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Disintermediating finance: Fintech and its limitations

January 8, 2021

1 Comment

The recent Wirecard scandal highlighted an old issue that has been disturbing scholars and policymakers about technology companies offering financial services – trust. While Wirecard collapsed due to fraud, the public debate has shifted towards the fact that most of the Fintech industry is subject to minimal regulation at best.

In our recent paper, we discuss the wave of technology-enabled disintermediation of financial services and ask how regulation should cope with the risks associated with disintermediating finance. Although we contend that the Fintech industry has the potential to improve the efficiency of financial services, Fintech will not be able to lead the radical financial revolution that we are told about unless it deals with its Achilles's heel – a lack of trust.

A suggestive indicator of our conclusion is history; this is not the first time when "conventional wisdom" concluded that technological innovations will end the existing financial system as we know it. Back in 1995, there was a consensus that the imminent demise of the banking industry was unstoppable because securitization would change the financial landscape. Such reports were indeed greatly exaggerated, as the banking industry exhibited resilience and incorporated some of the financial innovation that many did not expect.

There certainly are some similarities between Fintech and securitization, but the two innovations inextricably differ in scale and scope. The current technological step forward is arguably bigger because it aims to take over financial intermediation as a whole. To assess whether this is a realistic goal, we take a law and economics approach and combine it with the theory of financial intermediation.

At its core, financial intermediation is costly. This cost has remained relatively constant over the past century. In contrast, Fintech promises to decrease the costs of financial intermediation by introducing more efficient technology. That brings about several challenges for regulation. Financial regulation pursues financial stability and investor protection to remedy financial market failures. The question we ask, is whether financial disintermediation, to the extent that it is feasible, undermines the pursuit of these goals.

Banking activities and the Fintech industry

Financial intermediaries emerge to cope with asymmetric information. Banks, in particular, engage in costly screening and monitoring to make sure that potential problems are anticipated and solved. However, banks differ from other intermediaries because they perform this task by turning liquid, short-term and safe claims, into illiquid, long-term risky assets (known as liquidity transformation and maturity transformation). It comes as no surprise that banks are inherently fragile because they are prone to runs and panics as they cannot liquidate assets quickly enough to honor the high demand for short-term liabilities at once. Given this, there is a general agreement that regulation is needed to preserve financial stability.

Replacing banks in financial intermediation (henceforth, disintermediating) is a complex task that involves both the asset and liability side of the balance sheet.

On the asset side, Fintech firms are offering Peer-2-Peer (P2P) lending as a suitable alternative to traditional lending. The basic tenet of P2P lending is that lenders and borrowers are matched without an intermediating bank through the Fintech's platform. To the extent that P2P lending is competitive, it leads to efficiency gains. This form of lending also substitutes "heavy" bank intermediation with a "light" platform intermediation. However, this crucially does not amount to a full disintermediation. One should consider P2P lending platforms not as computer codes matching lenders and borrowers, but rather profit- maximizing entities that are acting as an agent of both.

While this sounds appealing, financial stability concerns loom large. Since platforms do not perform qualitative asset transformation, they may contribute to building up systemic risk elsewhere. First, platforms often run a fee-based compensation scheme, which generates incentives to over-lend or to originate riskier loans, often through highly leveraged lenders. Second, the competitive pressure could prompt banks to prefer transactional activities – which are more exposed to systemic risk – over relationship banking. If banks were to acquire existing platforms or set up their own platforms, then the two threats would merge and magnify.

On the liability side, three key elements (safety, liquidity, and payments) need to be satisfied to disintermediate banks. Cryptocurrencies are the most paradigmatic example. Armed with the power of modern technology, Fintech firms aim to replace the current framework of licensed intermediaries and trusted central gatekeepers. In theory, blockchain technology should provide a completely decentralized and trustless system. However, we contend that such a system is far from being achieved – if it is even possible.

We offer three reasons to support our claim. First, there are concerns associated with digital wallets that store cryptocurrencies. Despite some claims that the blockchain is incorruptible, the fact that cryptocurrencies get stored in digital wallets is troublesome, as there have been numerous instances of digital wallets being hacked. In our view, the disruption that follows, whether it were to happen on the blockchain or digital wallets, is equally worrisome. Second, if blockchain technology will continue to rely on digital statements that create self-executing contracts (also known as smart contracts), then parties need to trust the coder, who also needs to signal a certain level of quality work. After all, whether it is smart contracts or regular contracts, legalese is often considered opaque and difficult to fully comprehend. Trust (in the counterparty, or the intermediary) remains essential for rational human beings to sign documents that bind their actions. Third, cryptocurrencies cannot fully replace fiat money because all the transactions between private parties and the government require legal tender. If conversion to legal tender happens outside the perimeter of licensed financial intermediaries with access to central bank financing, then it will lead to high volatility, which goes against investors' demand for safety and liquidity. As cryptocurrencies do not currently perform any of the functions of fiat money (medium of exchange, store of value, and unit of account), they do not live up to their promise to replace fiat money.

Conclusion

Our work pinpoints some of the major developments and setbacks of Fintech. We argue that the transition toward a technology-based financial system is likely to reshape the role of intermediaries and gatekeepers. This is challenging for financial regulation as it is difficult to regulate what you cannot see. "Smart" investment contracts that are fully designed and executed on the blockchain do not require cooperation from the legal system. Regulation cannot prevent financial intermediation via smart contracts from happening unless it prohibits it. But how could we enforce such a prohibition? While our analysis does not address how exactly to design the optimal regulatory strategy to solve this issue, it does suggest that regulating the convertibility of cryptocurrencies into fiat money is a promising strategy. It has the potential to attract financial services into the regulatory perimeter by appealing to investors' demand for safety and liquidity.

The authors of this post are professors Fatjon Kaja at the University of Amsterdam, Edoardo Martino at the University of Amsterdam and the European Banking Institute, and Alessio M. Pacces at Amsterdam Law School, Amsterdam Business School, and the European Corporate Governance Institute.

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One thought on "Disintermediating finance: Fintech and its limitations"

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