which they increasingly want to be doing through digital devices."

He adds, "The risk for financial institutions is that they become simply a utility; an expensive set of pipes and plumbing. To compete, financial institutions need to remain relevant to consumers and continue to provide a range of services."

Financial institutions have sources of capital, established brands, loyal customers, access to behavioural data and relationships with regulators, but they are disadvantaged by the burdens of legacy IT systems, investor and commercial constraints, a lack of familiarity with IP and tech as a revenue source, and overly complex governance structures.

The rating agency Moody's said, as part of its predictions for the banking system in 2016, that: "The more nimble and technologically advanced players will continue to gain market share," highlighting just how critical innovation will be. As regulators encourage fintech innovation, financial institutions find themselves under attack on several fronts.

Regulators breaking down barriers

Governments around the world have been backing fintech through regulatory changes which help new entrants to the market or in more practical ways such as tax incentives, government funding and the provision of office space.

It is no surprise that payments has been one of the biggest success stories for the fintech industry, given that the Payment Services Directive, published by the European Commission in late 2007, was one of the first

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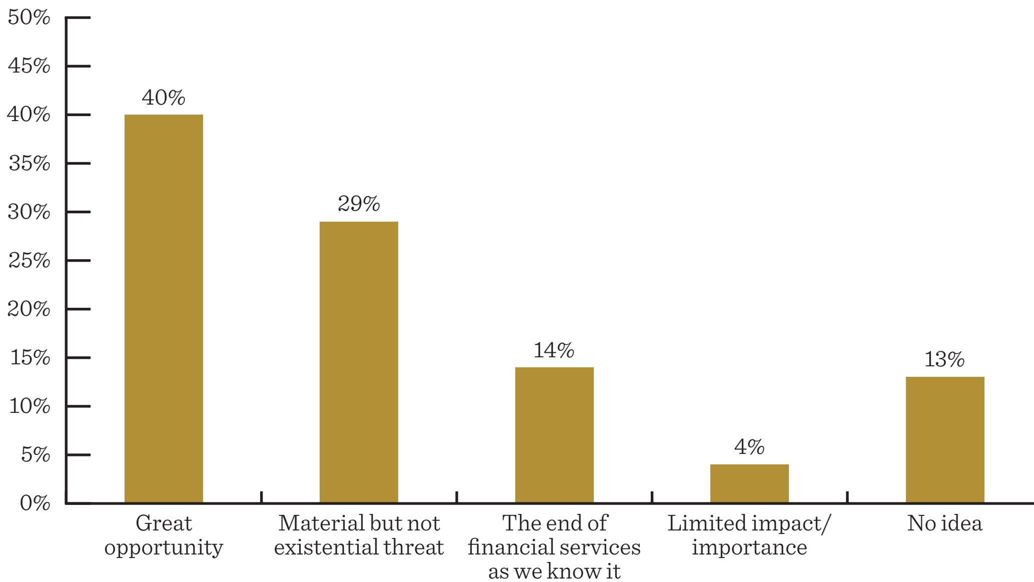
We have drawn on data gathered in live polls conducted during presentations on fintech in London to provide a snapshot of what our audience thinks about some of these issues.

What does fintech mean for financial institutions?



Source: Clifford Chance audience poll

pieces of legislation designed specifically to encourage non-banks to enter the market. An upgrade to the Directive (PSD2) was published at the end of 2015, and will come into force in January 2018.

Aimed at breaking down barriers and increasing competition, PSD2 attempts to open up access to payment systems and broadens the range of providers that can get a licence to do pan-European business. The first of these – account information service providers – is permitted to access people's bank accounts, to pull and provide data to the account holders about their balances and so on. The second new type of payment service provider is permitted to access bank accounts and initiate payments on behalf of account holders.

PSD2 requires that banks allow this to happen, by permitting these new entrants access behind their firewalls. It prohibits banks from forcing those providers to sign contracts as a condition to access.

Chapman says: "For the first time, PSD2 introduces a requirement for banks to open up their systems to third parties, allow data to be copied and even allow third parties to make payments on behalf of account holders and the bank's ability to say 'no' is very limited."

Beyond EU regulatory developments, several UK domestic changes are also addressing barriers for fintech challengers. The Bank of England's Blueprint for Access complements what PSD2 is doing on access to payment systems, while the Treasury's Open Banking Standard seeks to facilitate the sharing of data between providers by advocating common methods of transfer and common languages across institutions.

Finally, the Financial Conduct Authority (FCA) is making moves to reduce regulatory barriers to innovation in digital and mobile solutions, and is conducting a clinical trial for financial services through its regulatory sandbox project. The idea is that challengers have a safe space in which they can test innovative products, services, business models and delivery mechanisms without immediately incurring all the normal regulatory consequences.

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Simon Crown, Partner, Financial Regulation

“Regulators are trying to achieve a balance between opening up the market to new entrants, and also ensuring they don't allow in people that can cause systemic risk,” says Clifford Chance partner Simon Crown, a specialist in financial regulation.

Options for financial institutions

Given the rapid growth of fintech, financial institutions face three options: they can attempt to compete by building their own organic fintech capabilities; they can acquire fintech businesses; or they can collaborate with fintech providers, through joint ventures, partnerships, outsourcing or white label arrangements.

Most banks are doing elements of all three, but each option comes with its own challenges.

Organic growth

Organic growth can present speed-to-market issues for large financial institutions, given the bureaucracy of their organisations compared with start-ups. They may also struggle to find the necessary expertise to develop products in-house.

“Some banks have adopted an approach where they set up a separate team within the organisation,” says André Duminy, a partner specialising in technology at Clifford Chance, “to replicate the look and feel of a start-up within the established business. That separate team is then given a lot of free rein to come up with new technologies.”

Another challenge is developing and capitalising on innovations. The upside of the organic route is long-term ownership of the intellectual property, which is a valuable asset to exploit, gives a competitive advantage, and may generate revenues.

Acquisition

The fintech M&A market was worth in excess of US$30 billion last year. An acquisition strategy can be seen as a quick-fix, but it is not without difficulties. Due diligence can be a particular issue, given the difficulties that exist around establishing ownership of technologies, and there is also a danger of importing risks, particularly around cyber security. The integration of technology between a high-tech start-up and the bank's legacy systems can be challenging, and a lot of thought needs to be given to the cultural fit.

“Some companies, when they acquire new technology companies, keep that new organisation very separate from the rest of the business,” says Duminy. “This allows the developers to continue to operate in a very innovative environment, and can be the way to achieve the best of both worlds.”

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André Duminy, Partner, Technology and Outsourcing

Crown points to Powa Technologies, as evidence of the risks financial institutions face if they rush into tie-ups with fintech businesses. Powa Technologies, which specialised in payment software, raised an estimated £1.8 billion in investment in just three years but recently went in to administration.

Collaboration

Collaboration is currently by far the most common way for financial institutions to invest in new technologies. There are a number of different options, ranging from joint ventures to outsourcing to partnership structures, and in each case the issues centre on things like the allocation of liabilities between a smaller and a much larger organisation; the allocation of risks and rewards; and antitrust concerns.

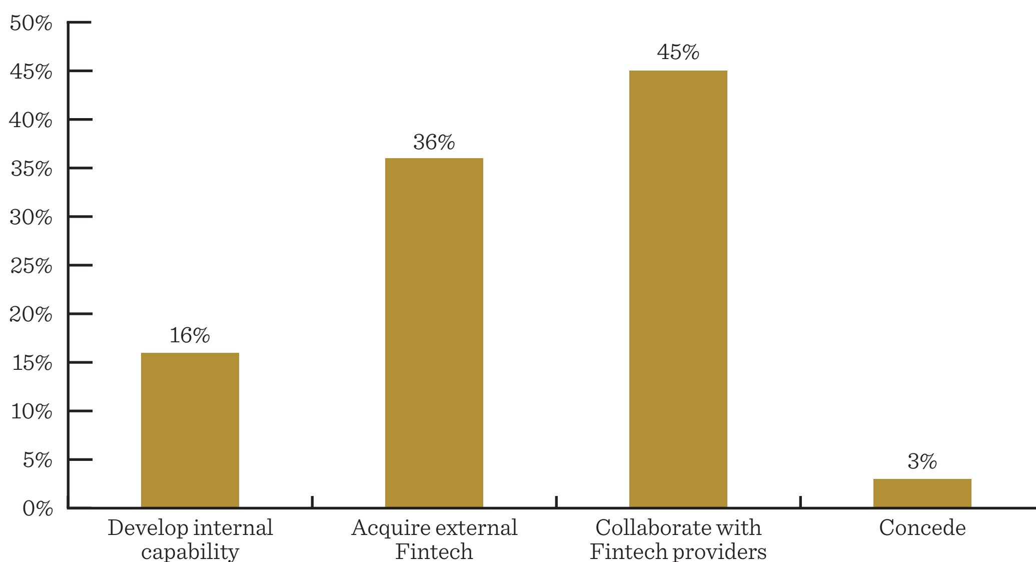
Then there is the question of who contributes what and who can use what: "The new venture will own what it creates," says Duminy, "but how do you use it if it is owned by the joint venture? How do you as the bank get access to that technology? Are you going to be exclusive users or is it going to be made available to a much wider group? All of these questions need to be addressed."

From financial institution to tech powerhouse

Whatever route is chosen, there is no doubt that financial institutions are facing a brave new world with new legal hurdles, and that previously 'back office' considerations, such as data, IP and tech licensing, are becoming key revenue generators.

Against this backdrop, larger financial institutions need to adapt in the face of three major issues: tech renewal, IP strategy, and cyber security.

What approach will financial institutions adopt to fintech?



Source: Clifford Chance audience poll

Tech renewal

Jonathan Kewley is a senior associate in the technology group at Clifford Chance, and says: "Very large financial institutions are now facing a generational issue on the systems side. Over the last 20 or 30 years they have built up IT systems through a series of acquisitions and mergers, and some are now left with spaghetti-like platforms that are not really fit for purpose. The challenge is to replace those rapidly, because these institutions need to compete with fintech start-ups that don't have those legacy headaches, and who are building technology solutions on a mobile-first basis."

Tech renewal is now a board-level concern, with several major UK banks recently suffering issues with online system failures. Organisations face decisions on whether to outsource or not, given that doing so may involve one of the biggest projects that the bank will undertake, and will take years to deliver. Outsourcing has many advantages, but encompasses compliance issues with the FCA's SYSC requirements on systems and controls, which require regular reporting on outsourcing suppliers and associated service levels.

Other issues include data flows, says Kewley: "The data that may have traditionally been in your business is suddenly around the world, at a time when we are seeing a significant shift in data privacy, and regulation is becoming increasingly complex."

Finally, legal resourcing can be a big challenge, given that tech renewal is likely to absorb key people in the business for a very long time.

IP strategy

IP teams in large financial institutions are increasingly focused on the value of IP being brought in as part of their fintech strategies. M&A due diligence is of particular concern, given that the purchase of relatively unsophisticated businesses can give rise to significant IP issues if the right questions are not posed.

If organisations choose to establish technology in-house, there are questions around establishing licensing models for those, and rolling out third-party contracts. The power of the brand also has to be protected. If joint ventures are entered into, IP becomes a big issue in terms of who contributes what: "Some of the most complex negotiations in these joint ventures are around IP," says Kewley.

Cyber security

Finally, cyber security is the big issue that every financial institution is focusing on, given that big data brings big reputational risk, and there is increasing public interest in IT security arrangements.

Kewley says: "If you use any form of IT, that IT can be brought down at any moment and your business becomes difficult to operate. It looks increasingly likely that a cyber-attack will actually bring down a business before too long."

The EU Directive on Cybersecurity, comes into force in 2017 and provides for fines of up to 5% of global turnover in the event of a cyber security breach. This will herald a significantly increased compliance burden, and requires banks to act now.

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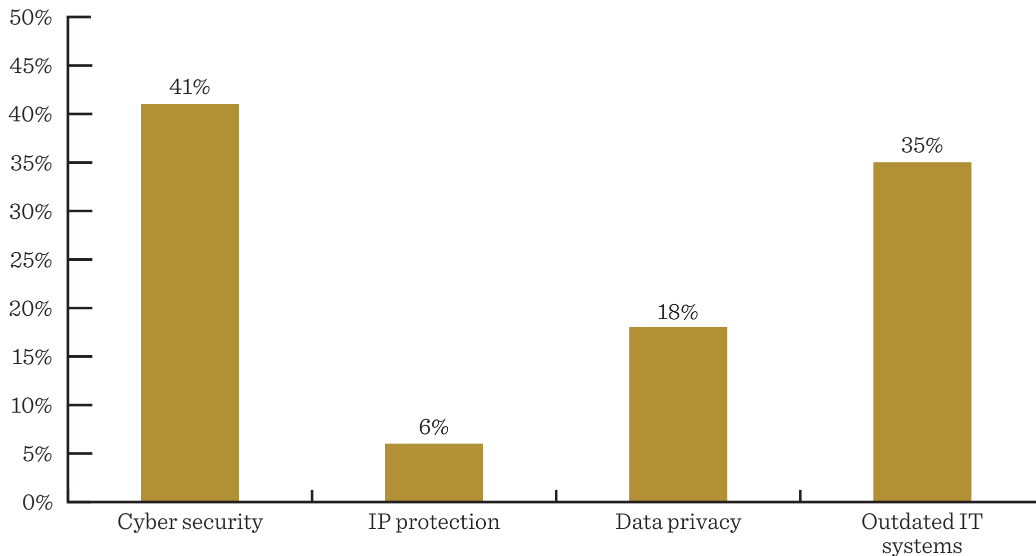
Jonathan Kewley, Senior Associate, Telecommunications, Media and Technology

Kewley concludes: "The regulators know that everyone is suffering when it comes to cyber security, but they also know that some organisations are doing nothing about this, and that often contracts are silent on cyber risk. This is no longer an IT issue, it's a legal issue, and from the boardroom down, businesses need to be educated on the risks."

As financial institutions attempt to keep pace with the fintech revolution, these new legal hurdles will only grow in significance.

Which concerns you the most?



Source: Clifford Chance audience poll

Note on audience poll figures

- The audience live-polling figures included in this piece are not intended to be representative of wider market sentiment. They can however be taken as an indication of market sentiment at the time of the vote, as expressed by the individuals who attended these events.
- The figures have been combined from voting which took place at two events in London on 15 and 16 March 2016. 93 people attended the event in Canary Wharf, and 86 people attended the event in the City. Each person was given an electronic voting keypad and asked to choose from pre-selected options.
- The audience largely consisted of individuals working in financial services, regulators and other interested parties.

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