Challenges of fintech

A new breed of financial technology is shaking up the industry, but it's not all plain sailing

BY NEIL HODGE

The rise of financial technology – or fintech – firms may well be both a blessing and a curse to traditional financial services providers. While some of these new starters have set themselves up as challenger banks to sell and deliver fairly simple financial products quickly and easily to a growing population of tech-savvy customers, others have taken the route of selling their services to existing players, enabling banks rather than competing against them.

Experts say that fintech firms have much better customer interface tools and customer relationship management (CRM) programmes and, because they can analyse customer behaviour via social media, they have a much broader understanding of what customers want. That enables them to sell more products with larger profit margins. Furthermore, traditional banks and insurers are in danger of being left behind in the race to digitialise services.

"Traditional financial services providers need to embrace fintech more rapidly to accelerate their digitalisation plans," says Bertrand Lavayssiere, UK managing partner at financial services consultancy Zeb. "Traditional banks and insurers are hampered by

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their legacy systems and cannot easily make the transformation to increase and improve their range of digital services, which is why fintech companies make attractive acquisition targets."

Buy in

Last year, French lender Groupe BPCE bought Germany's online challenger Fidor Bank, which had built up a network of 350,000 people in the UK and Germany. It was a quick and simple way of improving its own digital services and a route towards adopting similar technologies throughout the group.

Instead of acquiring technical know-how, other major banks are trying to embrace cutting-edge fintech solutions, such as application programming interface (API) banking. This basically allows different technologies to work within an existing platform. Spanish bank BBVA has recently announced a set of APIs for fintech innovators to interface with their bank, while, in the US, Cross River Bank works with over a dozen fintech companies to provide services to customers.

Whichever commercial route fintech firms decide to take – to either challenge existing players, or facilitate them – they are bound by the same risk management and regulatory compliance issues that traditional banks and insurers need to abide by. And that burden has increased: since the financial crisis, it is not unusual for major banks to spend around US$1bn annually on risk management and compliance. While a fintech firm's risk management spend is nowhere near that amount, the sector is expected to attain the same level of assurance around the risks inherent in its business, operations, products and services.

Risk management

Steven Minsky, CEO at governance, risk, and compliance IT specialist Logic Manager, says that there is no real difference between the risks facing fintech firms and financial services firms. The main preoccupations for both are credit risk (ensuring that firms stay solvent while lending money), market risk (ensuring that they have the appropriate knowledge to know how the economic environment will impact their strategies), and operational risk (incorporating every other risk that affects the day-to-day running of the business).

"Both banks and fintechs have to abide by the same rules – it's as simple as that," he says. The way they manage risk can be different though.

"Traditional players have been doing risk management in a certain way for many years, and they have large teams of highly-skilled and experienced people who know what they are doing and how to react," says Minsky. "Fintech firms, on the other hand, tend to have small teams using risk management processes that have been developed over a relatively short timeframe and which can be untested in terms of dealing with major fall-outs."

He believes that many fintech firms tend to have better IT tools and skills and people with technological expertise, but lack the armies of

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professional risk managers employed by global financial institutions.

Some fintech pioneers believe that the new entrants can teach their traditional rivals some lessons in how to improve compliance. Kevin Wilbur, senior vice president, accounts payable automation at e-invoicing fintech company Tungsten Network, believes that "fintech companies find it easier to ensure full compliance" because "we don't have to operate using legacy systems that simply aren't fit for purpose. All our processes are built from scratch to be transparent and agile. The truth is fintech is what helps businesses be compliant."

Wilbur also believes that traditional banks and insurers can learn from the way fintech firms are managing risks. "By adopting a digital approach and automating core business processes, compliance is far easier to achieve, as paper-based invoice processes make it difficult, if not impossible, for businesses to ensure they are compliant," he says.

Cross over

On the other hand, there is a lot of knowledge sharing between the two sectors. Romi Savova, chief executive officer and founder of PensionBee, an online pension manager that enables people to find and then combine their old pensions into one plan, formerly worked in the risk management department at global bank Goldman Sachs. She is well-versed in the approach that large, traditional financial services firms take towards risk and compliance. "Many of the large company practices have stuck with me and have influenced the setup of PensionBee," she says.

Savova says that fintech firms need to manage the same sorts of risks as big financial services companies, and that "fintech firms are held to an equal standard as regulated firms". However, she adds that "it is important to note that traditional banks and insurers have diverse lines of business and the compliance requirements on those firms are reflective of that."

For example, she says, capital and reporting requirements are more onerous where customers are relying on product guarantees – and for good reasons. Different lines of business also come with the potential for conflicts of interest, where one arm of the business is acting in a way that furthers the commercial interest of another department – at the expense of the customer. While these risks can present themselves for fintech companies too, Savova says those business models are usually simpler and more focused. "This setup makes the risks more apparent and therefore, in many ways, easier to manage," she says.

Downsides

On the flipside, if something goes wrong at a fintech company, it can be substantially more damaging. "There is less history there to create a 'context' for what has happened," says Savova, "and to provide confidence that the fintech company can manage through a problem. That's why risk management should be on the top of every fintech CEO's agenda."

Ali Alani, CEO at Imperial FX, a fintech firm that specialises in foreign exchange and remittance, agrees. "It's imperative that leaders within fintech firms fully understand risk management. At the end of the day, managing risk is at the core of financial services, and fintech isn't excluded from this."

Alani says that the key compliance and risk management issues that are at the top of his organisation's risk agenda are enhanced due diligence, anti-money laundering and terrorist financing procedures. "It's business critical that these are enforced," he says.

"We are required to keep records of transactions that date back five years and all clients must be checked against a number of sources, such as the EU sanctions list, and lists issued by the Office of Foreign Assets Control and the Financial Actions Task Force. Given the current political turbulence, you can see how this is a demanding task – but one that is fundamental to the business," says Alani.

As fintech is synonymous with cutting-edge technology, Alani says that a key aspect of any risk management approach must also mean "identifying any risks, or opportunities that present themselves with emerging technologies." He also believes that those responsible for managing risk need to work closely with the product and operations sides of the business "to ensure a seamless customer experience."

Real time

Fintech customers expect real-time responses to their requests, such as for loan approvals, which means that risk management must be able to assess risks automatically. To achieve this, says Alani, fintech firms are using modern intelligence such as social media behaviours and spending history to analyse credit risk and target profitable customers, while algorithms – which can be used for underwriting, monitoring and fraud detection – and machine learning are being readily used to reduce operational risks including human error and cyberattacks.

Matt Stanton, head of business intelligence at IT provider Synectics Solutions, says that although fintech companies' technology may be cutting-edge, the investment in cybersecurity measures is nowhere as much as traditional banks are spending. "If a bank gets hit, it can deal with the fallout, however bad," he says. "If a fintech firm gets hit, it can be over – the whole business premise is built upon transacting quickly and safely online."

There is little doubt that much of the innovation in the financial services space is being driven by the fintech revolution – and that sound risk management will be at the heart of its success. While the banks and new entrants fight it out, customers will continue to go where they can find the best returns at a level of risk that suits them. ER

Neil Hodge is a freelance journalist