The future of shadow bank and fintech lending in Australia: Curb your enthusiasm

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Abstract:

A number of key policy developments, including the phased introduction of Open Banking and Comprehensive Credit Reporting, are expected to foster innovation and provide growth opportunities for fintech lenders. Big technology firms with strong brands, and access to granular data sourced from their well-established platforms are likely to also see growth in fintech lending. But our key contention is that institutional and policy developments – notably a stated intention for policymakers to extend regulation to the provision of short-term credit and Buy Now Pay Later arrangements and a desire to contain systemic risks to the financial system stemming from shadow banking – will impose a constraint on the growth of shadow bank and fintech lending.

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Introduction

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry carries few direct implications for alternative and fintech lenders because most of the allegations of misconduct were levelled at, or documented, among regulated financial entities. Nonetheless, in the lead up, during and following the Royal Commission, there was and has been a focus on regulatory solutions to address consumer detriment and achieve better consumer outcomes. This represents a shift from the focus on financial system resiliency during the Financial System Inquiry, whose final report was released in 2014. Given the word constraint, we confine our discussion to four implications of the heightened regulatory focus on consumer outcomes for alternative and fintech lenders.

- The use of ASIC's proposed product intervention power as applied to payday and small amount consumer lending activities, and Buy Now Pay Later (BNPL) arrangements.

- Robo-advisers have emerged at a time when the Hayne Royal Commission has drawn attention to the conflicts of interest in the provision of financial advice. We discuss the limited research undertaken on the performance and characteristics of these low cost, portfolio optimising investment vehicles.

- We discuss the sources of growth in shadow banking and fintech lending to date and how disruption in this space is expected to continue, reflecting rapid technological advances, the introduction of Open Banking and Comprehensive Credit Reporting, and the ongoing encroachment of large and well-established technology firms into the provision of financial services.

- Nonetheless, our key contention is that policymakers' desire to carefully manage systemic and contagion risk within the financial system will impose a limit on the growth and size of shadow banking and fintech lending.

Defining fintech

'Fintech' broadly refers to the integration of technology and finance. Much of this activity is occurring among young start-ups and established technology firms (Goldstein, Jiang & Karolyi 2019). But the application of information processing technologies to the provision of financial services is not a new phenomenon; it has been taking place among traditional (ie. regulated) financial institutions for over five decades (Arner, Barberis & Buckley 2016).

Fintech lenders offer prospective borrowers the ability to fill out a loan application completely online. They hold out the promise of disrupting the provision of traditional financial services through both intermediated and disintermediated solutions. Blockchain or distributed ledger technologies offer a completely disintermediated solution. In contrast, online lenders (including payday lenders and mortgage providers) and online marketplaces (including peer to peer and crowdfunding platforms) represent solutions that involve lighter touch intermediation than traditional financial institutions (Davis & Murphy 2016).

Fintech firms also encompass non-lenders, such as those that use technologies to facilitate mobile or online payments, cross border payments and money transfers more generally, and robo-investing.

The dark side of fintech

Online lenders (also known as digital or neo-banks) have typically focussed on small personal loans and mortgage lending. These loans are more homogeneous than business loans and rely heavily on 'hard' source of information. Their processing and distribution lend themselves to the use of information technologies. Business loans in contrast, rely on softer sources of information and are typically more relationship intensive (RBA September 2014; Stein 2002).

These digital banks benefit from low cost 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). These fintech lenders not only have a cost advantage but they also leverage technology to offer greater convenience and immediacy of loans. For instance, *HomeLoan Experts* advertises that if a borrower meets certain conditions around credit worthiness, they can expect to hear back within three days from the time of lodging their online loan application (https://www.homeloanexperts.com.au/home-loan-articles/how-long-to-get-approval/).

This convenience can be a double edged sword. Having accessed five online short-term credit lenders on Friday 15 July 2019, I was able to obtain an estimate 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. I computed the implied annual interest rates to range from 120%pa to 220%pa. The implied interest rates calculated do not incorporate the impact of default fees. Some of these lenders advertise 'low' interest rates but with a sting in the tail: high establishment or set up fees and high default and late payment fees. Applicants can fast track the application to receive the money on the same day.

The fast track applications of some of these business models are exempt from the National Credit Act which imposes caps on costs payable for these short term credit products. In effect, the borrower is being charged significant financial supply and account fees to obtain 'credit'. ASIC has proposed to use its new product intervention power to remove this exemption (ASIC July 2019).

The consumer protection provisions of the National Credit Act also do not apply to buy now pay later arrangements, which allow a consumer to buy and receive the good or service immediately but pay for the purchase over time (ASIC November 2018). The providers typically charge a small fee or no fee to consumers – as long as consumers meet their scheduled payments – but charge the retailer. Because of the small fees levied on consumers, the arrangement is not considered to be a provision of credit and are therefore exempt from the responsible lending provisions of the National Credit Act. Therefore at present, the BNPL providers have little incentive or obligation to assess the creditworthiness of users. ASIC is considering using its proposed product intervention power to resolve any significant detriment to consumers arising from BNPL arrangements.

The rise of the robo-adviser: A triumph of Modern Portfolio Theory

In anticipation of, and in response to the recommendations of the Hayne Royal Commission, Australia's major banks have divested or sold their wealth management businesses (or have flagged to the market their intention to do so). The Royal Commission and Financial System Inquiry highlighted the conflicts of interest in the provision of financial advice within vertically integrated wealth management business models. The Royal Commission drew attention to various case studies where customers with low levels of financial literacy were particularly vulnerable and suffered significant detriment arising from the distorted incentives inherent in this model. Customers were encouraged to purchase wealth management products that they did not understand, with high fees and higher than desirable levels of risk.

Robo-advisers offer a light touch and low-cost vehicle for customers to access wealth management products. Robo-advisers do not suffer from conflicts of interest because they do not have affiliation with wealth management product manufacturers and do not pay trailing commissions. Many have developed automated portfolio optimisers, where various assumptions around asset class return and risk characteristics are combined with a risk aversion parameter to arrive at an optimal asset allocation. Robo-advisers such as Six Park use exchange traded funds to give the customer exposure to the asset classes consistent with the optimal allocation.

The key interaction between the robo-adviser and the customer is the use of an online survey or a meeting to facilitate an understanding and calibration of the customer's risk aversion parameter to be used in the optimiser.

The limited research in this area suggests that users of robo-advisers are more sophisticated or more involved in the management of their portfolios, are wealthier than non-users, and for previously undiversified investors, adopters benefit from more diversified portfolios and higher risk adjusted portfolio returns (D'Acunto, Prabhala & Rossi 2019).

Against the backdrop of a consumer drive focus on low cost solutions and regulatory focus on conflicts of interest in the provision of financial advice, we believe that robo-advisers represent a key disruption to the financial planning space and wealth management space more broadly. Because they are not leveraged vehicles, they are unlikely to pose a risk to systemic stability of the financial system and are therefore not expected to attract the attention of either APRA or the RBA.

Shadow bank and fintech mortgage lending remains small in Australia

As mentioned above, 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, that can be easily communicated online and processed quickly. 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)also show that there has been a material 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.

Has a more stringent regulatory environment facing Australia's major banks - particularly in the provision of mortgages - been associated with a migration to shadow bank and fintech lenders? The Australia's major banks have faced a number of regulatory headwinds in recent years, relating to a tightening of macroprudential policies designed to curb lending to housing investors, as well as a lift in APRA recommended capital ratios and higher risk weights attached to residential mortgages. But the size of Australia's shadow banking sector remains small by global standards. Shadow bank lending accounted for 7% of all financial assets in 2017, and mortgage lending by shadow banks was less than 4% of housing credit, well below their respective peaks (Gishkariany 2017). In contrast to the evidence presented for the United States in Buchak et al. (2018), there has not been a significant migration in lending to shadow banking and fintech lenders in Australia.

The present and future of fintech lending – Institutional constraints outweigh disruptive technology

Policy makers' desire to manage shadow banking - including fintech lending – because of concerns around systemic risk represent a key constraint to the sector's future growth. A key lesson that prudential regulators globally took from the financial crisis was to better understand and manage the systemic risks posed by growth of shadow bank lending. In the United States, the securitisation of poor quality assets by shadow banks, their excessive leverage and limited access to sources of central bank liquidity exposed fault-lines and vulnerabilities in the financial system. The Reserve Bank has enunciated that growth in shadow bank lending could potentially pose a risk to financial sector resilience (Gishkariany 2017).

A former member of the Board of Governors of the Federal Reserve, also 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).*

Other constraints revolve around the fact that shadow bank and fintech lenders will remain at a competitive disadvantage to regulated entities in terms of access to low cost funding, notably short term wholesale debt markets and government guaranteed customer deposits.

This is not to deny that fintech holds out promise to improve access to finance from small and medium sized businesses, particularly when implemented by large technology companies with strong brands and well established platforms. Fintech lenders will also continue to focus on activities that involve less onerous regulation, although we have documented that ASIC is looking to use its proposed product intervention power to have jurisdiction over previously unregulated areas, including short-term credit provision and BNPL activities.

Other policy developments such as the phased introduction of Comprehensive Credit Reporting and Open Banking should foster innovation and offer opportunities for fintech lenders, particularly with the application of big data technology. The anecdotal evidence to date is that fintech firms are more inclined to collaborate than compete with traditional banks (Commission 2018). It remains to be seen if this trend continues with these developments.

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