# 5. Fintech: implications for regulation and supervision

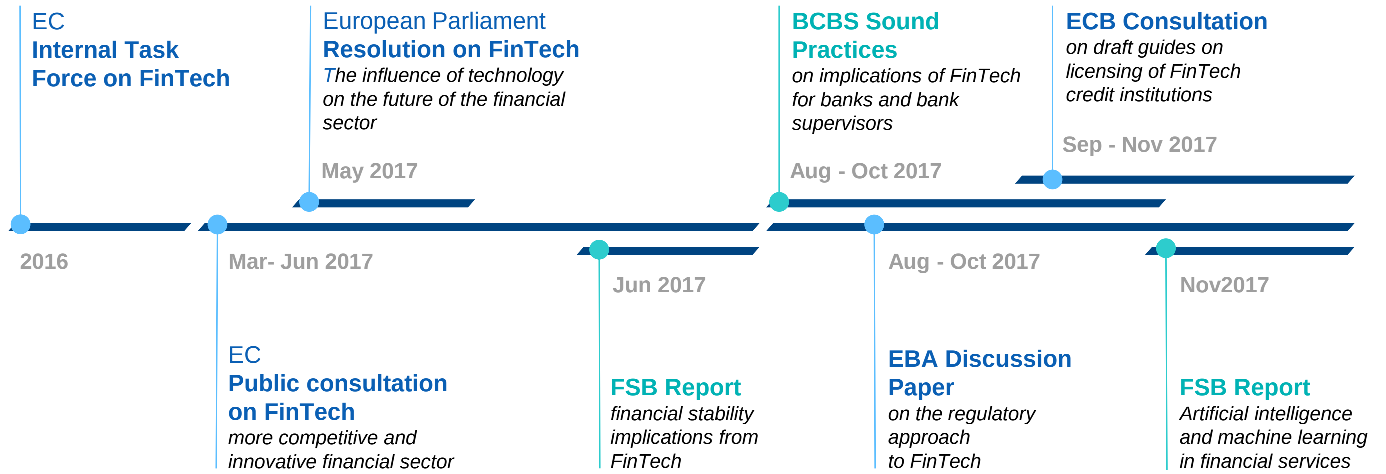
## The regulatory debate gains momentum

**During 2017 financial regulators and supervisors have released several consultations and reports on the impact of financial technology (fintech) on the financial sector. This article analyzes authorities' priorities and major concerns and discusses what is needed to go forward.**

In Europe, the European Commission (EC) was the first body to issue a broad consultation paper assessing measures to foster the development of technology-based innovation for financial services. This document published in March is the outcome of the high-level public-private dialogue established by the EC in 2015, which resulted in the creation of an inter-services FinTech Task Force. Following the EC, the European Parliament adopted a resolution on Fintech and the influence of technology on the future of the financial sector, and more recently the European Banking Authority (EBA) stepped into the debate by issuing a discussion paper on its approach to fintech, which will serve to guide the EBA's work in the months to come. Although narrower in its scope, a recent publication of the European Central Bank (ECB) is also worth highlighting, as it represents a first glimpse of the supervisor's mindset. The ECB has recently drafted a guide to clarify the process of assessing new banking applications for institutions with a fintech business model.

However, the debate has escalated the regional level and has become central in the work of several standard-setting bodies (SSBs). In June, the Financial Stability Board (FSB) published a report analyzing the consequences of Fintech on financial stability, which has been followed by a deep-dive into the use of artificial intelligence and machine learning in financial services. Under the leadership of the FSB, other SSBs have followed. For instance, the Basel Committee on Banking Supervision (BCBS) adopted the FSB's definition of FinTech in its August Sound Practices paper**.** This discussion paper analysed the current and potential future environment for banks and bank supervisors in light of recent developments in financial innovation, and outlines 10 high-level recommendations for banks and bank supervisors.

**Figure 5.1** Debate on FinTech gains momentum in 2017: Timeline




Source: BBVA Research

## Different approach, same concerns

Authorities have followed different approaches and thus the follow-up is expected to differ as well. The global SSBs have developed different analytical frameworks to look at this phenomenon, arriving at high-level observations and recommendations. For instance, the Basel Committee has depicted five scenarios of the future of the banking sector depending on whether incumbent banks, small new entrants or big technological companies manage the customer relationship and ultimately provide the service. At the European level, however, the EBA and the Commission have followed a more hands-on approach that aims at defining specific policy actions. This analysis is based on an assessment of the European fintech landscape and its regulatory status. In this regard, the EBA's Discussion Paper takes stock of a mapping exercise conducted earlier in 2017 which identified that a significant proportion of the so-called fintech firms (31% of the sample[6]) in the EU are not subject to any regulatory regime or are only subject to a national authorisation or registration regime (14% of the sample).

Having said that, authorities are aligned in their analysis of the opportunities and risks arising from fintech as well as on the main concerns and priorities going forward. The latter can be summarized in the following three broad themes.

**1. Understanding the change**

Amid rapid technological changes and shifting customer expectations, interest in digital innovations in the financial sector is growing. Regulators and supervisors need to follow market developments to understand how the appearance of new players and the emergence of new infrastructures, products and distribution channels are going to reshape the financial system. It is reasonable to expect that new or evolving risks will appear for the system and for individual institutions. Regarding the latter, operational, IT and cyber risks have become a key concern for authorities, together with the additional pressure on the profitability of individual firms created by tougher competition.

6: The EBA has identified that there are over 1500 fintech firms in the EU, although it only has detailed information on a sample of 282 firms.

All of the above has systemic and financial stability implications as well, which may be exacerbated by an increase in market volatility and procyclicality, driven by the growing use of automated tools and services, and more concentration as a result of economies of scale and network effects. Apart from financial stability risks, policy makers are concerned about the risks posed to consumers, which may relate to data protection, financial inclusion or the ability to effectively exercise customer rights in a more complex world; and to the integrity of the financial system.

**2. Assessing the adequacy of existing regulatory frameworks**

International SSBs and EU bodies recognise that current bank regulatory, supervisory and licensing frameworks generally predate new technologies and business models, and this may create unintended regulatory gaps and pose undesired barriers to innovation. Going further, this may also lead to an unleveled playing field among different players. The results of the aforementioned EBA exercise are quite telling in this regard. Therefore, regulators and supervisors recognise the need to consider, within their statutory objectives and jurisdictions, whether existing frameworks are sufficiently proportionate and adaptive to reach an appropriate balance that guarantees safety and soundness and consumer protection expectations while mitigating the risk of inadvertently inhibiting innovation. As a result, they show an intention to assess whether updates of the existing frameworks are needed.

**3. Defining their role**

Beyond specific regulatory measures, financial authorities around the globe need to take a more pressing decision: their stance towards innovation in financial systems. Generally speaking, regulators and supervisors seek to find the right balance between guaranteeing safety and promoting innovation. In the quest for this balance, European and international policy makers are taking note of initiatives being deployed in some countries, such as innovation hubs or regulatory sandboxes, as these may help build an open dialogue between all stakeholders and provide fruitful insights into emerging models.

At the same time, however, authorities acknowledge that the global dimension and cross-sector nature of the fintech phenomenon raise the bar as regards the need for cooperation and collaboration among authorities, including across countries. The latter implies that a continuous dialogue should be established with authorities from different digital-related areas, including conduct, data protection or cybersecurity authorities. Finally, regulators and supervisors realize that their knowledge, skills and tools may need to be updated as well.

## The road ahead

The efforts of the different bodies to outline the current landscape and start envisaging how this may affect their mandate as regulators and supervisors is much welcomed, as these institutions are a central piece in the new fintech ecosystem. Still, most often their analysis is still at a high level and a lot of work needs to be done to materialise concrete actions. Given the global dimension of most innovations and the increased interconnectedness of the financial system, international cooperation is a must. This is needed in order to define guiding principles at global level that serve to avoid fragmentation across countries' regulatory approaches. The work of the FSB and other international SSBs will be crucial in this endeavour. Also, in this exercise, there are three main areas that deserve deep reflection:

- **The concept and categorisation of the fintech phenomenon.** Most institutions have followed the FSB's definition of FinTech, which is inclusive. However, often they identify fintech firms with smaller new entrants, without encompassing banks or big technological companies. This seems inconsistent with the definition and may lead to an underestimation of the real impact of the phenomenon.
- **The understanding of what is behind a true level playing field**[7], which ought to comprise two aspects. First, activities involving the same risks in terms of financial stability, consumer protection and the integrity of the financial system should receive the same regulatory treatment. Therefore, any difference in regulation and supervision should be based on the risks posed by different products and services. Second, there should not be unnecessary barriers to competition in the market beyond those justified by risk considerations. In relation to this, authorities should further assess the implications of prudential regulation, which often leaves banks in a situation of competitive disadvantage vis-a-vis other players, and work towards eliminating existing loopholes in regulatory frameworks. Also, regulatory sandboxes may be a useful tool to facilitate innovation for all players under safe and equal conditions.
- **The increased role of data as a driver of change.** Data is a key strategic asset in the digital economy, fundamental to reinforce customers' trust and to create compelling value-propositions. Regulators should remain mindful that rules on access and portability of customer data have numerous implications as regards consumer protection, competition and the structure of the financial sector.

7: Urbiola, P. Banks and new digital players: Is there a level playing field? BBVA Research Digital Economy Outlook, September 2017.

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