FINTECH REGULATION: A BALANCING ACT

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AMMAR AL-SALEH
SENIOR COUNSEL, EBRD
AlsalehA@ebrd.com

with a contribution (Box 1) by

2
POLYXENI PENTIDOU
ANALYST, LC2, EBRD
PentidoP@ebrd.com

3
JACEK KUBAS
ASSOCIATE DIRECTOR, LC2, EBRD
KubasJ@ebrd.com

Fintech, the marrying of financial services and technology, has only recently made its way into the dictionary, although apparently the term was first known to be used in 1971.[1]

So Fintech is far from a new concept, being defined as "products and companies that employ newly developed digital and online technologies in the banking and financial services industries".[2] The definition does not specify the size of the company or the type of technology used.

It is therefore no surprise that Fintech products exist today across the entire spectrum of the financial service sector. Chart 1, which is not intended to be exhaustive, highlights the various Fintech products available.

CHALLENGES OF REGULATION

There is no doubt that Fintech plays a role in efficiently providing new investment opportunities for consumers and investors, which increases access to finance and promotes competition across the economies where the EBRD invests.

However, Fintech is not without its challenges. In the last couple of years we have seen regulators across the globe attempt a cautious balancing act of permitting Fintechs some freedom with the eventual goal of bringing uniformity between them and traditional financial service providers.

Regulators recognise the need for innovation and are working to support and encourage Fintech activity through regulatory changes and the creation of innovation hubs or regulatory sandboxes. At the same time, regulators are becoming more cautious about Fintech, specifically with regards to data privacy, customer protection and systemic risk.

ONE SIZE FITS ALL?

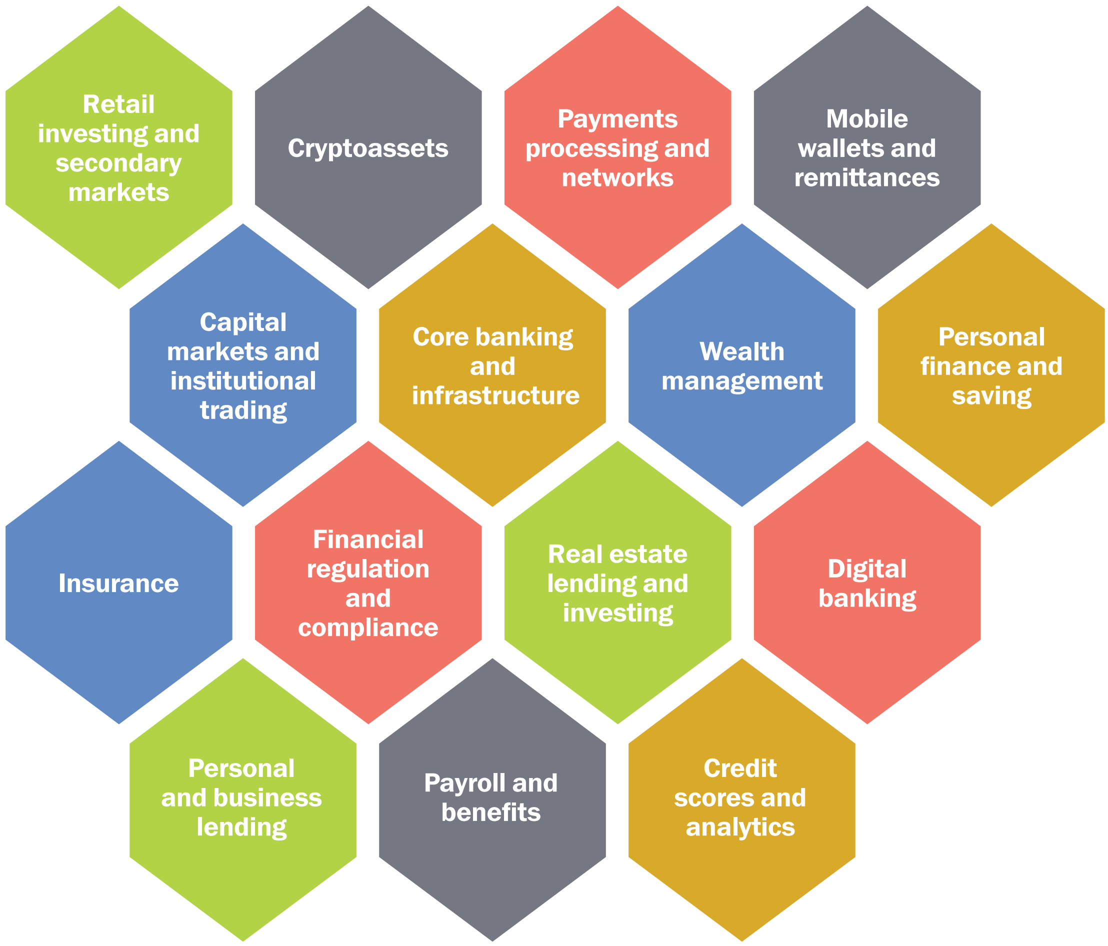
There is no legislation dedicated to Fintech in the EBRD regions. In fact, no dedicated legislation exists within the European Union (EU). So how do regulators go about regulating Fintech? It is important to note that while regulating a Fintech entity depends on the actual activity performed by the entity in question, the technology that the particular entity uses is not regulated.

Nevertheless, regulators need to be flexible in order to create uniformity in regulations between Fintechs and traditional players without stifling innovation. Regulators must shift their approach, moving from a rule-based approach to regulation to a principle-based methodology.[3]

As well as ensuring that their approach does not suppress innovation, regulators are expected to adjust their methodology in order to exhibit focus, dexterity and completeness in their regulatory outlooks and mission. On the one hand, if stringent regulatory control is applied too early, innovation can be stifled, while on the other hand, delays in regulatory intervention can result in serious systemic risk.

Brummer and Gorfine contrast the two approaches and note that with respect to Fintech, in "circumstances where innovation is offering potential benefits to markets and customers, but is not yet well understood, erring on the side of "principle-based" regulation would seem to

Chart 1: Available Fintech products



Source: EBRD.

maximise the benefits and minimise applicable negative trade-offs as the new innovation develops. Once the innovation matures, thereby allowing for learning and analysis, it may become increasingly appropriate to promulgate a larger set of detailed rules that prohibit negative behaviour and encourage observed best practices. The key here, however, is to not stunt the development of innovation with non-indicated rules and regulations".[4]

Regulations have traditionally been set up in a way that is specific to a product. Regulators must move to broader principle-based frameworks to ensure unbiased regulations that allow less scope for entities to manoeuvre in a crowded playing field. In order to generate a uniform approach to regulations, regulators must broaden their scope to non-financial service providers depending on the activities they undertake.

This, perhaps, is the fundamental challenge faced by regulators. They would need to blend the supervision of different regulated entities under their purview into one regulatory framework. Regulators would also play an important role in fostering collaboration between Fintechs and traditional banks through the guidelines they set, including any restrictions on activities. To allow for innovation within financial markets, regulators must also create an environment in which this can be fostered.

Only time will tell if Fintech could lead to new types of systemic risk. However, uniformity in regulations is key to managing this risk. Regulators will have to allow for principle-based regulation as long as the risks are low, and once Fintechs have a broader scope, regulators must align regulatory expectations with those applicable to traditional players.

THE IMPORTANCE OF INTERNATIONAL COOPERATION

It is important to note that, to a certain extent, regulators across the globe are attempting to deal with the challenges identified. However, creating a level playing field does not necessarily mean that regulation must be uniform.

There are commonalities in the global dimension of many Fintech activities; there are therefore many benefits to increased international cooperation. Increased cooperation will be particularly important to soften the risk of disintegration in regulatory frameworks, which could obstruct innovation in the financial industry.

Through its Legal Transition Programme, the EBRD has been working with governments across the economies where it invests to help them create an investor-friendly, transparent and predictable legal environment. To that end, we have been looking at different types of Fintech solutions and the issues that merit the attention of supervisors and regulators.

Box 1: **Innovation hubs and regulatory sandboxes**

by Polyxeni Pentidou, Analyst, LC2, EBRD; Jacek Kubas, Associate Director, LC2, EBRD and Ammar Al-Saleh, Senior Counsel, EBRD

Certain countries have arrangements in place that aim to promote an orderly application of new technologies in the financial industry through innovation facilitators, which take the form of regulatory sandboxes or innovation hubs.

Through sandboxes, regulators allow entities to test new ideas in a "controlled" regulatory environment for a specified period with actual customers pursuant to a strict testing plan agreed and monitored by them. This also offers an opportunity for collaboration between incumbent financial institutions and Fintechs. Innovation hubs, more widespread than sandboxes, are a form of community to provide support and non-binding guidance to innovative firms, as well as to provide an understanding of regulatory requirements.

Such arrangements are generally considered a forward-thinking approach for Fintech adoption.

The EBRD's work in this sector includes several technical cooperation projects led by the Local Currency and Local Capital Markets Development (LC2) Team. For instance, in Poland, Fintech was identified in the EBRD's Capital Market Development Strategy as one of the strategic sectors with the potential to become a driving force for the Polish economy.

Because of this, with the support of the European Commission's Structural Reform Support Service (EU SRSS), we are currently working with the Ministry of Finance and the Regulator (KNF) in Poland to conduct a feasibility study and Fintech roadmap and, in parallel, to establish a regulatory sandbox. With the support of the EU SRSS, we are also conducting a similar project in Estonia, where we are exploring the possibility of establishing a thematic sandbox focused on Regtech. Similar projects are also in the pipeline together with other regulators.

Lastly, we are actively engaged in policy dialogue and engagement on innovation facilitators. To this end, it is worth noting that the EBRD is an observer to the Global Financial Innovation Network (GFIN), which was launched in early 2019 by the UK Financial Conduct Authority, together with others. GFIN is now a network of 50 financial regulators and related organisations with a commitment to supporting financial innovation in the interests of consumers. In parallel, we have an open dialogue with the European Commission, the European Banking Authority (EBA), market participants pioneering in Fintech and other stakeholders.

> "It is important that regulators are agile in responding to rapid changes in the sphere of Fintech and should review the regulatory perimeters regularly."

We sometimes find that it is more difficult for regulators to supervise alternative finance than it is to supervise traditional sectors. Reasons for this can include limited technical expertise, limited funding and resources, difficulties in coordinating multiple supervisory bodies and a lack of reliable data. Therefore, working jointly with other departments within the EBRD, we have developed regulatory innovation initiatives, for instance, exploring the use of regulatory sandboxes (see Box 1).

One way to help regulators is through benchmarking. In 2018 we worked with Clifford Chance to prepare a report on the best practices for regulating lending-based and equity-based crowdfunding platforms, based on the existing regulation of several jurisdictions (see Box 2). This report could serve as a toolkit for lawmakers and regulators who are looking to foster the crowdfunding industry while protecting consumers. Against this background, several countries across the EBRD regions have been very keen to promote crowdfunding with help from the EBRD and are looking to enact, or have already enacted, crowdfunding legislation (for example, Armenia, Egypt, Kazakhstan, Morocco and Turkey). We have also published a study, Smart contracts: Legal framework and proposed guidelines for lawmakers.

Box 2: **Crowdfunding**

The availability and provision of financial credit is a key driver of economic growth. Financial credit can be used to bridge cash flow gaps and make investments. This is particularly important for small and medium-sized enterprises (SMEs). The 2008 financial crisis has, however, led to an increased systematic risk and therefore a tightened credit market for SMEs.

As a result, new financing methods offered by Fintech firms have appeared, with two central models emerging.

1. Peer to peer (P2P) lending: money is lent to individuals or businesses through an online platform, with a view to a financial return in the form of interest payments and repayment of capital over time.
2. Equity crowdfunding: money is invested in unlisted shares issued by businesses, allowing SMEs to raise capital from a large pool of investors through an online platform.

Crowdfunding has the potential to mitigate some of the issues faced by SMEs in obtaining credit, while allowing investors to access new products that are normally out of reach in traditional markets. Nevertheless, providers of these platforms face significant barriers that may be inhibiting their market entry and growth.

Several of our economies have been very keen to promote crowdfunding and are looking to enact (or have already enacted) crowdfunding legislation. Kazakhstan, Latvia, Lithuania, Morocco and Turkey are a few of the countries leading the charge at the digital frontier.

Because the process of crowdfunding is still being established, no consensus exists as to what constitutes best practice in this area, which makes it difficult to advise lawmakers.

It is in this context that the EBRD prepared a best practice report on the regulation of investment-based and lending-based crowdfunding, based on an analysis of six jurisdictions: Austria, the Dubai International Financial Centre, France, Germany, the United Kingdom and the United States of America. The report makes recommendations in a number of areas, including: (i) types of authorisations required for the operation of platforms; (ii) capital and liquidity requirements; (iii) know-your-customer (KYC) rules and anti-money laundering (AML) checks; (iv) consumer protection measures, such as investor disclosures; (v) conflicts of interest inherent in the crowdfunding platform's role; and (vi) platforms' governance requirements.

We have already begun putting these recommendations into practice with our ongoing technical cooperation projects. It is motivating to read in the recently published report, *Regulating Alternative Finance – Results from a Global Regulator Survey*,[5] that as industries mature, many policymakers are considering changes to their regulatory frameworks for alternative finance sectors. The study showed that half of the regulators surveyed (of about 110 regulators across the globe) are planning to review their regulatory frameworks for equity crowdfunding by early 2021.

CONCLUSION

It is important that regulators are agile in responding to rapid changes in the sphere of Fintech and should review the regulatory perimeters regularly. This is particularly important as many innovations have not yet been tested through a full financial cycle and decisions taken in this early stage may set important precedents.

Over time, the regulation of Fintech firms will inevitably increase. This is both necessary and important to providing stability and protection to both financial markets and users. International financial institutions can play an important role in in this.

1. See https://www.merriam-webster.com/dictionary/fintech (last accessed 19 December 2019).
2. *Ibid.*
3. C. Brummer and D. Gorfine (2014), *Fintech: building a 21st century regulator's toolkit*, Centre for Financial Markets, Milken Institute.
4. *Ibid.*
5. The report was prepared by the World Bank and the Cambridge Centre for Alternative Finance (CCAF) at the University of Cambridge Judge Business School.