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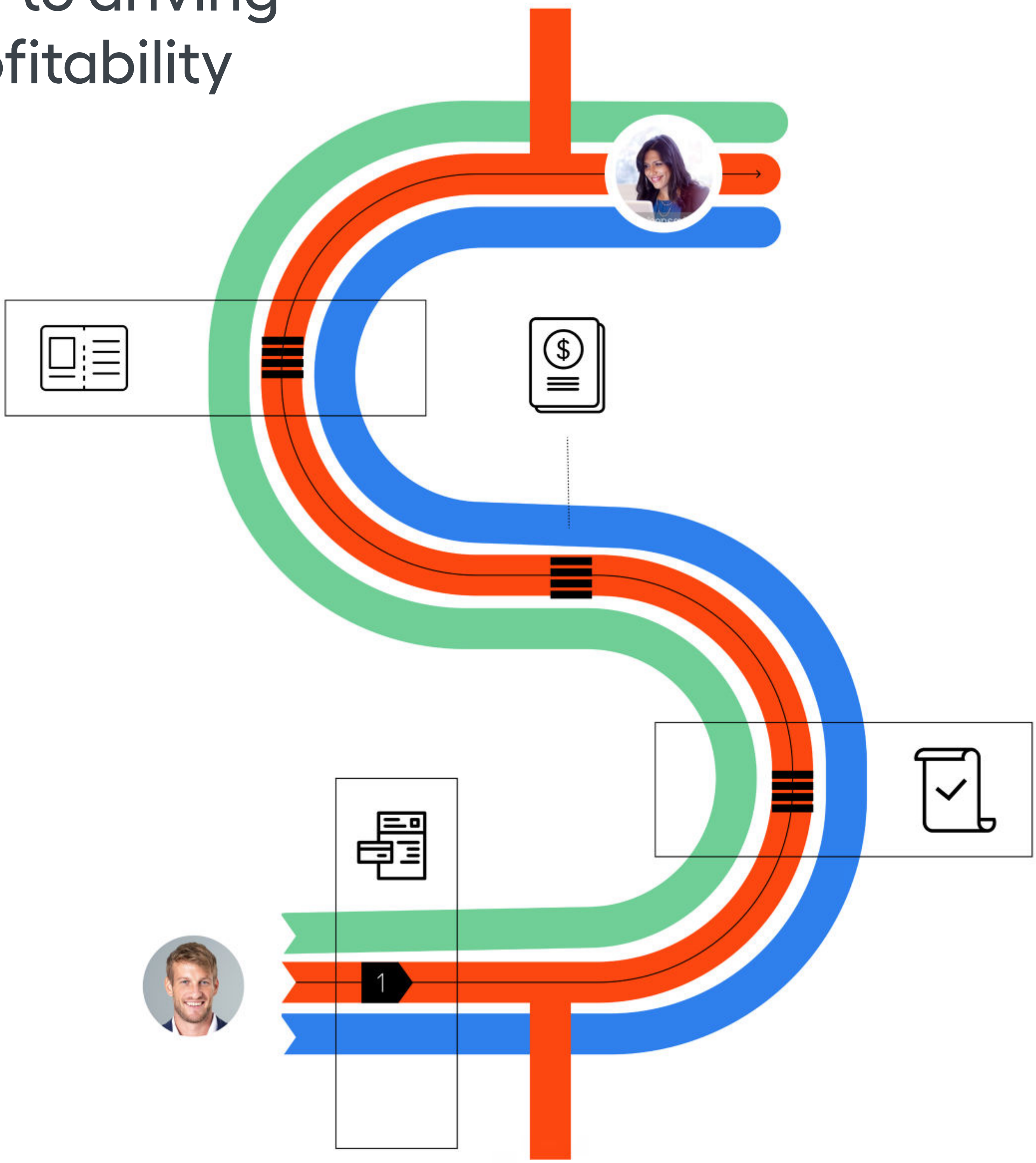
For neo-banks, digitizing compliance key to driving profitability



> “Innovation in anti–money laundering, KYC, fraud, and sanctions compliance programs can become a competitive advantage for neo-banks.”

Neo-banks are revolutionizing how the world moves money, stores wealth, and obtains credit. These financial innovators — which include “challenger banks” and “Virtual Asset Service Providers (VASPs)” — have created new consumer and shareholder excitement regarding the “future of money.” Yet few are profitable thus far. For almost all of these challengers to traditional financial institutions, the path to profitability is identical: aggressively launch new products, increase transaction volumes, and expand geographic footprints. Many strive to become a super-app version of a traditional diversified financial institution.

This growth model has predictable consequences, especially in relation to financial crime compliance obligations. Headcount will grow. Compliance costs will erode margins. Customers will be asked for more documents, their payments will be slower, and their overall experiences will be diminished. Some neo-banks will get in trouble with regulators for processing funds for fraudsters, money launderers, or sanctioned parties. Some will be penalized for not adhering to their own internal requirements. In extreme cases, compliance costs or failures will lead neo-banks to close down or exit lucrative markets.

These predictions can be made confidently because the story has been played out many times before, in the very same financial institutions that neo-banks are looking to disrupt. Why should neo-banks follow a compliance playbook that isn’t working for traditional banks anymore? Innovation in anti–money laundering, KYC, fraud, and sanctions compliance programs can become a competitive advantage for neo-banks. Or, failure to innovate in products and compliance alike can threaten growth. In an emerging marketplace, falling slightly behind peers means never catching up. Leading the industry in this context means making compliance as digital and transformative as financial products are.

Growth and the impact on compliance spend

Business growth often has a non-linear impact on compliance spend for financial institutions. This is especially true when that growth comes in the form of acquisitions, new product launches, and geographic exposure. As neo-banks grow in this manner, they will quickly realize:

- Transaction volume growth brings additional revenue and valuable data on customer habits. However, it also requires close scrutiny to root out illicit or unexplainable activity. Transaction monitoring becomes more complex with multiple products. The time analysts spend reviewing output from these systems increases, and likewise do the costs. More and more time is spent collating investigative data, rather than analyzing risk. It is not uncommon for 40% of all costs for a mature compliance program to be deployed into transaction monitoring.

- Each new customer has the potential of generating screening alerts, whether it is for negative news, political exposure, or sanctions risk. Each screening alert costs $1–$3 when manually handled. Qualified staff to manage screening systems command top salaries. Screening names and payments is not enough; for example, checking IP addresses is now normal. For those servicing international customers, screening tools need to be tuned to capture linguistic name variations.

- Expansion into corporate customer servicing is lucrative for many neo-banks, but it also creates KYC and due diligence headaches not typically seen in retail banking. Corporate onboarding is synonymous with handling high volumes of documents. A retail customer is onboarded through a phone app; a corporate customer may require dozens or hundreds of emails. Analysts will spend 20 minutes or more sifting through documentation for a small-but-critical amount of information on beneficial ownership, source of funds, and authorized signers.
- Many foreign jurisdictions have enacted regulations that require neo-banks to collect documentary proof of source of wealth/funds. Some of these documents will be fraudulent. Checking the documents for business data and then checking them again for signs of fraud is pricey. Doing it while a customer waits for a payment to settle threatens the relationship.
- More manual compliance operations result in more errors. More errors results in hiring quality controls, testing, and audit personnel. Before long, neo-banks find themselves with 3 sets of eyes reviewing even the simplest of compliance tasks. The cycle goes on.

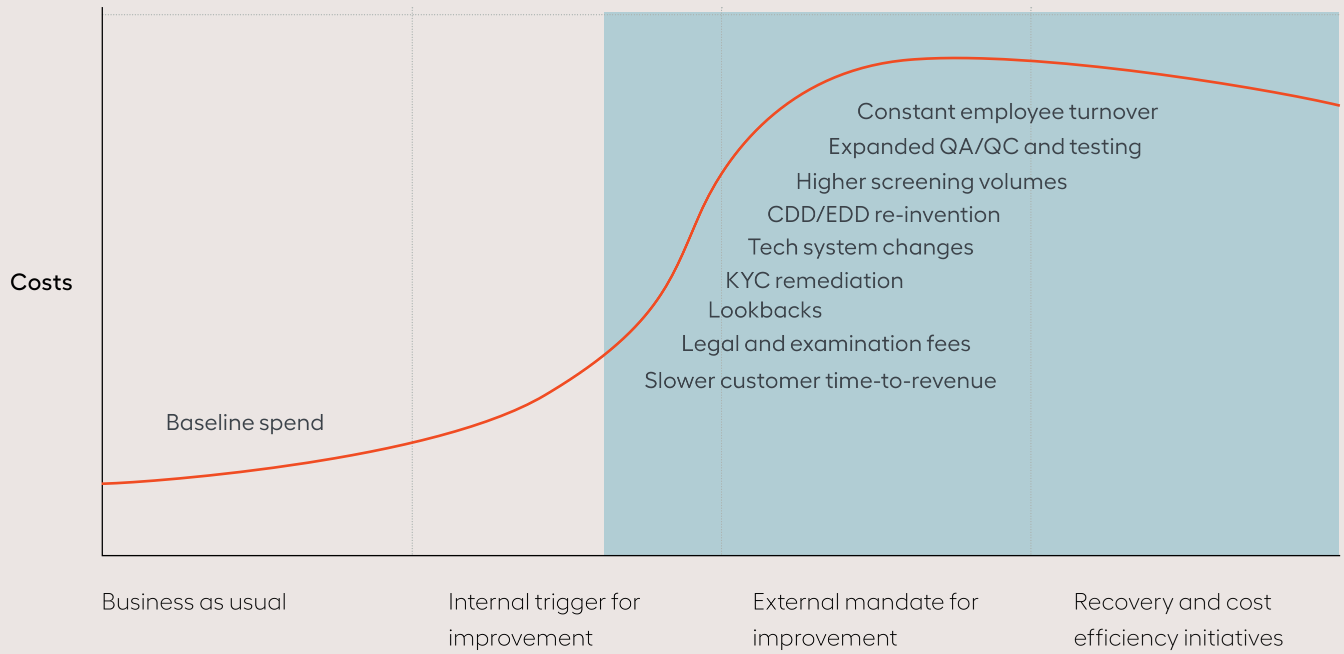
An American neo-bank's recent S-1 filing summarized how growth affects compliance: "The risk of non-compliance is exacerbated when we introduce new products or services that subject us to new laws and regulations."[1] Growth is synonymous with increased compliance spend, risk, and error because growth usually precedes hiring more staff.

Importantly, increased human labor is not the same as increased effectiveness. Here, neo-banks can learn from traditional legacy financial institutions and find a better path forward. The best way to de-couple the cost of compliance from growth is to look at compliance operations as a function that can be automated. At the September 2021 London AI Summit, the CEO of a global neo-bank shared this sentiment: "We think about compliance and risk the same way that we think about our product. Risk and compliance means ensuring that your software is designed properly and then you don't really rely on people. Human labor is a problem for compliance. Effective risk and compliance is about making sure policies are built like products: digitally and with few human interactions."[2]

Digital bank, digital compliance

The compliance journey for many brick-and-mortar financial institutions followed roughly the trajectory shown in this illustration. Compliance costs increased due to external factors — most often regulatory orders — and many institutions never recovered to previous levels, even when accounting for business growth. Neo-banks can avert taking on compliance burdens that will keep dragging down profitability and threaten speed of growth.

Neo-banks can avoid creating a "mountain" of compliance burdens



A digital compliance program will allow neo-banks to spend resources on business growth rather than increasing compliance headcount, deliver superior customer experience rather than issue constant requests and rejections, and ultimately satisfy business missions and shareholder interests. There is a proven playbook for achieving digital compliance. Machine learning can augment compliance "knowledge workers," especially by completing compliance tasks that involve reviewing false positives (screening, fraud, monitoring, etc.) without labor. Automation can help with the first touch and last mile of due diligence work, including reporting, collating information, and identifying red flags. Those same knowledge workers can focus on exceptions or high-risk areas. Even when document images are unavoidable, manual review of all of them is entirely avoidable due to intelligent document processing technology. Analytics and entity resolution can provide risk insights that a human eye alone would miss. Network learning ensures that the machine learning models that underpin digital compliance keep improving.

Ineffective or inefficient compliance will jeopardize speed of growth

A financial penalty paid to a regulatory agency as a result of poor compliance practices very often is the least expensive part of dealing with a compliance lapse. As neo-banks increasingly become subjects of U.S. and foreign regulatory actions, related costs will erode profitability. Mandated remediation and its legal costs can exceed initial penalties many times over. Regulators apply much higher administrative examination costs for institutions under a formal order. For a select few neo-banks, new compliance requirements will create an existential threat. In 2020, a UK neo-bank warned that financial crime regulatory requirements would threaten its ability to operate.[3] Eventually, these concerns led it to withdraw from consideration for a U.S. banking license.[4] A separate Korean neo-bank shuttered operations altogether after AML requirements came into force.[5]

Yet, even these costs are not the most impactful when it comes to neo-banks aiming for sustainable profitability.

Instead, the biggest cost of an ineffective or inefficient compliance program could be how real or perceived breaches can jeopardize a neo-bank's ability to move quickly to acquire market share. Much of neo-banks' success has stemmed from creating or serving new markets faster than peers and competitors can. Compliance concerns can threaten that ability to move quickly. A New York regulator in 2019 required an American neo-bank to close 35,000 accounts for local customers due to AML concerns.[6] This gave 29 peers and competitors the opportunity to expand in that state.[7] In March 2021, A UK-based fintech stopped onboarding United Kingdom customers after a "constructive dialogue" with a local regulator around AML obligations.[8] Around the same time, a local competitor announced a path to capturing nearly 20% of a lucrative corporate market segment.[9]

Neo-banks service customers at one-third the cost of traditional institutions.[10] Established neo-banks are launching upwards of 20 financial products per year. Only 17% of neo-banks operate in more than one country. The market share remaining to capture is immense, but only if a neo-bank retains the ability to grow quickly. Even when a regulator has not rejected a new license application or mandated a stop to new customer onboarding, dealing with compliance issues has a significant opportunity cost. OFAC, the U.S. sanctions administrator, in mid-2021 issued a neo-bank a relatively modest $1,400,301 civil penalty. But, it also mandated a set of enhancements that likely cost upwards of $4 million to implement, test, and maintain.[11] The result is an aggregate ~$5.5 million that the penalized neo-bank could not spend on entering a new market and growing, a handicap not necessarily experienced by competitors.

On the path to profitability, compliance efficiency and effectiveness must become part of regulatory and investor relations, reputational risk management, employee retention, and customer loyalty strategies. Neo-banks can bypass the costly experience of traditional "brick and mortar" institutions during the past 15 years. The most successful, profitable, and (eventually) global neo-banks will be those that enable their business to grow under the protection of industry-leading compliance measures. Neo-banks are committed to expanding a digital-first financial ecosystem. Without digital-first operations to compliment financial products, this digital future may be nothing more than a façade. There is no debate that neo-banks must have strong financial crime compliance controls. There is no path to sustainable profitability by ignoring compliance. However, "we increased compliance headcount by 20 people" is not the same as compliance efficiency. In fact, it may be the opposite. Profitability calls for digital-first products and a runway to expand into new markets, which requires strong compliance practices. Digital-first compliance requires neo-banks to constantly be asking: "Is there a better way?"

[1] https://sec.report/Document/0001628280-21-017788/

[2] London AI Summit 2021, CEO of Revolut, session titled "Accelerating Transformation in Financial Services - Revolut's Vision for the Future of the Banking Industry"

[3] https://kyc360.riskscreen.com/news/warning-over-monzo-financial-crime-review/

[4] https://thepaypers.com/payments-general/monzo-withdraws-its-application-for-us-banking-licence--1251889

[5] https://www.coindesk.com/business/2021/03/23/crypto-exchange-okex-korea-to-close-as-new-aml-rules-come-into-force/

[6] https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1904101

[7] https://www.dfs.ny.gov/apps_and_licensing/virtual_currency_businesses/regulated_entities

[8] https://www.prnewswire.com/news-releases/crypto-friendly-fintech-wirex-temporarily-pauses-recruiting-new-uk-customers-301254230.html

[9] https://www.businessinsider.com/starling-doubles-down-on-uk-smb-growth-ambitions-2021-2

[10] https://www.mckinsey.com/~/media/mckinsey/industries/financial%20services/our%20insights/next-gen%20technology%20transformation%20in%20financial%20services/next-gen-technology-transformation-in-financial-services.pdf

[11] https://home.treasury.gov/system/files/126/20210723_payoneer_inc.pdf

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