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Impact of Regulation on Financial Services Providers

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Abstract

Digital pundits and research analysts regularly gush about the slew of innovative financial products launched by nonbanking financial services providers almost daily. They'd have us believe that unless traditional banks match the new players with equal degree of innovation, they face extinction. In this paper, we present the counterview that banks have little to fear from these new kids on the block. We then explain how, contrary to popular misconception, most nonbanking players will vanish overnight if banks were to stop operating the rails on top of which most of these new products are built. We go on to examine how regulations restrain banks. In conclusion, we expose a graver threat to banks that's unconnected to regulation. Good news is, banks can overcome this internal challenge without facing any roadblocks from regulators.

Keywords: **Retail Banking; Payments; Non Banking Financial Services Providers; Frictionless Solutions; Know Your Customer (KYC); Two Factor Authentication (2FA); Customer Experience**

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INTRODUCTION

Nowadays, we regularly read about the slew of virtual currency, personal finance management, mobile wallets, peer-to-peer lending and other financial products launched by Facebook, Google, PayPal, Prosper, Square, Wonga, Zopa and a scad of other nonbank startups and established companies. Digital pundits and research analysts keep exhorting banks to match these new financial services players with a similar dose of innovation or face extinction.

STORIES OF BANKS' DEATH ARE GROSSLY EXAGGERATED

Against the backdrop where seven out of ten startups fail whereas banks somehow get rescued with taxpayer money, such doomsday predictions about banks are ridiculous right off the bat. However, since I don't have any personal interest in either banks or these new financial services providers (FSPs), I haven't bothered to drag myself into these discussions apart from leaving the odd comment to a blog post or two.

All this changed when a couple of close associates came to me recently with deeply creased brows. One is an IT professional with two decades of experience in credit card management software like VisionPlus. After hearing all the buzz around mobile payments, he feared that his lifelong expertise in card networks would be rendered redundant by Google Wallet, Nokia Money, Airtel Money and other mobile wallet providers. The other is a friend who owns a substantial number of American Express, Citi, MasterCard and Visa stocks in his portfolio and wanted to know whether it was time he shorted them.

It's when all this clamor around non banking FSPs touched me personally that I decided to weigh in with my views on this subject.

BANKS HAVE LITTLE TO FEAR FROM OTHERS

First off, banks face negligible existential threats from the new kids on the block.

To see why, let's examine the clusters under which most nonbanking FSPs fall:

1. Virtual Cash such as Facebook Credits. They've created a new currency that can be used in large online communities that rival China, India and other populous nations. However, they still need traditional cards to fund the virtual currency account.
2. Mobile Credit Card Acceptance such as SQUARE and Intuit GoPayments. They expand the reach of credit card acceptance to those businesses that banks won't want to deal with directly. Please see the sidebar on how Square is disrupting the card acceptance space and why banks have every reason to see it as an ally, rather than threat.
3. Peer-to-Peer Lending Websites such as PROSPER, Wonga and Zopa. While they've certainly made waves by permitting loans to be sanctioned in minutes without any documentation or branch visit, we need to remember that they address the high-risk customer segment that anyway won't qualify for loans from

traditional banks. Besides, as of now, they handle less volumes in a year than banks possibly handle in a minute.

4. Mobile Wallets such as Nokia Money and Google Wallet. Most of them shoot themselves in their feet with misguided offerings and are likely to fade away by themselves. To be fair to them, their attractiveness for consumers and merchants is stunted by some of the regulatory influences that also curb the innovativeness of banks. More on that later.
5. Generation Y Mobile Payments from Boku and Zong. When they launched a few years ago, they did appear to disrupt traditional banks by using telecom carrier billing. However, the 30-40% transaction fees they charged made them a viable method of payment only for virtual goods used in digital games. Recently, they started supporting credit cards in a tacit acknowledgment of the fact that real world commerce will continue to require traditional banking rails for a long time to come.
6. Prepaid products from eCount and Revolution Money. They entered a new market that banks had missed, proved their potential to banks, and then sold themselves off to banks for a fraction of the latter's net worth / market capitalization.

It's evident from the above list that some of these innovative products are too small to threaten banks and the others will simply cease to exist without the banking rails on top of which they're built.

REGULATIONS PUT A BRAKE ON INNOVATION

Secondly, all the present hype around urging innovation from banks misses the fact that banking is a highly regulated industry. While regulations are no excuse for banks to take a laidback approach, they do pose certain limits to what banks can and can't do, as well as dictate how banks can go about doing things that they can.

Regulations impact banks on at least three fronts:

- They put roadblocks in the way of creation of new products by banks.
- By making them answerable to a regulator, regulations curb banks from being aggressive and using shortcuts that could potentially enhance consumer experience.
- They de-motivate senior banking executives from competing on the basis of innovation by giving them the warm and fuzzy feeling that they'd anyway get bailed out by governments in the end, come what may.

Let's take KYC (Know Your Customer) and 2FA (Two Factor Authentication) as two examples to illustrate the role of regulation.

Because of KYC, customers are unable to open bank accounts instantly and it usually takes a few days and a branch visit before an account can be activated. Given that most people don't open more than four or five bank accounts in their entire life, that doesn't sound like a big problem. But, KYC does lead to certain situations that appear ridiculous to the average banking customer. For example, you could have a savings account and a fixed deposit with a certain bank and be receiving monthly statements from this bank displaying your address. However, these statements are not accepted as proof of address when you want to buy a pension product from the same bank – only documents from another bank will serve the purpose. While the regulator might've a good reason for insisting upon third-party documentation to fulfill KYC requirements, such regulation undeniably causes poor consumer experience for customers of banks. What's worse, even as I'm writing this, two of my banks have contacted me, asking me to submit fresh proof of identity and address documents to "renew my KYC", which now needs to be done once a year.

With 2FA, an online shopper using her credit card in the Card Not Present (CNP) mode is shunted around between the websites of the merchant, acquirer's processor and the issuer's processor. While each system works fine most of the time, the end-to-end uptime – that is, when all systems are working alright at the same time – is often wanting, which results in more failed transactions than the shopper would like. What's worse, when there're so many moving parts, no single party in the payment chain takes full ownership, causing untold hardship to the shopper. While 2FA is mandatory in several nations, the extent of enforcement varies from country to country: In India, the banking regulator uses its direct jurisdiction to ensure that banks comply with this regulation. It also uses indirect heft via acquirer banks to make merchants – over whom it otherwise has no control – comply with this regulation. In the USA, 2FA has been mandated by the Federal Financial Institutions Examination Council (FFIEC) way back in 2005. While not all banks and merchants are compliant with it even today, the existence of regulation can't be denied.

Both KYC and 2FA cause friction and mar consumer experience.

Where banking is regulated, which is virtually everywhere in the world, customers can complain to the banking regulator if something goes wrong in their dealings with their banks. Since no banker wants to appear in the six o'clock news, banks might be compelled to make their customers jump a few more hoops (e.g. insist upon applicants to visit a branch before activating a bank account), even if this results in relatively inferior consumer experience. On the other hand, nonbanks can provide better consumer experience (e.g. by activating a merchant account instantly, the way PayPal does) because they're safe in the knowledge that, even when they treat their customers badly (e.g. when PayPal puts an arbitrary freeze on merchant accounts), there's no one to complain to.

NONBANKS WON'T ESCAPE REGULATORY SCRUTINY FOREVER

At their inception, nonbanks were free of regulatory shackles. However, many of them have started attracting regulatory scrutiny in recent times.

After facing a partial suspension of its operations in 2010-11 for running afoul of currency exchange regulations in India, PayPal has recently come under the American regulator's radar post Dodd-Frank-Durbin.

Even as I write this, Wonga, the online provider of "short term cash loans" – aka payday loans – has invited the ire of British politicians.

BeamIT, a recently launched mobile-remittance startup, recently raised a round of venture capital and specifically announced that it's planning to use a bulk of its funding to break down regulatory barriers. If BeamIT's action is any indication, nonbank FSPs seem to have not only recognized the strong arm of regulation in financial services but are also investing to manage their way through this apparent minefield. Given the huge amount of lobbying money that traditional banks spend every year to promote favorable regulation, it's anybody's guess how successful nonbank FSPs will be in their ambition to shape legislation, but that's another story.

If they fail, they might face the same fate as Nokia Money: The handset giant's mobile payment service was straitjacketed by so much regulatory overhead that it turned out to be too cumbersome to achieve mainstream adoption in India, the only country in which it was launched two years ago. On the back of this experience, Nokia has shuttered its entire financial services division globally.

BANKS CAN STILL DO A LOT MORE

Having said this, it's not as though regulations have totally paralyzed banks. There're several areas in which banks can enhance their services without running afoul of regulators.

Let's take electronic fund transfer (EFT) as an example. Most EFT solutions found on Internet Banking websites ask a payer to select a method of payment (e.g., Faster Payments, BACS or CHAPS in the UK), enter the beneficiary's bank account number and a few more pieces of complicated information. Instead of offering to help customers to navigate through this treacherous process, many websites actually warn customers that the bank will not take responsibility if a payment gets lost in the cyberspace.

By sticking to the status quo and failing to improve the customer experience, banks face the risk of their customers going back to branches, checks and cash, which have higher operating costs compared to Internet Banking and electronic payments. This would severely undermine return on banks' digital channel investments. Besides, since banks have never been very successful in levying fees for such basic banking services, they'd have to eat the higher operating cost accompanying the shift to traditional channels and products themselves.

This is the clear and present danger for traditional banks – not disintermediation by non-banking financial services providers.

Good news is, banks can overcome this challenge without facing any roadblocks from regulators, that is if their executives would display some proactive drive and determination. To continue with the above example, rather than taking an adversarial position, banks can improve customer experience by tweaking their internal systems such that they ask their customers to enter the most elementary information and backfill the remaining details from their backend systems.

A good example of a bank that has done something like this is Barclays Bank with its recently launched PingIt mobile app. PingIt allows payers to make a fund transfer from their mobile phones by simply entering the receiver's mobile phone number. By using the phone number as an easy-to-remember surrogate for complicated banking details, Barclays has shown that it's possible to deliver superior customer experience, yet stay on the right side of regulation.

SIDEBAR ON SQUARE

Square is well known as the mobile payments provider that enables merchants to accept credit card payments on their iPhones and Android smartphones. Square relies upon cards issued by traditional banks and isn't a new method of payment. Therefore, contrary to popular hype, Square poses no threat to banks. In fact, a less acknowledged fact about Square's model would clearly establish Square as an ally – not adversary – of banks. Businesses signing up for Square can accept credit card payments without requiring a merchant account from a bank. Square does all the heavy lifting by signing up with an acquiring bank as a sort of master-merchant. Now, Square's customers wouldn't have qualified for merchant accounts on their own because the stringent risk management models used by banks would've flagged them off as high risk. Without Square, all their transactions would've happened in cash, fetching no card interchange revenues for banks.

With Square, the bank is shielded from acquiring risk and still earns interchange revenues since Square assumes the role of a merchant aggregator and allows these businesses to accept card payments. Therefore, Square has expanded the market for credit card acceptance, enlarged the interchange pool for banks and card networks – all with no incremental risk to banks. This is really what separates Square from many other players before and after who allow card payments via dongles plugged into smartphones but insist that the sellers should have a merchant account with an acquiring bank directly.

CONCLUSION

Banks don't have much to fear for their survival from non banking financial services providers. However, unless they substantially reduce friction in their current offerings, their customers might ditch their sub-optimally implemented digital channels and go back to branches, checks and cash. When that happens, banks risk ROI of their digital channel investments getting undermined and elevation of operating costs that they won't be able to pass on to their customers.