

Europe focuses on FinTech

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The European Commission has turned its regulatory searchlight on the FinTech industry. In a series of pronouncements made last month, it is clear that we can expect significantly more regulatory input in this area from Europe. As London is the leading FinTech hub in Europe, the effects of any increased Europe wide regulation will be particularly felt here.

This regulatory charge is being led by the European Banking Authority (**EBA**) and the European Central Bank (**ECB**). The EBA, as one of the three European Supervisory Authorities (**ESAs**), recently published a [Discussion Paper](#) (which built on its "mapping" exercise carried out earlier in the year) regarding how it intends to step up its approach to FinTech under the auspices of its consumer protection and market integrity objectives. Whilst the EBA has previously carried out a significant amount of work on the regulation of discrete areas of FinTech innovation such as crowdfunding and virtual currencies, it is now expanding its sights to FinTech more broadly in order to examine its prudential and regulatory impact on the financial system itself.

Meanwhile, the ECB is focusing on the authorisation and regulation of FinTech banks with the publication of a draft "[Guide to assessments of fintech credit institution licence applications](#)" (**Draft Guide**) last month.

The ECB acknowledges in its Draft Guide that there is "scope for innovative market participants to contribute positively to the financial sector" and similarly the EBA recognises FinTech's "potential to transform... the provision of financial services". However, both bodies are clearly concerned to ensure there is a level playing field between new FinTech entrants into the market and existing financial services providers and that the continued and increasingly rapid evolution of technology-driven financial services does not interfere with regulators' ability to effectively regulate and supervise the financial system.

Impetus for action

As mentioned above, earlier this year the EBA carried out its first EU-wide FinTech mapping exercise in order to obtain a greater understanding of this emerging and growing industry. As part of this exercise it sought and received detailed information from 282 FinTech firms. The EBA reports its findings from the mapping exercise (and other work done by intergovernmental and EU agencies) in the Discussion Paper and we have highlighted some of its most interesting findings below:

- the **regulatory status** of FinTech firms appears to be highly varied, for example, 31% are not subject to a regulatory regime under EU or national law;
- FinTech firms appear to provide a **wide range of financial services** and whilst they are particularly dominant in the provision of payments, clearing and settlement services other areas including lending (including consumer credit) and portfolio management also rank highly;



Financial markets are changing fast. We are seeing renewed cross-border integration, new opportunities in FinTech and a boom in sustainable and green finance. The EU needs to act as one player so that we can stay ahead of the curve. More integrated financial supervision will make the Economic and Monetary Union more resilient.

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20 September 2017.



- that 100% of **RegTech** (technology supporting regulatory compliance) is not subject to any regulatory regime;
- **consumers are the main target end-user**, rather than professional firms, which is an important observation in relation to the EBA's consumer protection objective;
- a significant proportion of **FinTech firms hold client money**, including 12% of FinTech firms not subject to any regulatory regime;
- **the national authorisation regimes vary in their approach to FinTech**, leading to patchy and uneven regulatory coverage. The EBA identified that sandboxing regimes such as that operated by the FCA and the PRA's Regulatory Accelerator, innovation hubs or similar regimes are in place in almost half of the jurisdictions and in their view these support the development of FinTech while maintaining a healthy and stable financial system.

These findings, which clearly identify scope for better consistency of regulation in this area, together with the EBA's mandates which include:

- promoting a sound, effective and consistent level of regulation and supervision;
- enhancing consumer protection;
- promoting a sound, effective and consistent level of regulation and supervision;
- promoting equal competition; and
- monitoring new and existing financial activities,

have prompted the EBA to put forward its proposals to supervise the regulation of this sector on a Europe-wide basis.

The EBA's proposed way forward

The EBA has identified six areas in which they propose they should carry out further work:

1. **authorisation and sandboxing regimes** – in particular assessing the current national authorisation and sandboxing regimes and considering developing current EBA guidelines on authorisation into RTS in order to ensure compliance and further work to establish the benefits of greater consistency in supervisory approaches across Europe;
2. **the impact on prudential and operational risks for credit institutions, electronic money institutions and payment institutions** – including work on the increased operational risk observed in recent years eg cybersecurity issues, digital fraud and increased outsourcing risks and the EBA envisions carrying out an in-depth analysis of these risks, further training for supervisors and publishing additional guidelines to deal with these risks;
3. **the impact of FinTech on the business model of incumbent credit institutions** – FinTech is clearly a disruptive influence on existing credit institutions, requiring such institutions to rethink how they interact with consumers. While FinTech may offer opportunities to reduce overheads and to reach customers in new ways (for example via apps and other mobile technology) it does pose significant risks for existing institutions which are of necessity using

legacy technology and IT systems as opposed to pure FinTech firms who are free to engage with the latest technological developments without considering how to marry the new system with the old. There are also potential demographic issues; the almost inevitable closure of branches may negatively impact on older consumers. In order to address these concerns the EBA intends to engage with existing credit, payment and electronic payment institutions and to develop a thematic report regarding the changes to business models of such institutions;

4. **customer protection and retail conduct of business issues** – the EBA also flagged that consumer rights are currently unclear because of the ambiguous regulatory status of the FinTech firms themselves and issues with cross border provision of such services. The EBA intends to deal with this issue through carrying out further work on the regulatory perimeter that such firms should operate in (as mentioned above at point 1) which it believes will enhance consumer protection. It also intends to carry out work on a co-ordinated approach to complaints handling and the extent and quality of client disclosure in the digital world. The combination of increasing digital access to financial products and services with ongoing low levels of financial literacy was also identified as a risk to consumer protection with the EBA determined to continue to foster national initiatives on financial literacy. The risk posed by the use of Big Data analytics (including social media) is also of concern and the EBA intends to work with other ESAs to counter this risk;
5. **the impact of FinTech on the resolution of financial firms** – there are a number of aspects where FinTech and FinTech providers can impact resolution scenarios – for example, the use of instant payments through distributed ledger technology (such as blockchain) means that deposits can be paid out more quickly than would be the case with a traditional credit institution and that the "resolution weekend" may disappear, and in turn increase pressure on the institution at an already difficult time. However the EBA also recognises that FinTech could also be useful in a resolution situation, for example by facilitating and improving reporting and monitoring processes. The EBA intends to carry out further scrutiny of the impact on and by FinTech firms in relation to resolution planning; and
6. **the impact on anti-money laundering (AML) and countering the financing of terrorism (CTF)** – from the EBA's point of view there are several AML/CTF issues emerging in the FinTech sector. Under the EU's Fourth Anti-Money Laundering Directive (AMLD) firms designated as "obliged entities" are subject to strict AML procedures, however not all FinTech firms have been designated as "obliged entities" and the EBA believes that this may "lead to regulatory arbitrage and create terrorist financing and money laundering vulnerabilities in that sector". The potential for cross border provision of digital financial services also creates issues as to which AML/CTF regime a FinTech firm needs to follow. Together with the other ESAs, the EBA is working on an opinion setting out their views on how FinTech firms should comply with AML/CTF obligations. The EBA will also update its guidelines to take account of AML/CTF risks related to the increasing FinTech industry.

The ECB's proposed approach

The ECB's Draft Guide notes that there are an increasing number of credit institution licence applications for FinTech banks (which the ECB defines as banks whose "production and delivery of banking products and services are based on technology-

enabled innovation"). Balancing its objective to maintain a sound banking system with a desire to allow space for these new entrants to make a positive contribution to the market and thereby widen consumer choice the ECB explains that it is publishing this Draft Guide with the aim of both increasing understanding of the licencing procedure and enhancing transparency for applicants. While the Draft Guide is technology neutral, the ECB is clear that FinTech banks must be held to adequate authorisation and prudential standards as traditional credit institutions are in order to maintain a "level playing field".

The Draft Guide sets out four areas of general criteria assessed in the licensing process and we set out the most important points to note below.

1. Governance

- *Suitability of the members of the management body:* in addition to the general suitability criteria for a bank's management body ("adequate knowledge, skills and practical and theoretical experience in banking and/or financial services"), members of the management body of a FinTech bank must have sufficient technical knowledge, skills and experience.
- *Suitability of shareholders:* Shareholders must have management and technical competence in the area of financial activities, including financial services. Additionally, the financial soundness of shareholders should be sufficient to ensure the sound and prudent operation of the FinTech bank for an initial period of usually three years.

2. Internal organisation

- *Credit risk approval and governance:* the ECB acknowledges that FinTech banks may not have sufficient information to build bespoke internal credit scoring systems in the initial phase of their operations, although the ECB is clear that FinTech banks need to have properly instituted processes in place for approving loans and indicate that both the ECB and/or the relevant national competent authority may consider carrying out additional assessments post authorisation to ensure this is the case. Any alternative credit scoring process that a FinTech bank intends to rely on will need to be thoroughly risk assessed. The ECB also flags that given the potential for FinTech banks to be more internationally focussed, such banks should consider whether they require to take into account country specific credit scoring risks.
- *IT-related risks:* applicants should ensure they have specific controls and safeguards for cybercrime as there is an increased vulnerability to cyber-attacks due to the fact that at their core they are technology driven and their tendency for greater levels of outsourcing. The ECB sets out the following in relation to IT:
 - i. that after a licence is granted it may carry out on-site examinations of IT infrastructure;
 - ii. it expects specialised staff and an internal risk management framework to enable the FinTech bank's management body to develop a strategy and procedures to monitor, rapidly detect and respond to cyber

incidents; and

- iii. arrangements should be in place to ensure business continuity and sustainability including how customers could be compensated if they are victims of a cyber-attack.
- *Outsourcing risks (other than cloud)*: applicants should also ensure they are able to exercise contractual rights to audit outsourced activities and consider assessing dependencies on suppliers (for example third party vendors of credit scoring programmes), in particular, vulnerabilities owing to contractual lock-in clauses which may pose risks related to business continuity. The FinTech bank applicant or an independent third party must have carried out appropriate due diligence on service providers considering the financial situation of the service provider, its market position, quality and turnover of its managers and staff, ability to manage business continuity and provide accurate and timely management reports.
 - *Cloud outsourcing*: the applicant must give due attention by way of a comprehensive assessment of:
 - i. the nature, scope and complexity of the cloud contractual arrangement and technical set up;
 - ii. the level of dependence on cloud service providers, minimising dependence on a single cloud service provider;
 - iii. the compliance of the cloud service provider with legal and regulatory requirements;
 - iv. the actions the cloud service provider will take in the event of a failure of its systems to continue to support the applicant;
 - v. the level of protection for personal and confidential data established in the service level agreement.
 - *Data governance*: applicants should ensure that information is protected against disclosure to unauthorised users (data confidentiality), improper modification (data integrity) and inaccessibility when needed (data availability).

3. Exit plan

- Given the recent entrance into the market of FinTech banks and the lack of past performance data, the ECB believes that there is a level of uncertainty as to their future performance, in order to deal with this risk, the ECB is urging applicants prepare an exit plan. This exit plan should identify how the FinTech bank "can cease its business operations on its own initiative, in an orderly and solvent manner, without harming consumers, causing disruption to the financial system or requiring regulatory intervention". One specific point the ECB and relevant national regulators will consider is whether the cost of such an exit plan together with the FinTech bank's first three years' worth of operational costs can be met by the FinTech bank's own funds.

4. Capital, liquidity and solvency

- As with many businesses in its start-up phase a FinTech bank could be subject to significant financial losses, which would then eat into the amount of own funds available to the FinTech bank. Therefore the ECB suggests that in certain circumstances (for example, if the initial business plan of a FinTech bank was to offer high interest deposit accounts) the ECB may require additional capital above the minimum regulatory capital.
- In terms of liquidity, FinTech banks can be subject to particular risks, for example, online depositors tend to "shop around" more for better deals and therefore its deposit base may not be as secure. This is a risk that the aspiring FinTech bank should expect to have to address in its application.

Conclusion and next steps

From the recent work carried out by both the EBA and the ECB it is clear that they regard the FinTech industry as worthy of considerable regulatory scrutiny. This has particular importance for London as it is currently considered by many to be the leading global FinTech location outside China. If there is to be further European co-ordination on the regulation of the FinTech industry, the impact of Brexit will need to be considered in depth. However, given the global cross-border reach of FinTech both in terms of benefits (greater access to financial advice and products) and risks (in particular in relation to AML/CTF) it is arguable that perhaps a global G20 approach may be more appropriate. Such an approach could help sidestep some of the potentially negative Brexit consequences, although it would require an almost unprecedented level of global co-operation. A more practical approach may be to ensure that Britain contributes strongly to the current discussions taking place in Europe in order to ensure that we are ideally placed to be recognised as an equivalent jurisdiction in terms of the FinTech industry immediately post Brexit.

Finally, whilst the EBA and ECB focus on the banking sector, the FinTech revolution clearly impacts all aspects of the financial services industry. The paper published by the European Securities and Markets Association in June 2017 covers much of the same ground as it relates to automated investment management and advice, RegTech, outsourcing and conduct issues around crowdfunding platforms amongst others, illustrating that these issues are clearly at the top of the agenda across all of the ESAs.

The industry should note that the EBA has requested that comments on its proposals are provided from stakeholders by 6 November 2017. They will then assess the responses with a view to deciding what further steps to take during 2018. The EBA has also set out that the regulation of FinTech will be a priority in its work programme for 2018.

Any new FinTech banks should consider the ECB's Draft Guide in their application for a licence as the ECB has set out the Draft Guide is intended to "facilitate the application process" and in particular applicants should consider the potential for increased capital requirements. However, it is currently still in draft form with comments from stakeholders requested by 2 November 2017.

If you require further information on anything covered in this briefing please contact Andy Peterkin (andy.peterkin@farrer.co.uk; +44(0)20 3375 7435), Rachel Lowe (rachel.lowe@farrer.co.uk; +44(0)20 3375 7514) or your usual contact at the firm on 020 3375 7000. Further information can also be found on the [Compliance and Regulatory](#) page on our website.

[FinTech Update: Bank of England publishes results of FinTech Accelerator's latest Proofs of Concept](#)

[European Commission backs FinTech innovation and competition in the face of tightening regulatory standards governing FinTechs](#)

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