Institutions

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The regulatory framework for FinTech in the European Union

The global 2008-2009 financial crisis has defined the framework for financial services and information technology that we know today, and had the catalysis effect on **FinTech**. The post-crisis financing gap, distrust of formal financial institutions, and regulatory reforms such as the Dodd Frank Act and Basel III have increased financial institutions' compliance obligations and introduced viability stress tests (Gomber et al., 2017; Philippon, 2016). Consequently, the FinTech sector have had the opportunity of providing innovative and cheaper services (González-Páramo, 2017).

At the time of writing this article, not the whole European Union (EU hereafter) legislation covers all aspects of services provided by FinTechs due to the broad spectrum that they supply, e.g. lending, financial advice, insurance, payments, or virtual currencies. Different regulations are applicable depending on the activity carried out, for instance Directive 2000/31/EC is applied for e-commerce, Directive 2002/65/EC for distance marketing of consumer finance services, Directive 2009/110/EC for electronic money, amongst others (EP, 2017).[9] The European Central Bank (ECB, 2017) will require FinTech banks to apply for the licencing of any bank within the Single Supervisory Mechanism. This measure is aimed at ensuring that FinTech

9. The Single European Act (1986) and the Maastricht Treaty (1992) set the conditions for a single framework in the European Union, setting the conditions for an increasing number of financial services directives and regulations.

banks are properly authorised and controlling risks. Moreover, the ECB and the national competent authorities will assess whether the new start-ups have enough capital to cover start-ups losses in the first three years of activity, and where applicable, the costs associated to an exit plan.

The **European Commission** (EC, 2017c) launched a **public consultation** on June 2017 to seek input from stakeholders to develop the Commission's policy on FinTech. Public authorities show mixed views on the need to introduce new licensing regimes for Fintech activities. The EC (2017a)'s **Consumer Financial Action Plan** includes a number of actions to support financial innovations in financial retail services, whilst the European Parliament, EP's (2017b), **Report on Fintech** calls on the EC to draw up a **FinTech Action Plan** and deploy cross-sectoral in its work of FinTech (EBA, 2017a).

As a basis of enabling **crowdfunding** to become a regular activity, seven EU Member States have introduced bespoke regulatory frameworks for crowdfunding activities, with requirements for borrowers, lenders, investors and platforms (Ferrarini and Macchiavelo, 2017; EC, 2017b).[10] Tailored regulations may encourage the creation of crowdfunding companies, which would be unable to develop under securities regulation applied to large firms. These regulations would also reduce transaction cost associated to information disclosure (Cumming and Schwienbacher, 2016; He et al., 2017; Hornuf and Schwienbacher, 2015).[11]

Business models such as **peer-to-peer (P2P) platforms, business-to-business (B2B)** and **business-to-consumers (B2C)** require the application of the national rules and implementing the EU consumer protection directives notably the Unfair Commercial Practices Directive (Directive 2005/29/EC) and the Unfair Contract Terms Directive (Council Directive 93/13/EEC). **Information technology** (**IT** hereafter) and **data regulation** might be an obstacle to information sharing across jurisdictions leading to inefficient 'silos' of information amongst groups.[12]

10. France, Spain, Portugal and the UK have adopted special regimes for lending based-crowdfunding, whilst Germany, Austria, and the Netherlands issued *ad hoc* provisions for some lending based- and investment based-crowdfunding products (Ferrarini and Macchiavelo, 2017).

11. The literature offers an ambivalent effect of regulation on innovation. Blind (2012) shows that incorrect design of regulations may create compliance costs with deter innovation.

12. Tight regulatory deadlines for IT updates amplify this problem by requiring financial institutions to tinker around the edge of the existing infrastructure, or complicating the application of such innovations like requiring in-person identification instead of allowing for digital identification methods.

The Financial Stability Board (FSB) and the national regulatory authorities are expected to remove regulatory barriers and to progress in data harmonization (BIS, 2017; Silverberg et al., 2016). The rules of the Data Protection Directive (Directive 95/46/EC) applies to platforms and issuers/borrowers where personal data are processed. Afterwards, the General Data Protection Directive (Regulation (EU) 2016/679) - which entered into force on the 26th May 2016 but it will apply from the 25th May 2018 - will modernise the data protection rules by providing tools, such as data protection by design, to assist data controllers to comply with the data protection rules. The European Crowdfunding Network has also published its Code of Conduct for observation and application by the European industry at large (EC, 2016).[13] Importantly, the FSB developed a framework that defines the scope of FinTech activities to identify potential risks and enhance **financial stability.** Increasing cooperation amongst jurisdictions will diminish the risk of fragmentation and or divergence amongst new regulatory frameworks. The FSB identifies mitigating operational risk from third-party service providers, increasing cyber-security measures, and monitoring macrofinancial risks as the three mayor priority areas for international cooperation. Importantly, **regulatory technologies (RegTech)**, which is defined as an application of FinTech for regulatory purposes, may help banks to reduce compliance costs and make internal risk management more efficient, and pursue regulatory objectives such as consumer protection, or anti-money laundering, amongst others (FSB, 2017).

Importantly, the **MiFID** (Directive 2004/39/EC) offers, in principle, the natural regulatory framework for investment based-crowdfunding, as shown by the ESMA's (2014) consultation paper. The regulation of lending based-crowdfunding falls below the banking regulation, but these platforms also offer their products in secondary markets. The **MiFiD-II** (Directive 2014/65/EU) and **MiFIR** (Regulation (EU) No 600/2014) will set up the regulatory framework for investment firms from 3rd January 2018 onwards. Capital adequacy requirements should be proportional to the risk undertaken by the platform. Additionally, MiFID-II also enhances investors' protection of crowd-investors by setting conditions to Member States to adopt exemptions

13. The European Crowdfunding Network is a based-Brussels professional network promoting regulation and transparency. The Code of Conduct is available at: http://eurocrowd.org/about-us/code-of-conduct-2/

from the Directive in cases of services like reception of deposits or transmission or orders. In this regard, Ferrarini and Macchiavelo (2017) suggest that MiFID should consider other than transferable securities, when they are offered to retail investors on a marketplace-investing platform.

Regarding **payment services**, the Payment Service Directive (PSD hereafter) (Directive 2007/64/EC) introduced more competition in the European market, and the Single European Payment Area (SEPA) which harmonized card and bank-to-bank payments, but electronic payments remained fragmented. The PSD2 (Directive (EU) 2015/2366) expands the definition of payment services, and the diversity of suppliers. The deadline to introduce the PSD2 into national regulation is 13th January 2018. Additionally, the European Banking Authority's Guideline (2017) sets out the criteria and methodology to be used by payment services to consider an incident as major and, therefore be notified to the competent authority in the Member State. Finally, they detail the minimum information that the national authorities should share.[14]

As for **virtual currencies**, e.g. blockchains and cryptocurrencies, there is not a specific regulation at the EU level. However, the European Commission (EC hereafter) suggested a proposal (COM/2016/0450 final - 2016/0208 (COD)) for anti-money laundering directive, and regulation of virtual currencies in July 2017. The European Parliament released in May 2016 a resolution on virtual currencies with a more precise scope (EP, 2016).

In February 2015, the EC adopted the Green Paper (2015a) on building the **Capital Market Union** (CMU hereafter) which sought stakeholders' view on the barriers to develop appropriately regulated crowdfunding or peer-to-peer platforms. Respondents to the CMU Green Paper consultation called for (i) intervention at the EU legislative level mostly referred to ensure investors' protection; (ii) facilitate cross border transactions, and (iii) other respondents answered that a market-led approach would be preferable. Considering this feedback, the CMU Action Plan commits the Commission Services to take stock of the European crowdfunding markets and its regulatory landscape (EC, 2015c, 2017).

The UK Financial Conduct Authority (FCA hereafter)'s Project Unit defines a **regulatory sandbox** as a safe space in which businesses can test new products,

14. See also EC's Green Paper (2015b) on retail financial services.

services, or business models delivering mechanisms without incurring in the whole normal regulatory responsibilities on carrying out the activity in question (Treleaven, 2015).[15] The principles behind the UK FCA's regulatory sandboxes can be unbundled and enhanced by introducing 'Minimum Regulatory Obligations', while 'Recovery and Resolution Plans' should resolve possible deficiencies of the start-ups, moving the sandbox from a pilot project to system-wide framework able to nurture innovation in financial markets, and providing a basis for an appropriate way forward to regulate new entrants, i.e. without distorting competition (Arner et al., 2017).[16] Furthermore, the Bank of England's **FinTech Accelerator** works along with firms on how FinTech innovations could be used in central banking to improve financial stability.[17]

The aim of these initiatives is to help companies navigate the supervisory regulations applicable to fully operational fintech financial services. On the one hand, **innovations hubs** can be described as an information exchange regime between companies and the supervisor. Supervisors may use innovation hubs to understand and monitor FinTech companies in order to identify risks and opportunities and thus shape new regulations if necessary. On the other hand, **accelerators** are usually funded and run by the private sector. They can be understood as projects or programmes by supervisors or central banks, where private sector firms are involved to address specific problems or to explore new technologies. We may find some examples in Europe. In the **Dutch regulatory sandbox**, the supervisor monitors the application and might impose additional requirements. The responsible for supervision will assess whether the sandbox requires any changes to established policies, rules or regulations. Moreover, supervisors may urge a change in the rules at national or European level. Moreover, the **Bank of Italy's 'FinTech Channel'** initiative is devoted to activate start-ups that offer services to banks and financial intermediaries (FSB, 2017).

15. The other jurisdictions which developed other regulatory sandboxes are Australia, Singapore, Switzerland, Hong Kong, Thailand, Abu Dhabi, and Malaysia (BIS, 2017).

16. Regulation and regulators should take into consideration the implications of Recovery and Resolutions Plans. Market entry for new participants could be facilitated for those that have a clear exit strategy in case of failure (Arner et al., 2017).

17. The other jurisdictions which developed other accelerators are Australia, France, and Singapore (BIS, 2017).

The regulatory framework for FinTech in China and the United States

In **China**, the People's Bank of China and nine other ministers jointly issued the Guiding Opinions, in July 2013, which requires that supervision and regulation of FinTech credit should follow the principles of "legitimate supervision, appropriate supervision, classified supervision, collaborative supervision, and innovative supervision". In addition, the China Banking Regulatory Commission and three other ministers jointly issued the Provisional Rules which forbids certain activities to FinTech credit platforms such as fund-raising for themselves, accepting and collecting lenders' funds, carrying out securitization or assignment of debt, amongst others (BIS and FSB, 2017).

In the **United States**, the legislation does not envisage a single licence or a regulatory agency. FinTech activities fits within the existing financial regulation conducted by several agencies at the state or federal level. The US supervisors are stablishing **innovation hubs**, such as Consumer Financial Protection Bureau's Project Catalyst, the Office of the Comptroller of the Currency's Office of Innovation, and the Commodity Futures Trading Commission LabCFTC program, through which FinTeh firms can communicate their concerns to the above-mentioned agencies.[18] Additionally, The US have begun to address chartering and licencing consideration on the FinTech space, for instance the New York State's 'Bitlicense' program or the Office of the Comptroller of the Currency in Texas. Importantly, the Vision 2010 initiative is aimed at addressing some cross-jurisdictional issues related to the 'passporting' efforts under consideration in the EU. Finally, the Financial Consumer Protection Bureau sought information from the industry and the public about the use or potential use of data and modelling techniques in credit scoring (Tsai, 2017).

18. Other jurisdictions which set up innovation hubs are Australia, Belgium, the ECB, France, Germany, Italy, Hong Kong, Japan, Korea, Luxembourg, the Netherlands, Singapore, Switzerland, and the UK (BIS, 2017).

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