Digital Economy, Digital Regulation, Digital Trends, Financial Regulation

Implementing the principle of “same activity, same risk, same regulation and supervision”: activity vs entity-based frameworks[1]

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The principle of “same activity, same risk, same regulation and supervision” is at the heart of discussions on how to achieve a level playing field for all providers of financial services, and particularly between banks and non-banks (fintechs, bigtechs). This principle is often associated with the need to move from an entity- to an activity-based approach to financial regulation, which would mean imposing similar requirements upon all active players in a particular market segment, regardless of the legal nature of those entities. However, the “same risk” element of the principle means that there are limits to a pure activity-based approach, since the provision of the “same activity” can sometimes lead to different risks (for financial stability, mainly) depending on certain factors such as the scale at which the activity is provided, whether the service is provided end-to-end by a single player and whether the activity is offered in combination with other regulated or non regulated activities.

This discussion is growingly relevant as bigtechs are increasingly making inroads into financial services. The business model of bigtechs includes building around their customers an ecosystem of interconnected products and services, amid which financial services are not an exception (Fernández de Lis and Urbiola, 2019). Financial services can be ancillary or embedded in the provision of other non-financial services of bigtechs, can be offered under a wide range of modalities (directly or through partnership agreements) and from different legal entities within the group. Moreover, as has been discussed extensively in the recent literature[3], bigtechs have competitive advantages over their competitors - arising from the existence of network effects, their role as gatekeepers of certain markets and services and their ability to access and exploit vast amounts of customer data - which explain why these companies could gain a very significant scale in the provision of financial services rapidly.

Generally speaking, finance-specific regulations are geared towards individual legal entities within bigtech groups or the specific financial activities they perform, and not towards the risks from possible spillover effects across all the activities bigtechs perform (Restoy, 2021).

The first section of this article elaborates on the principle of “same activity, same risk, same regulation and supervision”, with a focus on the “same risk” element. The second section includes proposals on how to put it into practice through a combination of activity and entity-based approaches to respond to the challenges of new developments in finance.

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2: This article has benefited from the collaboration and comments of Jaime Zurita (Financial Systems, BBVA Research), Salvador Portillo (Regulation, BBVA), Pablo Urbiola (Head of Digital Regulation, BBVA) and Santiago Fernández de Lis (Head of Regulation, BBVA).
3: See for instance Financial Stability Board (2019), Bank for International Settlements (2019) or Fernández de Lis and Urbiola (2019).

1. When may the “same activities” not lead to the “same risks”? The (existing and new) limits to a pure activity-based regulatory framework

- The most paradigmatic example can be found in the **provision of credit by banks**, which entails the combination of taking deposits (short-term) with investing those funds in riskier, longer-term assets (credit) through financial intermediation. This activity clearly involves different risks than non-bank lending, due to the special protection of deposits and the underlying risk transformation. This is the rationale for the entity-based approach behind banks’ prudential regulation, which applies on the consolidated balance sheet of financial institutions and has implications on the non-core activities within banking groups, even if performed by different legal entities within the group.

- The provision of certain activities at a **large scale** can also lead to differential risks. Services provided at a great scale by one provider could become essential for the financial system and thus pose greater risks for financial stability, since their failure could cause widespread disruption to other parts of the financial system or the economy more broadly. The idea that size and significance in the provision of a certain financial activity might be a source of financial stability risks is already recognised in financial regulation, as is already the case with systemically important banks, payment systems or other financial market infrastructures, which are subject to more stringent requirements and oversight to prevent problems affecting these large individual entities from spreading and thereby undermining financial stability. In the future, new types of players – particularly the bigtechs due to their “winner-takes-all” trend – may also reach such a scale that they become systemically important in certain activities, or parts of the financial system, that are currently not covered by frameworks to deal with systemic risk (Pacheco and Urbiola, 2020). This may happen for instance in:
  - Services that add new layers on top of existing services, often acting as end-user interfaces, that could become critical infrastructures for ensuring access to the market. For instance, some technical services that support the provision of payments services (e.g. mobile wallets) could potentially become essential for the availability of retail payments. Also, this could be the case with providers of deposit or credit marketplaces. Three trends could lead in the future to such a scenario: (i) the digitization of financial services and particularly payments, with an increasing reliance on mobile-based solutions, (ii) the trend to concentration of the digital ecosystems where financial services are being embedded by bigtechs, and (iii) the increasing fragmentation of the value chains, commented below.

  - A large-scale provision of e-money products, stablecoins or similar payment services could also generate risks related to the availability of retail payments. Also, such products could grow to a scale such that a relatively large pool of funds may be controlled outside of the banking system. Bigtechs’ payments activities link them to the financial system through deposits and investments in other financial assets for the purpose of safeguarding. A financial problem of a bigtech firm (e.g. sudden loss of customer trust and the need to redeem deposits or quickly sell assets) could potentially disrupt the funding of custodian banks and generate a financial stability problem. Also in the case of stablecoins, the reserve assets backing the stablecoin could become systemic for the market of those assets (G7 Working Group on Stablecoins, 2019).

  - Non-bank lending at a large scale can lead to macroprudential risks: a greater risk appetite of non-bank lenders or a less stringent governance framework could lead to a potential reduction in lending standards. This may also happen due to the use of alternative forms of creditworthiness assessment whose performance has not been tested through a full business and financial cycle. All the above might lead to enhanced procyclicality in credit provision, as funding flows from bigtech could become large or unstable or concentrated in some market segments and the ability of non-bank lenders to maintain the credit supply during a downturn is not clear (although this is probably less of a problem for largely capitalized bigtech companies than for smaller fintech companies).

- Also, growing credit activity outside the prudential regulatory net could create risks akin as those often attributed to the phenomenon of "shadow banking" and could limit the effectiveness of macroprudential policies, since traditional tools are almost exclusively applied through the banking sector.

Unlike existing regulations for banks, financial markets infrastructures and other providers of systemic importance, existing activity-specific rules seem unlikely to ensure the continuity in the provision of those essential services should an idiosyncratic or system-wide event take place.

- The **fragmentation** of the value chain of a financial activity – for instance, where the end-provider outsources a significant part of the product/service or where new players provide technical services that support the provision of regulated services – can lead to different risks, particularly if critical functions are provided by non-regulated players. This is especially acute in the field of payments, where technology has driven an unbundling of activities that historically were done under the roof of a regulated bank. New providers in this field include processors or acquiring aggregators. Regulation has also contributed to this trend in the attempt to increase competition by allowing non-banks subject to softer regulatory requirements to enter the payment market,e.g. as payment initiation service providers (European Commission, 2021).

  Although activity-based frameworks generally include provisions on third-party risk management, these may not always be robust enough to ensure resilience and continuity. Therecently EU Digital Operational Resilience Act (DORA), whose scope includes a broad range of financial service providers, proposes to establish an oversight framework for critical third-party providers. However, this framework is unlikely to address all the challenges. Moreover some of the new providers of technical services provide their services to regulated providers whereas others provide services directly to merchants. Therefore, this provision of technical services is not always captured by outsourcing frameworks.

  Also, from a consumer protection perspective consumers might face trouble to know who is responsible for each part of the service he receives, who to request information or remedies from.

- The **provision of several financial activities together, or financial and nonfinancial activities by the same undertaking** can lead to some differential risks on top of those of the individual business units, depending on the degree of interconnectedness between such activities and the risk of non-effective monitoring of risks that fall outside the remit of sectoral supervision. This is the reason behind the special regulatory treatment of **financial conglomerates**, which at least in the EU have been focused on the entities under the bancassurance model (e.g. undertakings combining banking, insurance and investment firms) - *see box 1 for a deep-dive on the EU financial conglomerates framework*. In view of the challenges arising from the combination of financial activities, a system of 'supplementary supervision' has been developed for financial conglomerates, with the aim of ensuring that supervisors have a realistic insight into a group's risks.

Box 1 - The EU regulatory framework for financial conglomerates

In the EU **the Financial Conglomerates Directive, FICOD** (last amended in 2011) defines 'financial conglomerate' on the basis of two situations: (i) where the head of the group is a 'regulated entity'[4] or (ii) where at least one of the subsidiaries in the group or subgroup is a regulated entity.

In both scenarios, qualifying as a financial conglomerate requires meeting certain **conditions regarding the materiality of the financial activities. Also, at least one entity within the group must be within the insurance sector**, reflecting the nature of the financial conglomerates (i.e. bancassurance groups) operating in the EU at the time.

Basically, if a financial conglomerate that operates in the EU is subject to FICOD, it will be supervised as such in terms of capital adequacy, size and complexity, risk concentration, contagion (financial or reputational) and conflicts of interest.

Also, traditionally, **industrial conglomerates (or mixed activity groups)** have existed which have included a limited financial business within their core industrial or commercial offering (e.g. car manufacturers with a bank unit).

Recent developments in digital finance have proven there is a possibility that new types of groups combining activities emerge - other than pure financial conglomerates or traditional mixed activity groups. Bigtech firms, in particular, have the capacity to offer a wider range of financial and non-financial services at a larger scale, both in terms of customer and jurisdictional reach, than other types of conglomerates. On top of this, the great number and size of intra-group connections between business units and activities (financial and non-financial) poses risks of a more systemic dimension (Noble, 2020).

Risks might arise from the combination of different financial activities (e.g. payments, non-bank lending) but also from the combination of financial activities with non financial activities.

- **Risks arising from the combination of financial activities**

  a. The combination of financial activities might generate an excessive build up of risks arising from common risk exposures (to the same counterparties or to specific products or markets). This might be the case in the combination of non-bank lending, payment services (via the investments for the safeguarding of clients' funds), asset management, etc. and other activities that are likely to be offered simultaneously by bigtech companies. The narrow focus of activity-specific supervisors might make it difficult to assess these large exposures.

  b. Difficulty to assess the capital adequacy: a problem of double gearing might occur if one regulated entity holds regulatory capital issued by another entity in the same group and the issuer also counts that capital in the balance sheet. However, this risk appears relevant only for activities whose regulatory frameworks include capital requirements (e.g. banking, insurance, payments – to a limited extent only).

  c. Difficult supervision of complex group structures with potential interdependencies (operational, reputational) between different specialized entities. These interdependencies may be difficult to supervise by different sectoral authorities (for banking, payments, lending, insurance), focused only on individual

4: A 'regulated entity' is a credit institution, an insurance or reinsurance firm, an investment firm, an asset management company or an alternative investment fund manager.

entities and no monitoring capacity on a group-wide level. Lack of access to information and insufficient supervisory coordination contribute to this situation.

- **Risks arising from the combination of financial and non-financial activities, and the former being auxiliary to the latter**

   a. Greater and more complex intra-group dependencies, for instance on data pools, IT systems or customer bases between financial activities and potentially multiple non-financial businesses. This may increase risks related to operational and cyber-resilience (e.g. by creating more points of entry for cyber threats or failure), and demand complex governance and risk management procedures to ensure continuity of the financial activity or to ensure an orderly resolution in case of failure. The latter becomes specially relevant if the financial activity is significant at a system level, which as has been argued, is not negligible in the presence of bigtech companies. Activity-specific frameworks are unlikely to be comprehensive enough to deal with these intrincated interconnexions.

   b. Contagion from the nonfinancial to the financial part of the group can also occur through other means: dependency in terms of funding, reputational linkages, etc.

   c. Financial activities (individually or as a whole) might be small relative to the total size/revenues of the group and be only ancillary to the ecosystem's core business lines, but still be of significant importance for the financial system. This means that the financial stability impact of decisions on the failure/discontinuity of financial activities may not be factored in by bigtechs.

   d. Looking beyond pure financial regulation policy goals, the combination of multiple activities can harm competition in the provision of financial services. Companies with dominant and gatekeeping positions in one market might utilize that position to enter and gain a strong position in adjacent markets. Also, companies that play dual roles (as providers of critical inputs and as competitors) might impose unfair conditions and use some activities to privilege others (Fernández de Lis and Urbiola, 2019). An example of this can be found in Box 2.

Box 2

Large digital platforms are increasingly participating directly in financial markets (e.g. as payment service providers) and indirectly by providing technical infrastructure that is increasingly relevant for the provision of digital financial services. These infrastructures include devices and their associated functionality, such as near field communication (NFC), which is essential for the provision of contactless payments and mobile wallets.

In some cases, digital platforms allow its own mobile wallet service to utilise the NFC feature, but do not allow the mobile wallet of other competitors to use it, making their own payment solution the only viable one for customers that utilise their mobile device and operating system.

Therefore, digital platforms are able to leverage their market power in the mobile device and operating system market to create an advantage over other mobile payment competitors and extend into the payments market..

   e. Consumer protection risks might arise for instance as a result of cross-selling strategies or potential misalignments in incentives between different parts of the business, e.g. customers being required to subscribe or contract a certain service to access other services of the bigtech. Data protection risks might arise for instance due lack of clarity about the different uses of personal data.

Finally, it is worth noting that these situations are not mutually exclusive, but can happen simultaneously and exacerbate the different risks described above. For example, the risks posed by a combination of financial and non-financial activities within the same undertaking (e.g. complex intra-group interdependencies and difficult risk management and supervision) would be much more prevailing if those financial activities grow to a scale such that they become of systemic importance (e.g. ensuring continuity of such services would be essential for financial stability). This is not only possible but likely in the context of bigtech companies, given their features and competitive advantages.

2. What regulatory response is needed for those situations? Re-assessment of the mix of entity-based and activity-based rules for bigtechs

- To ensure a more risk-based approach to the **entity-based regulation of banks**, authorities should explore how to reduce the burden from prudential regulation on those subsidiaries of banking groups whose activity is not related to deposit-taking and financial intermediation.

  While the need for an entity-based regulation for banks is uncontestable, this does not necessarily mean that applying all prudential requirements automatically to all subsidiaries of banking groups is justified on the basis of risks. A more risk-based approach could imply introducing more proportionality for the non-deposit-taking subsidiaries - ring-fenced from the core banking business and that do not add risks to the group other than the potential loss of the investment -, and considering which individual requirements are needed relative to their contribution to the risk profile of the group.

- In response to the potential risks of a **large-scale** provision of certain activities, authorities could consider introducing **size-based requirements or supervision, on top of existing activity-based frameworks.** This might require a reform of the licensing and supervisory frameworks in place for activities (e.g. payments, electronic money or non-bank lending) and could include tightening operational resilience and third-party risk requirements, introducing resolution requirements, demanding closer supervision and more exhaustive risk governance or defining additional reporting and disclosure requirements (Pacheco and Urbiola, 2020).

  This approach has been followed by the European Commission with the proposal for a Regulation on Markets in Crypto-assets (MiCA), which defines criteria for the identification of e-money tokens and asset-referenced tokens to be deemed significant. These criteria include the size of the customer base, the size of the reserve assets or the significance of cross-border activities. Issuers of these tokens are subject to additional requirements, such as higher capital requirements, reserve liquidity policies ensuring the continuity of operations under stressed scenarios, and non-discriminatory token custody by service providers, among others.

  For activities that are currently not regulated - e.g. certain marketplace business models, mobile wallets - authorities might consider introducing certain requirements or oversight mechanisms only for players of certain size, without necessarily introducing a general bespoke licensing regime.

- To respond to the risks of the **fragmentation of the value chain,** certain **activity-specific regulatory frameworks should be enhanced by introducing stricter requirements on third-party risk and outsourcing** to improve regulated providers' internal governance and risk control on third parties to which they delegate their activities. Eventually, it might also be needed to **extend the regulatory perimeter to cover for certain technical or ancillary activities.** However, it should be assessed whether it is needed to regulate the activity itself, regardless of the scale at which it is provided, or whether requirements should apply only in case the provision reaches a significant scale.

  So far, we have proposed regulatory responses that rest prominently on the revision, upgrading or extending of activity-based regulations. However, when the main features of bigtechs are considered (size, interconnectedness, relative importance of financial operations within the consolidated group, etc.) it appears that activity-based regulation may not be sufficient. A purely activity-based approach means regulating individual parts instead of an interconnected system, and would miss the systemic component that is created by the combination of all activities a bigtech firm performs. Therefore, there seems to be a case for developing more entity-based rules for bigtechs (Carstens (2021), Restoy (2021)).

  However, developing a comprehensive regulatory approach for bigtechs does not mean that authorities should (or can) implement a bank-like regulatory framework, unless bigtechs enter into core banking activities through deposit-taking and financial intermediation. Instead, they can build upon other existing policy frameworks, such as the ones for financial conglomerates (Noble, 2021).

- To respond to the risks of the **provision of multiple activities by the same undertaking**, we propose an **entity-based regulatory response based on introducing supplementary regulation and supervision for groups engaging in a wide range of financial and nonfinancial services**.This shall consist of:

  - **Supervision**: Create a new mechanism for supervisory coordination that ensures a holistic surveillance. Currently, the narrow focus of supervision - sectoral supervisors only observe the risks of the relevant legal entities providing the activity under their scope (payments, lending, …) - does not allow the adequate monitoring of wider risks emerging from bigtechs' activities.

    Ideally, this would require creating a supranational and holistic supervisor, but this feels unlikely considering current institutional architectures and the heterogeneity in bigtechs' business model.

    Therefore, we propose to create a "college type" supervisory setup that ensures adequate coordination between relevant supervisors. This idea builds on the concept of supervisory colleges of international banks, and would, thus, be a permanent, though flexible, structure comprising the relevant supervisors of the financial activities performed by each bigtech company as well as authorities charged with the supervision of other non-financial bigtech activities or enforcement of other cross-cutting rules. The exact authorities to be included in this structure would likely vary per country/region depending on the existing setup. Generally speaking, it could include: financial supervisors (including sectoral supervisors charged with the monitoring of payments, lending, banking, insurance, etc.), conduct and consumer protection authorities, the AML/CFT agency, as well as the data protection and competition authorities.

  - **Reporting**: Increasing the amount and reach of the information available on bigtech groups would be critical to better monitor and mitigate the systemic component that is created by the combination of all activities a bigtech firm performs.

    This must include, other than financial information, information on overall governance structure and risk management, and any information on unregulated activities performed within the consolidated group that are relevant for the provision of financial services. Enhanced disclosure should allow authorities to have a holistic understanding of their domestic and cross-border operations; the nature and extent of the risks involved; and important interlinkages between entities within the group, external financial institutions and the financial system as a whole.

Ideally, if financial activities are of systemic importance, financial authorities should be able to monitor non financial activities to some extent. This might be unrealistic at the moment due to the lack of resources and expertise of financial supervisors, but at least it should be ensured that financial authorities have a detailed mapping of intra-group dependencies between financial and nonfinancial activities. This should cover operational, reputational, financial (funding) and strategic links.

- **Other requirements** - additional requirements could be imposed, depending on the risks identified via the enhanced supervision and reporting, and potentially tailored or conditional to the size, including: governance and risks management requirements to deal with risk concentrations and interdependencies, conflicts of interest; resolution and crisis management framework; more comprehensive operational resilience requirements; stress testing (depending on size) to assess how different parts within the group would perform in the event of crisis in the rest.

- This could be implemented through a **revision of existing regulatory figures** to better capture groups that currently fall outside.
  - A **revision of the financial conglomerates framework, as suggested in Noble (2020)** could include the reassessment of the definition of "financial conglomerate" to align current regulations with new types of "conglomerates", formed by different types of entities (e.g. other than bank, insurance company or investment firm) such as those being developed by the bigtechs. However, drafting such a definition to cover new digital providers could prove challenging, given the heterogeneity of the business models within bigtech companies. Moreover, the new thresholds of materiality/scale to trigger the application of supplementary regulation and supervision should consider not only relevance within the group (*statu quo* in financial conglomerates) but relevance for the financial system.
  - Alternatively, this could also require **reflecting on the supervision and regulation of mixed activity groups**, for which currently there is no group-level supervision and regulation applicable. The absence of any prudential rules allowing some oversight of the group-level financial activities might be problematic for some of these groups. Authorities could consider how to make them subject to some extent to consolidated supervision.

- **Other relevant policy considerations (beyond the entity vs. activity-based discussion in financial regulation):**
  - **Update competition policy needs to ensure that policy tools remain effective for digital markets.**

    For instance, investigations should move fast enough, and the use of interim measures should be considered to address certain conducts before they have led to entrenched market effects difficult to undo. In addition, **this should be complemented by regulatory action**. The latter could take the form of ex-ante rules for large digital platforms, and would provide a clear framework for action to allow policymakers to respond rapidly to existing challenges. Experience across digital markets indicates that the rules need to address from the outset self-preferencing that clearly undermines competition, as well as returning control to users over their own data in order to reduce lock-in effects and stimulate wider data-driven innovation. The recent European Commission proposal for a digital markets act represents a good example (see box 3 for more information).

Box 3 - The EU Digital Markets Act

The EU Commission released in December 2020 a proposal for a new regulation – the Digital Markets Act (DMA) – to introduce ex-ante rules for large digital platforms that act as “gatekeepers” in digital markets. The new rules will designate as gatekeepers those providers of “core platform services” (inc. marketplaces, app stores, operating systems and social networks) that have a strong economic and intermediation position (e.g. more than 45 million active end users, among other criteria).

These obligations are aimed at ensuring neutrality in the treatment of own vs. third-party products, granting business users with fair access rights (for instance, to app stores) and preventing unfair practices related to data and advertising. While obligations apply only at service level and not to the company (or its economic group) as a whole, ancillary services of the gatekeeper might be impacted by specific obligations. As a result of this, the Digital Markets Act can be seen as a good attempt to balance activity-, entity-, and size-based approaches to regulation, and might be taken as a guide to advance towards the implementation of the principle of “same activity, same risks, same regulation”. While all the obligations will be directly applicable to all designated gatekeepers, some of them can be further specified by the Commission through a procedure of regulatory dialogue.

- **Enhancing local and international supervisory coordination.**

  In the light of the cross-sectoral and cross-border nature of bigtech activities, it is imperative to put increased emphasis on cooperation and coordination at the local and international level. A practical step in this direction could be to establish cross-sectoral and cross-border cooperative arrangements between national authorities, including at least financial, competition and data protection authorities. These cooperation arrangements could involve or augment existing arrangements and build, among others, on the experience collected in running supervisory colleges for banks.

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