The Race for Virtual Banking

While Europe and the US have taken starkly different approaches to the introduction of virtual banking, Hong Kong is in prime position to hit the ground running.

– By Sandra Wu

The wake of the 2008 financial crisis has been catalytic to a growing wave of technological developments looking to challenge the financial services industry. Moreover, the financial crisis put traditional banking systems and their flaws on the global stage. Consequently, regulators have since grown increasingly concerned about the power of large banks.

Similarly, mobile technologies and a renewed interest in alternative assets like digital currencies are permeating the public eye, creating a new class of consumer demands. Modern consumers now demand more personalised, immediate payment or banking solutions.

One such example is the emergence of virtual banking. In Britain, policymakers adopted alternative regulatory mechanisms termed fintech regulatory sandboxes. These "sandboxes" allow start-ups, or challenger banks, to develop and test new financial technologies with direct feedback from regulators.

The result was the growth of UK start-ups like Monzo and Revolut, both of which offer in-app-only checking accounts and ATM cards, with no need for physical branches. Last year, Revolut raised US$250 million, while Monzo reported adding around 2,000 users a day.

In sharp contrast, policymakers in the United States have been relatively slow to catch up with consumer demand for alternative banking solutions. Unable to obtain proper licensing, US-based fintech start-ups have been forced to set up partnerships with traditional banks. Simultaneously, traditional US banks have begun to execute plans to adopt virtual banking offers into their business model.

Goldman Sachs now offers Marcus, an online banking product offering loans and high-yield savings accounts. Meanwhile, JPMorgan Chase launched a digital smartphone bank account and recently announced plans to launch a digital coin.

Examples like these illustrate how regulatory systems still actively protect incumbents from small challengers and disruptors that, given their size, are more apt to remain nimble and quickly respond and adapt to both regulator and consumer feedback.

Overall, the most important financial and technological hubs around the world have been arguably slow to loosen regulations.

Even in Europe, where policymakers first took the initiative to facilitate financial technologies, virtual banks are still struggling under compliance laws designed for traditional banking models.

In 2017, UK-based start-up Monzo reported £33.1 million in losses. Most of this was due to an inability to monetize. For example, a significant revenue source for banks is the ability to offer mortgage and loan services subject to high-interest rates. However, existing policies traditionally demand that banks retain a large portion of their customers' deposits in reserve to conduct business. Although these policies protect consumers, they make it significantly harder for mid-market start-ups like Monzo to generate profit and scale to offer services like mortgages.

One polarizing argument amongst innovators and policymakers is that new technologies demand new policies. In other words, just as challenger banks are an iteration of traditional banking models, so should regulations governing challenger banks be an iteration of those that govern traditional banks.

This mixed bag of regulatory sentiment towards discontinuous technologies has created a regionally competitive vacuum. Forward-thinking markets like that of Southeast Asia have already taken the lead towards disrupting the consumer-banking industry.

As of last year, the Hong Kong Monetary Authority (HKMA) has been accepting applications for and awarding virtual banking licenses that allow a business to offer digital savings and loan products.

This strategy can easily position Hong Kong a global centre of fintech development. Besides boasting a business-friendly regulatory environment, Hong Kong is at the centre of the Southeast Asia region, and its 650 million+ population of smartphone users. To put this into perspective, consider the following: in a 2017 survey by McKinsey & Co, 55 to 80% of consumers in Asia reported an interest in virtual banking. Moreover, 40 to 50% of consumers in developed Asia are already using digital-only payment solutions, with China accounting for 67% of reported users.

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Of course, this doesn't mean that Hong Kong start-ups are anywhere near giving traditional banks a run for their money. On the contrary, out of the eight virtual banking licenses Hong Kong has awarded, three of them went to B.O.C. Hong Kong (Holdings) Ltd., Standard Chartered Plc, and Industrial & Commercial Bank of China Ltd.

Additionally, challenger or start-up virtual banks in Hong Kong are facing similar obstacles like those evidenced by UK start-up Monzo.

All virtual banks are currently subject to the same excruciatingly, tedious know-your-customer (KYC) routines that users experience with traditional banks. The catch-22 situation here is that challenger banks or small start-ups get most of their revenue from small-to-medium enterprises (SMEs). Where an individual is able to set up a virtual account quickly, SMEs need to bend over backwards to prove their general goods store isn't a money laundering operation. This is important because most SMEs have already completed exhaustive KYC processes with traditional banks and are unlikely to do it again.

It is also important to note that these complex regulatory hurdles will prove harder for start-ups to navigate than they will for established banks with seasoned experience in operational risk management.

As it stands, regulators' continued approach of holding virtual banks to the same governance policies expected of traditional banks will continue to hinder their growth.

All is not lost. Hong Kong remains one of the world's leading international financial centres. It is ranked first among the worlds' freest economies, enjoying low taxation and near-free port trade, backed by a global financial market infrastructure that makes starting a business safe and easily accessible. Hong Kong has also been ranked the 5th fastest growing start-up ecosystem in the world, boasting the 5th strongest and most stable financial market, and named the most competitive financial and business hub of 2017.

To top it off, Hong Kong is geographically located at arm's reach of almost 50% of the world's population, making it easy for start-ups to test, scale, and rapidly expand outwards. Its close proximity to Shenzhen gives it direct access to the largest manufacturing hub in the world. Moreover, both Hong Kong and Shenzhen are already in the midst of jointly creating a 1.2 million square metre business park to exchange talent in the areas of robotics, biomedicine, and fintech.

Any step towards innovation creates new market opportunities, or in their absence, service vacuums. Just as the Southeast Asia region stepped in to fill the US-Europe void, various companies have emerged to help new and established enterprises expand into Hong Kong and the general Asia-Pacific region. These third-party business developers are composed of legal services firms with a deep understanding of corporate compliance, governance models, and regulatory hurdles as they relate to financial technologies and the challenges they pose.

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These innovative legal service providers are themselves disruptors of the classic law firm model and are invested in facilitating the establishment of enterprises in accelerated innovation hubs like Hong Kong. One such example is Origin X Capital. With strong roots in both Europe and Hong Kong, Origin X is positioning itself as a bridge for Western market companies looking to expand their business into the Asia-Pacific hotbed of entrepreneurship. The firm is currently working with a number of investment firms, SMEs, and both fintech and blockchain start-ups. Service providers like Origin X are creating a model for a global-forward business development strategy. Ultimately, any headways made by innovators in the financial technology sector will have universal repercussions. Expanding into the Asia-Pacific market is not an option, it is a must for any player looking to compete with market incumbents like big banks.

Despite regulatory resistance, discontinuous technologies like Bitcoin and other alternative digital assets, tokenised securities, and the emerging force of virtual banks will keep adding salt to the wound. For better or worse (more better than worse), the financial services industry is changing.

While most experts argue that market penetration is a battle of nimble, overwhelming force; the race for financial technologies is more a battle of attrition. As innovative businesses continue to improve and expand their efforts to challenge the financial services industry, regulators will find they can either keep peeling away at the layers of legal complexity or rewrite them altogether.

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Origin X is a legal services firm for blockchain and fintech startups. We specialize in governance and regulatory compliance for disruptive technologies in a complex legal landscape. Our team is a mix of legal and technical professionals dedicated to producing innovative solutions for new and established founders. www.origin-x.capital

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