A wave of financial tech firms is shaking up the world of banking

February 4 2015, by Carla Bonina

Digital technology and pervasive access to the internet have reshaped many industries, and banking is no exception: Hampden and Co is the latest in a short but growing list of digital-only banks built not of bricks and mortar, safes and strongboxes, but which instead operate entirely virtually in the realm of cloud computing.

Fidor Bank in Germany implements web 2.0, e-commerce and gaming features together with mobile internet access to provide a seamless service. From the adoption of virtual currency payments to Facebook campaigns to increase interest rates for savers, Fidor Bank is a great example of how the banking industry is being shaken up.

Historically the banking sector was innovative, but has become moribund. Mainstream banking in developed economies has dragged its heels to adopt new services, in part due to the inflexibility of their legacy information systems.

But the wave of changes that followed the 2008 financial crisis has put pressure on the sector to meet more stringent requirements of transparency and consumer choice. At the same time, the availability of increasingly cheap cloud computing and storage, business analytics and speedy mobile internet on smartphones allows for the creation of new businesses that were unthinkable only a few years ago.

Re-inventing the wheel

So while the big banks are taken to task for their lack of innovation and dull or unreliable online services, a new landscape is being carved out by smaller competitors and other financial services companies. Known as "fin tech" firms, they are upping the game and driving change faster through the otherwise staid financial services industry. For example, in the UK:

- Crowdfunding sites that help entrepreneurs to raise cash from the public in forms of donation, and rewards (Kickstarter, Indiegogo, Crowdfunder) or even equity (Crowdcube, Seedr).
- Peer-to-peer lending platforms, which matches lenders to individual borrowers (Ratesetter, Zopa) or companies looking for cash to invest or expand (Funding Circle), or those creating a new marketplace for mortgages (LendInvest).
- Online investment tools for wealth management (Nutmeg)
- Currency trade systems based on mobile and cloud technology (The Currency Cloud, TransferWise).

Take the example of booming crowdfunding and peer-to-peer lending, an industry worth £1.2 billion in the UK. Peer-to-peer lending is a way of obtaining a loan via small contributions from a large number of lenders. It relies on online platforms that, together with powerful algorithms for risk analysis and tools to connect with social media channels, can bring together funders who spread over various geographical locations. In part, its digital only strategy makes this business viable, as this significantly reduces the cost of communicating and accessing information about both lenders and borrowers' reputation and credit reliability.

These fin tech companies are great examples of how digital tech is being put to new uses, in stark contrast to most established banks. The lack of large legacy systems is an advantage, as adjustments to new features of their products or services can be performed rather quickly and with more agility. Of course they do not also rely on retail locations, large physical offices, or even buying and maintaining their own hardware.

The future of digital banking

How likely is all this to shake up the established order? Recent figures from Nesta show the crowdfunding market more than doubled to £1.74 billion between 2013 and 2014, but this is only 2.4% of the business lending market.

However, even if the niches that fin tech companies colonise do not seem to directly threaten established financial companies, they introduce alternatives to well-established ways of doing business. Perhaps one of the biggest threats comes from digital giants such as Apple, Google or Facebook who are moving into the financial sector, either with new products or by acquiring fin tech start-ups.

Technology and new businesses also challenge assumptions about how financial services might be governed and regulated in the future. For the most part the boundaries between regulated and unregulated practices are not disputed. However, recent responses to virtual currencies such as Bitcoin and the financial advisory functions of some firms seem to prompt national and international regulators for a response.

These new businesses and their models could develop in a number of different ways. They could be largely absorbed into established elements of the financial sector, however reformed, through acquisition or by becoming part of a value chain with established firms. Alternatively, fin tech firms could extend their services to challenge the high street banks, aiming to become the answer to the criticisms levelled at today's financial services sector.

In any case 2015 is, like recent years, shaping up to be a very active and interesting year for a sector where change is not generally kindly regarded.

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