LEND ACADEMY

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Welcome to the Lend Academy Podcast, Episode No. 126. This is your host, Peter Renton, Founder of Lend Academy and Co-Founder of LendIt.

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Peter Renton: Today on the show, I'm delighted welcome Miles Reidy, he is a partner with QED Investors. Now QED Investors is probably the pre-eminent venture firm in the fintech space. They have been expanding their horizons to include regtech and Miles has become something of a regtech expert over the last couple of years. So I wanted to talk to Miles specifically about what are the areas of regtech that he thinks are most interesting, how is it making a difference, how is technology actually being applied in compliance departments at large banks. What about artificial intelligence, how is that impacting this space? It was a fascinating interview, I hope you enjoy the show.

Welcome to the podcast, Miles.

Miles Reidy: Thank you, Peter, I'm glad to be here.

Peter: So let's get started with giving a little bit of background about yourself. You've had a...looks like a pretty interesting career to date and like many people from QED, you spent some time at Capital One so just tell us a little bit about what you've done in your career.

Miles: Oh, it's a very boring story so your listeners might want to tune off while I am going on a bit. (Peter laughs). So I'm a CFO type and between me and my other partners here at QED, we've all done just about every C-level job there is in a financial services type company. I've been in CFO/COO type roles and we've got other roles so we compliment each other. Particularly, at Capital One, I was CFO of the card business, Head of Financial Strategy, eventually kind of ran planning for the company and then oversaw the expansion into banking, including buying the largest bank in Louisiana the day before Katrina hit which was an interesting process.

Peter: Wow, okay so then what made you decide to leave…I know you worked in other jobs at other large companies and you decided to...

Miles: Yeah, I've done bank M&A for most of my career, you know, I helped run Mellon Bank's M&A department in the 90's and what made me kind of leave Capital One was a really dumb decision (Peter laughs). I decided to retire and in fact, this conversation will be a series of failed retirements (Peter laughs). Apparently, I'm quite annoying to my wife, who's a surgeon, when I'm bored and since she has access to all sorts of horrible tools, I've been finding refuge in professional endeavors ever since. (Peter laughs)

Peter: Okay, okay, so then you came to QED and what was the reason behind that?

Miles: At Capital One, I got bored, I decided to try retail so became CFO of Sears Holdings for a bit and came and helped General Atlantic get out of an investment. Then at age 50, I did my first startup in the healthcare space, it was a company called Audax that I helped start it up and organize and had a very good exit to United Healthcare and before I could say the R word, my wife had called Nigel and told him to get me out of the house and that's how I came to QED.

Peter: (laughs) Okay, so coming to QED, what has been and what is your area of focus?

Miles: I do a couple, I focus on the UK and Europe so I do our venture build there called ClearScore and some of the investments in that area. I do regtech, I'm also the guy who kind of shows up when stuff is not going well so I'm the workout guy here.

Peter: Right, okay, Mr. Fix It.

Miles: Me being a grizzled old CFO apparently, I get all those...

Peter: (laughs) Right, right. Okay, so what we're going to talk about today is more focused around regtech so being like a bank CFO and doing M&A, I imagine this has been an interesting way, this sort of new field has developed because obviously it's been around for a while, but I want to talk about...firstly, let's just talk about how do you define regtech?

Miles: Regtech, it's like fintech, it's a label we actually don't like because really fintech is just financial services. Regtech is looking for efficiencies in large institutions, whether they're banks or other types of financial entities. It's trying to automate and reduce the friction of being compliant and it's not something that just kind of showed up over the night that there's some eureka moment. It's something that's been building slowly over time and we think, you know, the pace of regulatory change has slowed enough where banks can actually catch their breath and start to think about not just complying by throwing money and bodies at it, but how to comply but do it in a way where they drive efficiency and do it in a way wherein they actually get some competitive advantage out of it.

Peter: I'm curious about...like going back to your days at Capital One, even your days at Sears Holdings, obviously you want to automate as much as possible and companies have been automating since Henry Ford was around. I'm just curious to know like when...just stepping back I'm trying to dig into the origins of sort of the technological kind of change that's happened, whether there was real technology being applied to this area 20 years ago. I'm curious to get your perspective on that.

Miles: There really wasn't. The compliance...at least compliance at a manic level that banks endure today really is an outgrowth of 2008 where bad executive management in these institutions ran them off a cliff. The pace of change has been really fast in terms of the scope and complexity of the rules and the rules themselves have just started to kind of settle out. Nothing gets a bank CEO fired quicker than a compliance issue and so it's something that…you know, it strikes a lot of fear, the fines can be staggering, the fines are often deserved, but you know with billions upon billions of dollars and when you are faced with that kind of existential risk it’s not a function of how can I do it cheapest, it's just how can I do it.

Peter: Right.

Miles: And that creates an opportunity just to throw bodies at it because a systems project, may or may not work when you throw bodies at it…at least, you're doing it like everyone else. There's also a herd mentality. In the past, there was very little upside for a large financial institution to be a maverick, to be doing compliance different from everyone else because if it worked, you're still viewed as a high risk because you're different. But man if it didn't work, you know, you are exposed, whether you're an executive or a board member, there just wasn’t really a rational financial incentive to do so.

Peter: Right, so what you're saying is like the Dodd-Frank regulations have created a lot more complexity and it's out of that complexity that companies have said let's see how we can actually automate some of these processes.

Miles: Yes, and that complexity changed almost every quarter. The rules would change, the definitions would evolve and suddenly you would have to do things differently. That pace of change has slowed down significantly and that's not something that's related to the current administration, it's globally, the pace of regulatory change has slowed. Now people are kind of grappling with it and so instead of figuring out what it is, they're figuring out now how to do it better.

Technology has advanced with advanced machine learning techniques and natural language processing, less AI; there's a little bit AI, but you're interpreting the set of rules where there usually is a factual statement of truth which lends itself really well to an automated process. Maybe the best example, historically, is what happened to consumer credit analytics.

In the late 80's/early 90's, when I was just entering the workforce and, you know, consumer credit was done by humans and done with all the things humans can do with lots of judgments usually on checklists and then companies like Capital One essentially did a form of regtech. They automated it, they moved from humans doing it to algorithms and they got rid of a lot of the human bias and they got rid of a lot of the human error. There's always risk with algorithms, but the process and pace of change is so far better that it radically changed the consumer finance industry worldwide where it used to be a cottage industry. Now most players are national players.

Peter: Yeah, that makes sense.

Miles: And I think you're going to see a similar thing in some aspects of the regtech world, especially in KYC, Know Your Customer, and AML, Anti-Money Laundering, where again, it's a pretty specific set of checklist you have to go through that right now people do. You know, large super regional money center banks here in the US can have anywhere from 15,000 to 30,000 people doing KYC in soul crushing jobs.

Peter: Right, and so I guess that's really the promise I imagine. I'm curious to get your perspective on how far along we are, but I mean, you don't want 15,000 people doing soul crushing jobs if you can have a machine do it as well or even better. So maybe just take us through a real example with KYC, or AML of how automation is really making a difference today.

Miles: I think, you know, if look at how a fintech company does KYC, they outsource through a company. There's a bunch of companies that provide that service, they do the database checking and they say, Joe Smith has provided enough credentials that we are 98% sure he really is Joe Smith, and they can go forth and do that. They do that for fraud reasons, they do that for compliance reasons, a whole host of...in large banks, where you have multiple departments, so a lot of times that is done by hand, literally somebody looking up on a machine and we put Joe Smith into a data provider that provides me all of the address matching. You don't really have to do that, a person can do that.

We kind of look at three levels of regtech engagement. The first one is providing data, companies that provide the raw data that people feed into their processes. Here's my address book, here is where I get addresses from international companies, that's kind of a commodity. That exists now.

The second one is now let me automate both how that data is used and so rather than humans looking it up and making an assessment that's 98%, it's all done by a machine, an algorithm, and users set parameters as to what level of specificity they want. We think that that's the next big step going on right now and there's a bunch of companies vying for that space.

The third level is what really changes it and takes it out of the banks because at this point... speaking specifically KYC. Right now, consumers' data is owned by large corporations, whether it's a credit bureau, whether it's a bank and banks, you know, are very explicative. If I have an account with Capital One and an account with Bank of America, they both KYC me and they can't rely on each others credentials, they have to do it separately.

If you had a structure where potentially the consumer owned their data and the consumer actually said, yep, I'll let Capital One look at my credit, to make an offer, but I won't let Bank of America. There's a single point and we think that that's a really interesting aspect, but I'm getting a little out there in my ramblings. (Peter laughs) I want to make sure I'm answering your question.

Peter: No, that sounds good. We were just all in London recently at LendIt Europe and open banking in Europe or in the UK is going to become a reality in 2018 where that exact concept you're talking about is going to change things where the consumer is going to be able to own their data. We don't have an equivalent yet in the US, but that's a topic for a whole another show.

Miles: I find that really exciting. We have a company, ClearScore, that's going to be, you know, in the first wave of people being able to access that, but I think anytime you put a consumer in control of their information, it's a good thing. We as corporate entities, pretty much have not covered ourselves in glory recently in terms of how we manage that fiduciary responsibility so I think it's probably another way to better do it.

Peter: Yeah, so I want to talk a bit about one specific company, IBM, who bought Promontory. This happened last year and the whole premise of this deal was for the IBM Watson technology to be applied to compliance and regulation. I'd like to get your thoughts on what you think IBM is doing in this space and how much of a game changer their Watson technology is.

Miles: I'm not sure Watson technology is a game changer, I think they are trying to apply that as a brand name that they apply to a whole host of industries, whether it's healthcare or financial services. I don't think they have a particular advantage over a handful of statisticians from Stanford or even better, Carnegie Mellon. I'm on the board Carnegie Mellon so I'm a little biased towards them, but I think the real benefit is it kind of legitimizes the space. When the large service providers, the banks start getting into this, you know, it creates one, as an investor an exit path which is important to us and in the past we've looked at about 38 exits and 37 have been to strategics and that's probably the path most of these companies go and where they essentially become development labs, almost like pharma for these are large entities.

Peter: Right.

MIles: So for me, I'm less concerned about the competitive aspect and maybe I should be more concerned, but I'm not, but more I'm actually, I'm excited that it legitimizes the space and makes it easier for a bank executive to say, hey, I think I will take a look at this in a serious way and maybe I won't get fired if I'm wrong.

Peter: So then just on that point though...you touched on this briefly, how much of the future of regtech is going to be about artificial intelligence?

Miles: That's just a tool. I think the real future of regtech is moving us away from sampling as our surety method and so right now, we assess whether we're actually compliant using sampling technology and then usually the largest sample is 10%. The really profound implication of regtech, in addition to doing it cheaply, is now I can, rather than check 10% of my files, I can check them all and rather than check them once a quarter or once a year in my regulatory review, I can check them all the time and that's a really profound change to how we assess and manage risk in financial institutions.

I think the real promise of regtech is not just cost savings, it's lower capital because if I'd created a structure where I know I'm compliant...I don't hope I'm compliant, I know I'm compliant, the operating risk aspect of my capital ratio will go down.

If I've created an environment where my regulators always know I'm doing everything right or we catch stuff really quickly so we can fix it before there's a harm to a consumer or a business, the whole regulatory regime changes from finding ways to slap people with big fines, to finding ways to anticipate problems better in the future.

Regulators are really good at reacting to last year's problem, they're not so good at anticipating problems because they're so overwhelmed with doing the first part that they don't have the time to do that part…so to me and again this is a little esoteric, this whole concept of moving to universe testing is the single most profound aspect of regtech in terms of improving the efficiency of financial services.

Peter: Interesting, really interesting. So then if you run a big compliance department today at a large bank, I mean, how's that going to evolve? Are you going to see your head count drop by half because you're talking tens or hundreds of thousands probably if you look at all the banks.

Miles: I think you won't see it drop quickly. I think you'll see the rate of growth slow. So right now, compliance expenses and there really isn't a hard number, but the kind of round number people use is about 18 to 20% of bank expenses now. It used to be pre-crisis 5 to 6% and it's been growing at double digit rates. We've seen in the past year the rate of growth slow down. Now most banks have to have a negative expense growth, so even flat is still too high, but I think you'll see first it's going to bend that growth curve and alleviate the talent shortage that's in this space.

I mean finding quality compliance people and then retaining them is the single hardest job in the bank I think. If people get more comfortable with the technology, they'll start to take heads out, and again, that sounds...I don't mean to be flippant about people losing their job, now if there's some profound societal impacts about technology and automation. But, you know, these banks have to find ways to be more efficient. Once they're sure that the regtech technology works in whatever vertical they're trying to do it.

I think the bigger issue is, and especially here in the US, the best mouse trap will not win, it's the mouse trap that is the easiest to integrate because you think about a compliance manager's kind of role in life. They're usually a mid-level executive, they don't really have a huge equity portion and they might get a bonus, they might not, but they get a pay raise and so their form of compensation is salary and they have an asymmetric risk. If I pick a regtech thing to put in and it doesn't work, I'll probably get fired.

Peter: Right.

Miles: And so there's no incentive to try to find the best technology. There's every incentive in the world to be average and so they behave quite rationally and so it makes selling into this space really difficult. One of things that we advised companies when we talk to them, and we've talked to close to a hundred, is you have to focus as much on your integration skills as the actual quality of whatever mouse trap you're trying to build which is a little jarring to a lot of the tech startups who want to focus on the tech because that's the cool part, but that alone won't make it a sellable prospect into an enterprise structure.

Peter: Yeah, it reminds me of something that was said in a panel at LendIt Europe where they said this is our big bank panel and they said, look, we are not interested in ideas as much as we are interested in capability. If you have a great idea and your capability to integrate with us is weak, it doesn't matter how good the idea is. Conversely, if your idea is just incrementally a little better but you have great capabilities then we will welcome you with open arms kind of thing.

Miles: And it's actually quite logical from their perspective. I mean, they bear a lot of risk, you know, they bear regulatory ire if they screw this up, they're not being dumb, they're just reflecting the constraints of the world they live in.

Peter: Right, which brings up another point I'm curious to get your take on and that's about the regulators themselves. I mean, how are they viewing this space? As you said they're overwhelmed, they're trying to always be backward looking, but what's your perspective on the regulators and their approach to and their attitude towards regtech?

Miles: I think you have to look at it by country. It's clear to me, the real regtech innovation is going to be driven out of London and Europe because the regulatory structure there is a lot simpler than that of the US. The opportunity is still in the US, but you know, the FCA, there's a single regulator. They're quite forward leaning, they have a stated mission of bringing fintech jobs to the UK and I find them to be a pleasure to work with. Their regulatory bar is as high as the US, but they're not pushovers, but you can get clear answers from them. Here in the US, and I want to be careful how I phrase this, because you know, people who go into regulatory jobs go into it with good intentions, but they're hand strung in supporting innovation in the US for a couple of reasons.

One, there's a whole bunch of them that overlap and no one's really clear who has authority.

Peter: Right.

Miles: And they're really good at squabbling just like the vision in a company or children in a family squabble, you know, regulators squabble and so there is no clear leader unlike the FCA in the UK, there's one.

Two, they are really still focused on finding bad actors, putting pelts on the wall and I think they get a lot of their kind of accolades from that so helping the industry is really not something that gets a lot of traction there.

We're starting to see outreach from regulators here in the US and you mentioned earlier, our regtech conference...we've got a regtech conference at the end of November. It's November 27th to 29th here in DC. We specifically chose DC, not because it's the greatest place in the world to host a conference, but we wanted to make sure we created an environment where the regulatory community can come and engage. We think that educating them and making them knowledgeable is the best thing we can do to facilitate some more active and constructive engagement. I think they all want to be more efficient and the regulatory agencies themselves, the days of unlimited budgets for examiners, there never really was a day, but they've got to find a way to become more efficient also and these tools will allow them to do so.

Peter: Right, right. So I want to ask about…you said you looked at close to 100 companies, I know you don't want to sort of provide favorites or whatever, but can you just give me some examples of...who are some of the more interesting companies in this space or at least what are the areas there's most entrepreneurial activity?

Miles: I'll go with areas because I'm always afraid if I start naming companies, I'll skip a company that I should name and they'll get really mad at me or (Peter laughs) I'll mess up a company's name and they'll get really mad at me.

I think for us, we see kind of three really interesting areas. We like the KYC/AML space because it sits in the acquisition funnel and is really transaction oriented. You know, if I can reduce the cost for each AML pull from $8 to $2, I'm literally making those numbers up, no one write those numbers down, we think there's a real ability to do that plus from kind of the implementation viewpoint with large banks you can start with a proof of concept and essentially gradually kind of escalate your size up to get the full contract. These are 7 to 8 digit contracts if it's a very large bank.

We love documentation support and if you think about compliance the first thing that usually comes to mind are these giant mind numbing manuals that often are contradictory and we love the area of smart contracting which actually changes these things to a form of code where your changes kind of ripple through, where you have the ability to make sure your contracts are compliant. There's a lot of activity there which we think is actually a giant efficiency gain and a risk reducer because a lot of institutions get into trouble because what they do versus what they've written down in their manuals often don't coincide. Some people call it desperately boring, sometimes I like desperately boring because there's a really core value thing there.

And then we like anything that moves data to be owned to by consumers and we feel long term, whether it's the open banking in the UK, essentially, consumers are going to have to own this and own their data and tools that allow that, whether it's a blockchain type structure, we're quite interested in that. We're not interested in blockchain for bitcoin, I'm still too dumb to figure out bitcoin (Peter laughs), others will and I wish them the best of luck. I can't figure it out, but I do see real value in the blockchain technology applying potentially to other types of things on the IT avenue.

Peter: We're almost out of time, but I wanted just to...you mentioned your conference earlier, how can people find out about that event?

Miles: The best way to find out is to go to the website which is regtechenabled.com. We're having it from Nov. 27th to 29th, we've got a range of people from regulators, including Nick

Cook from the FCA, to some politicians, Bob Corker, will be speaking, he's been in the news lately. I expect Senator Corker to be quite interesting, Senator Warner will be participating.

We're trying to get a wide range of people who have essentially a dog in this fight and the real goal with this conference is walking around and making these introductions and learning about everyone's perspective. Because it's really easy to demean compliance and regulators, it's a really difficult job and for us as investors, it's really important to know all of the kind of drivers that kind of shape behavior because if we understand that we can create value propositions that get the behavior we want and drive the efficiencies that make the investment pan out for us. So I would encourage people to come, I think it's going to be a really informative conference and we're looking forward to hosting it.

Peter: Okay, we'll have to leave it there. I really appreciate you coming on the show today, Miles.

Miles: My pleasure, always a pleasure talking to you. Have a great day.

Peter: You too. Bye.

You know, many people have been saying that regtech is the next big thing and that fintech is just yesterday's news. Now obviously these two verticals are not mutually exclusive, there's a lot of overlap. Regtech is primarily applied to financial services and that is really what fintech is all about. But to me, it's going to be fascinating to see some of the things that Miles was talking about there with these smart contracts, with really being able to have compliance departments that take out the mundane work and really have machines do it.

I think there's going to be so much change and this is where a lot of startups are going to be bringing about new ideas and I think we've seen it in the lending space several years ago, we're seeing it now in the regtech space. I think it's going to be a fascinating area to be involved with and we'll be paying close attention here at LendIt and Lend Academy.

Anyway on that note, I will sign off. I very much appreciate your listening and I'll catch you next time. Bye.

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