Why Traditional Banks are Faring Better than Challenger Banks During COVID-19

The social guidelines around COVID-19 resulted in a significant realignment of consumer behavior. E-commerce and digital platforms are booming during the pandemic, while traditional brick-and-mortar commerce centers are in decline. Surprisingly, the banking industry has, by and large, rebuked this market trend. Challenger/neo-banks that seized upon digital platforms as a competitive advantage over traditional banks face the unpleasant truth that, during a global crisis, relying on consumer behavior alone is not enough. Traditional banks may be slow to adopt new technologies and expand to new markets, but they are quick to fortify themselves during a global crisis. By leveraging their PACs, engrained relationships with the regulatory community, and diverse avenues of generating capital, traditional banks are rearing back with a vengeance to present challenger banks with challenges of their own.

Challenger and neo-banks have experienced notable success in South America, Europe, and Asia but have been slow to establish a foothold in the United States. The pandemic's surge in demand for mobile and online services should have been a boon for tech-savvy challenger banks seeking to break into the American financial services market, but recent data shows the opposite. The top reasons traditional banks are faring better than challenger banks, even during a time of unprecedented digital consumer participation, is due to various factors like regulatory expertise, charter banks, funding, operations, established customer trust, and target market size. This article addresses how regulatory mandates are exacerbating issues for challenger banks and preventing them from capitalizing upon COVID-19 digital trends, why traditional banks are less affected, and what solutions are available to banking's latest disruptors.

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The Complexities of Chargeback Regulations for Banks

Challenger banks seeking to disrupt the US market with innovative digital services are often stalled by the sheer breadth of America's governing bodies, local and federal laws, and consumer protection rights – all of which tend to be far more nuanced than what challenger banks have hitherto experienced abroad. When it comes to disputed financial transactions, upholding compliance with Regulation E, Regulation Z, Nacha, and association network mandates is a daunting prospect for even the largest, more established traditional financial institutions. Many neo-banking firms tend to either willfully ignore or accidentally neglect the very real need to establish internal fraud and dispute management systems and operational processes to avoid the inevitable fines and penalties that result from regulatory violations.

The federal regulations governing debit and credit transactions require challenger banks to establish and maintain a host of requisite operational processes to uphold compliance. Debit transactions fall under Reg E, which mandates that financial institutions have ten days to either make a final case decision or provide provisional credit, if issuers take the latter action, they have 90 days to resolve the dispute. Reg E noncompliance can result in a $1,000 fine per violation, not to exceed 1% of the financial institution's assets. Credit transactions are governed under Reg Z. These dispute deadlines depend on the last statement date, as well as when the claim was submitted to the customer's issuing bank. These dates result in highly incongruous timeframes in which a credit dispute must be resolved.

Nevertheless, debit disputes tend to be more challenging to resolve than credit disputes due to the simple fact that money involved in debit disputes is real. To underscore the difficulties that challenger banks have when upholding regulatory requirements around debit disputes, one must consider that when the Bank of England conducted a regulatory stress test on all British challenger banks last June, every single one failed. All were ordered to "tighten standards and correct 'over optimistic' risk modeling." To put this failed stress test into perspective, the UK has three regulatory bodies governing issuing financial institutions (PRA, FCA, and the Bank of England). The United States has nearly a dozen, and that doesn't even include state regulations.

Foreign-originated challenger banks pursuing US market entry on average will need to adopt three times the number of regulations under which they operate oversees. According to Virtual Investech Forum, "The EU-based challenger banks only must get approved to operate in one member state to open shop across the entire European Economic Area." If challenger banks continue to approach America's regulations the same way they have abroad, they will not survive the financial repercussions. Given that most challenger banks are looking for funding and operating on venture capital alone, noncompliance is something they cannot endure.

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Delegated Regulatory Compliance

Many challenger banks looking to establish themselves in the United States have taken the charter bank route – delegating regulatory concerns to whatever traditional bank holds their charter. This may seem like a simple solution but establishing a charter bank relationship can take up to two years, requiring costly and lengthy legal procedures. A research brief by CB Insights showed that Atom and Tandem bank spent over $18 million dollars to pursue a charter bank relationship. Some challenger banks are applying directly for banking licenses in the United States. However, this is no less lengthy of a process. In 2018, Varo Money received preliminary approval from the Office of the Comptroller of the Currency. Since then, Varo has still not received a national chartered banking license.

Challenger Banks Have a Greater Susceptibility to Fraud

Challenger banks have risen in popularity by appealing to niche groups and underbanked and unbanked consumers. These account holders are generally more susceptible to fraud. Banks targeting niche markets tend to appeal to young adults, who are more likely to make purchases online and conduct P2P transactions – which tend to have a higher risk of fraud. The overarching strategy that challenger banks have is to target underbanked and unbanked groups. To achieve this goal, challenger banks have fewer requirements to open accounts than traditional banks. This inevitably attracts account holders with lower credit ratings, poor financial history, and inconsistent sources of income. These factors tend to result in higher disputed transaction volumes than traditional banks experience and present more significant regulatory challenges for the neo-banking industry.

Additionally, fraudsters find new ways to exploit the digital only aspect of challenger banks by hacking credit/debit information – including credit card numbers, CVVs, and billing addresses. Fraudsters may find it easier to target challenger banks than traditional banks. The Brazil-based challenger NuBank was the victim of a fraud attack in early 2020 when an employee scammed a cardholder of R $12,000 ($1,000 USD) by falsely claiming that third parties were trying to hack his account improperly.

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Traditional Banks Have a Firm Hold on Consumer Trust

Even during COVID-19, American consumers are still reluctant to trust digitally based banks. In a recent EPAM survey, 82% of people stated that they were happy with their traditional bank. During such a tumultuous time, consumers are less likely to make significant changes, especially in an area as sensitive as finances. What's more, consumers are seeking refuge in what is tangible and comfortable. Traditional banks with brick-and-mortar locations symbolize stability and a veritable comfort that, should the pandemic threaten the global economy, consumers can physically reach their bank to access their money.

Furthermore, challenger banks are overwhelmingly used for secondary rather than primary bank accounts. According to a recent article by The Financial Brand, even during COVID-19 only 3% of account holders worldwide use a challenger bank as their sole bank.

The biggest mistake a challenger or neo-bank can make is to ignore regulatory requirements. The regulations surrounding dispute claims alone support this. Challenger banks can overcome compliance difficulties by employing automated fraud and dispute technology that streamlines complex and competing regulatory requirements. Efficient fraud and dispute management will help challenger banks build consumer and investor confidence to ultimately strengthen their entry into the US banking industry.

Learn more about how Quavo's Disputes as a Service offering can help all issuing banking organizations reduce losses and ensure compliance during the era of COVID-19 by visiting us online or by emailing our experts at experts@quavo.com.