FINASTRA

MARKET COMMENTARY

Is Fintech a Zero-Sum Game?

Is Fintech finally growing up and becoming part of the mainstream technology contribution to financial services, or is it still the disruptive child seeking to impose its concepts of innovation on an outdated and unwieldy industry? And more importantly, can it be profitable?

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Time to Regulate?

Like with so many things it depends who you talk to. But at a recent roundtable debate in London that Finastra attended – under the Chatham House Rule so none of the protagonists could be identified – the clear majority of a wide cross section of mainstream bankers, Fintech disrupters and experienced industry watchers gave the impression that financial technology innovation is entering a new phase of maturity. And, with it, also raising some fresh concerns about its ethical and moral direction.

This was echoed in a timely speech by the president of the Federal Reserve Bank of Philadelphia, Patrick T. Harker, who said it was time for Fintech firms to start embracing regulation. In fact, he said that these start-up firms should actually want to be regulated as this would not only build trust in their products and services, but would avoid the potential for more penal retrospective regulation.

Mr. Harker says the explosion of investment in Fintech since the 2008 crisis meant that this segment of the industry had yet to experience a reversal or downward cycle. He adds that "trust will be shaken" and "what Fintech outfits don't want is regulation that comes in after a crisis. That type of regulation almost always fights the last war and that could mean tighter strictures and less room for innovation after the crash at the end of a credit cycle."

Fintech needs to continue to have a serious business case to survive. It is widely acknowledged that the low-hanging fruit for Fintechs is cost reduction. But once that is achieved, it is in danger of becoming a zero-sum game.

High-Frequency Trading (HFT) appears to be at such a crossroad. So long as there was money on the table HFT firms used technology to take it, for the benefit of themselves and their customers. Now that everyone who is interested in this space has caught up, the zero-sum game has begun. Many HFTs are now turning to big data and analytics as an alternative means to generate alpha due to meeting the law of diminishing returns from their original business model.

However, by conceding that they are now moving over to compete with hedge funds that already lead in this space, some expect that natural competitive forces will prevail. As another suggested, this was the case with the Oakland A's baseball team as chronicled in Michael Lewis' Moneyball. They had one season of glory (well near-glory as they lost in the World Series final) before everyone else caught on to the analysis they were using to differentiate themselves and afterwards it was once again a level playing field.

THE FUTURE OF FINANCE IS OPEN

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Predictive or Counter-Productive Analytics?

So how do so-called new technologies, such as big data, and analytic capabilities continue to deliver the "mousetraps" the industry leaders need to stay ahead? Is there still a business model for genuine capital creation, or is it just dog-eat-dog? There were real concerns that the combination of big data and ever-more sophisticated algorithms and analytics are potentially creating a future creating a future where investment strategies will effectively be front-running. Is it really predictive analytics or just a matter of cause and effect? It is fair to say at this point that there was healthy cynicism throughout the room and no gratuitous fawning at the feet of newly-funded start-ups.

Looking at the insurance market, an industry founded on the principle of mutualization of risk, its very business model could be threatened by the rise of big data as the industry seeks to use machines to become ever more discriminatory in the way it deals with customers. These markets benefit from non-discrimination. Good drivers subsidize bad drivers. That is the way these markets work. But the more insurance starts to break into behavioral analysis, the more it risks becoming more discriminatory and exclusive. This would not be a healthy departure.

Of course, the use of Artificial Intelligence (AI) and Machine Learning (ML) can bring specific and tangible benefits to financial institutions, particularly when we get back to the focus on costs. Likewise, in areas like trade finance, which is still awash with paperwork, greater automation and the potential injection of Distributed Ledger Technology (DLT) and blockchain-type technology could produce significant future gains. However, some widespread concerns remain that there is becoming too great a rush in some areas to use robotics and predictive analytics to replace human capabilities. "Many HFTs are now turning to big data and analytics as an alternative means to generate alpha due to meeting the law of diminishing returns from their original business model."

One speaker from a major technology vendor said that, because of those concerns, they had shifted from using the term "predictive" capabilities, describing them rather as "cognitive". By doing this they believe they acknowledge the wider social and ethical considerations and now more clearly position AI as being a complement to more effective human decision making rather than an alternative. But it is not a universal stance.

Regtech: Who Benefits?

While it is great to be able to augment the cognitive capabilities of humans with big data, there is strong evidence that many financial institutions are jumping at the opportunity to employ bots to reduce headcount. No signs of moral scruples there when it comes to saving money.

Looking forward and considering opportunities, Fintech's younger cousin, Regtech, is now seen as a primary focus of investment in technology innovation. Again, the costs imposed on banks by recent and forthcoming regulatory initiatives are being seen as the main driver for interest and adoption. One big question remains though: are the benefits created by either Fintech or Regtech being passed on to customers?

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Turning to innovation, it can be argued that some was designed solely with regulatory arbitrage in mind, so as to develop ways to circumvent new rules, or at least maximize the gaps from inefficiencies and contradictions inherent in many of them. Which, rather nicely, takes us back full circle to what Philly Fed President and CEO Patrick T. Harker focused on in his recent speech. Certainly, established players are arguing for a more level playing field.

This is likely to be more of an American problem than a European one, given the more prescriptive nature of US laws meant that there is more traction for regulatory arbitrage to exploit. Whereas on this side of the Atlantic, the adoption of a more principles-based approach to financial rules means that there exists more wriggle room for both banks and regulators to establish best practice, but not avoid the implications of it.

According to KPMG, global investment in Fintech fell sharply to USD 24.7 billion in 2016 from a staggering USD 46.7 billion the year before. Perhaps that shows investor enthusiasm is waning, or perhaps just a new realism that Fintech is not the Holy Grail some portray it to be. Either way, it certainly shows it is going to be tough to deliver a return on the more than USD 100 billion wagered on initiatives in recent years. We can assume those deep pockets don't believe it is turning into a zero-sum exercise just yet.

On a more specific note, JPMorgan Chase & Co (JPM) CEO Jamie Dimon said that the bank spent USD 600 million of its USD 9.5 billion IT budget last year on emerging Fintech solutions. These included a range of digital banking capabilities and partnerships with Fintech firms. The objective, he said in his annual letter to shareholders, was "to benefit customers with better, faster and often cheaper products and services, to reduce errors, and to make the firm more efficient."

Many banks are following this more collaborative route with Fintech start-ups, partly to hedge their bets on potential future disruption, but also to recognize that if they are allowed to flourish in isolation they could represent unwelcome future competition.

Finally, we cannot avoid mentioning blockchain. The consensus was that both blockchain and the cryptocurrencies that are driven by it will remain firmly on the fringe until they prove their ability to scale and meet the challenges of real markets instead of theoretical ones. Some would say that the reluctance of major central banks to formally acknowledge Bitcoin also means it is about as much legal tender as a Scottish pound note… Deep fried Mars bars anyone?

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