6. Financial innovation policies across the European Union

A new approach to foster FinTech

The current economic environment is fast-changing and highly competitive. The ability to innovate becomes a necessity for leading financial institutions. Europe is aware of this and is introducing policies to enable innovation while keeping risks under control. One-stop-shops, Regulatory Sandboxes or regulatory adaptation are the tools used for this purpose.

The introduction of policies to foster innovation are vital for the financial services industry. Several empirical studies show the potential of innovation to improve the quality and variety of banking services, complete the market and improve allocative efficiency[16]. However, those innovations do not arise in isolation, they require an enabling environment to foster them[17]. **The creation of a friendly policy framework is one of the main enablers.**

Traditionally, most policies have focused on enhancing the work of research and development laboratories, mostly linked to scientific or industrial organizations. The tools used have been focused on the provision of economic benefits like financing, encouraging production through public procurement or tax benefits for businesses focusing on eligible research and development activities[18]. Along with these, there are other measures to foster the creation of intangible assets such as the establishment of clusters or hubs, physical places where similar industries share knowledge and rise creativity levels[19].

However, with those measures, the authorities did not enter into understanding the innovation process, as this approach only checked the pre-conditions and the final output. Furthermore, those policies did not fit well with highly regulated firms such as those engaged in financial services, where one of the main issues for innovation is compliance. As an answer to these concerns we observe that **there has been an evolution of those tools, introducing new actions that imply a more proactive role by the regulators in order to create evidence-based and future-proof regulations**.

New policies for a new phenomenon

Innovative firms, both start-ups and incumbents, often face difficulties to meet regulatory requirements. As a result, financial organisations spend huge resources in navigating the red tape and reduce their efforts focused on the creation of new value propositions. Moreover, the speed of change has increased because of the introduction of exponential technologies and new services are entering the market on almost a daily basis. In this regard, it is

16: Beck, T., Chen, T., Lin, C., & Song, F. M. (2016). Financial innovation: The bright and the dark sides. *Journal of Banking & Finance*, 72, 28-51.
17: EDQUIST, C., & CHAMINADE, C. (2006). Industrial policy from a systems-of-innovation perspective. *EIB papers,* 11(1), 108-132.
18: Larédo, P., Köhler, C., & Rammer, C. (2016). 2. The impact of fiscal incentives for R&D. *Handbook of Innovation Policy Impact*, 18.
19: Florida, Richard L. *The Rise of the Creative Class,* Revisited. New York :Basic Books, 2012. Print.

important to balance the creation of measures to foster the development of new offerings with the reduction of potential new risks, while ensuring a level playing field. Authorities globally are aware of this situation and are currently reviewing their innovation policies in order to provide more efficient tools and informed regulations that fit this new reality better.

There are different solutions to overcome this issue across the EU, although they all have something in common, those options are accessible to all players, incumbents and new entrants alike. Although the creation of these initiatives is positive, **there is a risk of fragmentation within Europe as there are different approaches and a divergent degree of maturity in the understanding** of the fintech phenomenon. In any case, this new approach aims to tackle financial innovation enhancing the whole ecosystem, taking into account the needs of all players.

On a first stage, regulators are aware of this change but seek for input to learn about this phenomenon. Public consultations and workshops released by authorities have opened a debate in order to listen to the market before taking any decision but targeting their questions on the most controversial issues. Examples are the Public Consultation on FinTech in March 2017[20] or the Financial Technology Task Force, both initiatives by the European Commision. Some countries are still in this stage such as Portugal with their Workshop on Digital Banking and FinTech or the Estonian Financial Supervisory Authority (FSA) FinTech Taskforce. The creation of knowledge is the first step to better understand the implications of this new environment in order to draft a new policy agenda that fits market needs.

There are other authorities who focus on establishing forums to nest the creation of initiatives, like the Bank of Cyprus hackathon for FinTech; or institutionally led accelerators such as the one arranged by the UK's FCA, which involves the authority in the creation of new value propositions fostering entrepreneurship.

One of the main problems observed is not only the legal framework but also its practical application. Most companies find difficult to interpret current requirements and what authorisations are needed. In this regard, one-stop-shops allowing companies to seek first-hand advice arise as a solution. In the case of Germany, BaFin has established a webpage dedicated to this issue, although no regulatory change is envisaged yet. However, other countries have gone steps further and include this option within a most ambitious innovation framework, such as France or United Kingdom.

A step further is the revision of the regulatory framework in order to attract investment. This is the case of France and their FinTech friendly regulation framework with the introduction of a new law that sets a threshold below which no authorization from regulators is needed to start FinTech businesses and the establishment of a one-stop-shop to attend company needs. This program eases the requirements to start a fintech business and the 2-Week-Ticket offers a pre-authorisation for foreign businesses to start operating in France until full authorisation is granted, followed by a six month monitoring period and the possibility to access to European passporting rights. This program

20: Casadas, V. Fostering financial innovation. Assessing a new policy framework for financial innovation. *Financial Regulation Outlook. Third Quarter 2017*. BBVA Research is boosted with the creation of several incubators established by the Fintech, Innovation and Competitiveness (FIC) division within the *Autorité des Marchés Financiers* (AMF). This comprehensive approach is called the 'Regulatory Soundbox', referring to sound rules giving access to European passports with an oversight that is proportional to these companies activities.

Finally, **the approach that implies a maximum degree of collaboration between the authorities and the industry are Regulatory Sandboxes.** First of all, it is important to clarify that **this initiative is not about deregulation, but rather an interactive regulatory dialogue between a company willing to launch a new product or service and the relevant authorities.** Furthermore, this option is only a temporary legal relief for the market testing of innovations, as there is a high degree of uncertainty and, once the project ends, it should meet all regulatory requirements before entering the market. Nevertheless, as a result of the process the authority in charge might consider reviewing its current framework in order to fit new realities. The origin of this concept is in the British FCA[21], but is currently under discussion in several geographies like Poland, Lithuania, or Spain.

As an example, there is an already operating sandbox in the Netherlands, within the boundaries of the Innovation Hub set up by the Dutch National Bank (DNB) and the Authority of the Financial Market (AFM). These sandboxes allow to assess whether the innovative concepts comply with the underlying purposes of applicable financial markets regulations rather than the strict letter of the law. However, there are restrictions for projects willing to enter: they must meet at least one of the objectives of financial supervision laws, run into unnecessary barriers that the company cannot reasonably overcome, and the company's corporate processes must include procedures and measures to protect the solidity of the financial services company and the interests of its clients and stakeholders. However, aside from the sandbox, the Netherlands also allows companies to obtain a partial authorisation, opt-in authorisation, or "authorisation with requirements". Finally, there is a contact center which allows companies to submit questions about regulations, regardless of whether they are currently subject to a regulatory framework.

Conclusion

The introduction of this new breed of policies to foster financial innovation is a recent phenomenon. Although their theoretical background is strong, it is still early to determine their success. However, there is no doubt that in order to obtain the most benefit of these initiatives at a European level, it is necessary to achieve a certain degree of harmonisation of the different initiatives. As a result, a common framework would reduce asymmetries among Member States and enable the provision of cross-border services.

21: Urbiola, P. (2016) Regulatory sandboxing: a risk-based approach to promote innovation in financial services. *Digital Economy Outlook.* BBVA Research

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This report has been produced by the Digital Regulation Unit:

Chief Economist for Digital Regulation Unit
Álvaro Martín
alvaro.martin@bbva.com
+ 34 91 537 36 75

María Álvarez
maria.alvarez.caro@bbva.com

Alicia Sánchez
alicia.sanchezs@bbva.com

Vanesa Casadas
vanesa.casadas@bbva.com

Javier Sebastián
jsebastian@bbva.com

Edward Corcoran
Edward.corcoran@bbva.com

Ana Isabel Segovia
ana.segovia@bbva.com

Jesús Lozano
jesus.lozano@bbva.com

Pablo Urbiola
pablo.urbiola@bbva.com

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Macroeconomic Analysis
Rafael Doménech
r.domenech@bbva.com

Global Macroeconomic Scenarios
Miguel Jiménez
mjimenezg@bbva.com

Global Financial Markets
Sonsoles Castillo
s.castillo@bbva.com

Global Modelling & Long Term Analysis
Julián Cubero
juan.cubero@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Financial Systems & Regulation
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Countries Coordination
Olga Cerqueira
olga.gouveia@bbva.com

Digital Regulation
Álvaro Martín
alvaro.martin@bbva.com

Regulation
María Abascal
maria.abascal@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Spain & Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

United States of America
Nathaniel Karp
Nathaniel.Karp@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Turkey, China & Geopolitics
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turkey
Álvaro Ortiz
alvaro.ortiz@bbva.com

China
Le Xia
le.xia@bbva.com

South America
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

CONTACT DETAILS: BBVA Research: Azul Street, 4. La Vela Building - 4 and 5 floor. 28050 Madrid (Spain). Tel.:+34 91 374 60 00 y +34 91 537 70 00 / Fax:+34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com