Issues Impacting FinTech

Submission

James Bligh, October 2019

Executive Summary

This submission has been written in response to the Select Committee on Financial Technology and Regulatory Technology to provide some issues and frameworks that the Committee may consider in framing their activities.

RedCrew is actively engaged in the sectors covered by the work of the Committee and provides support to organisations of all sizes in financial services. In addition, the author – James Bligh – has a long history of driving innovation in the financial services both inside and outside the major financial institutions in Australia. Most recently this included leading the standards development process for the Consumer Data Right regime being developed by the Federal Government.

The specific goal of the document is to provide a series of frameworks and avenues of investigation that could be of use to the Committee in shaping their work.

The key concepts proposed in this document are:

- **Startup Lifecycle as a conceptual framework** – When investigating the success of existing reforms and proposing new programmes or policies it may be useful to frame these in the context of the generic journey of a startup transforming into a sustainable, internationally active business.

- **Key concerns facing FinTechs** – A series of specific concerns facing FinTechs.

- **Passive support from government** – Opportunities for the government, in the normal course of operation, to support the development of new services and businesses.

- **Active support from government** – Potential areas where the role of government in actively supported FinTechs and RegTechs could be considered.

RedCrew are proud to have sponsored the creation of this submission and are enthusiastic supporters of the work of governments at all levels in supporting innovation in the financial services and regulatory sectors.

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Introduction

Document Purpose

This submission has been written to support the announced Select Committee on Financial Technology and Regulatory Technology. The intention of this document is not to propose specific findings or opportunities to include in the work of the Committee but to provide foundational insights and concepts that contribute to the foundational planning of the Committee's work. This document seeks to suggest avenues for investigation and consideration.

The author of this document has extensive experience in promotion of innovation in the financial services sector in Australia with perspective gained from working internally and externally to the major banks. The suggestions and insights contained in this paper are drawn from this experience and from extensive interaction and collaboration with FinTechs of all sizes.

Document Structure

This document contains the following four sections:

- **Startup Lifecycle** – This section introduces a conceptual framework that may be useful to ensure that the work of the Committee is holistically examining the full journey of a FinTech from inception to maturity.
- **Key concerns facing FinTechs** – This section uses the framework of the Startup LifeCycle to outline some key concerns currently facing Australian FinTechs.
- **Passive support for innovation** – This section introduces the concept of government as a source of demand for financial services that could, if appropriately steered, support and facilitate innovation in financial services without the need for direct investment or intervention.
- **Active support for innovation** – This section outlines some possible policy or programmatic approaches to encouraging FinTech and RegTech in the Australian context that could be considered.

About The Author

The author, James Bligh, is an experienced technologist who has worked extensively in digital delivery and transformation in the financial services sector. Most recently, James has been leading the development of the technical standards for the Consumer Data Right as a key member of the Data Standards Body established for that regime. He has also been providing Enterprise Architecture support for Services Australia with a focus on their major transformational programmes of work. Prior to this James worked for NAB where he was responsible for some of the key digital initiatives including the creation of Australia's first open banking developer portal, the API enablement of key mobile apps and a global first with the use of APIs for integrated payments via the Xero accounting platform.

About RedCrew

RedCrew are a boutique firm specialising in the reliable creation of highly technical solutions for large organisations undergoing transformational change. RedCrew are proud to have sponsored the creation of this submission. For more information see redcrew.com.au.

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Startup Lifecycle

Overview

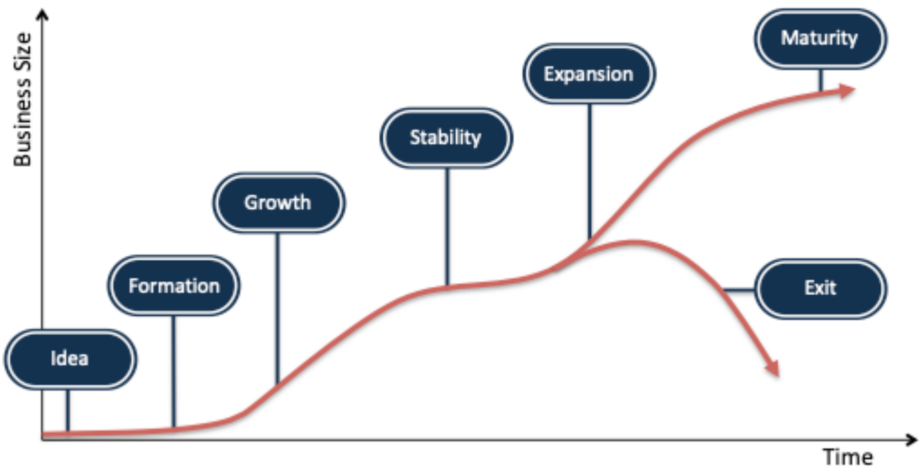
All businesses go through a generic lifecycle from inception to maturity. There are many ways to describe this lifecycle depending on the current focus of the discussion. The lifecycle for a startup will look different to a Founder than it will to a Venture Capitalist for instance.

In the context of this submission a lifecycle for a startup in the financial services sector, that is focused on growing a business to full economic stability and contribution, has been created. This framework is identified within this document as the Startup Lifecycle.

The purpose of the Startup Lifecycle is to provide a common language describing the journey of a business from ideation to maturity that can then be used to categorise the challenges and opportunities faced by businesses at different stages of growth.

Startup Lifecycle – A Conceptual Framework

The diagram below describes the Startup Lifecycle



Phase 1. **Idea:** Initially, all new startups begin life as an idea. The vast majority of good ideas never see the light of day. This first phase where someone with an idea decides, or decides not, to commit to that idea is a key failure point for a potential business.

Phase 2. **Formation:** Once one or more founders believe in an idea to the point that they have made a commitment the real work of forming the business begins. This is often when the risks and requirements of creating a business become real and founders become discouraged.

Phase 3. **Growth:** Once a fledgling business has survived long enough to have a real product, real customers and some sustaining investment, the startup will enter into a growth phase. If the business is able to grow fast enough to generate returns that justify the investment then it will survive. If growth is too slow it will likely face closure or be acquired or subsumed by another business.

Phase 4. **Stability:** The business is now of moderate size and operating sustainably. Businesses will sometimes stay in this phase for a long time depending on the aspirations of the founders. Most businesses have not reached their full potential, however, if they remain in this phase and they will not be internationally competitive.

Phase 5. **Expansion:** In the Australian context, due to the relatively small local market, for a business to expand it must move into international markets sooner than would be the case in other jurisdictions. This is a process that requires significant capital and management capability and can represent significant risk to the business.

Phase 6. **Maturity:** The business has expanded to the point that it is no longer a startup. It is now a relatively large and sophisticated business generating significant economic activity.

Phase 7. **Exit:** At any stage of this lifecycle the business may cease to exist in its current form. This could be through a positive event such as a sale of the business or a negative event such as liquidation. This is a critical stage in the lifecycle that must be considered as most entrepreneurs will start many businesses over their career and will sometimes have multiple failures before final success. Managing the exit phase well could result in more successful businesses being started as a consequence.

Using The Startup Lifecycle

The characteristics, needs and challenges faced by the same business are entirely different as it progresses through the full Startup Lifecycle. For a business to reach its potential, and maximum economic contribution to Australian society, it needs to survive each of the phases of development in the lifecycle. Government programmes and policies, however, are generally able to only target the challenges of one or two of these phases at a time.

The Startup Lifecycle is therefore a good framework for holistically assessing and planning policy responses to the challenges faced by startups in the financial services sector.

For instance, the framework could potentially be used in the following ways:

- As an assessment framework to identify if there is a specific phase in the lifecycle where the current government response is excellent or inadequate
- As a measurement framework to categorise businesses by phase and health to identify the high risk areas that could warrant further intervention
- As a communication framework to explain how specific policies or programmes are intended to assist startups and allow them to be targeted at businesses with the size and sophistication for which they were intended.

To illustrate this, the Startup Lifecycle, will be used as a framework in later sections of this document.

Key concerns facing FinTechs

This section outlines a number of concerns that have been observed by the author or directly related as frustrations by FinTech founders. These concerns vary according to the level of maturity of the business in question so they are described in terms of the Startup Lifecycle phases.

Idea Phase Concerns

- **Obtaining advice and mentorship** – The availability and discoverability of good advice and guidance. At the beginning of the process of establishing a business good advice is often more valuable than capital.
- **Finding trustworthy business partners** – A single entrepreneur will often lack the complete set of skills to deliver on their vision. Finding a compatible and complementary business partner that believes in the idea is often pre-requisite to an idea becoming a business.
- **Validating the feasibility of the idea** – A founder will often have a clear vision of the problem they are trying to solve and the solution that will solve it. Their passion for the solution will sometimes blind them to challenges that will cause a business to fail. An objective assessment of the feasibility of an idea can help a founder refocus on an alternate solution that will be more successful.
- **Risk aversion** – The potential downside of failure is a significant inhibitor to an entrepreneur taking the step of initiating a business.
- **Surfacing latent innovation** – Sometimes the people that know the right solution are not interested in the problem or in working towards solving it. Surfacing the ideas of these people so that other, more enthusiastic, entrepreneurs can develop the idea can result in a venture becoming real where it otherwise would not.

Formation Phase Concerns

- **Access to capital** – Banks in Australia are unlikely to lend to businesses that are not established. Venture capital is available but is hard to access and can result in interference or ownership models that are unattractive to founders. The ability to obtain capital is the most frequently cited issue faced by FinTechs.
- **Understanding compliance requirements** – New FinTechs will often have a clear idea of what they are trying to do but no idea how to navigate the wide array of regulatory and legislative requirements that they will need to comply with. This is why many FinTech founders are ex-bank executives with experience in the regulatory environment. This limits the pool of talent that can innovate in the financial services sector.
- **Support to comply** – Even if the compliance requirements are understood and known the best way to meet these requirements can still be hard to identify. Information on best practice compliance and partners that can assist with compliance is often difficult to find.

Growth Phase Concerns

- **Access to capital** – As described above. This also applies to the growth phase.
- **Managing costs** – As an organisation rapidly expands its customer base, ensuring that costs do not increase commensurately is essential to attaining profitability. It can often be difficult to grow efficiently.
- **Managing an expanding staff** – As an organisation grows it will expand its staff to accommodate the increased activity. This can be difficult to manage for a team of

founders wearing many hats to manage, especially if they do not have extensive human resources experience.

Stability Phase Concerns

- **Complacency** – Once an organisation is established and stable, the initial drive or mission can wane. Some business leaders can be reluctant to drive an organisation to the next level for a variety of reasons, stalling the growth of the business.
- **Founder transition** – The personality and skills required of a good founder are often not the same skills required of a good leader of a larger organisation. In some cases the original founder needs to transition out of the business before the organisation is able to expand.
- **Innovators dilemma** – The Innovator's dilemma, as described by Harvard professor Clayton Christensen, occurs when a business has exhausted the incremental value obtainable from its existing product but is unable to innovative a replacement product due to the dependence of the organisation and its customers on the existing, exhausted product. This can affect organisations of various sizes and can directly impact stable post-startup businesses with a single, successful product or service.

Expansion Phase Concerns

- **Expanding into foreign markets** – Due to the relatively small market and geographical isolation characteristic of Australia, to expand beyond a certain level, a business needs to move into foreign markets. This is good for the Australian economy but is also very difficult logistically.
- **Understanding the culture of foreign markets** – Lack of understanding of the culture and practices of a foreign market can be a barrier to success, even if the logistics are dealt with well.
- **Managing multiple physical locations** – Maturing the management of a business across multiple, distant locations, potentially in multiple time zones, can be difficult. Failure to deal with the issues that arise from this scenario can lead to culture fragmentation, loss of focus and distraction from the core activities of the business.

Exit Phase Concerns

- **Knowing when to exit** – When things aren't going well, making the decision to exit is hard and many businesses hold on for too long.
- **Landing safely** – Once the decision to exit has been made it is difficult to understand the best option to take to ensure the founders, their employees and investors are best served. Often an exit is such a negative experience that the founders do not seek to develop another business. This is a serious problem as, from international experience, most successful entrepreneurs have experienced at least one failure in the past.

General Observations

To emphasise the concerns articulated above it is worth articulating a number of observations of the Australian FinTech environment noted by the author in recent years:

- FinTechs are mainly being established by ex-bank executives. This is not because existing bank executives have better ideas or are unusually innovative. It is largely due to their subject matter expertise in the workings of compliance and regulatory regimes and their personal networks that facilitate access to capital.

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- There are three main types of FinTechs, each with their own concerns and risk profiles:
    1. FinTechs providing a direct service to customers. These businesses are effectively in competition or opposition to the incumbent banks. Despite this position of conflict they still require support from the banking sector for capital and access to data and payment networks.
    2. FinTechs providing a service to the banks directly so that they can better service customers or be more internally efficient. As these FinTechs are entirely dependent on the banks that are their customers they tend to align with the banking sector in terms of opinion given via public consultation. In addition, they can struggle if they become too aligned with one of the major banks. When a FinTech does a deal with a major bank this will often give that bank a competitive advantage. This often results in an exclusivity clause being requested as part of the engagement making the FinTech highly reliant on a small number of engagements.
    3. FinTechs that facilitate the wider eco-system. This includes intermediaries, general payment providers and providers of generic software platforms. This category encompasses organisations that are not strictly specialised in financial services but would still consider themselves to be FinTechs. They are less confrontational with the banks from a competitive perspective and also less directly dependent on banks.

Passive support for innovation

This section outlines indirect approaches of encouraging financial services innovation in Australia. These approaches are predicated on the fact that the Federal Government is one of the largest active consumers of financial technology and services in Australia. By leveraging this position as a single significant source of demand it is possible for the Federal Government to directly incubate new businesses.

The approaches outlined in this section are not considered fully formed proposals. They are intended to act as starting points for the exploration of new ways of supporting the FinTech and RegTech sectors.

FinTech friendly procurement

The Commonwealth Procurement Rules have recently been updated to encourage procurement from small and medium enterprises. The Digital Transformation Agency has also attempted to make things easier for smaller suppliers through various mechanisms. Despite this, the hurdles for a startup to compete with larger, international providers in obtaining a commonwealth contract remain high. These hurdles range from the cost of responding to the procurement process, to the personal risk to the career of Senior Responsible Officer conducting a procurement activity for selecting a small business with limited track record.

The result of this situation is the vast majority of the technology investment made by the Federal Government goes to large international organisations.

This situation also limits the ability of the Commonwealth to obtain cutting edge technology. As new and innovative services are, by their nature, differentiated, they are difficult to procure through processes designed for commoditised services with multiple respondents.

This situation could be addressed by providing a special procurement path for access to innovative services that is efficient and narrow in scope and size of procurement and managed centrally. Alternatively, an exemption process like those offered for procuring services from entities focused on indigenous or disabled citizens.

Encouraging experimentation in government service delivery

Another aspect of technology procurement for the larger Federal Government departments is that the contracts are very large in size. These contracts are beyond the scope of smaller businesses to deliver.

In the technology space, however, a large single contract is often unnecessary. The same benefits can often be obtained more efficiently through a series of smaller, co-ordinated investments. This is sometimes referred to as the tension between “best of breed” and “single provider” approaches. As technology evolves and changes these two approaches become more or less relatively attractive over time.

Currently, with the rise of open source technology and cloud based services, many organisations are moving to a “best of breed” approach, which is one of the reasons that startups are becoming more prevalent.

As this is a natural trend, if the Federal Government encouraged a bias towards smaller, shorter and lower risk engagements it would have the following benefits:

- Progress in service delivery improvement would be faster as the time to delivery for smaller engagements is usually much less
- Risk would be distributed as the failure of one of the smaller engagements would be far less than the failure of a large, single, integrated contract
- Government departments would be able to experiment with new modes and mechanisms of delivery as the negative impact of a failed experiment would be far lower. This would help drive innovation within government departments
- Tax payer funded investments would be distributed to a wider base of smaller enterprises that would be able to use that activity and growth to mature and drive additional economic activity

Active support for innovation

This section outlines initiatives or programmes that would support further innovation in the financial services sector that are of a more traditional form.

There are numerous such programmes that could be useful. The items outlined below are suggestions and have been selected to cover a variety of types of intervention. They are intended to be indicative and to promote ongoing discussion and ideation.

Low cost approaches

These approaches would be relatively low cost but, if effectively implemented, could be high impact, by promoting a culture of innovation and providing environments for people, who would not otherwise connect, to meet and partner on new business ventures.

- **Ideation events and hackathons**
  Hackathons and other ideation events have been used extensively over the last decade by larger organisations in Australia to solicit and develop ideas around specific themes or challenges. Many of these events result in active business being established. The themes for these privately organised events, however, are normally targeted at the challenges facing the business models of these large organisations and consequently veer away from pure innovation and disruption. For a relatively low cost the Federal Government could conduct a number of these events each year at various locations around the nation. These events allow innovative and creative people with similar interests to connect and develop their ideas.

- **Innovation evangelists**
  In the same way that government bodies will train and fund advocates in various public interest issues, such as safety and health, a team of innovation evangelists could be established with a mission to promote innovation within organisations and to encourage prospective entrepreneurs to take the step of developing their ideas.

- **Funding for meetups**
  Self organising meetups around various technical topics occur frequently in the technology industry. These meetups are drivers of innovation through the sharing of ideas and knowledge as the promotion of networking opportunities. These meetups do not need to be established by government as they are self forming. They could, however, be actively encouraged through small grants for refreshments, equipment or simply through the provision of a meeting space in a government premise. These meetups could also be encouraged through advertising and awareness support provided by government.

- **Sponsored directors**
  Once a business enters the growth phase the need for good, objective governance becomes an important pre-requisite for sustained success. This is even more important in highly regulated environments like financial services. Finding and remunerating independent directors with the experience and skill required can be difficult for a small organisation. The government could support FinTechs with the provision of grants to remunerate independent directors and also through a register of appropriately skilled and experienced directors that may be approached by FinTechs.

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Investment based approaches

These approaches are more costly as they constitute active investment in capital or resources to support and develop targeted FinTechs.

- **Supporting a graceful exit**
  By providing direct welfare support to founders who have closed down their business (with appropriate means testing), those founders are less likely to try to unreasonably maintain a failing business and they are more likely to start a new venture after the exit is complete. Such a programme would also reduce the risk of a potential founder thinking about starting a business in the first place, making it more likely that they will take the step of creating a business.

- **Improving access to capital**
  A variety of potential options exist to increase availability of capital for innovation. These range from subsidising market based lending to reduce the risk profile for the lender, to the government bearing the risk directly by acting as a provider of capital.

- **Supporting international expansion**
  For stable organisations seeking to expand internationally there are a variety of support mechanisms that can be provided, ranging from provision of capital (as described above), to more direct support from existing Australian diplomatic networks. Israel is an example of a country that has used its diplomatic services effectively to support startups engaging internationally.

Policy based approaches

These approaches to encouraging innovation in the financial services would be implemented via regulatory or legislative action but would not require significant ongoing investment.

- **Increased access to data**
  The current focus of innovation both in Australia and internationally is the use of data to create better, more intelligent, services for consumers. In Australia there has been a history of large organisations collecting the data of Australian citizens and using that data for existing purposes but not for new services that add value. This is driven by the lack of innovation characterised by large enterprises and the threat of new competitors but is also a side effect of privacy legislation and other regulation. Recent policy innovations initiated by the Federal Government (such as the Consumer Data Right and Comprehensive Credit Reporting regimes) are seeking to make data more available for innovation and competition, while maintaining citizen privacy and control. Programmes of this nature are likely to create more space for innovation and competition and therefore open the door for FinTech and RegTech growth.

- **Industrial relations flexibility during the growth phase**
  During the critical phase of growth from a very small business to a more sizeable enterprise, it is difficult to attract and retain the often unique skills that are required. In addition, the number of new employees being added to the business in a short period of time results in a higher risk of taking on an employee who is not suited to the culture of the organisation or the specific needs of the role. To reduce these risks and issues it would be worth assessing whether greater employment flexibility could be provided to these types of business for a short period of time as they grow. This could constitute exemptions to fringe benefits tax so that more attractive working environments can be offered, or, greater flexibility in the termination of employees that are not performing to expectations.

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- **Certification and compliance ecosystems**
  To actively support RegTechs and reduce the cost of regulatory compliance across the economy, regulators could be encouraged to actively create compliance ecosystems to ensure compliance. In such compliance ecosystems the regulator retains the enforcement and definition of regulation but ongoing activities of assurance or accreditation are licensed to private industries. The creation of such ecosystems is not unheard of in Australia but it is not standard practice.
  The establishment of such ecosystems would likely foster the creation of lower cost accreditation and conformance platforms through market forces. It would also reduce the need for the regulators themselves to develop such mechanisms, an activity they are often not well suited to do. It would also likely increase the level of certainty and specificity of regulation as the act of creating the ecosystem would result in regulations being clarified.