Commentary

EU Fintech Challenger Banks: Weak Internal Controls in the Spotlight

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Dimitra Louka
Analyst, Credit Ratings - Global Financial Institutions Group
+44 20 78556620
dimitra.louka@morningstar.com

Arnaud Journois
Vice President - Global Financial Institutions Group
+49 69 8088 3526
arnaud.journois@dbrsmorningstar.com

Kevan Viagas
Assistant Vice President - Global Financial Institutions Group
+44 20 3356 1526
kevan.viagas@dbrsmorningstar.com

Elisabeth Rudman
Managing Director, Head of Global FIG
+44 20 7855 6655
elisabeth.rudman@dbrsmorningstar.com

Overview

This commentary focuses on fintech challenger banks with a banking license in Europe (See a full list of the banks covered in this research in the Annex).

Fintech challenger banks have experienced significant growth in the past decade, especially during COVID-19 (see European Fintech Challenger Banks Face their Own Challenges). Along with this expansion, a growing number of fintech challenger banks have obtained a banking license in recent years, which has led to higher scrutiny and stricter regulatory requirements, notably regarding their financial crime controls. Several cases have emerged in which some institutions were investigated and fined because of weak risk management processes, highlighting the need to improve their governance frameworks. Risk management and operational control failures are generally flagged under Corporate Governance (also see ESG Factors for Banks, Part Two: Governance Factors).
In an increasingly difficult context for these institutions in the current environment, we view failures to comply with regulatory requirements and their potential financial implications could threaten the sector's long-term prospects.

Tightened Supervision: Fintechs With Banking Licences Are Regulated by Local Banking Regulators

Over the last decade, several European fintech challenger banks have obtained authorisation to carry out banking activities by obtaining a banking licence (Exhibit 1).

Exhibit 1 Banking Licences Granted to European Fintech Challenger Banks (2014 - 2021)

2014	2015	2016	2017	2021
Bunq	OakNorth Bank	Starling Bank	Monzo Bank	Revolut *
	Atom Bank	N26		

Source: DBRS Morningstar and Company Documents. Note: Revolut Bank UAB (Group's banking subsidiary) was granted a full banking licence by the European Central Bank (ECB) in Dec 2021.

As part of the application process, fintech challenger banks are assessed against certain criteria and standards to ensure they have adequate risk management and governance frameworks in place. When these banks are authorised, they are regulated and supervised in a similar fashion to traditional banks by their respective regulators (Exhibit 2) and subject to comparable rules regarding capital requirements, data governance and security, financial crime controls and other regulations. They are also required to offer deposit protection to their customers via deposit guarantee schemes.

Exhibit 2 Regulatory Authorities for European Fintech Challenger Banks

Challenger Banks Name	Country	Regulatory Bodies
Revolut*	Lithuania	Bank of Lithuania and the European Central Bank
Monzo Bank	United Kingdom	Financial Conduct Authority and Prudentail Regulation Authority
Starling Bank	United Kingdom	Financial Conduct Authority and Prudentail Regulation Authority
OakNorth Bank	United Kingdom	Financial Conduct Authority and Prudentail Regulation Authority
Atom Bank	United Kingdom	Financial Conduct Authority and Prudentail Regulation Authority
N26 GmbH	Germany	Federal Financial Supervisory Authority (BaFin)
Bunq B.V.	The Netherlands	Dutch Central Bank

Source: DBRS Morningstar and Company Documents. Notes: *Revolut Bank UAB.
Revolut Ltd operates under an e-money licence granted by FCA and its application to PRA for a UK banking licence is pending.

Regulatory Risks Faced by Fintech Challenger Banks: Financial Crime Controls in the Spotlight

In recent years, fintech challenger banks have faced greater regulatory scrutiny of their financial crime controls. Whilst digitalisation has enabled these banks to streamline customers' onboarding and verification processes, allowing customers to open accounts relatively quicker than at traditional banks, there are risks associated with this. For example, a fast onboarding process may result in a lack of sufficient information about the customer, and therefore in a poor assessment of the customer's risk profile.

This was evidenced in a review conducted by The Financial Conduct Authority (FCA) in 2021 covering 6 challenger retail banks with more than 8 million customers, which identified weaknesses in financial crime controls and Customer Due Diligence (CDD) procedures at some banks. The FCA stated that the majority of banks covered in its review failed to gather sufficient information about customer income and occupation at the account opening stage and also pointed out some limitations in their financial crime risk assessments frameworks.

Consequently, the FCA initiated in 2021 an investigation into Monzo's potential breaches of financial crime regulations over anti-money laundering (AML). The investigation is ongoing and could have a significant impact on the bank's financial position[1].

The German Financial Regulator (BaFin) imposed a fine of EUR 4.25 million in 2021 on N26 for weak AML controls related to the delayed submission of about 50 suspicious transaction reports in 2019 and 2020. Later in the year, BaFin also placed some limitations on the maximum number of customers the bank can acquire per month until the deficiencies identified in their financial crime controls are resolved.

In March 2022, the Bank of Italy also ordered N26's Italian branch to suspend onboarding of new customers until the bank deals with these issues. These limits to customer onboarding pose a risk to the growth potential of N26. This, in conjunction with a more negative operating environment, has led to suggestions that Allianz, a major shareholder in N26, will put their stake in the challenger bank up for sale. In our opinion, this exemplifies the risks associated with the challenger bank industry, where potentially undeveloped risk management processes pose both regulatory and financial risks significant enough to threaten an entity's credit strength.

[1] Per Monzo 2022 Annual Report; magnitude of financial impact was undisclosed

Current Economic Environment Poses Additional Risks to Fintech Challenger Banks
The rapid expansion of these banks over recent years has been helped by global investors looking for higher-return investments amidst low rates. Although these fintech challenger banks were still loss making, equity values remained elevated, providing investors with an alternative to lower yielding investments. However, in the current economic environment, we consider fintech challenger banks could struggle to raise as much external equity as they did in the past.

In this context, we view improving intrinsic profitability as key for the long-term viability of these banks. However, higher interest rates, high inflation, and increasing economic uncertainty will likely put these banks under pressure to slow their pace of growth while diversifying their funding mix further. On top of this, we view that this could make the costly investments needed to improve internal controls to comply with increased regulatory requirements more challenging, considering that apart from OakNorth, Starling and Revolut the rest of our sample was loss making as per the latest data available (Exhibit 4).

Exhibit 3: Evolution of Total Assets - 2017 - 2022 (EUR Million)

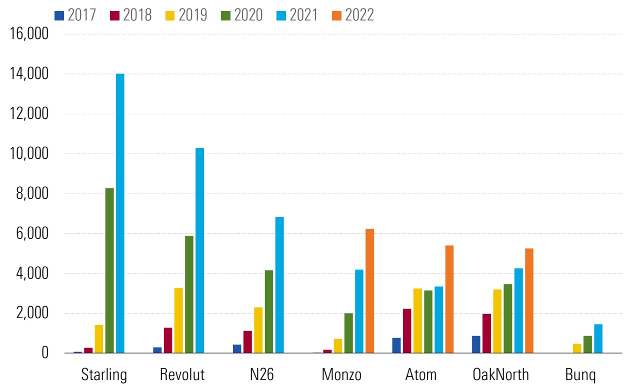
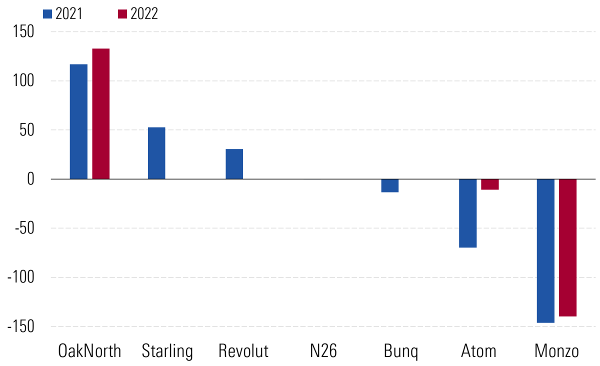


Exhibit 4: After-Tax Income at end-2021 and 2022 (EUR Million)



Source: Morningstar Inc. and Company Documents. Notes: Data based on latest information available. In 2019, Starling changed its financial year-end from 30 November to 31 March and data has been adjusted accordingly.

List of European Challenger Banks
Revolut
Monzo Bank Ltd
Starling Bank Ltd
OakNorth Bank Plc
Atom Bank Plc
N26 GmbH
Bunq B.V.

Notes:
All figures in EUR unless otherwise noted

Sources:
Morningstar Inc. and Company Documents.

For more information on this credit or on this industry, visit www.dbrsmorningstar.com

Related Research

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