Financial Innovation and riding the Fintech Wave

By: Dr Ziyaad Mahomed & Professor Shamsher Mohamad
Recent success in the technology sector has witnessed the transformation of start-up companies with relatively small or no seed capital into billion-dollar companies within a very short-space of time. The application of technology in the financial sector has ‘disrupted’ the traditional ‘brick-and-mortar’ style distribution channels and if not embraced would cause the current financial sector to lose a substantial (estimated between 20 to 40%) portion of their businesses to the firms using ‘fintech’.

Fintech or financial technology is the application of technology in the financial product ecosystem. This includes financial product administration, vetting, marketing, distribution and supervision. The tremendous speed of fintech development in recent years can be attributed to the advent of new technological applications, faster processing and immense storage capabilities.

Fintech start-ups have increased exponentially since the global financial crisis. In 2015 alone, US$14.5 billion of venture capital was invested into the sector. This translates to a 200% increase year-on-year, from 2013 to 2015. Researchers attribute the recent meteoric rise of fintech startups and the supporting equity contributions as a response to the financial crisis. They note that the 2008 Global Financial Crisis possibly acted as a catalyst to the growth of a new digital era in financial services. The wealth management industry has now ventured into the post-crisis digital revolution with lower transactional costs, challenging physical advisory functions and effectively disrupting the traditional investment distribution channels. Firms that embrace the technology as a solution rather than competition, are expected to be successful in riding the fintech wave and surviving in the digital era.

**The Fintech Ecosystem**

The most recent drive towards technologically-powered financial services has effected change in five broad segments.

1. **Banking and lending**

Traditional banking requires strategic adaptation to deal with fintech developments. Two specific issues impact traditional banking activity when considering fintech disruptors: an alternate banking strategy and peer-to-peer (P2P) lending.

   a. **Adapting banking strategy to deal with disruption**

      Traditional lending is quickly transforming into online distribution channels as banks are gearing up to challenge new fintech start-ups. It is estimated that between 30 and 80% of branch utilization will be reduced in the coming decade. This will decrease more expensive over-the-counter transactions and shift even more transactions to virtual digital platforms. In order to remain competitive, banks have adopted new product solutions that utilize virtual channels and mobile or online delivery. ‘Digital readiness’ or IT capacity for adopting new technological platforms become crucial to traditional bank survival in the near future. As software becomes more open-source, programming units have opportunity to mold them to suit specific sector needs.

   b. **P2P lending**

      The process of P2P lending allows interested parties to lend to each other on mutually agreed terms over an online platform. The rapid growth of the application extends beyond the innovative use of technology. Fintech platforms provide customers with a seamless experience that is focused on an objective evaluation through an easily accessible interface. P2P lending in the Asian region is at a nascent stage. However, P2P start-ups - Lufax and Jimubox in China - have already achieved in excess of US$1 billion in valuations. Milne
and Parboteeah (2016) list four categories of advantages that P2P lending offers over traditional bank lending:

i. Higher returns than bank deposits for lenders, with low fees
ii. Easier access to financing
iii. Perceived higher ethical contribution of P2P
iv. Rapid technological innovation.

2. Payment and Fund Transfer
Accessibility to mobile and smart phones have driven change in the payment and fund transfer sector, by enabling vendor payment gateways to recognize them through free downloadable applications. Using concepts like digital wallets where online details to accounts are stored, or simply transferring airtime to a vendor as an instant payment reduces the role of traditional banks even further. These services and apps have brought along new risks in security, although customer-demand for convenience and accessibility has forced providers to enhance security protection whilst improving the overall customer experience.

3. Investment and Wealth Management

a. Crowdfunding
Digital crowdfunding platforms can be traced back to informal micro-finance ventures that attract small equity contributions for an entrepreneurial activity.

b. Robo-Advisors and Wealth Management
Investors have always sought the advice of professional financial advisors for the placement of their funds. Whilst the investor’s objective of minimizing risk for maximum return has not changed, the delivery of financial advice is being revolutionized through a digital platform: either a fully automated ‘robo-advisor’ or a technology-assisted advisory service. They aim to offer a unique client experience: through a series of questions, the program (robo-advisor) determines an investor risk profile and recommends a portfolio based on the type of securities expected. Future wealth management solutions will be more sophisticated and more cost-efficient than traditional methods.

4. Insurance
A recent PwC survey on fintech application in the insurance sector indicated that self-directed service is the most notable trend in the near future. Although most of the larger insurance companies provide online quotes and claims, the user experience is not always as efficient as the customer expects. Sophisticated digital channels with smartphone capabilities will provide more customer-centric solutions with the objectives of speed, accuracy, understanding of unique cases and post-transaction support. Whilst human intervention is not expected to cease, the existing insurance market will be significantly enhanced with the new solutions.
5. Blockchain technology
At the beginning of 2009, blockchain technology was used to create a cryptocurrency by an anonymous developer, famously known as ‘Bitcoin’. By 2016, the market capitalization of approximately 600 cryptocurrencies were monitored, although Bitcoin remains the most dominant. For a digital currency to exist, its credibility cannot be compromised. Therefore, a decentralized or shared database of ‘tokens’ must be stored such that none can be replicated but rather transferred and owned.

Blockchain technology is being applied to more solutions both in the corporate and government sector. The UK government for example, has recently approved a blockchain provider for public sector organizations, introducing distributed ledger technology (DLT) to everything from health services to financial regulation.

Islamic Wealth Management and Fintech

Malaysian initiative
The Islamic finance sector has been growing at a steady rate globally, although many countries are yet to offer a full product suite to their customers. Malaysia however, is established as a pioneer in the field of Islamic finance since the 1960’s (Tabung Haji). Another milestone for Malaysia was the introduction of the first Islamic interbank investment platform (IAP) in 2015. The IAP was developed with the vision to allow cross-border investment and funding through a multi-currency channel that will eventually link with global markets. Individual, corporate and institutional investors channel investment funds through Islamic banks (due diligence and finance customer assessment filtering) to provide financing to approved customers that apply online. The investment platform is the first Islamic fintech solution offered by a consortium of six Islamic banks, indicating the willingness for Malaysian Islamic banks to embrace the fintech revolution and ride the wave.

The Securities Commission (SC) of Malaysia, under an initiative known as the Alliance of FinTech Community or ‘afFINity@SC’, has also been active in preparing regulation that will allow for fintech solutions to operate more seamlessly in the country. The initiative includes:

i. Creating awareness and catalyzing innovative fintech solutions
ii. Forming clusters to organize and nurture a wider fintech ecosystem, and
iii. Providing policy and regulatory clarity that is conducive for innovation.

The objective of the framework, is to enable a variety of company forms to participate and access market-based funding through a digital platform. In September 2016, the SC confirmed that selected and approved P2P entities will be announced within a few months, with six registered equity crowdfunding platforms that have already begun fundraising. The Equity Crowdfunding/P2P financing framework was issued in early 2016.

Malaysia is well-poised to benefit from the fintech wave as it has already introduced regulation for P2P and crowdfunding. Most recent regulation ensures that product testing is conducted in a controlled environment with sufficient monitoring and supervision, before going to market. These strategic initiatives will serve to enhance customer confidence and attract more players into the Malaysian market.