EU FINTECH

REGULATORY FRAMEWORK

EXECUTIVE SUMMARY

The so-called FinTech or the latest technologies used to undertake financial business is becoming a crucial issue that has an enormous impact on the way these services are rendered and supervised.

Thanks to IT systems, new participants have started to intermediate and to create new financial products and services, but the way they should be regulated and supervised is not always clear and continuously evolving.

IT brings advantages and disadvantages to borrowers and lenders, issuers and investors and to those supervised and the supervisors, but it is very challenging to properly handle its various aspects to ensure the improvement of the financial system as a whole.

The different types and levels of regulations and their different reach and scope make it even harder to optimize the incorporation of FinTech to the financial industry.

Time is ripe to integrate FinTech as one of the key aspects of the Capital Markets Union that deserves careful reflection by all those involved in the business.

This document aims to drive the attention of the EU Financial Centres Roundtable to start giving consideration on a regular basis to this topic, with a view to better understanding its impact on the various aspects of the financial activity and to providing appropriate feedback at local and European levels.

FINTECH CONCEPT

The contraction of the words "Financial" and "Technology", **"FinTech"**, broadly refers to the application of technology within the financial industry and covers a wide range of activities, including, among others, financing, payments & infrastructure, operations & risk management, data security and monetization, customer interface....etc.

Since the introduction in 1967 of the first Automated Teller Machine up to present virtual currencies and biometric recognition systems, the so called "FinTech" has been gathering momentum, particularly since the introduction of the "smart phones" in 2007.

Although there is a quite common perception that FinTech just refers to those start-up companies deeply rooted in IT systems to provide innovative financial or linked to financial services, it has to be borne in mind that the application of technology within the financial industry affects to all past, present and future intermediaries, markets, issuers, fund applicants, investors, supervisors, regulators and anyone somehow involved in this industry.

The financial sector has rapidly evolved from an "analogical-in person" activity to a "digital-remote" one, and this shift seriously affects all the players, infrastructures, behaviours, regulations and any other aspect one might imagine.

The key question is to make clear whether FinTech is capable of making the life of borrowers and lenders better, building a more stable, efficient and transparent financial system or, on the contrary, it´s being used to make the financial system much more complex, opaque, inefficient and fragile, providing tools to circumvent regulatory requirements.

All these issues are of utmost importance when the European countries are facing the Capital Markets Union which entails the removal of barriers, integration of market infrastructures, supervisory convergence, arrangements for clearing and settlement of cross-border transactions and so on, all of these issues closely tied to the technologies (FinTech) that shape the financial system.

It is important that EU legislation strikes the right balance between reducing risk and enabling growth and does not create new barriers that were not intended.

PLAYERS

There are basically three groups of entities with different origins, characteristics, interests and attitudes as regards the FinTech world:

- **Traditional financial intermediaries**: They are subject to strict regulations and supervision and are more than willing to adopt new technologies throughout their whole organizations, but they have to overcome lots of challenges in terms of costs (replacement of legacy systems) and compliance, particularly in terms of conduct of business rules.

- **Global ICT companies**: They are dealing with millions of clients on a daily basis with great performance, customer satisfaction and growing reputation that are leading to an immense trust in their brands and business that pave their way into the financial industry, initially focused in the payments area, but currently formally claiming a larger stake in the financial business (*e.g. Financial Innovation Now- US*)[1] .
- **Start-ups Fintech**: Financial technology companies founded with the purpose of disrupting incumbent financial systems, services or business models that sometimes are not duly or timely regulated and supervised, but that provide innovative and useful financial services demanded by the community that are challenging traditional financial institutions and their existing solutions. These start-ups may have independent lives or, later on, partner with banks or investment firms.

REGULATORY APPROACHES

A survey of financial technology founders released by the end of 2015 by Silicon Valley Bank identified regulation as the biggest impediment to growth. *"There is still faith that regulated industries are more trustworthy than unregulated industries[2]"*

Due to the breadth of the FinTech sector, it is hard to talk about "FinTech Regulation" *per-se*. Better to break down high-level approaches (*e.g. risk- or product-based*) and complement them with a sub-set of specific regulations (*e.g. payments, anti-money laundering).* At the moment, there appears to be far more attention on alternative lending and marketplace models, but concern is growing everywhere, especially when consumer protection is at stake.

And it is not just a problem of enacting new laws and regulations, but also and sometimes more crucially, of how to apply and enforce laws that go back hundred years or more. In these early stages of regulatory refurbishing, supervisors might be forced to apply "square" regulations to "round" disruptors.

Consideration should be given to the fact that there are many agencies involved in the regulation and supervision of FinTech activities, either at local or at regional and global levels, and there are many tiers of regulation (sometimes conflicting) at each of the mentioned levels.

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Financial Innovation Now is an alliance of technology leaders working to modernize the way consumers and businesses manage money and conduct commerce. They consider that technological transformation will make financial services more accessible, safe and affordable for everyone, and promote policies that enable these innovations.

2 Gilles Andrews, Co-founder and Executive Chairman of Zopa.

Many of this rules and regulations are pre-mobile, pre-eCommerce, pre-Internet; because many of the FinTech models are introducing innovative and new methods of delivering financial services, it can create confusion on which rules apply.

Regulation imposes considerable costs and innovation delays from which the start-ups are largely immune, but those same rules can also provide potent protections for incumbents, keeping the start-ups and the global ICT companies out of markets that require licensing and other government approvals before serving customers.

Broadly speaking, financial regulators have four key mandates that usually address through "re-active" or "pro-active" regulations:

- Financial stability
- Prudential regulation
- Conduct and fairness
- Competition and development

Although a culture of compliance should not impede innovation, the use of technology to disintermediate banks or investment firms and directly propose services or products to consumers, raises a set of questions:

- Increasingly a blurred line: Who can/should provide financial services or products?
- How to balance start-up low cost models and agility benefits with compliance costs?
- How can regulation cover an increasing number of new business models and match speed of innovation cycles?

A problem with new emerging FinTech companies is that they have limited track records regarding their business (*e.g. risk management, liquidity and profitability*) and it´s normally difficult to identify what are their obligations (*e.g. applicable regulations or licences*).

For regulators, these early-stage companies represent a limited prudential & consumer risk. However, exponential company growth can create a "risk blind spot". Additionally, frequent failures or fraud can impact market or investor confidence, which are also mandates for regulators.

All this leads to the traditional "regulatory threshold approach": a challenging crossing from "too small to care" through "too large to ignore" till "too big to fail", in which all the jurisdictions are nowadays, either at local, regional or global levels.

On the other hand, the increasing use of technology within the financial sector also offers opportunities for regulators to better perform their roles. Some of them have already started to evaluate the benefits provided by technology:

- **Smart contracts**: Reducing costs and trust issues around contractual performance.

- **P2P lending**: Providing real-time visualisation of geographical spread of credit risk.
- **Blockchain**: Ensuring Multilateral Trading Facilities (MTF) obligations under MiFID.
- **E-money:** Limiting the extent of money laundering issues with cash transactions.
- **Data transparency**: Allowing regulators to directly audit financial institutions.

Since 2008 national and international regulators have been focused on drafting and implementing **"re-active"** regulations covering the causes of the global financial crisis to avoid its repetition. However, the increased layering of regulations and compliance cost also allowed new FinTech start-ups to emerge.

There is nonetheless a set of "**pro-active"** regulations that were forward-looking and have allowed for innovative businesses propositions to emerge.

- US: Jump-start Our Business Start-up Act 2012 : Alternative financing
- EU: Payment System Directive 2008: Real-time payments

Nevertheless at global level, it seems difficult to properly cover all FinTech implications. Mr. David Wright, Secretary General of IOSCO has recently stated:

"It's a very challenging time for securities regulators: models and markets and structures are changing very fast and you've got to be very conscious of that and up to speed. Regulators first have to understand and be right at the frontier of thinking in terms of how these technologies are developing and, even more difficult, to work out the regulatory implications of this technology. I think regulators have got to wake up quickly. We need as IOSCO to get up to speed, very, very quickly."

The above mentioned "regulatory threshold approach" has its limits since it can prevent regulators from engaging early-on with new FinTech companies.

In the UK, the Financial Conduct Authority has under the Financial Services Act 2012 a new mandate whereby it should be '*promoting effective competition in the interest of consumers in the market for regulated financial services*'. This approach is in line with the Charter of the European Financial Roundtable which points out that the Centres: "*are fully committed to working together to promote the EU´s financial services industry in globalised wholesale and retail markets, in the interests of worldwide users of financial services.*

Therefore, it seems that regulators and financial centres should engage with even earlier-stage companies, provided that they can stimulate competition and have a positive impact on consumers (*e.g. wider access, better and cheaper services*).

This scenario leads to the question of what is the right regulatory-supervisory model, considering that when it is conducted by specialist bodies focused on products, it might appear inadequate when looking at the rate at which technological progress occurs, leading sometimes to “grey areas” as to what is the regulatory body on which a specific business falls. Furthermore, the use of personal data to tailor pricing levels or risk thresholds of consumers means that there will be an increasing granularity of products and services provided.

Consequently, financial innovation driven by technology might be preferably overseen in the context of a “twin peak” model or maybe it´s time to explore other possibilities.

In fact, one of the things that make disruptive technologies so unsettling is that they not only break down conventional wisdom about how industries are organized, but also how they are most effectively regulated. The banking system –incumbent and emerging– clearly needs strong oversight, but there is no reason to believe that regulation will always have to come from physical governments, which are slow to change and inefficient.

Self-regulation by FinTech companies might prove the better approach, but even more promising is the emergence of rating systems built into new lending, banking and investment platforms that empower consumers to do a lot of the policing themselves for each other´s benefit.

EU PRESENT FRAMEWORK: ROLE OF THE ROUNDTABLE OF EU FINANCIAL CENTRES.

Apart from the general financial EU Directives (ISD, MiFID,…etc), so far just the e-Commerce Directive 2000/31/EC has created the basic explicit legal framework for online services, including electronic commerce in the Internal Market. The purpose of the Directive has been to remove obstacles to cross-border online services in the European Union and provide legal certainty to business and citizens in cross-border online transactions. Likewise, the Directive 2002/65/EC concerning the distance marketing of consumer financial services and the Directive 2007/64/EC on payment services in the internal market make up the basic framework that somehow governs the cross-border and online financial activity in the EU.

The European Parliament has just also adopted a new directive, Payment Services Directive 2 (PSD2) that will be formally adopted by the EU Council of Ministers in the near future, which aims to replace the Payment Services Directive and amend other legislation/regulation. PSD2 is the major policy development set to impact the payments industry across Europe. The PSD2 seeks to:

- Further standardize and make interoperable card, internet and mobile payments.
- Reduce barriers to entry, in particular for card and internet payments.
- Align charging and steering practices across the EU.
- Ensure consistent application of PSD across the EU – for example, giving member states less freedom regarding the transposition of the directive/ aspects of the directive.
- Bring emerging types of payment services within regulation.

Considering the Communication from the European Commission on "A Digital Single Market Strategy for Europe"[3]: "*Enhancing the use of digital technologies and online services should become a horizontal policy, **covering all sectors** of the economy and of the public sector". "A Digital Single Market is one in which the free movement of goods, persons, services and **capital** is ensured…"*

This Communication, when explaining how to create the right conditions and a level playing field for innovative services, devotes one of its chapters to outline ***"A fit for purpose regulatory environment for platforms and intermediaries".*** It points out that new platforms in finance have rapidly and profoundly challenged traditional business models and have grown exponentially offering opportunities for increased efficiency through improved consumer choice, but also **potentially raises new regulatory questions**, that will be addressed in the up-coming Internal Market Strategy[4] and in the e-commerce framework[5].

From its inception, the Roundtable of European Financial Centres is identifying topics and features to build its distinctive role, having considered, among others, the goal of rebuilding trust in financial services, the holistic view of the financial sector, the promotion of the EU´s financial services industry in globalised wholesale and retail markets in the interests of worldwide users of financial services and, last but not least, ***"the identification of initiatives aimed at encouraging innovation with regard to technology and other shared services attached to the financial industry[6]".***

Considering the huge impact of FinTech in the financial industry throughout all the products, services, intermediaries and regulators, and bearing in mind the present moment of EU regulatory plans for the Capital Market Union and the Digital Agenda, it seems that time is ripe for the EU Financial Centres Roundtable to consider some potential initiatives to keep it duly informed on the evolution of FinTech impact and regulation, and to have the opportunity to be better involved at national and European levels in the coming initiatives to help set the regulatory agenda that, moreover, is fully in line with the spirit and focus of the Roundtable.

Therefore, and with a view to promoting FinTech as a tool for building a more stable, efficient and transparent financial system and not to circumvent regulatory requirements, it is proposed to the Roundtable:

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[3] COM-2015-192 final

[4] Communication from the Commission to the European Partilament, the Council, the European Economic and Social Committee and the Committee of the Regions: Upgrading the Single Market: more opportunities for people and business (COM-2015-550 final, Brussels, 28-10-2015).

[5] Public consultation on the regulatory environment for platforms, online intermediaries, data and cloud computing and the collaborative economy. Published on 24/09/2015

[6] Charter of the Roundtable released in 2010, when referring to potential areas for future work devoted to strengthening mutual business interaction.

- To monitor the evolution of the different EU initiatives through regular presentations and debates during future meetings of the Group.
- To ask its members to circulate among members any information, document or initiative in this field that might be of interest.
- To identify common ground and initiatives to improve the efficiency and the regulation of the FinTech industry as a whole, regardless of the type of entity (traditional financial intermediaries, global ICT companies, start-ups FinTech) potentially affected.
- To identify and contact the national “FinTech” hubs to create a network of European FinTech Hubs through the Roundtable, in order to broadcast and share initiatives of common interest, mainly focused on regulatory matters.

The secretariat will coordinate all this initiatives and keep members informed through its digital channels (web-site: www.europeanfinancialcentres.com; twitter: @EUFinCentres).

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