Banking on Competition

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Financial services innovations are popping up all around the world. They range from mobile money services like mPesa that are putting basic banking services in the hands of households who never had them, to virtual currencies such as Bitcoin that are reducing the transactions costs of paying people around the world, to online providers like PerkStreet that are providing people alternatives to traditional banks, to innovative small business lenders like Kabbage. These innovations could revolutionize many aspects of the financial services industry including traditional retail banking and lending.

Virtually all of these innovations are coming from outside—often well outside—the traditional financial services industry. Unfortunately, and herein lies the problem I want to talk about, they all live, but for the grace of God, at the mercy of financial services laws and regulators.

mPesa is a case-in-point. It was started by Safaricom, the dominant mobile network operator in Kenya, and not by a bank. As it happens, the Kenyan government didn't require mPesa to go through the hurdles of banking regulation, including getting a banking charter. What mPesa, and others who have tried to mimic its success, have found in other countries is that most governments insist on imposing banking regulations on these mobile money firms or require that they partner with a bank. When that happens the mobile money firms either don't get off the ground at all or don't secure anything like the rapid ignition that mPesa obtained in Kenya.

FaceCash is another example. This Silicon Valley startup developed a mobile payments scheme based on the iPhone. Not long after it went into beta mode and started trials in shops in Palo Alto, and elsewhere, the State of California shut it down. FaceCash as it turned out didn't have a money transmittal license. It found that it was pretty much impossible to get one. Many startups in California are finding the same problem and have started lobbying the State for relief.

Ironically, the very same regulations that governments have put in place to protect society from banks behaving badly and to protect consumers from unscrupulous financial service providers are standing like an enormous dike in front of a wave of creative destruction that could disrupt traditional financial services. The banks have their charters, their army of compliance officers, and know how to navigate the increasingly complicated regulatory environment. So do other large financial services companies. Not so even very well funded startups. In the current environment they can't engage in the trial-by-error, rapid experimentation, lean startup approach that has become standard practice these days. Some try to get as far as they can by just ignoring the regulations—figuring that paying fines and lawyer bills if they are successful beats sure death today.

Last week, the UK's FSA and Bank of England at least recognized this problem and have taken a step—a very small one in my view—towards remedying it. For those readers who do not follow UK banking, the government and various regulators have been complaining for many years about how horribly UK banks serve consumers and small businesses. Nothing they've tried seems to have done much but they keep trying. To help stimulate entry, the UK relaxed capital requirements so applicants for bank charters would have to have capital of only 4.5% of assets compared to 7-9.5% for incumbent banks under the existing rules. That's a start for sure. However, I don't think any entrepreneurs in Silicon Roundabout who were thinking about financial services innovation were bouncing off the walls at the pubs when that was announced. Getting a bank charter and dealing with regulatory requirements is simply a nonstarter for most new ventures.

From a social welfare standpoint, and no offense to my British friends, but I'm at least not losing any sleep over the UK. No one is going to die in London from bad banking services. It is more like being really annoyed as John Fingleton acutely described concerning his recent foray into setting up a small business account.

Sadly, that's actually not true in a good part of the world now. There are many undeveloped and developing countries where people are barely able to survive. And part of the reason is that they do not have very basic banking services that enable microbusinesses to get paid and for people to move money efficiently around the country. mPesa in Kenya for example has, in fact, improved the day-to-day lives of Kenyans and allowed the country to leapfrog the development of a banking system. It really isn't hard to imagine in these circumstances that mPesa actually has made the difference between living and dying for some people. There are now many places, including India, where banking regulation makes it very difficult to deploy these sorts of innovations.

Governments will need to find a way to lower—massively lower—financial services regulatory barriers to entry to increase competition in the provision of financial services and to permit innovation to sweep this industry, as it is so many others. This is, of course, a difficult problem to deal with. A lot of banking regulations serve legitimate purposes. It also seems unfair, and perhaps even inefficient, to impose increasingly severe regulations on banks while making life easier for all the entrants that want diminish incumbent players if not kill them off entirely. Nevertheless, the social welfare gain of lowering these regulatory barriers to entry is likely to be absolutely massive. It is time to lower the dike and use competition to promote better financial services.