THE UNIQUE ADVANTAGES FINTECHS HAVE WHEN EXPANDING INTO BANKING OPERATIONS – A TREND IS UNDERWAY

On March 1, 2021, Square, Inc. ("Square") announced that it had commenced banking operations under its independently governed subsidiary industrial bank, Square Financial Services ("Square Financial"). The announcement comes after Square successfully completed the charter approval process with the Federal Deposit Insurance Corporation ("FDIC") and the Utah Department of Financial Institutions for an Industrial Bank/Industrial Loan Corporation ("ILC") license. Square Financial will offer business loan and deposit products, beginning with underwriting and originating business loans for Square's existing sellers who use its card reader and other point-of-sale services.

As a financial technology ("Fintech") organization, Square's expansion into the traditional banking space may appear to be antithetical to the start-up nature of Fintech companies. In fact, to date, the most common business arrangement for Fintechs is to partner with more traditional financial institutions ("FIs"). This set-up gives FIs access to the innovations of Fintechs and in exchange provides Fintechs with an established customer base and network. Nonetheless, the highly efficient and cutting-edge characteristics of Fintechs make them natural competitors to FIs, which are typically much larger and less nimble.

In addition to Square, Fintechs Grasshopper and Varo Money have also been approved for banking charters (in May 2019 and July 2020, respectively). With the many advantages that Fintechs have when competing with traditional FIs, it is foreseeable that more Fintechs will expand into the traditional banking space and build their own customer bases. Four of these advantages are detailed here and provide evidence of why Fintechs are a natural fit for banking operations as well as excelling in the financial technology and innovation sector.

Fintech Advantage #1: Low-cost Products

Fintechs are able to offer customers lower cost products (as compared to those offered by FIs) by maintaining online-only platforms and eschewing physical branches and offices. Many FIs are starting to provide online resources and apps, but their overhead and operational costs are still much higher than what is required at a Fintech, and those costs are passed along to the consumer. Moreover, Fintech apps like Venmo or CashApp eliminate the FI intermediary and eliminate interest rates and transaction fees when borrowing money or making payments to friends and family. This allows Fintechs to provide the same or similar products to customers at a lower cost.

Fintech Advantage #2: Greater Accessibility and Inclusion

By erecting a relatively low barrier to entry, Fintechs are creating a more inclusive and accessible banking system. For instance, Fintechs more easily reach parts of the world where participation in the banking system is low (like Sub-Saharan Africa), and offer alternative paths to loans (including crowdsourcing) that provide opportunities to entrepreneurs or other individuals with low credit scores who find it difficult to get approved by traditional FIs.

Even more importantly, Fintechs offer accessibility solutions for people with physical disabilities. These individuals have historically had a difficult time accessing traditional services from large FIs because in-person visits to physical branch locations are inconvenient or impracticable. Using a Fintech's services does not require physically being present at an ATM or branch location to deposit checks or transfer money. Some Fintechs also provide touchscreen features that allow individuals with visual or reading disabilities to hear a verbal description of the button they are about to click. These technological advances utilized by Fintechs create a more accessible banking system for a wider swath of the population than what is traditionally employed by larger FIs.

Fintech Advantage #3: Innovation

In a world where the population is becoming increasingly comfortable with technology, Fintechs have leveraged consumers' technological intelligence to offer an array of innovative techniques that make banking and financing activities more appealing. As a result of their start-up culture mentality, Fintechs have innovated around the use of artificial intelligence, blockchain, and biometric applications, among other emerging technologies, to enhance banking. Many – if not most – FIs have not been nimble enough to easily transition to these types of innovations.

Innovative approaches to banking processes and products are nothing new; at one time, ATMS and chips in credit cards were considered cutting edge for FIs. Fintechs are pushing the innovation envelope much more quickly and on a larger scale, and the ability to modernize and transform how the world banks is not to be taken lightly. Even the U.S. Securities and Exchange Commission ("SEC") has recognized the importance of Fintech innovation by creating a dedicated fintech innovation hub (called "FinHUB") at the SEC to address the agency's – according to the SEC's Hester Peirce at an Institute of International Bankers conference on March 1 – "uneven response to fintech innovation." A regulatory acknowledgment that Fintechs' innovation is so critical and primary to their very existence that regulations related thereto will require "…a deep appreciation for the growth and ingenuity in the digital assets space" is significant. It is also evidence of the unique position that Fintechs have in the marketplace and speaks to their status as a viable player in the financial sector.

Fintech Advantage #4: Combining Agility with Traditional Banking Charter

Acquiring a banking charter provides Fintechs with the unique ability to maintain their agile business models while competing independently on the same playing field as FIs (as opposed to partnering with them). A banking charter may also give customers the same institutional trust they have in FIs and alleviate the concerns of those who are not willing to fully embrace emerging technologies like cryptocurrency.

The banking charter process is rigorous and challenging – Square's charter was granted in March 2019 after a 3-year process and its bank did not commence operations until March 2021. Fintechs that stay the course and achieve a charter end up with a unique combination of state-of-the-art technologies and traditional banking *bona fides*. This is perhaps the biggest advantage of a Fintech's banking charter; it gives customers an alternative to the traditional banking structure and access to the low-cost products, accessibility, and innovation detailed above.

Expect the Trend to Continue

Fintechs are well-placed to compete with FIs and it is only natural that more of them will create their own banking operations instead of simply partnering with FIs. Brex, a San Francisco-based Fintech best known for offering banking services to startup businesses, applied on February 17, 2021 with the FDIC for an ILC charter. Since its founding in 2017, Brex has relied on partnerships with FIs, but has now determined that a banking license would make it easier to provide its products to clients. Given their unique structural advantages, we should not be surprised to see more of these banking charter application announcements from Fintechs in the future.

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