(Vallstein was awarded the Fintech Innovation Award in Treasury Managemement Systems in London in 2016. The below article appeared the Dutch newspaper NRC Handelsblad on September 22, 2016.)

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Leap forward or Jump into the Abyss

Fintech. Start ups that offer new services pop up everywhere. The promises are huge, but regulators struggle with the risks. “Some innovations try to circumvent regulation altogether.”

By our Editor
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Fintech has the future. This again showed last week when ABNAMRO announced it is initiating a new restructuring including associated job losses of 975 to 1,375 (out of 22,000) jobs. The profit margin of the bank is being squeezed because of increasing competition. This comes partly from “fintech”, says the bank: the domain of often new providers who try to gain market share from established providers through smart innovations.

Fintech companies pop up everywhere. KPMG, a consultancy firm, calculated that last year investors financed USD 20 billion world-wide into fintech. This represents an increase of 70% compared to the year before. During the first 3 months of this year investments again increased sharply, with 67% to USD 4.7 billion (compared to a year ago). And even if the last quarter showed some slowdown, this year will be another record-breaking year according to KPMG.

Fintech companies provide a wide range of products and services, such as payment services, automated investment advice, crowdfunding and robotized mortgage advice. These are services also offered by traditional banks but fintech companies claim they can do this faster, cheaper, easier and better. Because of their technological power.

A number of these players has meanwhile developed into serious contenders.

The US-based Lending Club, an online platform that intermediates between parties wishing to borrow and lend funds claims to be the biggest in its sector. The idea behind the Lending Club is: if you need money you don't need to go to a bank.

In the Netherlands there is i.a. Ayden, the digital cash register for large webshops and online services like Facebook and Spotify. According to experts this company is valued at more than EUR 2 billion.

The rise of fintech is viewed by some, and certainly those within the sector, as a revolution that will provide much benefit for the client. They state it provides finally an alternative for those slow, old-fashioned, unfriendly traditional banks. Anthony Thomson, founder of the almost entirely digital British Atom Bank once said: "the first automated bank systems were introduced in 1967. Funny enough most traditional banks still run on those systems."

But according to Hugo van Wijk there are also shadow sides and risks for the clients. Van Wijk is founder of Vallstein, a firm that since 2000 supports clients in Europe, Middle East and the United States on bank relationships and that provides specialized software to do so. Vallstein is also engaged in financial innovation. Vallstein developed a product that enables clients to better negotiate

with their banks about the pricing for banking products and services. It is called *WalletSizing* and it recently received an important fintech award in London.

"Fintech is hip, but as with any financial innovation it can represent a leap forward, or a jump into the abyss", says Van Wijk.

"Fintech almost by definition is digital and cross-border. This represents a challenge for supervision. Who will scrutinize a Vanuatu-based online lending platform that offers its services to customers in Europe?", asks Van Wijk. "Without adequate international supervision fintech is vulnerable to Ponzi-schemes and money laundering. But we're still a long way from coordinated international supervision. Some innovations try to circumvent regulation altogether by offering solutions to which, at least not yet, no regulation applies at all."

Privacy is another issue that may be at stake. Free services, like an app that calculates a tip on a meal in a restaurant abroad are nice, says Van Wijk. "But the client may not be aware he usually will pay with something. In this case that will be personal data: where he is, and what he had for dinner." He wonders whether new entrants in other jurisdictions will be as restrictive with such data as traditional banks and insurers.

Fintech almost by definition involves technology and is cross-border.
Hugo van Wijk - Vallstein

The fall out could be significant, is his fear. Crises undermine confidence in the financial sector, and precisely confidence is highly important in this sector. If confidence evaporates, financial institutions may fail, is the lesson of the crisis, says Van Wijk. "A snowball effect could follow, leading to a systemic crisis."

Van Wijk gets support from financial supervisory authorities on a number of points. Also The Netherlands Authority for the Financial Markets (AFM) worries about privacy of clients being secured with new innovations. The quick ascent of fintech “raised new supervisory questions” said the AFM in an analysis prepared for a debate on fintech in the Dutch Parliament early this year. Many innovations rely heavily on personal data of clients, that become increasingly available and which can be analyzed deeper and better than before. But it should be prevented that data of clients that use some cool app are leaked into the open domain, is the opinion of AFM.

Also for this reason the AFM is reluctant to issue licenses to new entrants – which in turn sparked protest from the fintech sector that considers that the supervisor is raising unnecessary barriers to entry and that it costs too much time and money to get into business.

The supervisor is between a rock and a hard place. The AFM does not want to curb innovation because this may benefit competition and therefore clients. The Dutch financial sector is now dominated by a small number of players. This is why the AFM, together with other Dutch supervisor The Dutch Central Bank (DNB) recently announced a number of steps to facilitate fintech start ups. But they don’t want to see Wild West situations.

The other supervisor, The Netherlands Central Bank (DNB) faces the same dilemma. They are equally aware of the opportunities and threats of fintech. DNB also prepared an analysis for the debate in Dutch Parliament earlier this year. It stated that “strategic and financial risks may arise when new entrants pressure earning models of existing providers”. Also “operational risks” may arise if and when the risk management of the new entrants (and of existing

players innovating as well) is inadequate. Both situations may lead to “financial instability”, according to DNB.

This rise of fintech firms also gives rise to “potential risks concerning integrity”, fears DNB. “Innovative products and services [...] can lead to a more complex playing field and thus reduce transparency.” According to DNB this in turn can have “wide effects on confidence”.

The central bank of central banks, BIS, also cautions that innovations, whether introduced by entrants or existing banks, can lead to systemic risk. In a recent analysis BIS states that because of technological breakthroughs the financial world is undergoing a profound change. A wide range of new products and services has become onto the market, including automated asset allocation advice, crypto-currencies, mobile banking, crowd funding and robotised mortgage advice.

But “the unintended consequences of technology-leverage finance include fire sales, flashcrashes, botched IPO’s, cybersecurity breaches, catastrofic algorithm trading errors and a technological arms race that has created new winners, losers, and systemic risk in the financial ecosystem.” The BIS refers to Murphy’s Law: if something can go wrong it probably will.

The unintended consequence could be that anything that can go wrong does go wrong.
Bank for International Settlements

Founder Don Ginsel of Holland Fintech, the sector’s lobby group, understands the concerns. Some of it is justified, he agrees. “Wherever there is entre-

preneurship, things somethings go wrong." But that is not unique for the fintech sector, he adds, this is the case in all industries. "New entrants into an industry can potentially produce significant benefit for clients. But as long as you work with people, you'll have bad apples. So you have to check carefully whether new entrants are acting in good faith".

He acknowledges that this can become more difficult than before. Some new entrants are not subject to supervision, such as the American technology company Apple, which provides products and services to other financial insitutions, but which in the Netherlands, until now, is not yet directly active on the consumer market. "What kind of options do you have as Dutch supervisor to enforce something on such a company that is not subject to your regulatory regime?"

In all, however, Ginsel believe the risks are within limits. Many fintech firms – the estimate is about 80 percent - do not deal directly with end consumers. They provide products and services to other (traditional) financial institutions who use these firms in their own services. Only a small portion deals directly with consumers. "Those firms are subject to regular supervision. And certainly when they introduce completely new products or services into the market the license process is long an complex. You cannot go onto the market just like that".

Trying to restrain fintech in the Netherlands, or actively restrict it, is not an option, says Ginsel. "Every progress carries a risk. But you can't isolate yourself from that, because internationally, this development just goes on. You miss opportunities if you stay out". Ginsel would rather prefer if the government puts more effort into the development of The Netherlands as fintech hub.

Van Wijk believes it is above all important to assess whether any fintech firm takes a position itself. He points to innovative entrants that launch a lending platform and act as intermediary. “Such parties should be subject to close supevision and buffers should be in place to absorb losess in case of defaults on loans. Otherwise they’ll gamble with other people’s money who provide the funding”.

According to him, what in any case is important above all, is that the earnings model of fintech firms is well understood. Clients need to know what the product actually does and what the risks involved are. Clients also have a responsibility themselves, says Van Wijk. “No matter how much supervision you will have, one can not ever guarantee the financial system is safe. A simple principle applies: if you don’t understand it, you’re well advised not to invest in it”.