4. Licensing Fintech companies

Authorities are trying to strike a balance between fostering innovation and ensuring financial stability

The US debate

The beginning of the year is marked in the USA by a sports event that catches the attention of most Americans, the Super Bowl. However, this year, a square-off among American Financial Supervisors tried in vain to steal the limelight.

This unusual confrontation started in December 2016, when the US Office of the Comptroller of the Currency (OCC), one of the main US Financial Supervisors, issued a whitepaper outlining its intention to grant special purpose national bank charters to Fintech companies.

State financial authorities led by the New York State Department of Financial Services Superintendent (NYDFS) reacted immediately, opposing this announcement by claiming that it didn't fall under OCC competences. Critics also highlighted the potential negative impact of this charter on financial stability and consumer protection. Despite Republican and Democratic representatives joining the defense team, the OCC has continued to gain yards, finally issuing a Draft Licensing Manual Supplement for Evaluating Charter[16].

Although this conflict illustrates the global debate on the best regulatory strategy towards Fintech, the OCC's rather restrictive approach seems to have disregarded the steps taken by other countries on this topic.

Is there a case for granting Fintech companies special purpose licenses?

Before answering this question, we should establish what is understood by a 'Fintech company'. According to the European Parliament draft report on Fintech[17], "FinTech may be understood as finance enabled by new technologies, covering the whole range of financial services, products and infrastructure". However, it appears that discussion currently focuses on non-banking companies providing services that are subject to oversight by Financial Authorities when offered by financial institutions.

Bearing this in mind, the advantages of a specific license for Fintech companies are clear:

- Fintech companies would operate under regulatory certainty and supervision consistence.
- Regulatory burdens associated to applying for licenses on a state-by-state basis would be reduced.
- Fintech companies would have flexibility to decide their operating model, that is, to decide whether leveraging their services on existing banks or developing their own services from scratch.

16: Evaluating Charter Applications From Financial Technology Companies. OCC. 15 March 2017
17: DRAFT REPORT on FinTech: the influence of technology on the future of the financial sector (2016/2243(INI)). Committee on Economic and Monetary Affairs. European Parliament. 27 Jan 2017

On the other hand, specific licenses should ensure a better protection of the interests of customers and investors, a level playing field among incumbent banks and new entrants as well as more transparency and a better understanding of potential systemic risks associated with specific Fintech activities.

Overview of other regulatory approaches

Since the start of the Great Recession in 2008, higher capital and regulatory requirements have added to IT costs as (arguably) the main factors limiting innovation and availability of credit. This has created an opportunity for non-banking competitors to offer innovative services that fulfill unmet customer needs, although it has also raised concerns amongst financial authorities about the best way to increase the availability of funding and encourage financial innovation.

A typical strategy is unbundling banking activity in separate categories such as payments, deposits or lending and offering specific licenses and registration mechanisms for each activity. This approach increases the ability of new companies to provide banking services that are less risky by nature or that traditional banking institutions are not able to offer properly, boosting customer's satisfaction and choice.

The UK has pioneered this approach and subsequently emerged as the leader in Financial Innovation[18] thanks to a regulatory framework that supports financial innovation while keeping Fintech activities under control.

The EU also offers specific licenses for companies willing to focus on niche services. The landmarks are the licenses for payment and e-money institutions, created under the Payment Services and the Electronic Money Directives[19]. Both licenses allow new entrants to offer payment services with lighter capital requirements and offer a passporting facility across the EU, that is, the ability to offer authorized services in any Member State simply by notifying the Competent Authority of the country where services are to be offered. However, this approach in the EU is not final. The European Commission has recently launched a public consultation on Fintech that includes licenses among the addressed topics. The Commission is considering issuing guidelines regarding how certain business models fit under the current regulatory regime, issuing new licensing regimes at EU level or even a new "all-encompassing 'FinTech' license".

EU and UK legislation have influenced neighboring Switzerland and Turkey, which have enacted similar regulations. In fact, licenses for payment and e-money institutions have been in place since 2015 in Turkey. Switzerland has recently announced a new fintech license addressed to institutions taking deposits of up to 100 million francs that do not operate in the lending business. Switzerland has also followed the UK's lead, creating a sandbox facility that relaxes legal requirements for testing services under 1 million francs.

As far as the fast evolving Asian economies are concerned, both China and India have taken important steps to facilitate the access of Fintech companies mainly to lending and payment businesses.

18: See Fintech hub ranking in Ernst & Young, UK FinTech – On the cutting edge, February 2016;
19: See Payment Service Directive 2007/64/EC, the reviewed Payment Service Directive 2015/2366/EU and the electronic money Directive 2009/110/EC

Other countries such as Australia and Canada have joined the debate but are currently more focused on regulatory sandboxes and passporting agreements with countries as diverse as UK, Singapore, Kenya, South Korea, Switzerland, India or Japan.

The latest movement in this field comes from Mexico, where a proposed law on Financial Technology foresees new licenses for non-bank companies offering payments, electronic money, virtual currencies and lending.

Conclusion

As outlined above, the regulators' approach to Fintech companies differ greatly among countries. However, in order to reap the benefits that a seamless integration of Fintech companies in Financial markets can deliver, any regulatory strategy should encompass some features.

Firstly, it is important that regulators and supervisors take a proactive stance to balance financial stability and innovation, promoting competition and transparency. Authorities and Fintech companies involvement from early stages will ease communication, support Fintech development and allow Authorities to understand the needs of Fintech companies and identify potential risks at an early stage.

As technology is continuously evolving, it is important to avoid regulatory approaches that are too prescriptive. A dynamic, principles-based regulation which is as technology-neutral as possible and that includes incentives to innovate is imperative. Nevertheless, special purpose licenses should never exempt Fintech companies from complying with basic regulations such as data protection, security or anti-money laundering.

Finally, Authorities should factor in the global nature of technology and act in a coordinated manner, setting common standards and equivalent regulations while leaving room for the development of self-regulation and standardization initiatives at industry level. This is a major challenge due to the current competition among countries to attract FinTech businesses. However, international cooperation should strive for the creation of a level playing field among countries and market players, as well as for the implementation of smooth mechanisms, such as international passporting, that speed up the adoption of successful innovations.

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