TECH COMPANIES IN FINANCE

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The need for more entity-based regulation for big techs

There is a clear need for a determined policy response to the disruption created by the emergence of fintechs and big techs. In addition to traditional policy concerns such as financial risks, consumer protection and operational resilience, the entry of big techs into the financial services sector gives rise to new challenges surrounding the concentration of market power and data governance. These new challenges may not only affect market contestability but may also increase the vulnerability of the economic and financial system.

Therefore, regulatory reforms should aim to uphold primary policy goals such as financial stability, market integrity, consumer protection and fair competition. Unwarranted regulatory and supervisory asymmetries between different market participants should be eliminated, although only in so far as this is compatible with overarching policy priorities.

Contrary to what is often argued, the required reforms should not seek to replace entity-based rules with an activity-based approach to regulation. There are two major reasons for this. Firstly, most fintechs and big techs that are active in financial services are already subject to activity-based rules in the policy areas for which an activity-based approach is warranted (eg consumer protection or AML/CFT). In particular, big techs need specific licences to perform regulated activities such as offering payments or asset management services. Accordingly, they must comply with the rules that apply to all providers of those services. Secondly, replacing entity-based rules with activity-based rules in other areas may severely jeopardise primary policy objectives. An example is prudential regulation where such a change of approach could jeopardise financial stability. In such policy areas, rules need to address the risks stemming from a combination of all the activities that entities perform, regardless of the distribution of those activities across subsidiaries within the same group.

We need more entity-based rules to preserve financial stability and fair competition.

Moreover, there is a strong case in favour of greater reliance on entity-based rules to ensure the proper regulation of big techs. The unique business model of big techs is based on network externalities and is closely associated with the intensive use of data and new technologies. This model requires entity-specific safeguards because most of the risks that big techs generate – and that can potentially become systemic – are caused by interactions between the products and services which they offer (eg e-commerce, payment services and credit underwriting). Those risks cannot properly be addressed by a piecemeal activity-by-activity regulatory approach. Further, in the event that current plans by big techs to sponsor global stablecoins crystallise, the case for entity-based rules would be additionally strengthened.

The entity-based approach is gaining ground in several jurisdictions. This is the case in the United States following the publication last year of a report by the House of Representatives recommending the introduction of specific constraints and obligations on large technology companies. In China, regulators have gone as far as requiring some big techs – which offer several financial services – to become financial holding companies. As such, these big techs will need to satisfy prudential and conduct of business requirements across the entirety of their group. That approach may eventually prove to be helpful in other jurisdictions if big techs continue gaining market shares of a range of financial services.

The European Union's Digital Financial Package contains a number of newly created entity-based rules for big techs. In particular, the European Commission's proposal for a Digital Markets Act has specific requirements to prevent market abuse by firms that are considered to be "gate keepers". Those requirements affect areas such as information obligations, interoperability, access criteria and data sharing. Moreover, the Digital Services Act establishes specific rules and obligations for big tech platforms to protect users' rights and prevent the misuse of their platforms for illegal purposes.

In the area of operational resilience, the proposal for a Digital Operational Resilience Act constitutes an important first step in addressing the increased reliance by all financial institutions on technology and third-party providers. It would also help to regulate some relevant services provided by big techs such as cloud computing. However, in order to minimise the disruption that operational failures could cause to the economic and financial system, specific entity-based requirements affecting the big tech groups as a whole, and not only some of their subsidiaries, could also be warranted. This would help to safeguard primary policy objectives and it would also help to address competitive distortions which are emerging as a result of the paucity of regulation applied to big techs as compared with that applied to banks.

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Tech companies in finance: developments and implications for EU authorities

One of the pandemic's striking consequences has been the acceleration in the digitalisation of our societies. Covid-19 has made us rely more not only on innovative technologies, but also on the companies that provide them. Technology-powered business models that operate across different economic sectors are booming in these times of crisis.

Although their footprint in the financial sector is still limited at global level, with China-based firms offering the widest range of services, BigTechs have the potential to capture significant market share in the EU, including through partnerships with incumbents.

Not only have BigTechs been bolstered by the crisis, they can also bank on solid competitive advantages. Their large customer networks generate huge amounts of data, to which they can apply advanced analytics to understand customer needs. Like FinTech start-ups, they enjoy 'digital proximity' to clients who can use their services at the touch of a button. This reduces the advantage of physical proximity represented by the established branches of incumbent financial providers.

By tailoring their offerings and using the most up to date technologies, BigTechs and FinTechs can integrate different services, increase efficiency, and improve customer experience. Developments such as these are welcome, not least as they may promote financial inclusion. The tools developed by technology companies may have other useful applications, such as helping firms and authorities detect cases of misconduct, thus contributing to the integrity of markets.

Despite these potential benefits, BigTech and FinTech business models also bring some risks. While BigTechs entering the financial sector are likely to boost competition in the short run, they may in the longer term gain a dominant position in the market, putting at risk financial stability in the context of heightened interconnection between financial markets and technology services. Besides, cyberattacks are becoming a growing concern due to their increasing frequency and impact on digital platforms and financial entities. Finally, from the perspective of consumers, threats to privacy, poor sales practices, and price segmentation cannot be excluded.

Innovation can go hand in hand with investor protection and orderly financial markets.

It is our duty to be aware of these possibilities to ensure that the EU regulatory and supervisory framework remains fit for purpose. At ESMA, we believe that innovation can go hand in hand with investor protection and orderly financial markets and welcome the development of a comprehensive framework.

For this reason, ESMA fully supports the Digital Finance Package proposed by the European Commission (EC), which builds on 2019 ESMA Advice. The Regulation on Markets in Crypto- Assets (MiCA) is especially timely given the growing importance of blockchain based offers and recent developments around stablecoins. In addition, the pilot regime for market infrastructures based on Distributed Ledger Technology (DLT) will provide a welcome safe space for market participants, including players from the Tech world, to experiment using the technology. The legislative proposal for a Digital Operational Resilience Act (DORA) is a pivotal initiative to streamline and strengthen rules for entities across the financial sector, helping safeguard the financial system. ESMA actively supports the EU co-legislators as they refine these proposals.

To deepen our knowledge on how technology is shaping financial markets, ESMA launched a call for evidence on digital transformation and the application of innovative technologies in the EU financial sector. This call for evidence will gather information on i) fragmented or non-integrated value chains, ii) digital platforms and bundling of financial services, and iii) groups providing both financial and non-financial services. The feedback received will contribute to ESMA's technical advice to the EC which will outline, where relevant, proposals for changes to the existing legislative framework.

Last but not least, coordination among the three ESAs will be crucial to address the challenges posed by innovative financial technology as the business models are more and more cross sectoral. The work of the European Forum for Innovation Facilitators (EFIF) is a case in point. Established following a Joint ESA report on regulatory sandboxes and innovation hubs, the EFIF provides a platform for supervisors to meet regularly to share experiences from engagement with firms through innovation facilitators, to share technological expertise, and to reach common views on the regulatory treatment of innovative products, services, and business models.

All these initiatives – whether legislative or not – will help us achieve a Capital Markets Union that embraces the digital transition. ESMA, in line with its mandate, is committed to be a key enabler in this journey. To this end, we will continue our work on the convergence of supervisory practices and the development of a sound regulatory environment supporting the scaling up of technological innovation in the financial sector across the EU.

LIE JUNIUS
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Cloud adoption in digital finance: trends, regulatory hurdles and outlook

The financial services industry is changing at a rapid pace, with shifting consumer expectations, new technologies, and continuously evolving regulatory requirements. Financial services firms need the right technology to help them stay agile and prepare for the future.

The cloud is a key point of leverage for firms looking to improve performance across a broad range of activities. Moving to the public cloud can advance operational resiliency, staff productivity, increase regulatory compliance, and enhance business model innovation.

However, there are a number of financial services companies in Europe and globally that are still hesitant in their cloud journeys. The barriers to adoption vary, from the complexity of the legacy systems, trust and skills gaps, to regulatory uncertainty and fragmentation of supervision and compliance requirements. Although many companies have embraced the benefits of cloud technology, more robust cloud adoption—especially around core back-office functions—will require additional stimulus.

To better understand the challenges and opportunities of cloud adoption in financial services, Google Cloud, together with the Harris Poll, surveyed more than 1,300 leaders from the financial services industry across North America, Europe and APAC. Here are our key findings:

1. **A vast majority of financial services companies are already using some form of public cloud.** Of those using cloud technology, the most popular architecture of choice is hybrid cloud (38%), followed by single cloud (28%), and multicloud (17%). Notably, of respondents without a multicloud deployment, 88% reported they are considering adopting a multicloud strategy in the next 12 months.

2. **Financial services institutions in North America are leading in cloud adoption.** The lowest level of cloud adoption was reported in Japan (42%).

3. **As financial services companies continue to use the cloud, more core functionalities can be migrated.** While many financial services companies have migrated substantial workloads to the cloud, the industry is far from full adoption when it comes to core, back-office workloads. Data and IT security (74%), regulatory reporting (57%), and fraud detection and prevention (57%) rank among the highest workload adoption. Core underwriting activity (40%) and data reconciliation (48%) ranked lowest.

Cloud adoption will advance resilience, productivity and innovation but needs enabling regulation.

4. **Among respondents, there is a high positive perception of the potential for cloud technology to assist in business operations and regulatory compliance.** Nearly all respondents (>88%) agreed that cloud adoption can enhance operational resilience, support the creation of innovative new products and services, and enhance firms' data security capabilities.

5. **Certain regulatory challenges, including complexity of the sectorial compliance frameworks, and fragmentation of the supervisory practices, create hurdles to cloud adoption for financial services companies.** While 88% of respondents had a positive view of current regulatory efforts to provide guidance and clarity for cloud implementation, the results showed that more needs to be done to facilitate adoption. Most respondents (84%) agree that regulatory reviews and approvals take too long because of fragmentation of supervisory practices within the regulatory bodies. And 78% say that regulatory uncertainty over the use of public cloud prevents their organizations from adopting cloud technologies that would otherwise provide benefit to them.

Europe has been leading policy and regulatory agenda when it comes to cloud adoption in financial services. Initially the European Supervisory Authorities Outsourcing Guidelines paved the way for harmonisation of the regulatory requirements to cloud in the European Union, and largely became a benchmark globally. Now with the forthcoming Digital Operational Resilience Act (DORA) EU Financial regulators will have direct oversight over the critical providers introducing regulatory risk monitoring and mitigation processes.

If done right, DORA has a real potential to stimulate innovation and enhance trust and assurances in the new technology. However there are significant risks in national fragmentation with conflicting and overlapping Member State oversight regimes evolving in parallel (eg FISG in Germany). DORA needs to affirmatively remove this fragmentation and in time evolve into a practice of consistent regulatory action that will help guide adoption by the regulated firms - including by superseding the burdensome regulatory reviews and approvals of material outsourcing workloads, and individual customer audits.

At Google Cloud, we're committed to working with financial services customers and regulators to provide them with controls and assurances on risk management, data locality, transparency, and compliance, and have constructively engaged in the DORA discussions.

DANIEL KAPFFER
Chief Financial Officer
& Chief Operating Officer
DekaBank Deutsche Girozentrale

Tech is Tech and Finance is Finance

Three different potential roles of tech companies in finance

As technology becomes more sophisticated, there is a tendency to make things more complicated than they actually are. We also seem to have forgotten the difference between what is technologically feasible and what makes sense from a (macro) economic perspective.

Therefore, I will refer to a very simple three-layer model. At the top is the financial services client, with his needs. This may be for example the desire to finance private housing or to prepare for retirement. Next comes the financial service or product.

It usually requires specific know how and capabilities. In most cases, the provider needs to hold capital and liquidity buffers. Finally, the third layer is the technology used to deliver the service or product to the client.

Tech companies take three different relevant roles in finance: The role as a provider of financial services, an intermediary to financial services providers or a provider of tech services.

It is the nature of the service that matters, not the heritage or main business purpose of the provider

The authority to regulate financial services is in almost all cases dependent on the classification of the company, i.e. it is "entity based". In addition, sometimes in order to drive innovation tech companies may be less subject to regulation. However, financial services provided by these companies need to be regulated in the same way, i.e. "action based". This is also a question of ensuring a level playing field in the financial services market.

Take the example of Wirecard. Part of the failure on the supervisory side was to classify it as a tech company. Even though it offered payment services based on technology. Would the same conclusion have been reached for any incumbent bank that used technology for payment services to the same extent?

It is the nature of the service that matters, not the main business purpose of the provider.

Agent economy with potentially negative impacts

Another notable player in the level playing field of financial services will be the increasing number of cloud-service providers and the role of cloud services. Cloud applications are needed to provide frequent innovations to clients and ultimately remain competitive not only against traditional players but also FinTechs or BigTechs. Actually, it can observed that tech companies do not want to provide financial services because they are fully aware of the complex and expensive regulation. Often, their aim is to position themselves as intermediaries only at the interface to the customer. In the short term, this can have a positive impact as the consumer has access to a wider range of options. However, if they achieve significant distribution power in this role, then there are some undesired consequences.

In terms of consumer protection: the producer of the service loses the connection to the client - the client can no longer judge how reliable the service provider is and the provider does not have detailed knowledge of the client's needs.

In terms of efficiency and competitiveness: there are several providers trying to make a margin out of the same service as before (direct contact customer - provider). This either needs to result in higher cost for the client or will limit the number of products available to him. The intermediary could steer the available products based on financial incentives of the providers.

Sufficient initiatives to regulated tech services when it comes to cloud

While the genuine role in providing tech services is well established, the cloud outsourcing market, and the way the technology is used offers new digital challenges. The cloud is more than flexible hardware capacity. It is becoming the source for running applications and providing banking services over the internet.

Today, cloud services are concentrated in the hands of a few large CSPs, currently based outside the EU. The size and scale of such platforms pose significant risks to operational resilience. In addition the concentration of the CSP market raises questions about the imbalance of market power between CSPs and the individual firms that use them.

While CSPs operate globally, the responsibilities of regulators and supervisors are typically national and increasingly fragmented in their approaches.

In the cloud services sector, authorities also need to decide to what extent the CSP is regulated and how relevant the business itself needs to be supervised. We need to ensure that European financial services providers can use cloud services at least within an adequate framework to ensure their competiveness in the global level playing field.

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The future of technology in financial services

The future of technology in financial services is very bright. Recent policy developments around the world are reflective of governments and regulators' aspirations to foster the growth of the FinTech sector by encouraging investment in digital technology, training talent with digital technology skills, and creating a regulatory environment that is friendly to FinTech companies. As a result, investment in the sector has grown significantly, reaching $44 billion across 3,052 deals in 2020 according to research published by Finextra. Thanks to the significant variety of FinTech players, stakeholders across the financial services industry stand to benefit.

The promise of FinTech

FinTech promises to improve financial inclusion by increasing access to finance for the most disadvantaged in society. A report by the Boston Consulting Group highlights success stories of digital banks in Asia that leverage open APIs to create a digital ecosystem that brings low-interest rate loans to SMEs that are underserved by the traditional banking system.

At the same time, technological developments in regulatory compliance are revolutionising regulatory supervision. The RegTech sector, frequently considered a subsector of FinTech, has made many aspects of regulatory compliance more efficient, including regulatory reporting, anti-money laundering, and know-your-customer requirements. Research published by Suade highlights the potential of applying digital technologies and data standardisation to regulatory reporting processes at financial institutions to improve efficiencies, create cost savings, and increase the accuracy of reports submitted to regulators. The new regulatory regime for investment firms offers an interesting example where Suade has helped investment firms to digitalise their regulatory reporting processes. Investment firms have benefitted from being able to manage regulatory updates and achieve the auditability and granularity required with unparalleled speed and accuracy. In short, deploying technology to the financial services industry creates significant benefits for all stakeholders across the economy.

Existing proportionate and agile approaches to regulation show real promise in creating a FinTech-friendly regulatory ecosystem that fosters innovation, and research and development.

FinTech vs Incumbents

To further solidify these benefits, it is important to consider the position of the FinTech sector in the regulatory system, as it has important policy consequences for regulators and the FinTech sector alike. Regulators face the challenge of ensuring existing regulatory approaches continue to achieve their overarching policy objectives. Meanwhile, the FinTech sector must manoeuvre a regulatory system that was designed with incumbent players in mind. In a speech to the European Parliament in June 2021, Fernando Restoy of the Bank for International Settlements advocated for entity-based regulation designed specifically for the FinTech sector. This would allow regulators to deal with FinTech-specific challenges. At the same time, it would present regulators with an opportunity to create a regulatory system that fosters innovation. The latter is already being achieved with significant success around the world. Regulators are implementing successful programmes of proportionate and agile regulation, whilst providing guidance and support to innovative businesses in the FinTech sector.

Proportionate and agile regulation

For FinTech banks, for instance, proportionality measures in prudential regulation go a long way towards creating a stable ecosystem within which FinTech players can safely bring their products to market without adverse consequences on their operations. The European Union's Capital Requirements Regulation 2 introduces such proportionality measures across capital and liquidity requirements.

In the United Kingdom, the Kalifa Review recommends expanding existing regulatory sandbox programmes to what the review calls a 'scalebox'. The scalebox is designed to make the Financial Conduct Authority's regulatory sandbox available year-round, while offering additional advice and encouraging collaboration between incumbent financial institutions and FinTech and RegTech companies.

The UK's Information Commissioner's Office (ICO) provides detailed guidance on a variety of topics to assist organisations with understanding data protection laws. On the question of anonymisation, the ICO has drafted guidance that should assist FinTech businesses in understanding when personal data is sufficiently anonymised. This will assist developers trying to identify suitable training data, whilst being fully compliant with data protection laws.

Throughout the COVID-19 pandemic, the Monetary Authority of Singapore (MAS) introduced a number of measures designed to support FinTech companies through the economic impact of the pandemic as well as foster growth in the sector post pandemic. The measures include a variety of grants designed to support training and digital acceleration.

These regulatory and policy developments are part of an important trend towards encouraging FinTech growth, innovation, and development. Existing proportionate and agile approaches to regulation show real promise in creating a FinTech-friendly regulatory ecosystem that fosters innovation, and research and development.