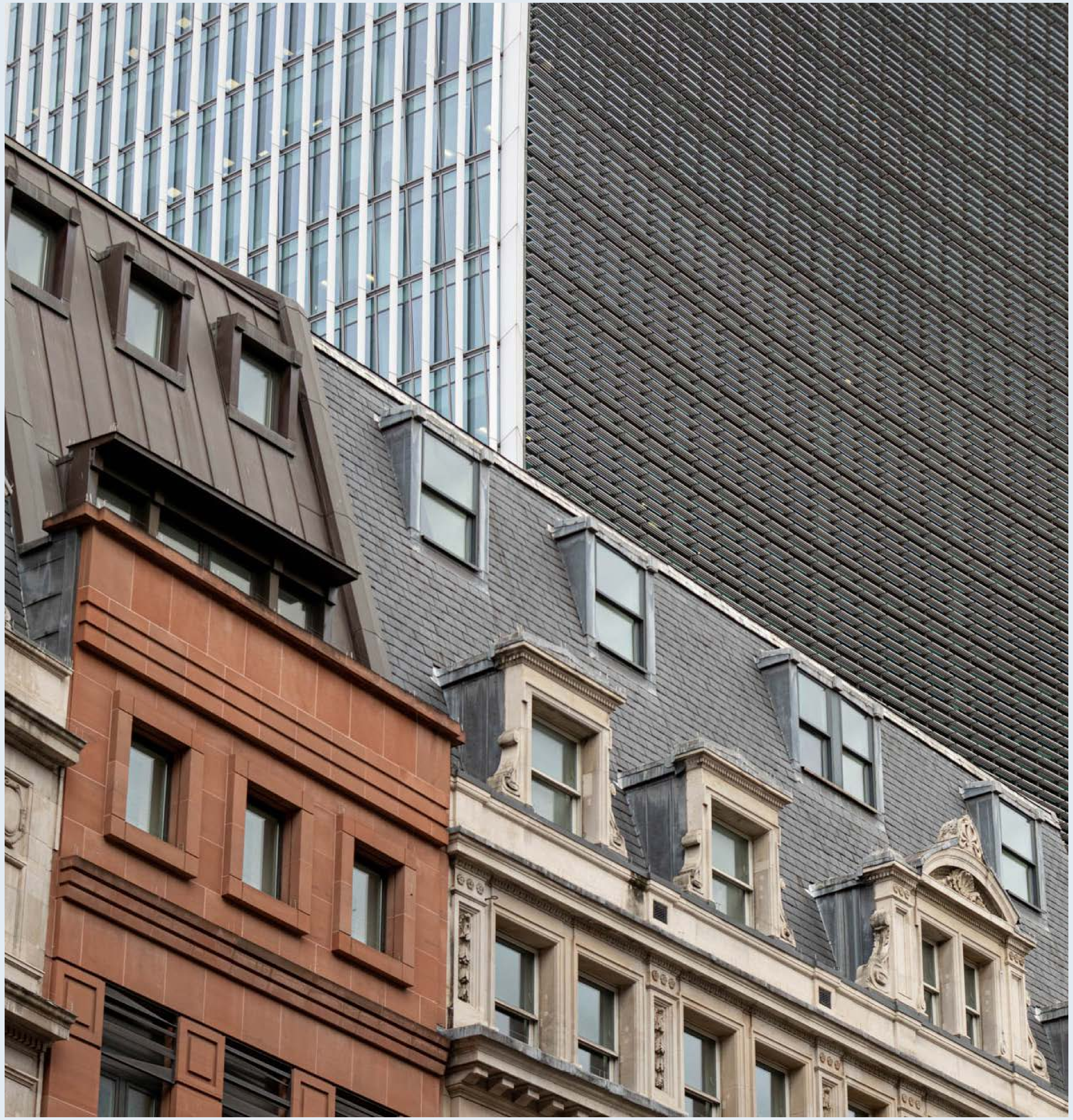
INFORM

The future of fintech disruption in Europe

Fintechs continue to challenge and influence the European financial landscape, but how is regulation, technology, and economic uncertainty shaping the future and the roles they play.



Foreword

What are the drivers of change for European payments?

The payments industry, once dominated by traditional financial sector players such as banks, payment institutions and card schemes, has transformed into an innovative, technology driven landscape that has opened its doors to new entrants that are looking to mark their place in the new payments ecosystem.

Due to regulatory and technology forces, fintechs are entering the European payment market and both directly and indirectly changing the future model of this payment industry. With companies taking different approaches to how they look to develop and provide payment services in Europe, there is much still to learn from the traditional players in this space and the roles each will take in the payments ecosystem.

In this report we look to dive into the key areas that new players must consider when looking at the European payments market. From the wide scale economic impact of current events, through to the regulatory requirements on banks and fintechs, there are still barriers to overcome. Finally we touch on the technological advances that we are seeing and how this is shaping approaches, and expectations from both fintechs as well as the customers they serve.

Section 01:

Macroeconomic review

Today's environment is once again characterised by significant uncertainty.

The most recent data points actually speak of a world economy in reasonable health: Snapshots taken before the effects of this latest crisis show the US economy enjoying impressive momentum, with Europe making solid progress recovering from the giant blows inflicted by the Covid-19 pandemic. Meanwhile, many developed world consumers continue to sit on significant stores of extra savings, in part thanks to the restriction of certain types of spending opportunities this last few years. Importantly, in the context of the incoming cost of living crisis, destined to hit the lowest income households the hardest, this savings arsenal is not distributed evenly among households.

Monetary policy had been in full acceleration mode during the crisis, but rightly was beginning to ease off, with real interest rates unevenly moving into less negative territory around the world. Central bankers had begun to raise interest rates in the UK and were certainly becoming more vocal about it in the US and even Europe.

Impact of the Ukraine crisis

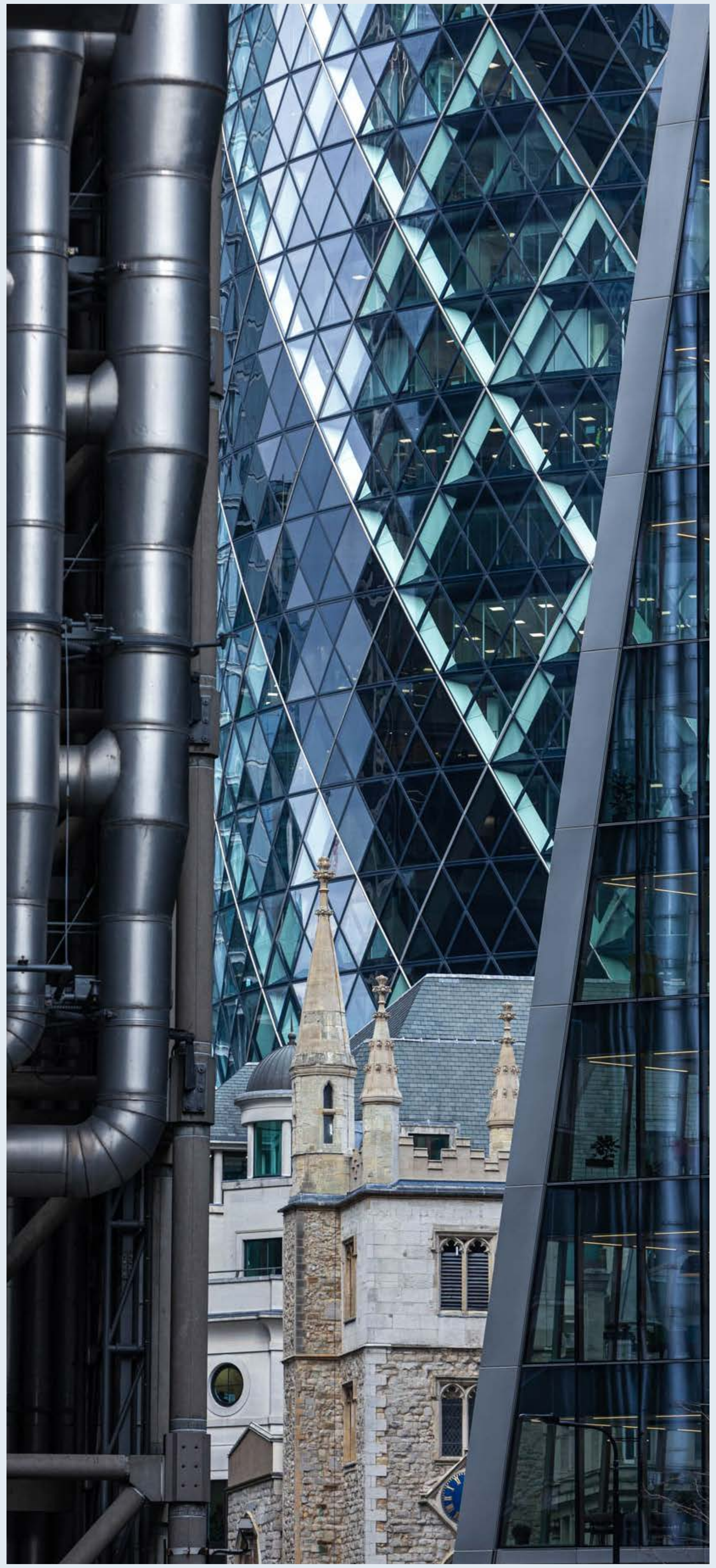
Outside of the gathering humanitarian tragedy, there are obvious economic consequences to the events in Ukraine.

While Russia and Ukraine are perhaps not considered major economies in a global context, they are certainly important commodity producers. Soaring prices for a range of basic goods, from cereals to gas, are adding inflationary pain to already heavily burdened parts of the global population. Europe's proximity and reliance on Russian gas suggests that the near term economic threat is greatest here. An abrupt halt to the gas supply (for whatever reason) would plunge Europe into economic darkness for a while.

For policymakers, this all serves to make it significantly more complicated to strike the balance between containing inflation and nurturing the recovery from the pandemic. We are still more or less in the dark as to the mechanisms that drive our collective expectations for future inflation. They are not easily measured either. However, the lessons from history, particularly the 1970s, would argue that this is a dangerous time for policymakers to stand aside. Interest rates likely need to rise around the world to reinforce that hard won credibility of central banks as an inflation fighting force. Turkey's current plight offers a salutary contemporary tale of the deleterious economic consequences of lost credibility.

> One of the big concerns at the moment surrounds this idea that we know much less than we need to know about how inflation expectations are formed. These expectations are hard to accurately measure. However, the longer this ongoing hump in inflationary pressure lasts, the more we risk it seeping into our collective consciousness. In this context, it is entirely right the central banks are easing off the accelerator even if, for now, the signs of the rightly feared wage/price spiral are substantially absent.

William Hobbs
CIO, Barclays



A closer Europe?

Amidst all the justifiable gloom, here are potential bright spots for Europeans to reflect on.

The stop start construction of a credible fiscal and political architecture for the Euro has often been spurred by crisis. Here again, we are potentially seeing steps forward as continental Europe tries to address the combined challenges of beefing up its security capability and hastening the energy transition.

The early stages of the pandemic showed how European policy-makers can take huge leaps forward when freed from the need to protect against moral hazard. The move to assemble common fiscal capacity was rightly hailed as a potential 'Alexander Hamilton moment' for Europe. As the Ukraine crisis continues, a similar moment may be gestating with regards to defence spending and the energy transition. While this is currently being dealt with by national governments, it's possible that these efforts could evolve into a more collective approach.

The unfolding refugee crisis is also important of course. In the short term, this is in some part a logistical challenge: how to get medical equipment, food and shelter to people who urgently need it. The financing of this aid will also be important to watch. To what extent will this short term burden be shared across states. In some part, the states bearing the greatest cost are the ones least able to bear it within Europe. Longer term, there are other considerations to think about with regards to how extra workers and new skills interact with the continents potential growth rate.

Many might have expected the trials of the pandemic and a war on its Eastern border to forcibly unravel the European project.
The reverse has so far been the case. The extreme wings of the political spectrum have so far been dampened significantly and a greater unity and European identity has been forged. In many ways, the last few months have highlighted some important advantages of the much maligned liberal democratic model.

> The forces currently pushing and pulling the global, US and European economies are larger than we've seen in a long time. There have been pandemics before of course, but when we incorporate the contemporary technological context and the epic policy maker response, there really is no relevant precedent.
>
> Sadly war is also pretty common in history, but it has been happily absent for a long time on the European continent. The response of German policy makers to this latest crisis is another sign that we are again living through some of those weeks when decades happen

William Hobbs
CIO, Barclays

Section 02:

Regulation

Regulatory change continues apace – particularly in Europe, where developments in the payments landscape are resulting in mounting costs for both new and existing players. The result: while both banks and fintechs would like to focus their money and attention on maximising the value of their customer relationships, this is being held back by the continuing march of regulation.

With that in mind, to what extent does the treatment of banks and fintechs vary in today's regulatory environment? How is the treatment of fintechs evolving? And which regulatory changes do fintechs need to be aware of?

"The payments landscape is undergoing so much change right now, especially in Europe. Alongside changes in market practices, relentless regulatory developments eat up a great deal of the budgets of new and existing players as they impact their payments processes.

Jolanda Schekermans
Head of Product – Europe, Form3

Banks vs fintech

Where payments regulation is concerned, it's important to understand the differences between traditional banks and fintechs, as the treatment of these two types of firms varies significantly.

One major difference is that fintechs are not allowed to hold a settlement account with TARGET2, or with TIPS for the purpose of instant payments. So although these institutions are subject to many of the same rules as banks, for example around ringfencing and AML, they are not able to participate in the payments ecosystem on an equal footing with credit institutions.

Crucially, the European Commission's Settlement Finality Directive (SFD) talks explicitly about credit institutions, whereas the wording of PSD2 refers to financial institutions. This discrepancy was mentioned in the European Retail Payments Strategy as a point in need of review, but there is currently no timeline in place for addressing it. So for the time being, with the SFD in its current form, regulated financial institutions that are not credit institutions cannot hold a settlement account with TARGET2 or TIPS, and therefore cannot participate as Direct Participants in clearing systems.

To overcome this barrier, fintechs must either get a banking license or work with a third party. The challenge with the latter approach is that where instant payments are concerned, fintechs risk losing out on the speed benefits of instant payments, as well as having less control over their liquidity. One solution is the access model provided by Form3 and our banking partner. Using this model, fintechs are able to access connectivity for SEPA Instant and SCT transactions, with the bank – as a dedicated liquidity service provider – enabling settlement and the flow of messages and information as if they were a direct participant.

Corporate customer or financial institution?

The original perception of fintechs as another type of corporate customer no longer fits, as banks now realise what fintechs truly need from their banks.

Beyond the regulatory treatment of banks and fintechs, there are also some notable discrepancies in terms of how these parties work together. Banks originally treated fintechs like any other corporate customer, but this approach does not take account of the significant differences between what corporations and fintechs need from their banks.

Likewise, the integration, servicing and pricing that banks provide to corporate clients will differ considerably from the treatment given to other financial institutions.

With the rise of instant payments, fintechs have evolved and recognised that what they need from banks is more sophisticated. For example, they need to be able to relay detailed clearing information to their own customers. Increasingly, they expect to have the same level of control as banks when it comes to the transactions they do on behalf of customers.

Changes in the pipeline

So which regulatory changes do fintechs need to be aware of?

One notable question is whether or not the use of instant payments is going to become mandatory in Europe. If this were to happen, it would have a significant impact on the industry: parties and countries that have promoted instant payments as a premium service would likely need to revisit their approach, as instant payments would no longer be a differentiator.

Also significant is the planned introduction of the Eurosystem Single Market Infrastructure Gateway (ESMIG), and the consolidation of TARGET2, TARGET2-Securities (T2S) and TARGET Instant Payment Settlement (TIPS) onto a single platform. On the one hand, this sounds like a very positive move, as participants would have a single entry point for all three systems, with a cash management system to follow in due course. But in reality the benefits will likely be limited, as users will still have to work with different user interfaces (UIs) for each of the systems.

A further point of interest is the significance of PSD2 and Open Banking. While Open Banking is an official term in the UK, it's also used to describe developments that are happening elsewhere as a result of PSD2. This area continues to develop: while collaboration between banks and fintechs has improved in recent years, banks are also increasingly waking up to the opportunities the regulation brings for them.

The original intention of PSD2 was to open payment markets to new entrants, by encouraging more competition, providing greater choice and competitive prices for consumers. Increasingly, however, banks are introducing spin-off units as a means of growing, or in fact protecting, market share. What is not yet clear is how quickly these spin-offs will present real competition to innovative fintechs, and indeed what level of innovation bank spin-offs are going to be able to achieve with the budgets available.

Section 03:

Technology and innovation

Over the last few years, European fintechs have evolved significantly and built a place for themselves in the payments market.

Fintechs are by nature heavily focused on technology and innovation – which means they tend to be comfortable operating on the cloud, or integrating APIs into their user interfaces. As such, fintechs are typically very strong when it comes to providing a user-friendly front-end.

But behind the scenes, most of their payment activities will still be based on traditional rails. For example, fintechs will typically make use of correspondent banking services for cross-border payments. As such, the relationship between banks and fintechs continues to play an important part in shaping innovation.

With that in mind, what are the challenges fintechs face as they continue to evolve – and what role will collaboration between banks and fintechs play in shaping the future of Europe's payments landscape?

Growing pains

While fintechs have much to offer, many are also facing a number of challenges and growing pains that will need to be addressed in the coming years:

Diversifying the business model

Many fintechs have started off with a monoline business model – such as making payments into Australia – which they have executed very effectively. At this stage, however, those same fintechs may now be seeking to expand, which requires them to shift to a more diversified business model.

Handling client monies

Fintechs which are involved with payments and e-wallets face a significant challenge when it comes to deciding how best to handle client monies. Without access to the deposit facility at the ECB, fintechs need to leave those funds with commercial banks, which can be problematic in the current liquidity environment. If fintechs are able to lend out money in the same way as fully serviced banks, they may be able to mitigate this issue – but again, this is a question of business model diversification.

Aftermath of Brexit

Until now, fintechs have been able to create a single entity to service all markets in Europe. As the post-Brexit regulatory framework begins to take shape, it's clear that these firms will now need to have two legal entities – one to cover the UK, and the other to cover the rest of Europe. This will involve additional work in the form of creating additional legal entities and getting the right licensing in place – but fintechs may also take the opportunity to consider how best to structure their European businesses.

Client services

For fintechs that have grown very rapidly, there is a risk that their support and servicing models are not yet sufficiently effective to support the size of their operations – which may deter customers from moving all of their business into these fintechs.

Compliance challenges

While the industry continues to innovate and disrupt, regulators still expect organisations to implement sound anti-money laundering (AML) compliance programs or face additional scrutiny and potential fines. FinTechs have historically looked at regulations and compliance as a barrier to entry and an innovation stifler. However, the FinTech industry doesn't have to be scared of compliance. Those companies that put compliance first gain an advantage over their competitors, and are more likely to come out on top in the race to capture market share.

Building resilience in the cloud

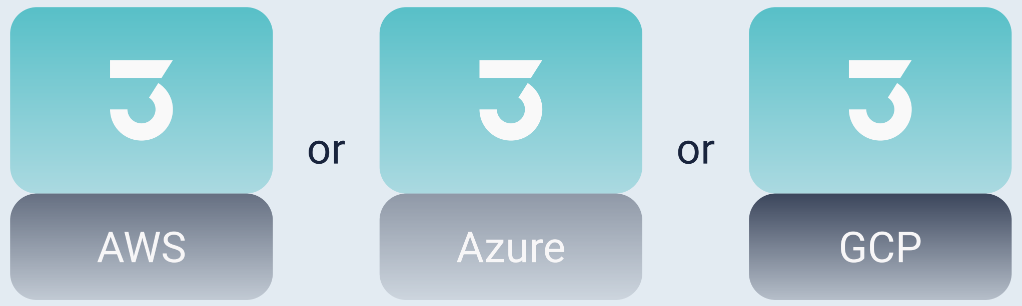
The pressures financial institutions face within payments are increasing the urgency to modernise their critical services through safe and accelerated cloud adoption.

The future direction of travel from a regulatory perspective is taking many forms but one that is becoming a significant agenda topic is that of cloud technology. As crucial operations, such as payment systems, move to the cloud, today's financial services need to be more resilient than ever. Business continuity management has become essential in every function. Operational risks – things that can prevent you from delivering to customers, shareholders and regulators are multiplying. Plus, the impact of getting it wrong is growing. We also see the recent trend where financial regulators and industry oversight boards are casting a closer eye on banks' cloud expansion and watching what new risks these shifts may create.

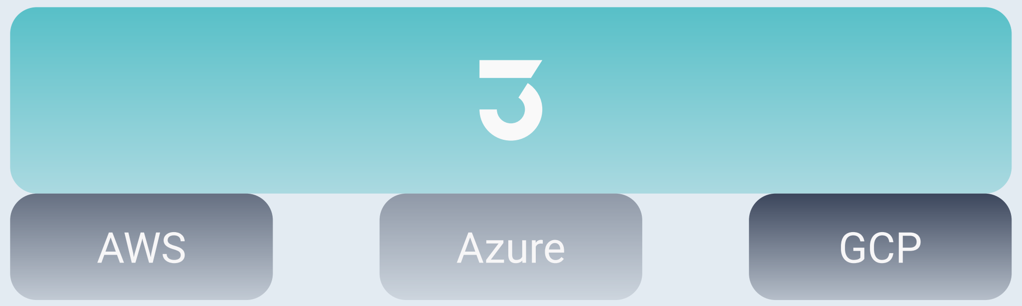
But even with this backdrop in mind we are seeing more and more of our customers looking to move their payment systems into the public cloud. To achieve this there are three main approaches that can be taken. The first option allows them to rapidly move into production and focus on a single cloud provider. However this brings a direct dependancy on this single selected provider. This over reliance on single technology providers is at the heart of what the EU's Digital Operational Resilience Act (DORA) is setting out to avoid due to the implications and question around what happens when a single provider goes down.

The next step in this journey is a cloud agnostic approach. This is where cloud tools not specific to any one provider are used so as to be able to run on a payments stack with any cloud provider. Whilst better this still means having to run individual payment stacks on each cloud provider you wish to connect with. The final approach and one what we believe is the future of cloud payment technology is that of Multi-cloud. Here one single platform is run simultaneously across all public cloud providers. This allows data to run across all platforms in real time. That means payments made in one cloud can instantaneously be monitored in the other. The architecture enables the highest degree of availability with reduced cloud provider concentration risk.

Cloud agnostic



Multi-cloud



Direction of travel

Ten years ago, it was much easier to delineate between traditional banks and fintechs. But today, the line has become much more blurred.

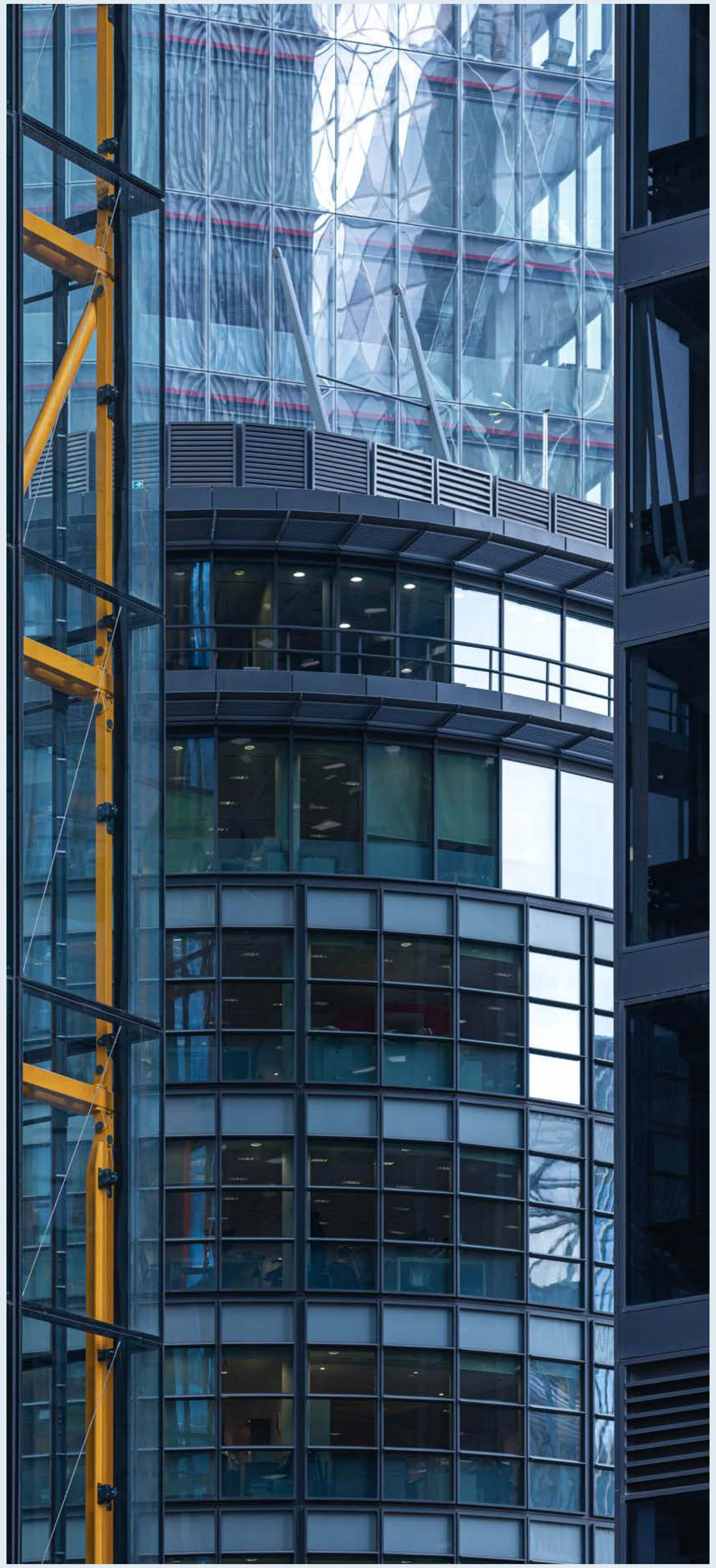
On the one hand, traditional banks are increasingly using agile software development, and the people who work for banks now expect development to progress faster than it has in the past. Fintechs, meanwhile, tend to attract more attention from central banks and become subject to more regulation as they gain more customers and market share – which has the effect of slowing down development.

Much has been written about the benefits of partnerships between banks and fintechs. Increasingly, however, banks are recognising that the starting point for innovation needs to be the specific challenges their customers are facing, and how these can best be addressed – whether that means developing a solution in-house, or collaborating effectively with a fintech.

Looking forward, the impact of Open Banking on these types of partnerships is likely to be significant. In one possible scenario, banks might find they transition to provide the plumbing of the bank industry, with little direct contact with customers, while fintechs are the ones engaging with clients and providing services. Alternatively, banks might use Open Banking in the same way as fintechs, and thereby continue playing a role in front-end client engagement.

> In today's market, fintechs are becoming more like banks, and banks are becoming more like fintechs. At this stage, if you can clearly see the difference between them, that's a cause for concern.

Maarten Lossie
Head of FIG Payments, Barclays



FORM3

Meet the authors

Will Hobbs
CIO, Barclays Wealth & Investments

Maarten Lossie
Head of FIG Payments, Barclays

Maarten van Rossum
Head of FIG Sales, Barclays

Jolanda Schekermans
Head of Product – Europe, Form3

Mike Walters
CPO – Europe, Form3

About us

Our vision is to be the world's most trusted provider of payment technology.

We provide Banks and regulated fintechs across the globe an end-to-end managed payments service that delivers complete payment processing, clearing and settlement to the universe of payment schemes through a single API. Our platform handles everything so you can focus more on serving your customers' needs and less on managing payments infrastructure.

Contact us →