MANATT JONES
GLOBAL STRATEGIES

March 2017

FinTech Trends: Investment opportunities, regulatory challenges and the outlook for Mexico

1. What is FinTech?

FinTech is the subsector of the financial services industry that employs new technologies not only to more efficiently deliver products and services but also to provide access to these services to underserved populations. FinTech does so by collaborating with traditional financial services, yet it also acts as a positive disrupting force by creating new competition and expanding ways to serve customers in the financial arena.

FinTech is not a new phenomenon. Advancement in financial services has been driven by new technology since its earliest days—from the advent of banknotes in England, to credit and debit cards in the mid-20th century, to loan syndication and credit default swaps in the late 20th century. The ongoing technology developments over the past few decades have fueled opportunities for FinTech to continually revolutionize the financial sector. For instance, Blockchain, a financial technology that uses a decentralized ledger system instead of the current centralized, single clearing house system, could completely change the way in which transactions are received, processed, and delivered, much as credit cards disrupted the financial system in the 20th century. Through the growth of Bitcoin and other technologies, Blockchain offers the possibility of virtually eliminating transaction costs and execution time.

Today's FinTech ecosystem is comprised of a wide array of agents. As categorized by PwC in Chart 1, participants at the center of FinTech advances include established financial institutions like banks, big tech companies like Apple and Google, major infrastructure providers such as MasterCard and Nasdaq, and of course, the innovators in the sector - startup companies. Satellite participants influencing developments include regulators and government, who set the rules of the game; emerging technologies and tools, that drive new FinTech products and services; investors, incubators and accelerators, who act as active promoters of the sector; and consumers and users, who interact day-to-day with FinTech tools and benefit directly from them.

Chart 1
FinTech Ecosystem

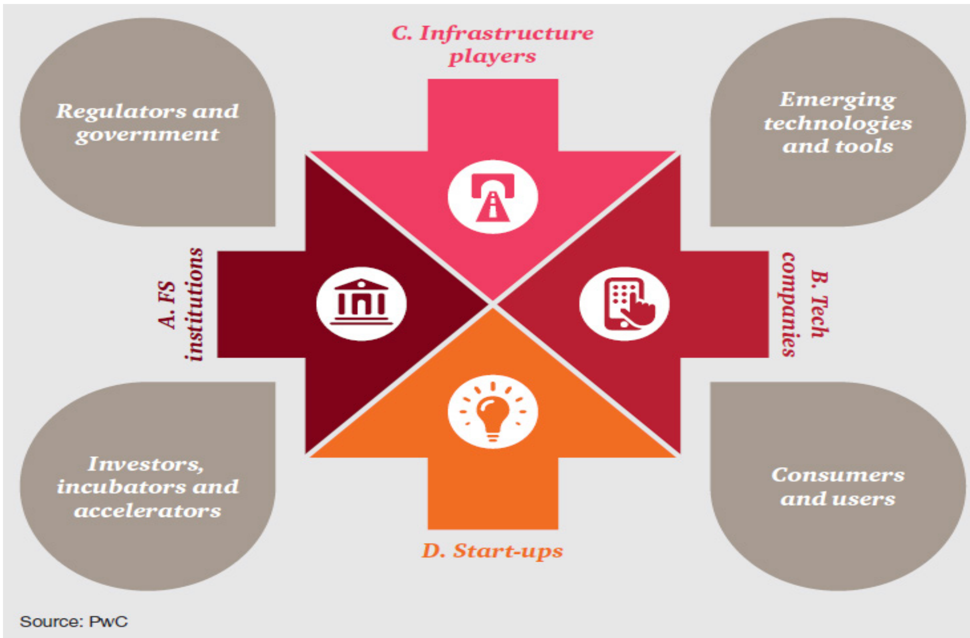


Chart 2 identifies the seven service areas in which FinTech has shown the most action and innovation.

Chart 2
FinTech Areas of Activity

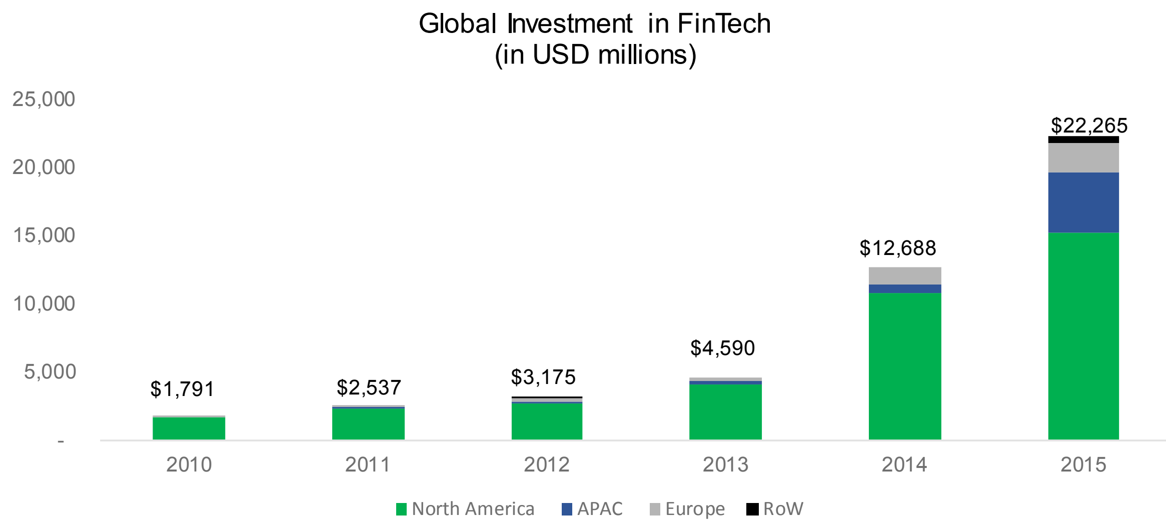
Payments and Cash Transfers	•Companies that provide services to facilitate payments and money transfers. Examples include mobile devices that can be used as banking terminals and websites, like PayPal, that facilitate financial transactions.
Lending	•Companies engaged in making loans online, which typically require less paperwork than traditional lending institutions.
Financial Management	•Companies that provide online fiscal information and money management advice for companies or individuals. Examples include tax investment advisory firms.
Insurance	•Companies that provide insurance services online, which typically requires less paper work than working with traditional insurance companies.
Scoring, Identity and Fraud	•Companies that monitor and provide information about the credit history of individuals and businesses.
Crowdfunding	•Companies that provide a platform through which businesses can raise investment capital from a large number of individuals with each contributing small amounts of money.
Financial Education	•Companies that provide instruction and advice on financial management, including assessments on how to pay debts and save money.

2. What Are the Current Global Trends?

Investment Trends

On a global scale, the FinTech sector has experienced robust growth over the past six years. As shown in Chart 3, from 2010 through 2015, over USD 47 billion was invested in more than 2,500 FinTech companies, with much of the activity occurring in 2015 when USD 22.3 billion was invested - a 75% increase from 2014. As indicated below, North America remained the leader in total investment throughout the period, but with the Asia-Pacific (APAC) region and Europe driving recent growth.

Chart 3



Source: Accenture

Chart 4 shows the level of investment in each of the service categories within FinTech. The largest share of FinTech investment activity has focused on the payments sector, particularly on retail payments and merchant acquiring[1]. Examples of transactions in this space include a USD 16.6 million investment in SlimPay[2], a French start-up that provides a smart recurring payment mechanism, and PayPal's USD 890 million acquisition of Xoom, a leading digital money transfer provider that enables consumers to send money, pay bills and send prepaid mobile phone reloads to family and friends around the world[3].

The largest growth in FinTech investment, however, has occurred in the retail lending and financial management sectors. Examples of deals in these areas, respectively, include SoftBank's USD 1 billion investment in marketplace lender SoFi, which recently raised 500 million dollars in an equity funding round[4], and Betterment, which provides online investment advisory services. It received USD 105 million of funding from 2010 through 2015[5] and raised an additional 100 million dollars in 2016[6]. The third notable FinTech sector that exhibits both high growth and sizable investment value is SME lending and asset finance, which targets more complex loans to small and medium size firms that traditionally have had only limited – and expensive – access to financing.

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[1] "Merchant acquiring is an integral part of card payment transactions processing. Acquirers enable merchants to accept card payments by acting as a link between merchants, issuers, and payment networks—providing authorization, clearing and settlement, dispute management, and information services to merchants", Capgemini, Challenges and Opportunities for Merchant Acquirers.

[2] Innovation and Payments: The Future is Fintech, The Bank of New York Mellon Corporation.

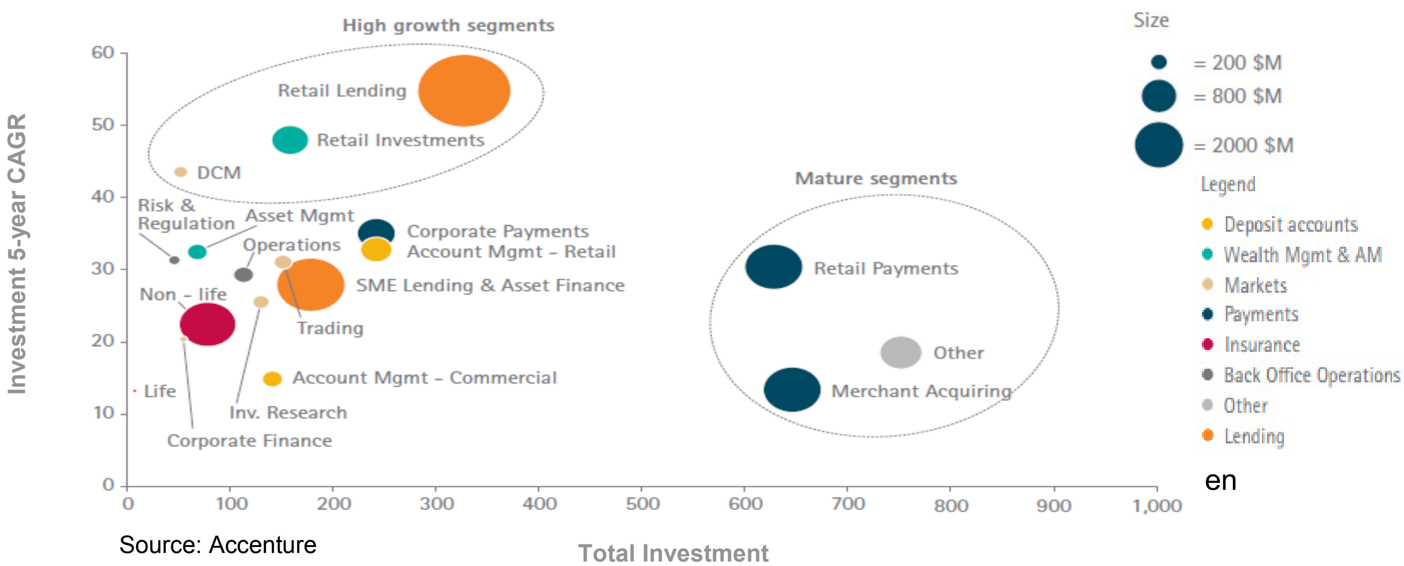
[3] http://www.businesswire.com/news/home/20151112005780/en/PayPal-Completes-Acquisition-Xoom

[4] https://www.bloomberg.com/news/articles/2017-02-24/sofi-raises-500-million-led-by-silver-lake-for-global-expansion

[5] http://empirica-software.com/fintech-companies-retail-investments/

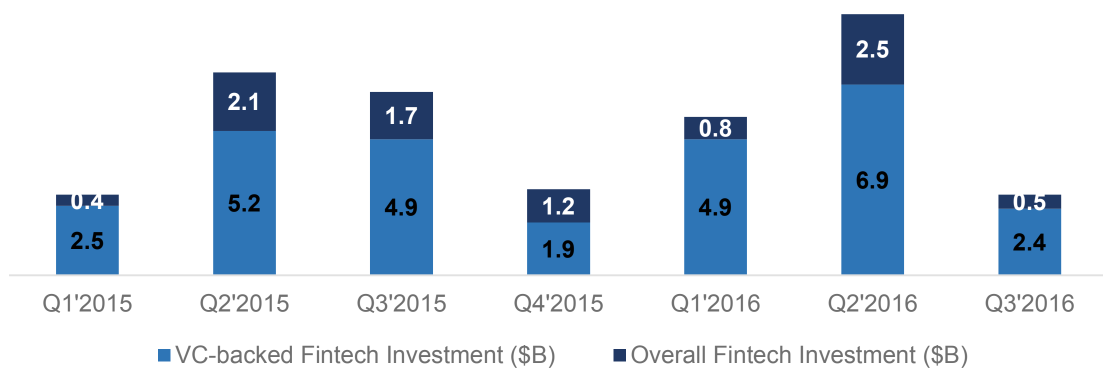
[6] http://www.businessinsider.com/robo-advisory-firm-betterment-raises-100-million-in-funding-2016-3

Chart 4
Global FinTech Financing Activity by Sector 2010-2015



Source: Accenture

Chart 5
Gobal FinTech Financing



Source: KPMG

Table 1
Most Active VC Investors in FinTech
Q1 2015 – Q3 2016

Rank	Investor	Rank	Investor
1	500 Startups	9	Bain Capital Ventures
2	QED Investors	9	American Express Ventures
3	New Enterprise Associates	9	Ribbit Capital
3	General Catalyst Partners	13	Sequoia Capital China
3	Khosla Ventures	13	SpeedInvest
6	Blumberg Capital	13	Union Square Ventures
6	Index Ventures	13	Route 66 Ventures
8	Spark Capital	13	Nyca Partners
9	Omidyar Network	13	Sequoia Capital India

Source: KPMG

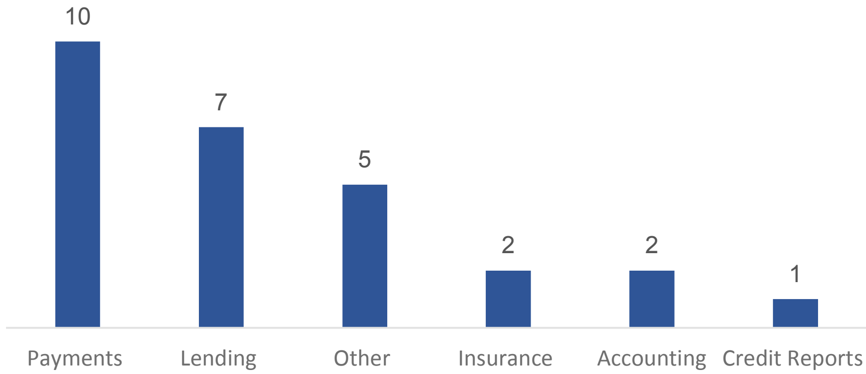
FinTech seems to be moving to a more mature growth stage as evidenced by the number of successful IPOs and the rise in private market valuations in 2015[7]. Examples of companies that have gone public include:

- Worldpay: An online payment service provider, IPO valued at GBP 4.8 billion on LSE;
- Square: A point of sale payment processor, IPO valued at USD 2.9 billion on NYSE;
- LendingClub: An online credit marketplace, IPO valued at USD 5.4 billion on NYSE; and
- OnDeck: An online lending platform, IPO valued at USD 1.3 billion on NYSE.

In addition to these four companies, there were a total of 27 FinTech companies valued at or above USD 1 billion at August 2016. These "unicorns" shared a combined market capitalization of USD 136.1 billion. FinTech firms offering payments and lending services represent almost three-quarters of the total valuation of this group as shown in Charts 6 and 7.

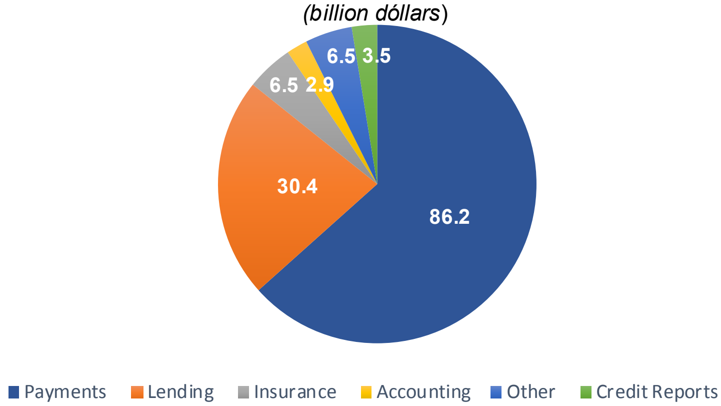
[7] Accenture; "The Future of FinTech and Banking: Digitally Disrupted or Reimagined?"

Chart 6
Number of Unicorns by Sector



Source: Business Insider

Chart 7
Total Valuation
(billion dóllars)



Source: Business Insider

Even with the successful IPOs and increased valuations of private FinTech companies, activity in the space has been trending to more of a focus on Mergers and Acquisitions, whereby the most successful companies are being acquired by private equity funds, other successful start-ups, and traditional financial institutions. For example:

- Alibaba and Ant Financial purchased a 20% stake in Paytm, an Indian mobile e-commerce company, in 2015 for USD 680 million;
- BlackRock acquired the online investment advisory and management firm, FutureAdvisor, in 2015 for USD 152 million; and
- BBVA bought the online bank, Simple, in 2015 for USD $117 million.

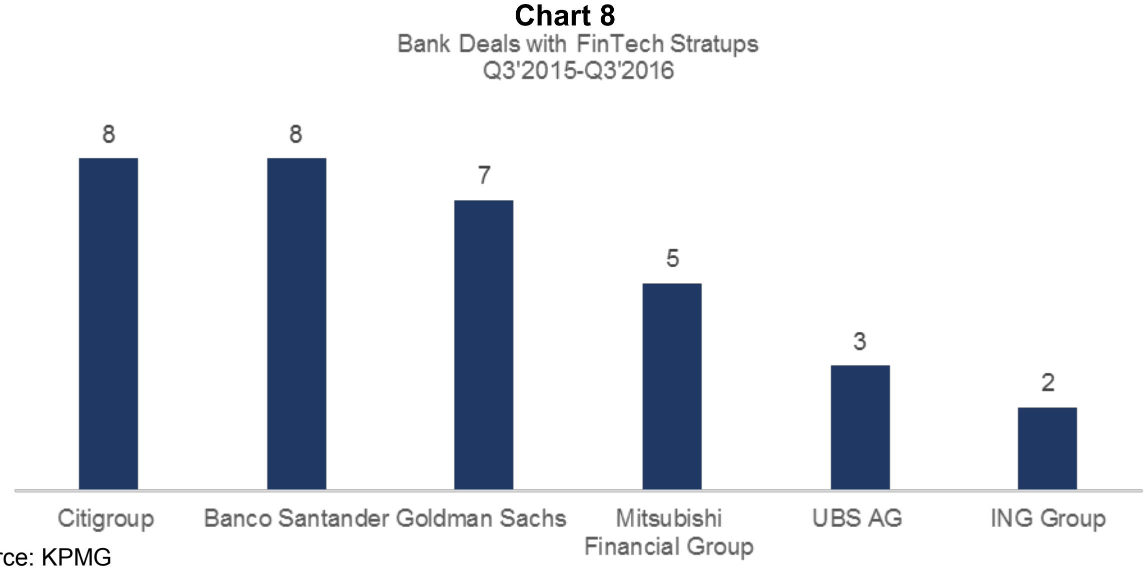
FinTech and Traditional Financial Institutions

Traditional financial institutions are beginning to adjust to the changing landscape in financial services by investing in FinTech companies and incorporating their services. As shown in Chart 8, Goldman Sachs has been the leader in this area by investing in nine worldwide deals with FinTech startups, with Citigroup and Banco Santander following with seven investments each. Other important financial institutions have struck deals with FinTech companies, including:

- JPMorgan Chase announced a partnership with the peer-to-peer lending company OnDeck Capital in December 2015. On Deck provides loans between USD 5,000 and USD 250,000 to SMEs.
- BBVA purchased the mobile banking company Simple. Notably, BBVA allowed the company to keep its own board of directors so as to maintain its "innovative startup environment" and not be dragged down by the bureaucratic systems of the bank.

According to a survey of C-level executives of both FinTech and traditional financial institutions conducted by our parent firm Manatt, Phelps & Phillips, LLP in partnership with financial intelligence firm Mergermarket, hopes are high for the future of collaboration between both types of institutions. According to the report: "Banks see FinTech as a way to enhance mobile capabilities, lower capital and operating costs and decrease technology expenditures. FinTech firms see working with banks as an opportunity to gain market credibility and access to the clients of midsized and smaller banks."[8]

Chart 8



Source: KPMG

Government Initiatives

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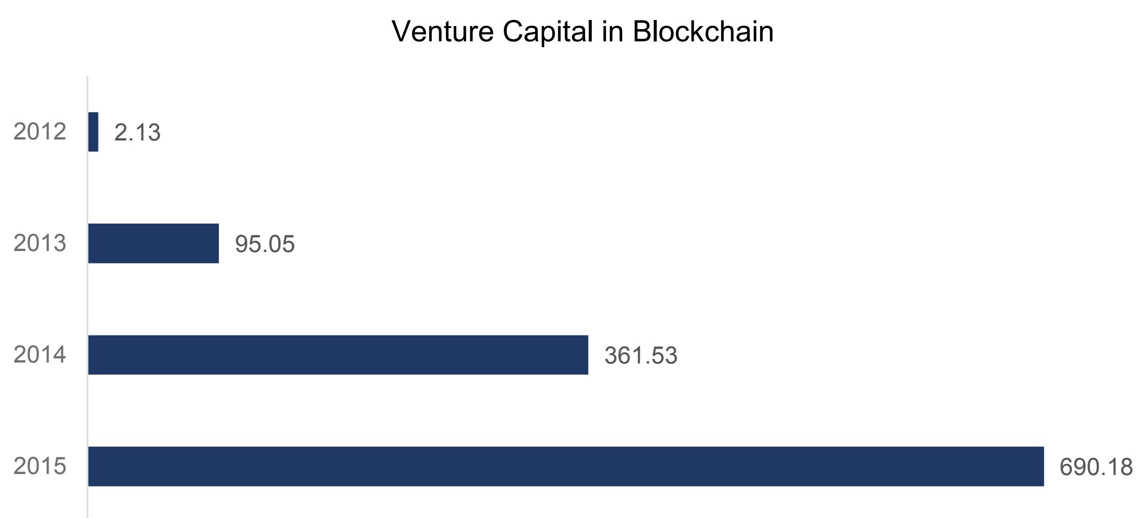
[8] See the report "Growing Together: Collaboration Between Regional and Community Banks and Fintech.", http://mergermarketgroup.com/wp-content/uploads/2016/10/Collaboration-Between-Regional-and-Community-Banks-and-Fintech-R.pdf

Governments around the globe have realized the importance of the FinTech sector and the development opportunities it brings, and so are active in boosting investment in the sector. For example, the Monetary Authority of Singapore pledged USD 166.48 million over a 5-year period to support FinTech innovation in that country. Similarly, South Korea set up the FinTech Center of Korea, an affiliate of South Korea's Financial Services Commission, as part of its USD 19 billion "Research Innovate Enterprise 2020 Plan". Likewise, Australia wants to encourage investment in the sector and is formulating a framework to grant tax incentives to venture capital directed toward FinTech startups.

Unleashing the Blockchain

We believe that the sector with the most potential to revolutionize the financial system may be blockchain. As of the end of 2015, companies in this area only made up about 1% of the valuation of the largest FinTech businesses. As shown in Chart 9, however, startups in this area witnessed a 91% growth in VC investment between 2014 and 2015, from USD 361.53 million to USD 690.18 million, and we foresee the trend continuing in the future.

Chart 9



Source: Coindesk

One reason for the relatively small investment to date in the area is the outdated regulatory burden to which blockchain startups are subject. For instance, for companies involved in the movement of money, they are forced to register with every country in which they operate. In the United States, this involves registering with every state—creating costly barriers to entry. According to the American Banker: "Virtual currency firms, typically have to register as money transmitters in each jurisdiction they want to operate in and then comply with varying standards for things like net worth, bonding and investor due diligence"[9]. To respond to this issue several companies have requested the creation of a "specialized charter that can allow the companies to comply with federal rules instead of facing a state-by-state licensing framework"[10].

Despite the regulatory burdens, there has been an uptick of blockchain activity by traditional financial institutions. They are participating in various collaborative projects, like R3, a blockchain platform developed by over 50 of the world's leading banks in order to promote and capture the benefits of the technology's capabilities[11]. This, in conjunction with hopeful improvements to the regulatory environment, has led to predictions for continued growth in the area. Accenture estimates that the use of blockchain will begin a steady growth phase in 2018, and by 2025, will fully be adopted by the financial services sector.

Regulatory Trends

One of the key factors that will determine the future direction of FinTech is the regulatory environment within which it must grow. Regulation of the sector is underdeveloped. However, 2016 saw an increase in government efforts to address issues arising from advances in the industry. For example, the United States Treasury published a white paper in May 2016 outlining the need to address issues from small business protection and efficient oversight of online lending to the creation of an intergovernmental working group in order to gather different visions, comprised of: the Consumer Financial Protection Bureau (CFPB), Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System (FRB), Federal Trade Commission (FTC), Office of Comptroller of the Currency (OCC), Small Business Administration (SBA), and Securities and Exchange Commission (SEC). The white paper, however, has prompted debate as to whether FinTech companies should be considered as part of the traditional financial sector be treated as a completely separate sector. No consensus has been reached, and none is expected soon.

In the UK, the main regulator of financial services is the Financial Conduct Authority (FCA), which works with the Prudential Regulation Authority, Bank of England, Financial Policy Committee and the Treasury to create an environment conducive to customer safety and innovation. It has achieved this through the concept of ***Regulatory Sandbox***[12]. In the *Sandbox,* businesses are allowed to test new products and services without having to comply with all existing regulations, and regulators can provide feedback to the company based on the results of these tests. The testing parameters, the number of customers involved in a test, and the duration of time (typically between 3 to 6 months) are agreed upon in advance. Singapore, another FinTech hub, has copied this framework in their FinTech and Innovation Group, which is under the authority of the Monetary Authority of Singapore.

[9] http://www.americanbanker.com/news/bank-technology/when-will-fintech-regulation-grow-up-1091743-1.html
[10] https://www.bloomberg.com/enterprise/blog/fintech-firms-press-occ-for-specialized-charter/
[11] https://r3cev.com/
[12] https://www.fca.org.uk/firms/project-innovate-innovation-hub/regulatory-sandbox

Risks will arise as innovation moves financial services into uncharted areas, and it is the job of the regulators to mitigate them as much as possible. Their main challenge will be finding the balance between creating an environment of innovation for startups, and at the same time, protecting users and the financial system as a whole. Because of its size and growth rate, a top priority area for regulators is that of payments and money transfers. They will have to figure out a way of maintaining the speed and ease of the movement of money that FinTech innovation has created, while at the same time creating a secure system to combat both money laundering and the funding of illicit activities. Another area of great concern, highlighted in the U.S. Treasury white paper, is online marketplace lending. Some of the more urgent issues that the paper argues must be monitored include (1) how online lending adjusts to changing economic conditions in order to prevent unnecessary collection risks when delinquent payments begin to accrue and (2) monitoring complicated credit scoring algorithms to protect consumers from unforeseen biases affecting certain groups of creditors. What is clear at this stage is that regulatory questions are running well ahead of the ability of regulators to answer them.

Implications for Emerging Markets

FinTech offers an area of great opportunity for nations whose populations are currently underserved by traditional financial institutions. This is exemplified by the sudden increase in financial activity in countries like India and China, where traditional financial service infrastructure is outdated or nonexistent. Concurrently, mobile devices and connectivity are coalescing with demographics dominated by tech savvy youth, leading to an increase in the use of non-traditional financial technologies to complete tasks from sending remittances to paying a phone bill.

Mexico shares these characteristics, signaling a high potential for growth in FinTech. A strong entrepreneurial base has begun to form, supported by a government focused on financial inclusion issues. As with other developing countries, however, the key missing ingredient is investment. Governments of the developing countries should thus, keep this in mind when designing regulation and related public policies. For example, they may consider the case of Australia, which, as mentioned earlier, is in the process of formulating a framework granting tax concessions to investment directed toward FinTech startups.

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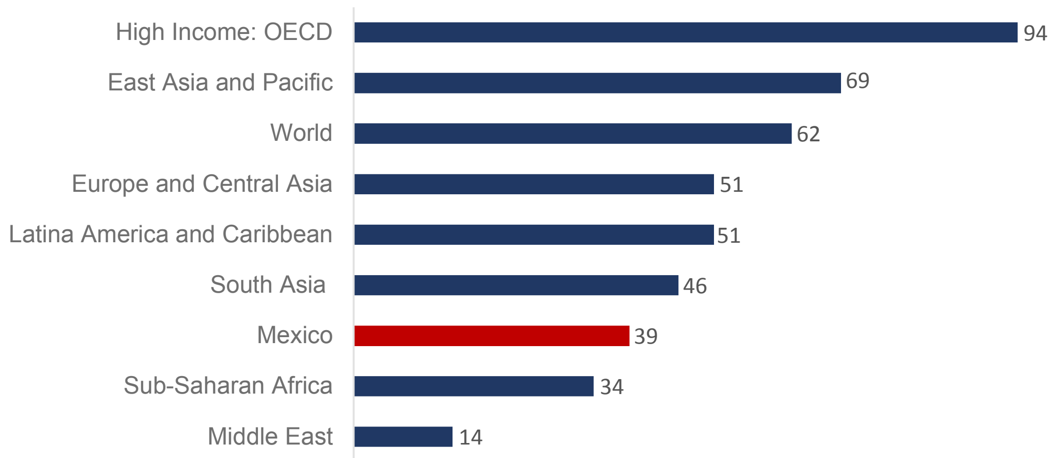
3. FinTech in Mexico

Chart 10
Percentage of Adults with Accounts 2014



Limited financial inclusion is an issue that continues to plague Mexico. As shown in Chart 10, it ranks last in financial penetration compared to other OECD countries, with only 39% of the population having a bank account. In addition, Mexico is also lagging behind in the Latin America and Caribbean region (LAC), where the average is 51%. For the region, a major contributing factor for this low penetration is the lack of infrastructure needed to reach both a broader population and SMEs. According to the Financial Inclusion Report published in 2016 by the National Council for Financial Inclusion (CONAIF), there are only 10.1 access points for every 10,000 citizens on average in Mexico where one can deposit or withdraw money.
Source: CONAIF

In addition to the lack of infrastructure, as of 2015 only around 41% of Mexicans had direct internet access, even if roughly 80% have mobile access to FinTech services, specifically to mobile banking. These two factors may provide the solution to reducing *financial exclusion*. Fortunately, these connectivity numbers should increase significantly as the government moves forward with its four-pronged *National Connectivity Program,* consisting of the following:

- *Backbone Network:* An updating of the federal fiber optic network that will eventually be leased to commercial contractors.
- *Shared Network:* The designing, financing, creation, and running of a wholesale network through private-public partnerships. The government expects it to be up and running by the end of the Q1 2018.
- *Mexico Connected:* A plan to install 250,000 Wi-Fi spots in public locations in order to provide free internet access.

- *National Digital Strategy:* A national program with the goal of increasing the development of Information Technologies and communication between citizens and the government.

Investment Trends in Mexico

Venture capital investment in FinTech companies in Latin America reached USD 143 million in 2015, of which Mexico received 28% (USD 40 million). Some of the more notable deals in 2015 were:[13]

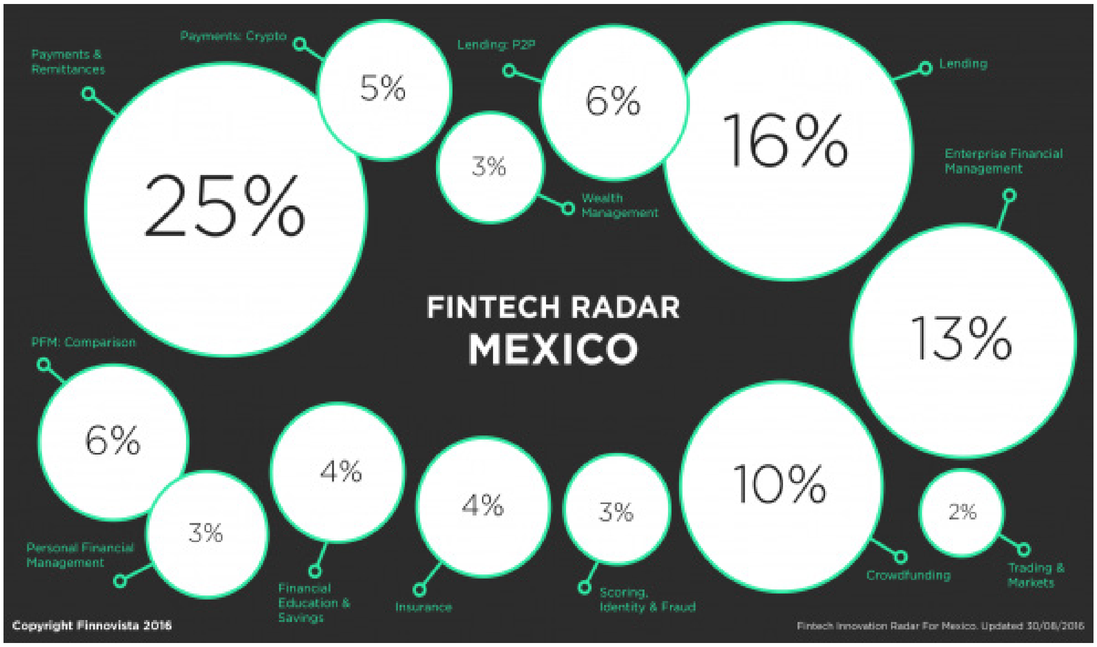
- USD 19 million Series C-round of investments by LIV Capital, Mexico Ventures, Fondo de Fondos, and the IFC in YellowPepper—a mobile wallet company.
- USD 8 million Series A round with Alta Ventures, American Express Ventures, Mexico Ventures, Sierra Ventures, Angel Ventures, and Endeavor Catalyst in CLIP, a mobile payment platform. CLIP eventually raised a total of USD 40 million throughout 2015.

This trend continued in 2016, with Kueski's closing of Mexico's largest round of FinTech funding. The Guadalajara-based online microloan marketplace closed a Series A investment round of USD 35 million in April, with the potential to bringing in up to USD 100 million. The principal investors were Richmond Global Ventures, Rise Capital, the CrunchFund, Variv Capital, Victory Park Capital, Angel Ventures Mexico, Core Ventures Group and Auria Capita.

A breakdown of Mexico's FinTech environment shows that the focus of Mexico's 158 startups has been on Payments and Transfers,[14] accounting for 30% of the companies, and Financial Management,[15] with 21%.

[13] LAVCA; "What can we expect from Venture Capital in LATAM?"
[14] Found by adding Payments and Remittances with Payments: Crypto from the graphic below
[15] Found by adding Wealth Management, Enterprise Financial Management, Trade and Markets, and Personal Financial Management from the graph below

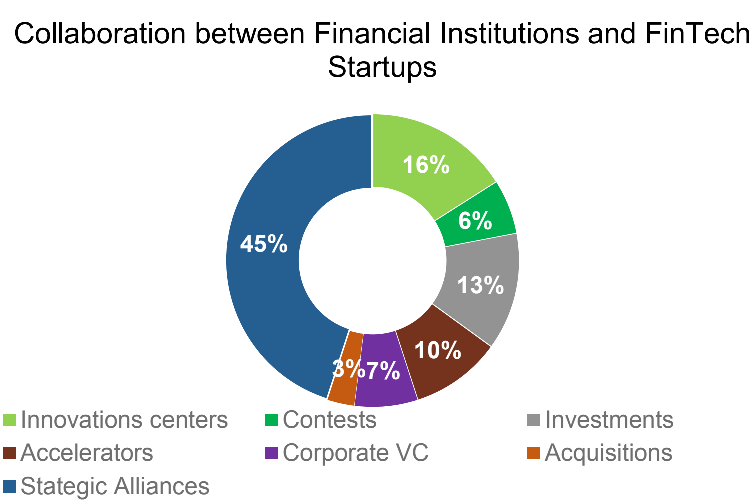
Chart 11



Source: FINNOVISTA

Another trend in Mexico is the move toward collaboration between startups and traditional financial institutions. According to ALLVP (a VC firm active in Latin America) and as shown in Chart 11, there have been 31 collaborative deals in Mexico taking place in seven different categories: Strategic Alliances; Innovation Centers; Investments; Accelerators; Corporate VC; Contests; and Acquisitions. The most prominent of these has been Strategic Alliances, making up 43% of the collaborative deals. The most active bank has been BBVA Bancomer, promoting collaboration through its innovation centers, contests, and venture investment branch.

Chart 12



Source: ALLVP

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Regulatory Trends & Recommendations for Mexico

Currently, there are no specific regulations or regulatory bodies set up to monitor the FinTech sector in Mexico. Any advancement that has occurred, or any company looking to register in Mexico, falls under the general jurisdiction of the traditional financial regulatory entities. This includes the Secretary of Finance and Public Credit (SHCP), the National Banking and Securities Commission (CNBV), Mexico's Central Bank (BANXICO), and the National Financial Services User Protection Committee (CONDUSEF). Nonetheless, local Fintech companies such as Kubo Financiero - a crowdfunding and peer-2-peer operator - have successfully worked through these traditional channels.

Many experts in the public and private sectors are aware of the need for more formal regulation pertaining to FinTech. As reported by Forbes in September of 2016, members of the business, government, and academic communities in Mexico will begin the process of creating formal regulatory committees needed to address the most pressing issues. The expectation is that a regulatory network will emerge that is conducive to a healthy FinTech environment of innovation, protection, and security—as is occurring in other hubs around the world. This, in combination with the strong entrepreneurial base in Mexico, could fuel the investment needed to capture the true potential the country has and further develop the nascent Mexican venture capital ecosystem.

At ManattJones, we believe that the new regulatory environment in Mexico will have to consider at least the following elements to unleash the power of FinTech. First, the regulation should be clear about its objective, meaning that the authorities have to define whether the purpose is to encourage investments in FinTech, mitigate risks in the financial system, or increase competition in financial services, to mention a few. Second, authorities must create a regulatory model consistent with that objective. For instance, Mexico may consider the Sandbox approach adopted by the UK and Singapore, or a stricter traditional regulatory model that minimizes risks by raising entry costs. Third, given the wide variety of products and services and types of offering institutions that fall within the FinTech space, it is essential that the regulatory framework begin by clearly defining which product and institution types are the focus of the regulation. Once this is determined, the objectives of the regulation and the regulatory model can be more effectively implemented.

Following categorization of FinTech companies set forth above, we believe that regulation for **payments and cash transfers companies** should focus on minimizing systemic risks that could affect the stability of the payment system while promoting competition and market expansion. In **lending and financial management** activities should be incentivized by adopting a sandbox approach, to ensure that the sector will not break. Regarding **insurance** companies, they are already regulated by the Law of Insurance Companies, which forces them to maintain a minimum of capital and to prove a minimum amount of reserves. The regulation must facilitate the creation of solutions that encourage insurance contract, optimize prices and reduce risks. Allowing the electronic signature for insurance policies is a key factor for success. **Scoring and fraud** FinTech firms are already operating in Mexico. The law should focus on encouraging the communication between the different actors of the market to allow the interaction of their databases, making sure they comply with policies that oversee the use of private information. With respect to **crowdfunding,** several financing platforms are already operating in this country under the Association of Collective Funding Platform (Afico), which aims to self-regulate this sector by establishing a code of practice. The regulation should establish the responsibility of the administrator of the platform and the mechanisms to reduce the risk of fraud.

Conclusion

The FinTech sector has enjoyed rapid worldwide growth since 2010, and we forecast the trend to continue over the next five years driven by the desire for expanded financial inclusion, enhanced security and lower transaction costs afforded by technology advances. In Mexico, in particular, we see great opportunity in all of the FinTech sub-sectors – Payments and Cash Transfers, Lending, Financial Management, Insurance, Credit Scoring/Fraud Prevention, Crowdfunding and Financial Education – but it will require the support of government through the adoption of regulations that provide a framework for attracting investment in new and emerging financial technologies.

For more information please contact:

José Carlos Rodríguez Pueblita
Senior Director
ManattJones Global Strategies
Campos Elíseos 385, Torre B, Piso 8
Col. Chapultepec Polanco
México, D.F., C.P. 11560, México
Off. +52 (55) 5281-8296
+52 (55) 5280-5609
+52 (55) 5281-2928
jcpueblita@manattjones.com

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