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Brexit triggers race to dethrone London

British capital won't easily give up its top place in the FinTech world.

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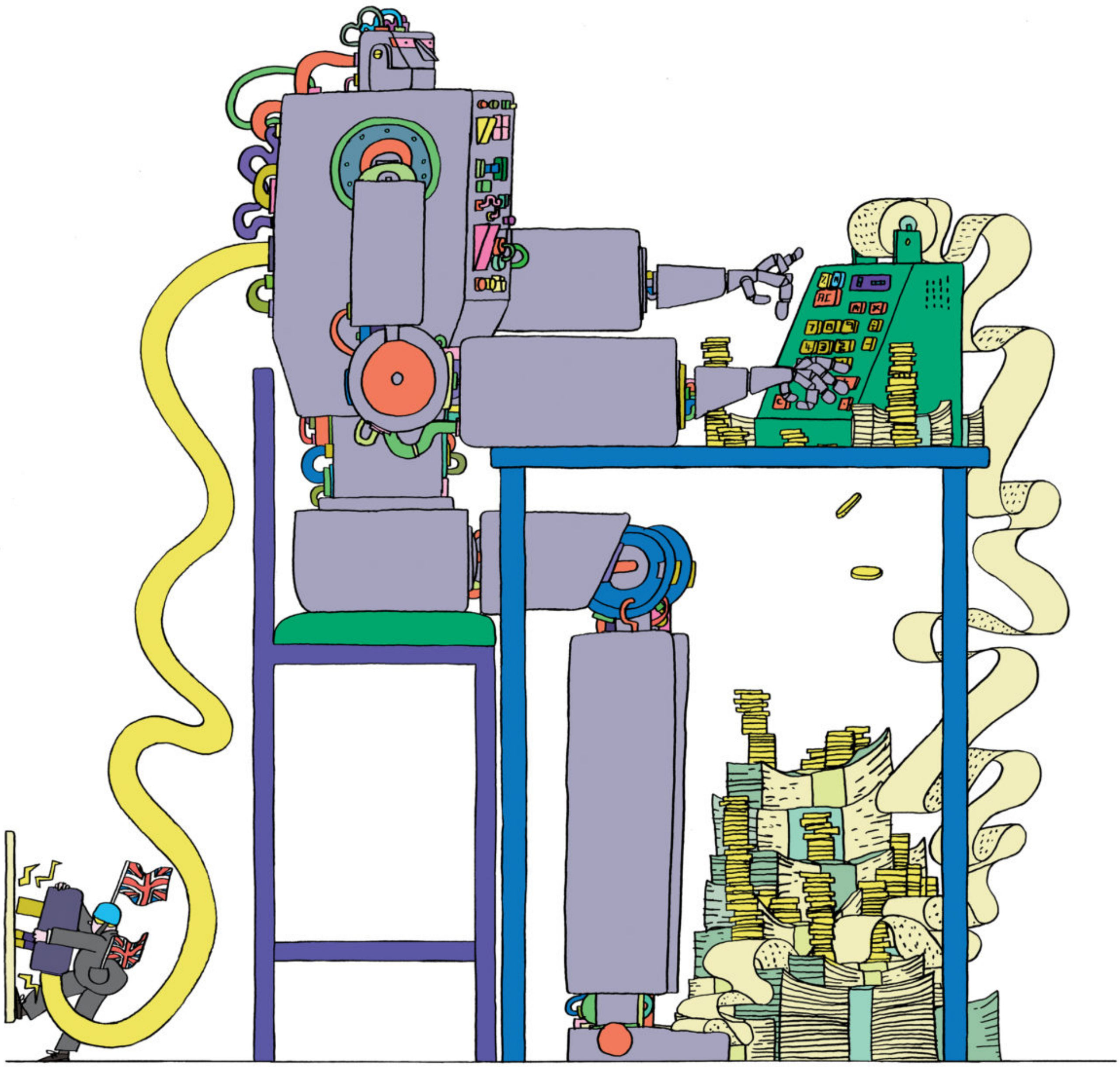

Illustration by Celyn Brazier for POLITICO

A perfect combination of business opportunities and friendly regulation in recent years has made London the European, if not the world, capital of financial technology companies, or FinTechs.

Now Brexit could take the title away and in its wake, complicate the rise of the nascent industry in Europe.

Other aspiring European FinTech hubs like Berlin, Stockholm and Zurich are hoping that London's loss will mean a potential gain for them. This, in turn, is forcing U.K. financial regulators to go on the defensive as they continue their work of balancing the interests of financial startups and their customers. How these competing interests play out is likely to determine the future of new finance in Europe (and probably beyond).

After the 2008 financial crisis, financial startups flocked to London to fill the vacuum left by failed banks and insurers. They were also attracted by the fact that access to funds and financial talent in the British capital was still plentiful to fuel their tech-savvy and simpler, more transparent business models. Rarely in the modern history of finance have newborn companies had the opportunity to challenge the City of London giants' way of doing business.

In addition to its world-class financial standing, London was the obvious place in Europe for the FinTech revolution to kick off because it also offers the European Union's so-called "passporting rights," which allow companies to operate across the bloc's single markets from their U.K. headquarters. According to a July survey by the industry's trade body Innovate Finance, these rights are of vital importance for the U.K.'s FinTech ecosystem.

Murkier future

As they await the British government's exit negotiations with Brussels, however, U.K.-based FinTech firms now fear the loss of the passporting privilege and, as a result, face a murkier future for their continent-sized ambitions.

Just two weeks after the Brexit vote, Cornelia Yzer, Berlin's economics minister, declared the German capital's intention to exploit the opportunity created by the U.K.'s decision to leave the EU. Her main selling points, in addition to the city's already strong reputation as a tech hub, are access to the EU's single market and the country's economic strength. According to Yzer, her office has received numerous emails in the immediate aftermath of the Brexit vote from U.K.-based FinTech companies that were considering relocation.

> “All indications, are that retaining the same passporting rights Britain has enjoyed as an EU member will be nearly impossible outside the bloc.

Venture capital investments in Berlin surpassed €2 billion in 2015, according to Ernst & Young, making it Europe’s No. 1 hub for startups. London came second, followed by Stockholm and Paris. Zurich was further down on the list, but the Swiss hub has recently been stepping up its efforts with big banks eager to contribute cash. At the end of August, Credit Suisse and UBS were among a group of investors that launched a business “accelerator” called, Kickstart, to help develop 30 international startups, including FinTechs.

The U.K. isn’t prepared to take this challenge to its FinTech supremacy lying down. The two-pronged counter strategy of Innovate Finance (which is backed financially by the City of London Corporation) consists of going all out to retain the passporting rights for FinTech firms while making sure they continue to find London the best place to set up shop.

Lawrence Wintermeyer, the head of Innovate Finance, said he is ready to work with the government and push access to the EU’s single market to the top of the U.K.’s agenda during its exit negotiations.

All indications, however, are that Brussels is going to be tough on the U.K. in negotiating its exit, and retaining the same passporting rights Britain has enjoyed as an EU member will be nearly impossible outside the bloc. Since the June 23 vote, EU politicians and officials alike have reiterated that there will be no access to the single market, including passporting, without free movement of labor — something many Leave voters intensely dislike.

This is why the British government will be redoubling its efforts at home. At a midsummer post-Brexit gathering, Chris Woolard, head of strategy and competition at the Financial Conduct Authority, the U.K.’s top financial regulator, reiterated his agency’s support for existing FinTech startups and its determination to attract many new ones to the country.

Since the launch of Project Innovate 2014, the FCA has been an avid supporter of financial services disrupters and has helped startups navigate the ocean of regulations. Its driving philosophy is to make finance more accessible for ordinary customers, from pensioners to young people.

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"The British government has been incredibly supportive of the technology and digital sector, particularly these last five years," explains Eileen Burbidge, the Treasury's just-reappointed special envoy for FinTech. "As the new government looks to reaffirm its commitment to a strong industrial strategy … FinTech will certainly continue to be held in high regard."

Regardless of supportive policy though, the success of many FinTech firms at the business level is linked to "disintermediation," or getting rid of the middleman, which allows cost-cutting and raises transparency. Examples include peer-to-peer lending, crowdfunding, and money-transfer platforms.

Safeguards for customers

But removing traditional banks' intermediation also eliminates the protection a customer would normally receive if something goes wrong. For example, earlier this year, the founder of San Francisco-based LendingClub resigned after an internal investigation into the soundness of the firm's loans.

So British regulators and their peers elsewhere want to make sure appropriate safeguards exist to prevent the system from being abused. The challenge is how not to kill the baby in the cradle by imposing excessive burdens on FinTech firms that have much lighter balance sheets than their peers in traditional banking.

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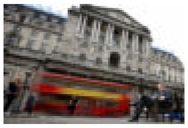

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Mark Carney, governor of the Bank of England, has said FinTechs deserve some "regulatory allowance" in order to grow. He dismisses the possibility that startups, such as peer-to-peer lenders, could constitute a threat to financial stability by ultimately deregulating the U.K. banking industry.

Mark Carney, governor of the Bank of England, has said that FinTech companies deserve some "regulatory allowance" in order to grow | Matt Dunham/AFP via Getty Images

The FCA's main tool for balancing the competing demands of FinTech entrepreneurs and customers has been a "regulatory sandbox" regime, which lets innovative startups test out their businesses without having to meet all the rules required of normal financial firms. The regulator has worked with around 200 startups since it launched the sandbox in May 2015 and has turned down just about as many for not being innovative enough.

As Carney put it, the key is ensuring that these emerging challengers aren't acting as typical lenders. However, this isn't easy, especially when it comes to FinTech startups offering the more traditional banking services like student loans, mortgages, and retail investing.

Now, the risk in light of the Brexit vote is that the U.K. regulators may go gentler on these developments than they would have otherwise so as to get as many FinTech firms to stay in London.

Innovate Finance's Wintermeyer dismisses such worries, noting that the U.K. has one of the most active and engaged regulators who are equally committed to "working on trying to democratize businesses and finding more solutions for consumers."

Indeed, the U.K. Competition and Markets Authority recently called for increased transparency, data sharing, and better technology to improve consumer experience and boost competition among banking institutions, including disrupters.

Sizeable edge

Ultimately, however, it's not regulators but market developments that will determine who wears Europe's FinTech crown. In that sense, London still retains a sizeable edge.

"The ingredients which have made London the FinTech capital of the world today — deep financial services expertise, skills from both the financial services industry as well as the technology-digital sector, and progressive policymakers and regulatory regime — will not go away because of Brexit," said Treasury's Burbidge, who is also a partner at Passion Capital, a venture capital firm.

> As with all sorts of business, competition to dethrone London can only be a good thing for the vitality of the FinTech industry.

Many FinTech players seem to agree. A German FinTech entrepreneur, who didn't want to be identified because his company is going through a fundraising round, said although his main activities and clients are Continental European, he is thinking about setting up an office in London because "that's where the best investors are based and where people know more about this rising industry."

And even without passporting rights and single market access, Wintermeyer notes that the U.K. has other attractions. "The bigger question is, are we going to have some tax advantage, will we be able to raise money on the government's balance sheet for FinTech or digital tech without falling afoul of EU competition law, and will we tweak our visa programs to make sure we are attracting people from all over the world, including Australia, Canada, and the U.S.?" he said. "There are so many variables in this."

Brexit has definitely triggered a contest to dethrone London as Europe's FinTech capital that would have been unthinkable before the June 23 referendum. But the competition is only just heating up.

As with all sorts of business, that can only be a good thing for the vitality of the FinTech industry.

Read the Q&A with Innovate Finance CEO Lawrence Wintermeyer: http://politi.co/2cGgREI

This article is part of a POLITICO special report on FinTech: The future of new finance.

Clarification: Switzerland's Kickstart Accelerator was launched by DigitalZurich2025 (now renamed, digitalswitzerland), a cross-industry association which is supported by 25 corporate partners, including UBS and Credit Suisse.