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THE FUTURE OF SHADOW BANK AND FINTECH LENDING IN AUSTRALIA: CURB YOUR ENTHUSIASM

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Abstract

Australia's shadow bank sector – which includes most fintech lenders – remains small by global standards. The phased introduction of Open Banking and Comprehensive Credit Reporting is expected to foster innovation and provide growth opportunities for fintech firms. Big technology firms with well established brands and access to granular user data are also likely to contribute to growth in fintech lending. Nonetheless, our key contention is that institutional and policy developments – notably the extension of regulation to address significant consumer detriment in the provision of short-term credit and a desire to contain systemic risks to the financial system stemming from regulatory arbitrage – will likely impose a constraint on the size of fintech lending and shadow banking more generally.

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Introduction

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, chaired by Mr Kenneth Hayne, carries few direct implications for shadow bank and fintech lenders because most of the allegations of misconduct were investigated and documented among authorised deposit taking institutions (ADIs). Nonetheless, the Royal Commission contains recommendations related to areas that are pertinent for all financial services firms including fintech companies: trailing commissions in the provision of financial advice and mortgage broking services, culture, governance and remuneration. Moreover, during and since the Royal Commission, there has been a renewed focus on regulatory solutions to address significant consumer detriment and achieve better consumer outcomes in the provision of short-term consumer lending.

This study focuses on current developments and future prospects for shadow bank and fintech lending.[1] The focus on lending rather than non-lending activities reflects space constraints as well as the relative economic importance of lending in the economy[2], particularly as fintech appears to have become synonymous with disruption in the provision of lending.[3]

The prospects of shadow banks and fintech lenders are likely to be subject to various countervailing forces. Although we expect innovation and disruption to underpin rapid growth in shadow bank and fintech lending - from a low base – three factors are likely to cap the relative size of non-regulated lending. First, shadow banks and fintech lenders will continue to be at a competitive disadvantage to ADIs with respect to access to an important and cheap source of funding, namely customer deposits. Second, there will be less scope for shadow banks and fintech lenders to capitalise on regulatory arbitrage as the Australian Securities and Investments Commission (ASIC) expands its authority over previously lightly-regulated areas, including short-term consumer lending and buy now pay later (BNPL) arrangements. Third, from a macro perspective, policymakers' desire to manage and contain systemic risk is likely to continue to stifle competition in the finance sector.

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[1] We therefore do not discuss the prospects for non-lending activities undertaken by fintechs, including the use of technologies to facilitate mobile or online payments, money transfers and automated or robo-financial advice.
[2] As of 31 December 2018, the eight institutions classified as 'Banks' by the Industry Classification Benchmark, account for no less than 65% of the total market capitalisation of the Financials sector in the ASX200. The next largest sector is 'Investment banking and brokerage services' (22%).
[3] See for instance, McKinsey (December 2018).

Defining shadow banking and fintech

Broadly defined, ‘fintech’ refers to the integration of technology and finance. Conventional banks and financial institutions obviously engage in fintech. The application of information processing technologies to the provision of financial services is not a new phenomenon; it has taken place among traditional financial institutions for over five decades (Arner, Barberis & Buckley 2016).

Nonetheless, the industry convention – which we adopt in this study - is to think of fintech activity as occurring primarily among young start-ups and established technology firms that do not have a bricks and mortar presence, such as networks of physical branches (Goldstein, Jiang & Karolyi 2019).

We adopt the convention of treating fintech lenders as shadow banks, which are non-ADIs that are involved in credit intermediation.[4] The key distinction between shadow banks and ADIs lies in the liability side of the balance sheet; shadow banks can rely on the same sources of funding as ADIs – including retained earnings, wholesale debt markets, hybrid debt and equity instruments and shareholder equity – except for customer deposits.

Fintech lending holds out the promise of disrupting the provision of traditional financial services through both intermediated and disintermediated solutions. Digital or neo-banks offer prospective borrowers the ability to fill out a loan application completely online, while online payday lenders provide immediacy in terms of the funds lent, often making the loan amount available on the same day. Online marketplaces such as peer-to-peer and crowd-funding platforms, represent solutions that involve lighter touch intermediation by matching borrowers with investors via a common digital platform (Davis & Murphy 2016). In future, blockchain or distributed ledger technologies might offer a completely disintermediated solution.

Open Banking and fintech disruption

High switching costs represent a key barrier to strong competition in banking. The time investment and related inconvenience associated with moving savings accounts and/or loans to another bank or financial institution is a deterrent for most customers. On 1 August 2019, both houses of Parliament passed the Treasury Laws Amendment (Consumer Data Right) Bill 2019, which confers a right for consumers to get access to any information and data in relation to them held by businesses in banking, utilities and telecommunications. The Consumer Data Right (CDR) is designed to encourage and promote choice, convenience and competition in these areas. Open Banking is the application of the CDR to banking, with the aim of empowering consumers with more information and greater flexibility to compare their current offering with accredited and trusted third parties, with whom they choose to share their data.

Borrowers will be empowered to instruct their bank to share their credit card, mortgage and personal loan details, and transaction histories with accredited entities such as product comparison websites, to identify if a similar product at lower cost or a superior product at comparable cost can be offered (Bullock July 2018). The ability for big data technology to process this information efficiently suggests that fintech firms will help to foster innovation, disruption and competition in a shared information environment.

The phased introduction of Open Banking will occur against a backdrop of comprehensive credit reporting (CCR), which mandates that all relevant credit history be disclosed to credit providers. Historically, most of the information that could be shared was largely negative information, which related to late payments and defaults. CCR ensures that all relevant information be used by credit providers – including fintech lenders - to assess a person’s credit worthiness, including positive information about their credit history.

In recent years, large technology companies in the United States, such as Paypal and Amazon have emerged as new entrants in the fintech lending space, offering loans and trade finance targeted to creditworthy, small and medium enterprises that use their platforms. Platform providers have access to granular and valuable information such as sales and transactional data that may not be readily available to other prospective lenders. As long as these online marketplaces remain popular, it would be reasonable to expect this source of finance continues to grow rapidly. These loans are currently funded from these firms’ balance sheets, which raises pertinent questions around whether they should be subject to some form of capital regulation in due course, which we explore in more detail below.

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The dark side of fintech

Fintech lenders have focussed on small personal loans and mortgage lending. These loans are more homogeneous than business loans and rely heavily on 'hard' sources of information around creditworthiness; information which can be easily communicated online and processed quickly.

Business lending, by contrast, is relationship intensive and relies more on 'soft' information, which is often textured and difficult to easily process and quantify (RBA September 2014; Stein 2002).

Digital banks benefit from low a cost structure thanks to the innovative use of technology to process hard information and the fact that they do not have the overheads associated with managing legacy systems or physical branches (Bullock July 2018). Fintech lenders not only have a cost advantage but they also leverage technology to offer greater convenience and immediacy of loans.

The fast track applications of some short-term lending models are exempt from the responsible lending provisions of the National Credit Act, which imposes caps on costs payable for short-term credit products. This allows the lender to charge borrowers exorbitant financial supply and account fees to obtain 'credit'. ASIC has proposed using its new product intervention power to remove this exemption (ASIC July 2019).

Some fintech lenders advertise low headline interest rates but with a sting in the tail: high establishment fees, and high default and late payment fees. Having accessed five online short-term credit lenders on Friday 15 July 2019, we obtained estimates of the weekly repayment and number of repayments based on a loan of $2,000 with the term ranging from 13 weeks to 52 weeks. The implied interest rates ranged from 120% p.a. to 220% p.a., which includes establishment or set up costs but does not incorporate default fees.

The consumer protection provisions of the National Credit Act also do not apply to BNPL activities, which allow a consumer to buy and receive the good or service immediately but pay for the purchase over time (ASIC November 2018). BNPL providers charge a small fee or no fee to consumers – as long as consumers meet their scheduled payments – but charge the retailer around four per cent of the purchase price. ASIC has found that some terms of BNPL contracts are potentially unfair to consumers: the providers have unilateral discretion to vary the terms of the contact and they provide for a wide set of circumstances that trigger consumer 'default' (ASIC November 2018). Because of the small fees levied on consumers, BNPL arrangements are not considered to be a provision of credit and are therefore exempt from the responsible lending provisions of the National Credit Act. Consequently, BNPL vendors have little incentive or obligation to assess the creditworthiness of users.[5]

ASIC is considering using its new product intervention power to extend its regulatory authority over BNPL arrangements and the provision of short-term credit, as part of its renewed focus to address and prevent significant consumer detriment. We view this as a welcome development. Firms will no longer be able to exploit loopholes in the National Credit Code to avoid responsible lending provisions, which should assist in reducing the incidence of 'at risk' borrowers getting caught in a vortex of debt repayments.

[5] According to ASIC, only one in six BNPL vendors examine prospective customers' creditworthiness, based on questions around income and existing debts (ASIC November 2018).

Shadow bank and fintech mortgage lending in Australia and offshore

Mortgage lending has attracted fintech firms because the processing of home loan applications tends to be intensive in the use of hard information to assess a borrower's creditworthiness. The application process can be undertaken completely online.

In the United States, fintech mortgage lenders have increased their market share to 8% in 2016 from 2% in 2010; they process loan applications ten days faster (20%) than traditional lenders but this does not come at the cost of higher default rates (Fuster et al. 2019). Relative to other shadow banks, fintech mortgage lenders in the United States charge a premium of around 15 basis points for their home loans and cater to more creditworthy borrowers, suggesting that borrowers value convenience over price (Buchak et al. 2018). Buchak et al. (2018) show that there has been a migration of lending to shadow banks more broadly as traditional banks have become more subject to regulatory constraints, with shadow banks lifting their share of mortgage origination to 50% in 2015 from 30% in 2007.

A tightening of capital adequacy standards facing Australia's major banks in recent years – particularly for mortgages – has not been associated with a migration of home borrowers to shadow bank and fintech lenders.[6] The size of Australia's shadow banking sector remains small by global standards, with shadow bank lending accounting for 7% of all financial assets in 2017 and less than 4% of housing credit, well below their respective peaks in 2007 (Gishkariany 2017).

Institutional and regulatory constraints likely to dominate disruption from fintechs

Policy makers' concerns around systemic risk represent a key constraint on the future growth of shadow banking and the fintech sector. A key lesson that prudential regulators around the world have heeded from the financial crisis is to better manage the systemic risks posed by the growth of shadow bank lending. In the United States, shadow banks' excessive leverage, their securitisation of poor quality assets and limited access to central bank liquidity exposed fault-lines in the financial system. The RBA has stated that growth in shadow bank lending could potentially pose a risk to financial sector resilience (Gishkariany 2017). This view is shared by a former member of the Board of Governors of the Federal Reserve, Mr Daniel Tarullo, who draws attention to the systemic risks posed by shadow banking. *"…the current regulatory framework does not deal effectively with threats to financial stability outside the perimeter of regulated banking organizations, notably from forms of shadow banking."* (Tarullo 2019). Further growth in lending to small and medium sized enterprises from large technology companies with funds sourced from their balance sheets, could also attract the attention of prudential regulators, concerned that this form of shadow bank lending could pose systemic risks to the financial system and the real economy.

We identify two additional regulatory and institutional developments likely to constrain the size of shadow bank and fintech lending in Australia. First, non-regulated entities will remain at a competitive disadvantage to regulated entities in terms of access to low cost funding, notably government guaranteed customer deposits. For non-ADI firms that are ASX-listed, a prolonged period of market turbulence could undermine an important source of funding precisely when they need additional loss-absorbing capital the most. Second, ASIC's proposed extension of its product intervention power to previously lightly regulated areas will limit the ability for fintech lenders that dominate this space to continue to benefit from regulatory arbitrage.

[6] In 2017, APRA announced a series of macro-prudential policies, designed to curb lending to housing investors, particularly for interest only loans. Separately, it lifted minimum risk weighted capital ratios and assigned higher risk weights to residential mortgages for Internal Ratings Based (IRB) accredited banks.

Conclusion

Fintech firms are at the forefront of the information revolution in finance and related sectors. The revolution is not all just about the technology of big data reducing the costs of efficiently processing large amounts of granular user and customer data. It is as much about the phased introduction of Open Banking, which will reduce the institutional barriers to information sharing between industry players. Fintech firms will continue to innovate and disrupt, some in collaboration, others in competition with conventional banks.

Despite these developments, we believe that a number of regulatory factors are likely to limit competition in financial services and cap the size of the fintech sector and shadow banks in Australia. ASIC is narrowing the scope for fintech lenders and shadow banks to engage in regulatory arbitrage because of heightened concerns around addressing significant consumer detriment in light of the findings of the Hayne Royal Commission. Moreover, ADIs will continue to enjoy a competitive advantage in relation to access to low cost funding. Finally, our analysis highlights the trade-off that policymakers face between encouraging competition in financial services and containing systemic risks within the financial system.

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