Finance Watch
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Dinosaurs in the Sandbox

Finance Watch briefing note on the FinTech Action Plan

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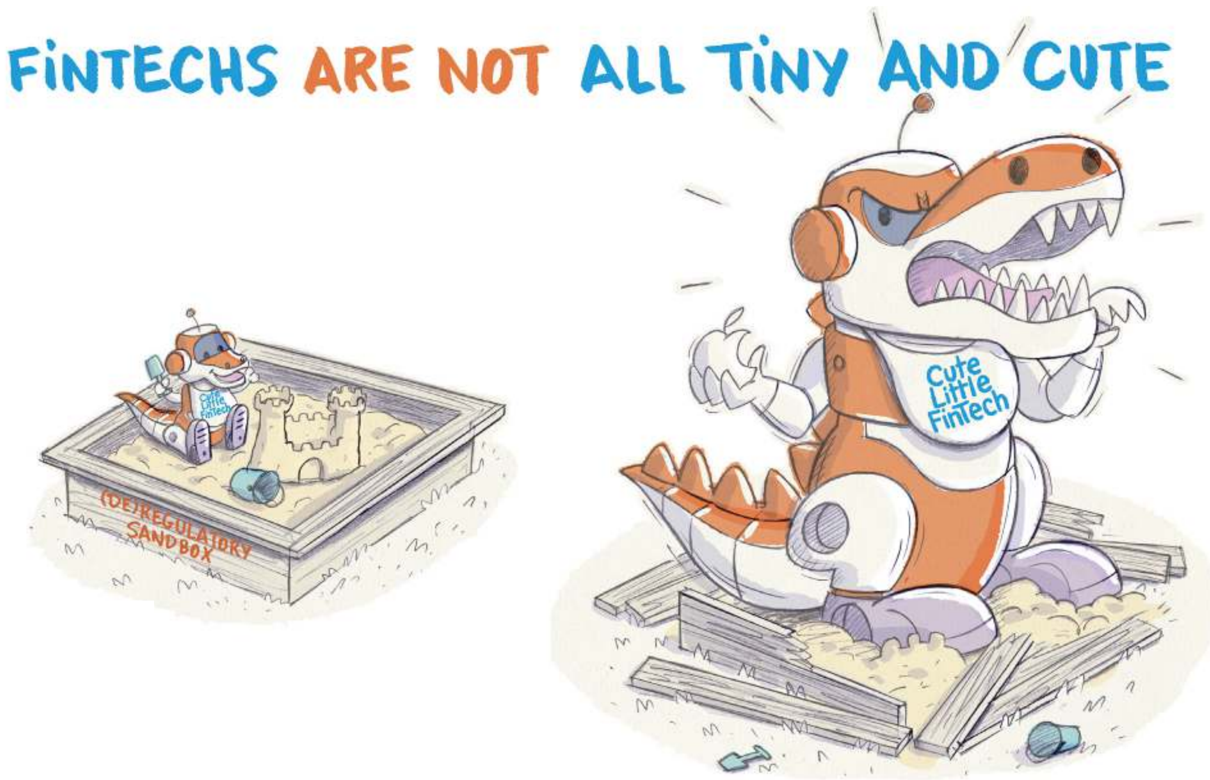

Finance Watch welcomes the European Commission's Action Plan as a timely recognition that the digitalisation of financial services is too fundamental a process to be left to the – all too limited – self correcting forces of the market. We are, however, less convinced by its lack of a methodical approach. The Action Plan combines a jumble of proposals that range from the protection of civil rights to industrial policy, with the odd 'goodie' for the banking industry thrown in (software accounting).

It would have been helpful if the Commission had been clearer and more transparent in setting out its intentions and objectives for each of these policy initiatives and involved all stakeholders in the preparation of legislative proposals and policy initiatives within its FinTech expert group.[1]

1 Does FinTech deserve special treatment?

In its Action Plan, the Commission defines FinTech as '*technology-enabled innovation in financial services that could result in new business models, applications, processes or products and could have an associated material effect on financial markets and institutions and how financial services are provided.*' To many the term conjures up an image of plucky little start-ups stepping forth to challenge the big, lumbering banks in a David-and-Goliath-style duel. That narrative deserves being put right.

FinTech is not always new and innovative: many allegedly 'new' digital businesses are but variations on a theme – re designs of existing business models that have been transferred onto digital platforms, sometimes in a conscious effort to short-circuit the relevant regulatory framework. In its milestone judgment against Uber, the online taxi service, in December 2017,[2] the European Court of Justice found, categorically, that the service offered by Uber's 'ride sharing app', was no different in substance from the traditional taxi business it had set out to replace. The same logic applies here: if a FinTech walks like a bank and talks like a bank it probably is a bank – and should be regulated as such. Only genuinely new services require new regulation – the updating and adapting of existing ones should be enough in all other cases. The first and foremost objective must be to maintain consistency and avoid regulatory arbitrage.

FinTechs are not always tiny and cute: FinTech is big business already and established players are, increasingly, setting the tone. Most of the large, global banks and insurers are constantly screening the market for promising FinTechs to acquire and some even run their own corporate VC funds with stakes in a whole range of FinTech start-ups. In fact, investment in FinTech start-ups by banks and other financial services incumbents has already overtaken investment by Venture Capital (VC) and Private Equity (PE) funds. In other instances, the same global players team up to create consortia or joint ventures in a bid to set and promote new standards.[3]

Most FinTechs will not remain challengers for long: the likelihood of a successful FinTech start-up growing up and remaining independent is quite limited. More often than not, successful FinTech companies are bought out at some point by one of their competitors. On the one hand it is quite normal for financial investors, such as VC and PE funds, to exit their investment – and realise their gains – through a sale. On the other hand, Europe offers precious few options for fast growing technology companies to go public on a major stock exchange and raise capital at terms that are competitive to what is available in other parts of the world. Only recently, PayPal, the US-based digital payments provider, paid EUR 1.8 bn for Swedish FinTech company iZettle, which had been tipped shortly before as a candidate for a USD 1.1 bn-IPO.[4]

FinTechs do not need special treatment: all European start-ups deserve better. Firstly, European start-ups face a persistent and well-documented shortage of growth capital[5] that prevents them from achieving critical mass and becoming viable stand-alone businesses with the size and resources to mount a genuine

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1 The European Commission's Expert Group "Regulatory obstacles to financial innovation" (ROFIEG) set up in March 2018 to assess whether current EU financial services rules are adapted to the challenges posed by new technologies does not include any representative of civil society in general or consumers organisations in particular and only one group member that directly represents FinTech firms. The 15 Members of the group represent to a large extent traditional financial institutions.

2 European Court of Justice, Judgment of 20 December 2017, Asociación Profesional Elite Taxi, C-434/15, ECLI:EU:C:2017:981

3 e.g. R3, a Distributed Ledger Technology ('DLT') company backed by a consortium of more than 200 financial institutions, or Symphony, a digital messaging and collaboration platform for financial markets professionals that is funded by a consortium of fifteen of the world's largest investment banks and money managers.

4 Venturebeat, Why Sweden's iZettle Sold To PayPal For $2.2 billion Rather Than IPO, 18 May 2018

5 European Investment Fund (Footnote 2), pg. 29

6 European Commission, Communication from the European Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Mid-Term Review of the Capital Markets Action Plan, COM (2017) 292 final, 08 June 2017

challenge to the incumbents. So far there is little indication that the Capital Markets Union Action Plan has done much to address these shortcomings.[6] Secondly, exit options for European VCs and their portfolio companies remain limited and often involve corporate investors from overseas or listings on NASDAQ. Very little has been done to make European stock exchanges more attractive – and effective – venues for realising VC investments. None of these issues is solved by granting start-ups that just happen to be in financial services special favours, e.g. a 'regulatory sandbox'. Even more so if traditional banks are now hard at work convincing the world – legislators and regulators, in particular – that they are, really, FinTechs, too. By the way, did we mention that we need a bigger sandbox?

2 Do we really need a stand-alone regulation for Crowdfunding?

The curse of fragmented regulation: more rules, less protection. With the proposed Crowdfunding Regulation[7] the Commission has chosen to create yet another stand-alone regulatory regime for an activity which could have been accommodated perfectly well under MiFID II. Instead of a 'twenty-ninth' regime sitting alongside Member States' national frameworks a gradual transition towards a Single Rulebook, coupled with an appropriate phase-in period, would have been preferable. In its impact assessment the Commission concedes that the option of bringing Crowdfunding within the existing Single Rulebook was considered and rejected, primarily because it would reduce flexibility for Crowdfunding operators and may increase funding costs for companies using their services[8]. Considerations of regulatory consistency, integrity and investor protection were, it appears, given only secondary priority.

The Commission implicitly recognises the need for stronger disclosure and investor protection by submitting Crowdfunding transactions with a volume in excess of EUR 1 million to the requirements of the Prospectus Directive. Regrettably, however, it stops short of extending that logic to the operators of platforms that handle transactions of this size. Given the fact that these transactions often target retail customers and involve high-risk investments it is not at all obvious why operators should not be required to comply with MiFID II, and in particular its rules on minimum capital requirements, underwriting and placements, customer classification and investor redress.

3 Is Europe still catching up (or could we be moving ahead)?

Cybersecurity: beware of false assumptions. Finance Watch agrees with the Commission's assessment that the security and integrity of financial services IT infrastructure is essential for the protection of critical IT infrastructures at the national and European level. We welcome the Commission's proposal to mandate the ESAs to prepare a harmonised framework for testing the resilience of significant market participants' IT infrastructures. We do not agree, however, with its assertion that the financial services sector is already better prepared than others to counter cybersecurity threats. Large-scale system outages (TSB, NatWest/RBS, Bank Austria) and processing errors of systemic proportions that slip through banks' IT systems undetected (Deutsche Bank) testify to their continuous fragility.

7 European Commission, Proposal for a Regulation of the European Parliament and of the Council on European Crowdfunding Service Providers (ECSP) for Business, COM(2018) 113 final, 08 March 2018

8 This option would have introduced provisions for investment-based Crowdfunding services under MiFID II and creating new rules for lending-based Crowdfunding, i.e. Peer to Peer Lending, that are not readily covered by an existing European framework

Another missed chance for Europe to reclaim the lead? The design of distributed ledger technologies (DLT) offers unprecedented new opportunities for restoring to citizens and consumers access and transparency of their personal data in a safe and largely tamper-proof way. It is that promise rather than the mere economic and security benefits to database operators that should be at the centre of all efforts to develop and disseminate a standardised, distinctly European incarnation of DLT. IF handled properly, perhaps under the auspices of the EU Blockchain Observatory and Forum, a European DLT framework could become a powerful tool for bridging the ever-widening gap between government and citizens and set, once again, a global standard of best practice.

Regulatory sandboxes and industry playpens. We support the Commission's initiative to encourage the establishment of innovation hubs across Member States. They could provide valuable assistance to start-ups and SMEs, helping them to tap into relevant experience and best practice. We believe, however, that this should not be an isolated, siloed initiative but should be combined with other existing efforts aimed at supporting innovative SMEs, such as the SME Instrument. FinTech-specific issues should be attached to existing platforms and infrastructures. We are sceptical, however, about the concept of regulatory sandboxes: conceptually, it is not the responsibility of supervisors to advise companies under their purview on regulation – such an arrangement is, to the contrary, very likely to create conflicts of interest; practically, it is nearly impossible to properly delineate and implement such regimes without inviting large scale regulatory arbitrage.

We are even more unsettled by the Commission's proposal to set up an EU FinTech Lab for selected vendors to educate supervisory staff about new technologies and "discuss regulatory and supervisory concerns." At a time when 'regulatory capture' is widely seen as an ever present threat to the integrity of the rulemaking and supervisory process[9] this initiative strikes, at the very least, a rum note. Even more alarmingly, however, the proposal has silently dropped any suggestion, still present in the [June 2017] consultation paper, of inviting other stakeholders, such as civil society representatives, to these events. The EU FinTech Lab sits, awkwardly, in no-man's land, looking to all the world like a thinly disguised lobbying vehicle masquerading as an educational workshop for supervisors. Unless it is opened up to public scrutiny it should be axed.

4 Can we reclaim control of our (exceedingly) mobile data?

Data protection and privacy: does Europe have the stomach to set new global standards? The General Data Protection Regulation ('GDPR')[10] has established the principle of 'privacy by design' in EU law. It is now up to the European legislators to ensure that this principle is implemented in all areas of application without dilution. Judging by recent controversy surrounding the e Privacy Regulation[11] this cannot be taken as read. Even if EU Member States were to finally agree a comprehensive and consistent set of data protection rules, that would be of little use if 'data controllers' are still free to move EU citizens' data out of EU jurisdiction without their consent.

Cloud storage is, arguably, part of critical IT infrastructure. Nevertheless, non-EU providers, such as Amazon, Microsoft, IBM and Google continue to dominate the market. Even the EU Cloud Initiative,[12] tasked

9 Finance Watch, Representation of the Public Interest in Banking, December 2017

10 Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data ('General Data Protection Regulation', 'GDPR'), OJ L 119, 04 May 2016, pgs. 1–88

11 McNamee, Joe, EU Council Indecision on ePrivacy Is Bad for Europe, European Digital Rights Initiative (EDRi) blog, 21 March 2018

12 European Cloud Initiative

with developing and promoting domestic European infrastructure and solutions, includes some of the very same overseas behemoths that it is intended to create a counterweight to. The position of these operators vis a vis the EU's efforts to restore to citizens' control of their personal data has been illustrated by Facebook's reaction to the introduction of the GDPR, when it changed the legal arrangements for millions of its users, moving them outside of the coverage of the GDPR.[13] If the EU is serious about creating its own digital space, based on exemplary privacy, security and data protection standards, it has to be more assertive in controlling its critical IT infrastructure and in policing providers of critical services. As with banking, half-hearted self regulation schemes, such as Safe Harbor, which was thrown out by the ECJ, and Privacy Shield, are clearly insufficient.[14]

My Data, My Rights. With the introduction of the Second Payment Services Directive (PSD2)[15] personal datasets of bank customers have now become mobile, too. While some herald a new age of "open banking" and more choice for customers, we would like to sound a note of caution from the point of view of customers, and citizens more generally: as many users of social media are beginning to find out to their dismay sharing personal data with commercial operators is always a double-edged sword. The level of insight that may be gleaned from a person's bank account is at least on a par with what the most enthusiastic users reveal about themselves on social media. Citizens and regulators should be wary of a situation where 'full account disclosure' becomes the norm and customers may be excluded from using financial services unless they agree to hand over an excessive amount of detailed data that goes well beyond what a bank, or any other commercial operator, could justifiably ask for as part of their 'know your customer' (KYI) and risk assessment procedures. If some customers are prepared to pay for convenience with their data – the basic deal underlying much of the 'Web 2.0' economy – others that set store by their privacy must not be forced into that bargain against their will.

5 And while we're at it …

A curiously off-topic addition to the Action Plan. Last, but not least, it appears that no legislative proposal is complete without the banking sector clamouring for yet another concession on capital requirements. This time, an amendment has been slipped into the Banking Package to give EU banks another break on capital requirements. The connection with FinTech is, in any case, more than tenuous.

At present, for the purposes of calculating regulatory capital all intangible assets, such as software and goodwill, are deducted in full from (accounting) equity capital (Art. 37 CRR). That implies that software purchased by a European bank is, effectively, paid for entirely with CET1 capital. In the US, by contrast, purchased software is not deducted from regulatory capital but treated like any other long-lived asset, e.g. equipment or buildings. This difference does indeed give US banks a certain advantage in terms of regulatory capital.

Nevertheless the approach currently in use in the EU does make sense. Intangible assets are unlikely to preserve any value in the event the bank is liquidated. This applies to software – which is often customised and tailored to the specific requirement of a particular bank that it is all but useless to any other organisation – in the same way it does to brand equity, acquisition goodwill and other intangibles. If regulatory capital should have any meaning in the future the proposed amendment should be resisted.

13 Reuters, Exclusive: Facebook to put 1.5 billion users out of reach of new EU privacy law, 19 April 2018

14 For background and further information see e.g. European Privacy information Center (EPIC), Max Schrems v. Data Protection Commissioner (CJEU-"Safe Harbor")

15 Directive 2015/2366/EU of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, OJ L 337, 23 December 2015, pgs. 35–127

About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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