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### **The impact of Fintech on banking market structure and regulatory**

***Annotation.** The paper assesses the potential impact of FinTech on the finance industry, focusing on financial stability and access to the services. In this introductory article, we describe the recent FinTech phenomenon and the impact on banking system and its regulatory.*

***Keywords:** FinTech, innovations, blockchain, banking system, Big data, financial services.*

FinTech is fast becoming a global phenomenon, led by innovators and followed closely by academics, and now drawing the attention of regulators. Broadly, fintech is an umbrella term for innovative technology-enabled financial services and the business models that accompany those services. In simpler terms, fintech can be used to describe any innovation that relates to how businesses seek to improve the

process, delivery, and use of financial services. FinTech covers digital innovations and technology-enabled business model innovations in the financial sector.

The influence of fintech is beginning to be felt in the banking sector and capital markets. This article surveys its development and its impact on efficiency, banking market structure, strategies of incumbents and entrants, and financial stability. Fintech has a welfare-enhancing disruptive capability but regulation needs to adapt so that the new technology delivers the promised benefits without endangering financial stability. Fintech may be understood as the use of innovative information and automation technology in financial services.<sup>1</sup> New digital technologies automate a wide range of financial activities and may provide new and more cost-effective products in parts of the financial sector, ranging from lending to asset management, and from portfolio advice to the payment system. In those segments, the impact of fintech competitors is beginning to be felt in the banking sector and capital markets.<sup>2</sup>

Banks, as well as Visa and MasterCard, still dominate the market for transaction payments, but payment innovations often come from nonbanks such as PayPal, Apple, or Google. It is worth noting that mobile-based payment schemes have a great impact in countries where the share of people owning a current account at a bank is small. For instance, countries in Africa where only one in four people has a bank account but, according to The Economist,<sup>3</sup> many more have access to a mobile phone, they are becoming testing grounds for new payment systems as well as for loans for consumers with little credit history.

Traditional payment systems may also be disrupted by digital currencies such as Bitcoin. In those currency systems, or cryptocurrencies, encryption techniques

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<sup>1</sup> According to the Financial Stability Board fintech is defined as ‘technologically enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services’. See <http://www.fsb.org/what-we-do/policy-development/additional-policy-areas/monitoring-of-fintech/>

<sup>2</sup> For an overview of several aspects of fintech and its evolution see Demertzis et al. (2017), EBA (2017), EY(2017), KPMG (2017), and IMF (2017).

<sup>3</sup> See The Economist (2015).

regulate the generation of currency units using blockchain technology. This technology consists of a public digital database in which transactions can be verified with a system of blocks of records in a decentralized way. Blockchain technology is potentially disruptive since it opens the gate to many potential cost-saving innovations. It also permits a currency without the backing of government or a trusted go-between, an intermediation function at which banks have specialized.

Fintech competitors are encroaching on the traditional business of banks, despite the fact that banks are adapting to the digital world. New competitors are able to use hard (codifiable) information to erode the traditional relationship between bank and customer, based on soft information (the knowledge gained from bank and customer relationships). However, most new competitors stay clear of asking for a banking license in order to avoid compliance costs, and try to skim profitable business from banks. A potential advantage of the new entrants lies in exploiting the mistrust towards banks that millennials have developed at the same time that they offer digital services with which the younger generation is at ease.<sup>4</sup>

Banks have traditionally focused on products, while new entrants are more focused on customers. Fintech competitors are putting pressure on the traditional business model of banks. Two competitive advantages of retail banks which may be eroded by the new entrants are that first, banks can borrow cheaply with their access to cheap deposits and explicit or implicit insurance by the government, and second, they enjoy privileged access to a stable customer base that can be sold a range of products. The presence of deposit insurance may facilitate the entry of new competitors as banks, but in this case the entrants will have to pay the cost of the banking license and compliance expenditures.

True disruption may come from the full-scale entry of top digital internet companies. Indeed, companies such as Amazon, Apple, or Google are already active in fintech, but have not entered the market in a resolute way. Their

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<sup>4</sup> See Deloitte (2016).

potential is very large, however, because they have access to massive amounts of customer data and they may control the interface with them when it comes to financial services. They are growing quickly in payment services, with close to 150 million users in the first semester of 2017. Amazon lending has been growing steadily since its launch in 2011. Even social media platforms may cross-sell financial services profiting on their knowledge of the characteristics of their users.

First of all, let us note that digital technologies can also be applied to solve regulatory and compliance requirements more efficiently. This is known as “RegTech.”<sup>5</sup>

The present tendency to regulate new services provided by fintech is to offer “regulatory sandbox” in order for fintech firms to experiment without the heavy regulation of the banking sector and for regulators to discover the best way to keep the activities safe. Consumer protection issues, in particular with regard to data privacy and cyber security, raise to the forefront. The tendency is to give customers more control of their data. This can be seen in the Payments Services Directive II (PSD II) and the General Data Protection Regulation in the EU, initiatives such as Open Banking in the UK, and the emergence of commercial banking aggregator models in the US.

In summary, fintech has a large and potentially welfare-enhancing disruptive capability. However, in order for the new technology to deliver the benefits for consumers and firms without endangering financial stability, regulation needs to rise to the challenge.

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