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Fueling Innovation in Times of Crisis: The Impact of COVID-19 on Fintech

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As people remained at home in response to COVID-19 in March, consumer behavior shifted radically in a matter of days. Consumers opted *en masse* to use grocery delivery services rather than waiting in line in stores, stream movies rather than attending theaters, attend virtual yoga classes rather than go to studios, and students stopped going to brick and mortar schools, transitioning to a virtual online learning environment.

These changes have had an immediate and profound impact on the economy, financial technology companies, and the financial services industry more broadly. To that end, we asked ourselves the following two questions and thought that you, our clients and friends, may find our answers helpful as we all manage through these unprecedented times:

1. What is the immediate impact of COVID-19 on Fintech?

2. What will be the long-term trends of COVID-19 on Fintech?

The Immediate Impact of COVID-19 on Fintech

- Those companies dependent upon face-to-face ("F2F") transactions/engagement will be impacted the most negatively (restaurants, bars, theaters, ride share, home share, travel, brick & mortar retail, airlines, and hotels) ("F2F Companies").

- Fintechs that derive a significant part of their revenue from F2F Companies will likewise be significantly impacted.

- Fintechs that do not depend upon F2F Companies or that facilitate the migration from F2F to virtual interactions will benefit.

- These thoughts can be expressed as concentric circles with COVID-19 at the center. The further a Fintech or other company is away from the center the better it will perform in the short term. For example, Fintechs whose principle lines of business are digital will do very well in the short term. Fintechs that service F2F companies will face greater challenges in the short term (*e.g.*, payment processing for the airlines or travel platforms).

- In the short term, one should think of COVID-19 as the great accelerator. Trends that existed prior to COVID-19 will continue and accelerate; oftentimes materially.

Long-term Trends of COVID-19 on Fintech

- There will be increasing digitalization in payments and virtualization of financial services; as COVID-19 is the great accelerator. We do not believe that this acceleration will end when a vaccine is available for COVID-19. Investments in digital innovation, once made, will create their own post-COVID-19 momentum.

- The digital banking moment has arrived. Some reports indicate digital banking usage is up approximately 35% during the crisis. We believe that this will become the new norm, particularly the longer the pandemic lasts.

- Increasing digitalization of fiat currencies; this will become imperative for our Federal Reserve. It will be hard for the U.S. dollar to remain the world's reserve currency if the dollar cannot be directly used in digital transactions, which will increase significantly over time.

- Increasing regulatory scrutiny on business continuity/contingency planning. The financial services industry has experienced two "once-in-a-lifetime" economic crises in the past 13 years. We expect banks' and Fintechs' business continuity/contingency plans will become an area of focus during diligence and in subsequent examination cycles. Banks and Fintechs alike should develop, implement, test, and revise robust business continuity/contingency plans on an ongoing basis. Updating business continuity/contingency plans will require an enterprise-wide examination of lessons learned during the last two economic crises.

- The desire to innovate may be in tension with the need to promote resiliency and financial stability in the global financial system. Perhaps counterintuitively, incumbent financial institutions will benefit from the fact that they are regulated which will allow them to defend their business models against Fintechs who proved their value as "challenger" institutions during the COVID-19 crisis.

- Going forward, and in relatively short order, the need to innovate will separate those companies with the financial resources to do so and those without the financial resources to do so. This is happening now and will become more evident quickly.

- Fintechs that have developed cutting edge technology or products may be attractive acquisition targets or partnership opportunities for incumbent banks needing to innovate quickly but lacking the expertise and resources to do so organically.

- There will be an increase in fraud; particularly synthetic identity fraud. Security of personal and confidential-commercial data will remain vital. Fintechs will continue to grapple with the conflicting interests of increased innovation and data security and data privacy and those that succeed will win consumer confidence.

- As a country, the United States will have to develop a distribution mechanism that allows the federal and state governments to distribute funds/benefits (*e.g.,* emergency impact payments, unemployment benefits) to residents and companies quickly (as in days, not weeks or months, as we have witnessed with respect to the CARES Act programs).

- Significant changes in consumer behavior and preferences. Those banks and Fintechs that will survive and thrive in the long term will be able to quickly pivot and continuously adapt to an increasingly digital world. Consumer preferences are likely to transform as more and more may expect to have the entire financial services experience re-bundled into one digital banking experience—*i.e.*, credit, banking, investing, budgeting, faster payments, better rates, better rewards, and other resources (such as 24/7 interactive tellers, news, crisis information, information on jobs, government benefits, etc.). This will raise significant questions around consumers and their financial data.

- There will be significant impacts on globalization. We predict an increase in Western countries in anti-globalization/protectionist policies, especially in anti-China sentiment which may negatively impact the recovery of the global and U.S. economies. This is not just a U.S. issue but a global issue.

- Changes to lending and underwriting. With rapid digitalization of the lending and underwriting process, we expect to see a rise in the use of real-time, alternative data in the credit underwriting process. Alternative data includes information not typically found in traditional consumer credit reports or customarily provided by consumers when applying for credit, such as cash flow data derived from consumers' bank account records that examines categories of income and expenses (e.g., wages, rent, utility, cell phone, and other regular debits and credits), as well as educational and occupational information, social media use, and other online or mobile activities.

- "BigTech" in banking. With the rapid shift to an (almost) entirely digital banking experience, we believe there will be a continued increase in partnerships between financial institutions and BigTech companies for the provision of technology services and infrastructure (*e.g.*, AI, cloud computing, and data analytics) to financial institutions. This will result not just in the BigTechs becoming the preferred third-party vendors to banks but in BigTechs becoming intertwined in financial regulation as part of the financial infrastructure.

- We do think the adoption of AI will accelerate with the increase in digitalization and this will lead to difficult, interesting, and challenging policy and regulatory considerations.

Conclusion

In every crisis lies an opportunity. There will be significant casualties as a result of this crisis. However, we believe that new technologies, new leaders, new service providers, and new ideas will be born out of this crisis and well-suited industry participants will emerge stronger and more powerful to address the revised economy.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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