

Summary of Discussion Points

**Presented by the Business and Industry Advisory Committee (BIAC)
to the OECD Competition Committee Working Party No.2**

Hearing on Disruptive Innovation in the Financial Sector

26 October 2015

BIAC welcomes the opportunity to provide its views to the OECD Competition Committee Working Party No.2 for its Hearing on the phenomenon of disruptive innovation in the banking sector and its impact on regulation. Generally, regulators are faced with the unenviable task of attempting to achieve a level of equilibrium between the benefits and risks of regulation and unfettered free market innovation. And the digital revolution has brought substantial innovation and new business models that will challenge not just banks but regulators as well.

Introduction

1. Retail banking is under increasing pressure in most countries. While there are differences in various jurisdictions, in general new entrants and new business models are threatening established providers. New and (so-far in many cases) largely unregulated players are emerging and are disintermediating the traditional incumbents.
2. The lessons from a wide range of industries are that the truly threatening challenges are those which result from disruptive innovations, whether these focus on new technology, new business processes or completely new business models. There are several recent examples in other sectors:
 - The traditional recorded music industry has been turned upside down by the consequences of digital downloading;
 - Within little more than five years, digital photography has largely destroyed the mass market for traditional film;
 - The passenger airline industry has been transformed by the rise of low cost carriers.
3. Disruptive innovation, as discussed in 2015 by the OECD, consists of product or business model breakthroughs that bring radical changes in the market, especially by reducing costs of service delivery ;

such innovations have the potential to take substantial market activities from pre-existing products and firms, providing that regulation permits and enables such activity¹.

4. This paper will examine the impact of disruptive innovation on traditional banking institutions and the role of regulators and their constant struggle to achieve the ideal balance between innovation and regulation. It will also cover, briefly, the interaction between regulatory and competition authorities.

The Banking Sector and the New Players

5. Retail financial institutions have been seen in the last few years as conservative although history suggests that retail banks have a long heritage of innovation and of adapting to changing environments. In fact financial institutions have quickly embraced technologies that have made them more efficient, more profitable and safer. The introduction of ATMs, pin codes and online banking are all good examples of such innovation.

6. But today, new technologies are bringing fast changes to the industry. Thanks to the use of mobile phones and the internet, retail banking is coming under increased pressure by new players, whether online or offline, and innovators.

- First, large players from the retail and telecommunication industries such as Paypal, Amazon, Apple have turned their attention to financial services. They do not want to become fully fledged banks but want to offer banking-type services to customers;
- Secondly, entirely new players are becoming active by offering new services or new ways of doing things, especially in the financing and payment systems, and competing aggressively on price and customer experience.

7. These new players are starting to remove the traditional intermediaries, the retail banks, from financial transactions. Digital technology is enabling new disruptive business models for making payments and matching savers with borrowers. Traditional intermediaries are facing potentially significant loss of market share to firms that sit outside or at the margin of the current financial system. Until recently almost all transactions, unless carried out cash, required a bank or regulated payment system operator to perform it on behalf of a customer. That is no longer the case.

8. Both the intermediation of payments and capital, mainly through the normative use of technology, is now being disrupted by a variety of systems, organisations and ideas. Payments are being disrupted by decentralised P2P payment systems and the creation of new payment systems. Capital intermediation is being threatened by non-banks providing banking services as well as crowd funding and P2P lending.

¹ The theory of disruptive innovation seems to have been invented by Clayton Christensen, of Harvard Business School, in his book "The Innovator's Dilemma". Mr. Christensen used the term to describe innovations that create new markets by discovering new categories of customers. They do this partly by harnessing new technologies but also by developing new business models and exploiting old technologies in new ways.

9. On virtual currencies, it is sufficient to mention Bitcoin, Bitcoin uses peer-to-peer technology to operate with no central authority or banks; managing transactions and the issuing of Bitcoins is carried out collectively by the network.

10. BIAC will now discuss in turn payment systems, crowd funding and P2P lending.

Payment systems

11. The payment sector continues to lead the way in terms of attracting new competition. In recent years there has been an abundance of new non-bank competition entering the payments market. Historically, banks have relied heavily on capturing retail commerce transactions through cards. However, alternative payment methods such as digital wallets are gaining traction and, over time, could present a significant threat to bank revenues as transactions cease to be card based. Ultimately, alternative non-bank payments providers have the potential to disintermediate banks, seizing the customer relationship.

12. Paypal was one of the original pioneers in this area. One of the key attractions of PayPal for many consumers is the ease of payment, with a username and password as opposed to having to enter bankcard details. Digital wallets have the potential to enable consumers to use their bank cards in the same way as they currently use PayPal.

13. With the ubiquitous availability of mobile phones, innovative mobile service providers are starting to roll out basic banking services that can be used without requiring a bank account and access to physical bank branch. This is particularly relevant to developing countries where the majority of the population does not have access to traditional banking. In these countries mobile payment systems are enabling a section of society previously unable to access financial services to participate economically.

14. A key example is m-pesa in Kenya. M-pesa is a mobile payment system that allows individuals to transact financially without the need to have access to the local banking system. It is now the world's most used mobile payment platform, processing more than 41 million transactions per month with over 18 million registered users in 2012. Users can pay and withdraw cash from 78,000 agent outlets countrywide and can use their phones to instantly send money to others, or to pay bills. M-pesa is used for salary payment, loans and repayment, cash grants from NGOs, and international money transfer through a partnership with Western Union. One of the main positive impacts of m-pesa has been to provide the unbanked with access to secure and affordable financial services.

Crowdfunding and P2P Lending Systems

15. Alongside disintermediation for payments we are also seeing disintermediation of capital on an increasing scale. Crowdfunding and P2P lending inverts the traditional model of intermediation. Instead of a small number of decision-makers allocating large sums of money, a large number of individuals each allocate a small sum of money.

16. Both utilise internet platforms to match those seeking and those offering finance without a financial institution acting as an intermediary to the transaction. While crowdfunding offers either rewards or equity participation in an enterprise, P2P lending involves debts contracts and payment of interest. With crowdfunding it has become increasingly possible for a person or organization to fund projects by connecting directly with the intended customer base.

17. P2P lending developed and grew along with the emergence and acceptance of P2P networks and was boosted by the financial crash in 2008. During this time, banks were offering relatively low rates of return, so people with liquid financial assets sought out higher yield elsewhere. In tandem, SMEs found it extremely difficult to raise funds through traditional means.

18. Zopa is the world's oldest and Europe's largest P2P lending service. It brings together individuals who have money to lend, and individuals who wish to borrow money. Its streamlined online architecture and minimal physical overheads have allowed it to provide savers with much higher returns than those of traditional financial establishments and to simultaneously offer borrowers lower rates.

19. Services like Zopa have also other advantages:

- Convenience - a digital lender does not require the customer to visit a branch secure funds;
- simplicity and transparency - to keep the lending process as streamlined as possible, the number of questions and information request from applicants is generally kept to a minimum
- flexibility and personalization - customers can readily determine how much they want to borrow and when they want to pay back

Regulation and Disruptive Innovation in Financial Services

20. For years regulators have been concerned by what they perceived as lack of competition in retail banking. Now we are seeing lots of new entrants and novel business models but regulators are struggling to keep up with such changes. The change is creating new challenges not just to banks but also to financial regulators charged with reducing misconduct and ensuring financial stability.

21. Financial regulation fundamentally aims at reducing prudential risk and misconduct. In the main, that is done by regulating institutions, such as those that hold banking licences.

22. Over the past five years, banks and other financial institutions have been faced with intense and increasing regulatory scrutiny, compliance with which has necessitated significant investments, potentially at the expense of innovation and growth. New regulatory requirements have attempted to level the playing field for the largest of traditional players; however, the significant overhead and operational implications associated with implementing and enforcing the measures has not flowed equally downstream to smaller financial services players. It is not unreasonable to argue that the banks are encumbered by a large amount of regulation that unregulated non-banks can avoid, including capital ratios funding requirements, liquidity and anti-money laundering regulation.

23. Virtual currencies, for example, are not subject to the same financial crime regulation. But such regulation is there for a good reason: to tackle money laundering, terrorist financing and sanctions. User should not be able to make payments which are entirely untraceable by law-enforcement authorities. It would seriously hamper the fight against crime if virtual currencies flourished simply because they had weaker financial crime regulation than banks.

24. An additional concern relates to payment and money flight risk. Many will remember the queues outside Northern Rock in the UK as people sought to withdraw the money at the beginning of the financial crisis. That was before the arrival of faster payments and digital wallets. Now it is possible for people with significant sums to move money at the touch of a button. There is nothing to stop someone from setting up or having another account and moving their funds over in a matter of minutes. This is a prudential risk as it could bring down a bank in a matter of hours.

25. Peer-to-peer lending is also something that is growing fast but do all investors really understand the risks they are taking? Regulation is there to ensure customers take risks they understand and banks have strict obligations as to the information they have to provide their customers which other new players might not have.

26. As in other sectors, there is always the danger that misconduct or risk is squeezed out of the regulated sector into the unregulated sector, hence the concern about shadow banking. That risk is massively amplified by the challenge of digitisation to the business model of banks, by giving greater opportunities to non-banks to do bank-type activities.

27. A good example of things that could go wrong relates to so called payday lenders, which have existed since time immemorial. Banking regulation, which restricts bank from lending to borrowers who cannot sustainably repay the debt, does not, in many countries, subject payday lenders to such rules. Digitisation enabled payday lenders to expand exponentially, unconstrained by bank regulation on lending practices. Many payday lenders were essentially internet firms offering bank-like services. Some of these did not have many scruples and were imposing APRs in excess of 1000%. This has led to a major reaction. For example the UK government brought them under the regulation of the Financial Conduct Authority, whose conduct rules subsequently led almost all payday lenders out of business.

Conclusion

28. The financial markets and consumers are greatly benefiting from a dynamic financial environment, such as one we face now. For this to be the case in the long term and to maintain a stable financial system, regulators and lawmakers have an important contribution to make to ensure consumer protection is extended to all aspects of financial services, regardless of the provider and to creating an environment where the right sort of innovation can flourish.

29. Many steps are being taken in that direction. For example, in the payments sector, on the 8th of October 2015, the European Parliament has adopted the European Commission's proposal for a revised Directive on payment services ("PSD2") which brings under EU legislation the new types of payment

service providers which were previously unregulated. That achieves the important objective of creating a level playing field amongst players while protecting the consumer and ensuring security in this area.

30. An efficient and resilient regulatory regime must not only deal competently with the financial system that exists currently; it must also have adaptive capacity to deal competently with the system that is emerging. Therefore to be truly effective, financial policy regulation must be forward-looking and prepared to accept the challenge of keeping pace with disruptive innovation.

31. In BIAC's view, these new financial technologies should be brought into the overall financial frameworks in a manner that does not neuter their creativity, or lower the potential to revitalize the economy. But at the same time, regulation should take into account the objective of mitigating systemic risk and ensuring the stability of financial systems. One option for regulation (an example of which is the PSD2 proposal), is to regulate activities rather than financial institutions. In the past there has been sometimes a tendency to look and regulate big players. The innovation in the banking sector will force a rethink of such practices.

32. One other point to consider relates to barriers to entry. Governments and regulatory bodies face the daunting task of composing policies to strike a balance between providing financial stability and security while also allowing innovative ideas to flourish. This task is becoming more difficult in the face of faster technological advancements. Ideal regulatory policy allows for the acceptance and growth of innovation without stifling it. It needs to be flexible enough to accommodate disruptive ideas and technologies with the potential for positive change while reining in their capacity for unacceptable risk if improperly implemented. The balancing act is hugely complex but if approached correctly it can result in the availability of smarter and fairer financial services without sacrificing customer confidence and trust.

33. As a final point, it should be stressed that interaction and coordination between different authorities is essential. In the past few years the banking sector has seen different authorities looking at the same issue under different lenses, sometimes in contradiction with each other. Coordination between a competition and a regulatory authority is essential. Each of them pursue certain objectives. But while looking at financial stability, it would be desirable for financial regulators to have an obligation to take into account the impact of the rules and intervention on competition and to promote competition in the markets they regulate. As for the competition authority, they should work with financial regulators to understand the regulatory environment (which sometimes act as a barrier to entry) and advocate rules that allow beneficial competition to emerge, while maintaining prudential concerns and consumer protection.