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The Fintech Revolution: Why the Predictions Have (Not) Come True

La revolución fintech: Por qué las predicciones (no) se han hecho realidad

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Abstract

Fintechs in the Netherlands appear unable to compete on fundamental grounds with major banks such as ABN AMRO, ING Bank and Rabobank. By means of interviews with representatives of fintechs, policymakers, supervisors and academics, research was conducted into the extent to which the predicted fintech revolution has failed, which obstacles fintechs experience and whether the introduction of a CBDC can stimulate the fintech revolution. Banks may not have been outcompeted by fintechs, but financial services have indeed been fundamentally changed by the application of digital technologies. Fintechs appear to face five obstacles in their competition with large banks. Depending on design choices, the introduction of a CBDC could reduce the dependency relationship of fintechs on banks and promote diversity in the monetary-financial system.

Keywords: Fintech, banks, Netherlands, CBDC, digital technologies, financial services, competition

Resumen

Las fintechs de los Países Bajos parecen incapaces de competir por razones fundamentales con grandes bancos como ABN AMRO, ING Bank y Rabobank. Mediante entrevistas con

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representantes de fintechs, responsables políticos, supervisores y académicos, se investigó hasta qué punto ha fracasado la revolución fintech pronosticada, qué obstáculos experimentan las fintechs y si la introducción de una CBDC puede estimular la revolución fintech. Puede que las fintech no hayan superado a los bancos en competencia, pero los servicios financieros sí se han visto fundamentalmente modificados por la aplicación de las tecnologías digitales. Las fintech parecen enfrentarse a cinco obstáculos en su competencia con los grandes bancos. Dependiendo de las opciones de diseño, la introducción de un CBDC podría reducir la relación de dependencia de las fintech respecto a los bancos y promover la diversidad en el sistema monetario-financiero.

Palabras clave: Fintech, bancos, Países Bajos, CBDC, tecnologías digitales, servicios financieros, competencia

Introduction

For decades, a global fintech revolution has been predicted in which established banks will be replaced by financial technology (fintech) companies(Boyd & Gertler, 1995) (McMillan, 2014) (Hernaes, 2017). Fintechs would make better use of (the latest) digital technologies and, through their innovative strength and greater agility, would be better able to respond to customer demand. The functions of banks would be taken over by specialist fintechs. That was and still is often the prediction.

In the Netherlands, in the decade following the financial crisis of 2008-9, there have often been calls for a more diverse financial landscape (WRR 2016, 2019) (Sanders & Zhang, 2018). These calls show that the fintech revolution has not (yet) taken place within the Dutch financial sector. In 2021, the three major banks (Rabobank, ING Bank and ABN AMRO) still have an oligopoly position in various areas, particularly in current and savings accounts and lending to SMEs and consumers. The concentration of market share calculated on the basis of the size of the balance sheet has also increased in recent decades for the 'big three' (WRR, 2019). Entrants appear to face various obstacles.

In addition, there have been various initiatives in the Netherlands over the past decade that aimed to achieve a more diverse landscape by implementing a safe alternative. Three suggested variants are a private deposit bank (Buitink & Van der Linde, 2019), a public deposit bank (Alkaya, 2018)and 'central bank digital currencies' (CBDCs) (DNB 2020). In all these variants, citizens and companies gain direct or indirect access to safe public digital money. Various institutes have stated objectives for this new form of money. For example, the WRR (2019) emphasises the macro-economic (system) importance of a "safe alternative":

The fact that there is a real alternative will have a disciplining effect on the existing banks. It will force banks to finance themselves more responsibly, with more equity (capital) and debt with a long

term. The creation of money and debt by commercial banks will also be better limited in this way. DNB (2020), on the other hand, considers the preservation of public money and having a backup for private bank money to be the most important (see objectives pyramid in appendix 3). Subsequently, 'diversity and privacy in the payment market' are mentioned as objectives. DNB's focus is therefore on payments and the WRR's (2019) focus on macroeconomic (system) effects. In the coming years, experiments will be carried out, DNB has announced (Business Insider, 2020), and crucial design choices will have to be made. The choices about, for example, the maximum amount (a cap) will largely determine the scope of CBDC.
This article examines three questions: 1) To what extent has the fintech revolution failed? 2) What are the causes of the (partial) failure? and 3) Could a system change contribute to (the success of) the revolution in order to create a more diverse monetary-financial landscape? The structure of this article is as follows: section 2 explains the method, section 3 presents the results, and section 4 draws conclusions and provides recommendations.

Methods

In the period May-September 2020, nine experts were interviewed in two rounds (see appendix 1 for the interview overview). In the first round, five experts who work with or for a fintech company were interviewed about the mission/vision of their organization, obstacles experienced, the relationship with banks, legislation and regulations, the predicted revolution, dependency on other players and the possibilities of a structural change within the monetary-financial system (see appendix 2 for the interview schedule). The focus was on CBDC because the other proposals for the establishment of a deposit bank did not make it in the Netherlands. It turned out to be impossible to establish a private deposit bank within the current legislation and regulations and in June 2020 the House of Representatives narrowly rejected a proposal for a public deposit bank, 71 in favor, 79 against (Tweede Kamer, 2020). In order to gain a broader view, four experts who are indirectly involved with the fintech sector were interviewed in the second round: policymakers, supervisors and academics. These experts were asked about the developments within the sector, the predicted revolution and the possible impact of a system change. The interviews were held digitally and audio recordings were made. The recordings were then fully transcribed. The interviews were then divided into thematic categories in order to be able to analyse the text.

All interviewees have indicated that they are participating in the research in a personal capacity. The results therefore consist solely of personal positions, analyses and recommendations. The individual opinion is not representative of the vision of the organisation to which he/she is affiliated.

Results

The failed revolution

In order to answer the question of whether the fintech revolution has failed, a distinction must be made between financial services and financial service providers. The predicted revolution concerns the service providers. The prediction was and still is that emerging relatively new companies will eventually outcompete the established (large) banks. The interviewees stated that in practice fintechs mainly specialise in 'front-end' user convenience and payment services. Developments in this area are currently moving very quickly. All interviewees felt that it is going too far to state that the revolution has failed in its entirety. Much progress has been made in the area of financial services. Examples include digital services such as applications (e.g. Tikkie) that focus on user convenience. Interviewee 9 summarised it as follows: "There is more of an evolution than a revolution."

In short, there is broad consensus that fintechs play a complementary role and not a fundamentally disruptive role. According to interviewees, the fundamentally disruptive role lies more in the corner of BigTech. These companies have the capacity to take disruptive steps regardless of the activities that fintechs develop. They can develop their own system outside the current frameworks.

Obstacles faced by fintechs

Interviewees mentioned several obstacles faced by fintechs. The (interdependent) obstacles can be divided into five categories: 1) regulation and protection; 2) small market with well-established players; 3) lack of tradition; 4) exit strategy, and; 5) market power.

Rules and protection

According to interviewees, the complexity, volume and continuous innovation of financial legislation and regulations offer established institutions an unintended form of protection and makes it difficult for fintechs to start and scale up.

Interviewees noted that major banks have invested heavily in recent years in complying with the rules within the framework of the 'Money Laundering and Terrorism Financing (Prevention) Act (Wwft)'. What distinguishes major banks from fintechs is that they have great financial clout to meet legal requirements, have experience and have access to legal guarantees. Fintechs, on the other hand, have less clout, less experience and often do not have access to legal guarantees. The relative costs they incur (the costs per customer) are therefore generally higher. Interviewee 5 concluded that there is unfair competition and mentioned the corona emergency aid as an example: "There is an uneven playing field. Banks have guarantees from the state when they grant credit, BMKB guarantee for SMEs. Fintechs cannot claim that scheme because they are not a bank, while in some cases they finance the same companies". According to four interviewees, this could be due to the influence of lobbyists. For example, interviewee 3 stated: "As with most laws, they are developed from a certain intellectual ideology and lobby, so they are subservient in that way. Power is always defended." In addition, the position of banks is strengthened by the deposit guarantee scheme to which all institutions with a banking license are affiliated. This mandatory insurance for private companies is intended to prevent bank runs and ensures that bank financing is insured. Fintechs without a banking license cannot rely on this insurance and are therefore seen as riskier.

Even after the 2008-9 crisis, "more legislation and regulation has been the political preference" (interviewee 6). In other words, politicians have chosen to stabilize the current system with more and stricter legislation and regulation rather than make major structural changes.

Netherlands: small market, well-established players

A second obstacle is the combination of a relatively small Dutch market and the efficient digital banking payment system that was co-developed by the major banks. With a population of 17 million, fintechs will soon have to look beyond the national borders to be able to grow substantially, according to the interviewees. In addition, the implementation of the payment system iDeal in 2005 has strengthened the position of banks in the field of payments. Due to the success of iDeal, it has become more difficult for new players to gain a foothold. The relatively small population and the mature payment infrastructure are therefore obstacles for Dutch fintechs.

Fintechs and their lack of tradition

The big banks rely on their name recognition and tradition for a significant part of their new recruits. Fintechs generally do not have either. Interviewee 2 put it this way: " Trust, many fintechs do not have that yet and there are two reasons for that. First, they have no history and track record. And second, they are not understood by many people". Research confirms that most people stay with the same bank their entire lives. For example, 90 percent of young customers stay with ING their entire lives (Dormaar, 2019). Banks try to bind young customers to them by means of special offers and children's accounts. Tradition is important because many parents choose the bank where they also do their banking.

Exit strategy

In recent years, the three major banks have made money available to invest in new financial-technological innovations. As a result, many owners and shareholders of fintechs with disruptive potential are confronted with the possibility of an early takeover. Interviewee 4 explained it as follows: "A large proportion of fintechs start with a noble goal, but they soon focus on making a good exit." For fintechs, being taken over by a larger organization has two advantages: the organization gains access to the professional network, financing and knowledge and expertise (including legislation and regulations) that are already present at the purchasing party, and in addition, in many cases it is financially attractive for the owners/shareholders of the fintech to be taken over.

Market power

All interviewees indicated that the three major banks use their market power to protect their profitable business model.

Interviewee 1 gave the following example: “I strongly suspect that banks will use the billions on their balance sheets to exert influence, including on policy”. Research confirms that Dutch banks spend several million euros annually on interest groups and lobby groups. Over the years, this has led to a distortion in which banks have much shorter lines of communication with policymakers than, for example, citizens or fintech companies (Stichele, 2016).

Another more direct form of market power is ‘mergers and acquisitions’ (M&A). Potentially promising fintechs are acquired at a relatively early stage by established players, as explained in the previous point. An example is ING Ventures. With 190 active partnerships between 2015 and 2019, this investment fund is the most active fintech fund in Europe (Banken, 2019). ABN AMRO and Rabobank also invest in fintechs. The amount of the ABN AMRO Ventures investment fund doubled in 2019 to 100 million euros per year (Banken, 2019). Rabo Frontier Ventures has 60 million euros available annually (Rabobank, n.d.). The figures show that the ‘big three’ use their market power to appropriate promising financial innovations. This is a win-win situation: banks gain access to the latest technologies, investments can pay off and the ‘competition’ is eliminated. “Join them if you can’t beat them” in the words of interviewee 3.

Structural change in the system

Fintechs have a one-sided dependency relationship with banks. As a rule, they need banks for a bank account and often for capital. Banks, on the other hand, do not need fintechs. Interviewee 7 states: “ Does a fintech have a bank account? Yes, then banks are still important.”

According to four interviewees, the development of CBDC could alleviate the dependency on commercial banks to some extent. The interviews in the first round showed that CBDC and the possible system-wide effect do not currently play a major role in business operations. More clarity will first have to be provided before it can be stated that fintech can benefit from CBDC, according to interviewee 2.

The interviewees in the first round had rarely considered the impact of the introduction of a CBDC on their business(operations) and the system. The interviewees in the second round all had a vision on this. Two of them emphasized the importance of public money and a public digital payment system. The objectives they mentioned were in line with those of DNB (2020). Two others focused mainly on the possibilities that a CBDC offers to improve the entire monetary-financial system, much more in line with the recommendations of the WRR (2019).

Interviewee 6 indicates that stimulating innovation is not the only reason to experiment with CBDC. An additional reason is that a public alternative undermines the market power of commercial banks, as consumers then have a choice regarding digitally holding capital. This is in line with the aforementioned recommendations of the WRR (2019), which speaks of a disciplinary effect when

an actual alternative becomes available.
With the planned implementation of CBDC, the position/opportunities for fintechs could therefore change for the better according to interviewees. An important question is whether a CBDC is used to improve the payment system or to improve the entire system. According to some interviewees, a CBDC makes it possible to liberalize the banking system. For example, interviewee 6 proposed phasing out the deposit guarantee scheme (DGS) so that commercial banks can no longer fall back on collective insurance. This would result in more market forces within the monetary-financial system and fewer government guarantees.

Conclusions

Based on the interviews, three conclusions can be drawn. First, stating that the fintech revolution has failed is too simplistic because a distinction needs to be made between financial service providers and service provision. In the service provider sector, there is an oligopoly with three major players in various areas, while in the service domain, many new services have become available for customers who use digital technologies. Second, there are at least five interdependent obstacles that hinder the growth potential of Dutch fintechs: 1) regulations and protection; 2) small market with well-established players; 3) lack of tradition; 4) exit strategy, and; 5) market power. Third, CBDC has the potential to strengthen the position of fintechs compared to large banks. When making design choices, it is important to take into account the widely shared desire to create a more diverse monetary-financial landscape. There is also a fundamental difference between diversity in payment instruments and diversity in the system as a whole. Some interviewees stated, in line with the WRR (2019), that a CBDC could lead to an improvement of the entire monetary-financial system; others, in line with DNB (2020), focused on payments.

Based on the conclusions of this exploratory study, the following recommendations can be made:

1) In designing CBDC, fintech will have to be approached in its own 'individual' way. If more diversity at system level is an objective, then the limit on CBDC should be high.
2) The objectives and design choices of a CBDC are subjects that concern political decision-making. It is so much about monetary matters but mainly about the (market) organization of the system.
3) Further research could map out in which areas fintech companies will use a CBDC and how high the limit should be to stimulate competition.

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