TECH COMPANIES IN FINANCE: MAIN POLICY OPTIONS

1. Opportunities and challenges from the increasing role of tech companies in finance

1.1 The increasing use of technology in finance and the acceleration due to COVID

An industry representative stated that technology has become one of the main drivers in finance and COVID has accelerated that change. Technology has significant impacts in terms of automation and the development of open and interoperable systems. In the past few years it has moved from being a side project to something that is entrenched in the way that business is conducted in the financial sector. In addition, the days of legacy silo systems and locked-in data will soon be over. Many financial companies and executives now see technology and tech companies more as an example to follow than as a threat.

A Central Bank official agreed that COVID has accelerated digitalisation in the financial sector in particular, changing customer behaviours. 40% of people in the eurozone decided to use less cash during the pandemic, which has increased the market share of electronic money and payment institutions. In Q1 of 2021 the income for those payment institutions was four times higher on aggregate than in 2020 in certain countries such as Lithuania.

A regulator agreed that technology is transforming financial services and has become central to financial services in all market segments. One potential benefit of digitalisation is increasing inclusion and facilitating access to financial services for a greater number of retail clients. This is a key driver for the Capital Markets Union (CMU) which aims at increasing retail participation in the capital markets, even though there are major challenges for regulators in making sure that the adequate safeguards are in place. A second benefit is for anti-money laundering (AML), as digitalisation can help to capture those risks in a much more efficient way.

An official agreed that the emergence of bigtechs and fintechs in financial services has the potential to bring some benefits in terms of competition, providing a larger set of opportunities for consumers and investors and also financial inclusion, particularly in certain jurisdictions.

1.2 Role of tech companies in finance and related opportunities

An industry representative stated that there are three different roles that tech companies can play in the financial sector: first as an enabler, providing third-party services such as cloud services to the financial industry, second as an intermediary, such as portals which control the client relationship and third as a provider of financial services to customers. The latter role should be regulated in the same way as financial institutions.

An official saw a key dividing line between services that tech companies are providing directly to the public and those they are providing as back office functions to financial institutions. This distinction is important from a regulatory and a public policy perspective. In the United States the services that tech companies provide individuals or businesses with are still largely dependent on an integrative, traditional financial system and some of these market segments have been dominated by non-banks for decades. For example concerning payments tech companies are only offering a subset of consumer and merchant-facing services, not the entire payment stack. A change however is that in the past, these services were provided by specialized tech companies, whereas now larger and more diversified players are entering the financial market. During the pandemic, financial institutions also saw the benefit of third-party providers such as cloud service providers (CSPs), which can contribute to greater financial sector resilience and continuity.

Another industry representative explained that technology providers act as partners of financial institutions in the drive to digital transformation to help them unlock data-led innovation and meet their security and compliance needs. Cloud services in particular have the potential to unlock immense opportunities, especially in data heavy industries like financial services, but the technologies have to be understood by clients and used properly. Cloud adoption is progressing in the financial sector but there are still opportunities ahead particularly concerning core financial activities. In a global Harris poll of 1,000 leaders from the financial services industry on their state of cloud adoption, 83% reported that they are using some form of public cloud as part of their IT infrastructure, with only 17% being exclusively 'on-prem'. Around 90% of respondents agreed that cloud can help financial services to adapt to changing customer behaviours and expectations, enhance operational resilience, support the creation of innovative new products and services that can enhance data security capabilities, and can help to better connect siloed legacy software infrastructure within financial institutions. Only 47% of the workloads of the respondents who declared that they are using a cloud-based strategy were reported to be on cloud and most of them tended to be non-core workloads, showing that financial institutions are still cautious in their approach to the cloud.

Giving a perspective on the development of fintech companies in Europe, a Central Bank official stated that 19 fintech unicorns have emerged so far in Europe in 2021, which represents a significant increase compared to previous years and fintechs now represent almost half of unicorns in Europe. There is currently accessible liquidity and investments into venture capital and private equity are growing. This shows the strong expectation among investors that financial services will be increasingly provided by tech companies. The return on equity (ROE) obtained with investments in US-based bigtech companies (25 to 30%) is also much higher than with the traditional European banking industry (5%).

1.3 Challenges raised by the increasing role of tech companies in finance

A regulator emphasised that last year ESMA published an analysis of the impact of bigtechs in the financial sector in its 'Trends, Risk and Vulnerabilities' publication. Although in Europe these entities are currently relatively small in terms of footprint, the analysis shows that they could grow quickly given their scale and business model. ESMA also identified issues in terms of concentration and competition and what that would mean particularly in terms of consumer impact and costs.

The regulator explained that ESMA has subsequently been asked by the European Commission to conduct a call for advice aiming to assess the role of tech companies and their potential impacts on customers and to define the regulatory implications of their growing presence in financial services. This assessment will cover three main areas. First value chains, how tech providers fit into the current financial system and the potential issues raised by players regulated in different ways operating in the same financial value chain. Second, digital platforms that offer different types of services. And third, entities that offer both financial and ICT (information communication and technology) services and the clarifications that may be needed in this regard. ESMA will provide recommendations for securities markets and the EBA and EIOPA will be examining in parallel the situation in the banking and insurance markets.

2. Regulatory approach for addressing the increasing role of tech companies in finance

2.1. Main issues and policy options to be considered

A Central Bank official considered that a decisive moment in the approach to regulating tech companies is coming. The challenge is supporting innovation on the one hand and maintaining financial stability and a level playing field on the other. In recent years the first phase in the regulatory cycle by some authorities was to support innovation in a safe environment with the concept of sandboxes. The second phase was to extend financial regulation to fintechs. The current third phase is examining the need to adopt a more holistic approach to big tech companies covering financial regulation and also other issues such as data security, data governance, operational resilience and fair competition. An additional complexity may arise from the fact that these are global companies that require a global approach.

An industry representative suggested that there needs to be a detailed assessment of the impacts of the different roles played by tech firms in the financial sector, not only from a level playing field perspective but also from a financial stability standpoint. If parts of the financial market are being captured by tech companies and appropriate rules are not put in place, this could result in a large proportion of the market not being adequately regulated.

Another industry representative acknowledged that while technology can bring many benefits in terms of resilience, efficiency and security, it also comes with some risks. However, there is a whole spectrum of available options to tackle these risks that needs to be considered, of which regulation is only one. The possible added value of these different options needs to be evaluated before deciding on a policy approach. On one end of the spectrum there is the 'wait and see' approach, and on the other end there is regulation and oversight, which can be an important tool to bring certainty to the markets. The Digital Operational Resilience Act (DORA) for example introduces a new oversight framework for critical IT third-party providers, which will bring more certainty, more harmonisation and common supervisory approaches to the use of cloud services in particular. In between these two approaches there are different other possibilities. One is the sandbox approach, which is an experimental process. Another is standard setting, which can be very effective at the global level for imposing common standards e.g. concerning interoperability or security. Self regulation and codes of conduct are another possible tool that is particularly useful in the first stages of the development of a new technology. Standards can also be effectively developed around supervisory practices, as has been done for cloud services with the cloud outsourcing guidelines and joint supervisory approaches introduced by the ESAs, which are a flexible way to respond to new market developments.

The industry representative concluded by emphasizing that bigtechs approach their products and services in a way that can also help to support risk mitigation, notably with regard to concentration risk and operational risk. Their company, a major CSP, favours portability, interoperability and customer choice in the way products and services are provided, in order to avoid business continuity and lock-in issues. These aspects need considering in the policy work going forward.

A Central Bank official stated that regulation must be defined in a way that does not stifle innovation, for example blocking the entrance of tech companies into financial markets on the basis that they are of a different nature, because tech companies have the potential to provide significant added value to consumers and the real economy. Bigtechs in particular are powerhouses of innovation and have many resources. There is also a need for clear definitions of what a digital market is and what a gatekeeper is for example in order to avoid decisions based on political motivations.

A regulator observed that addressing these new developments is challenging for financial supervisors because they are happening on a cross-border and cross-sectoral basis, evolve at a fast pace and also imply engaging with data or competition regulators.

A third industry representative noted that two aspects need considering when thinking about the regulation of technology and tech companies. One aspect is the need to upskill regulators in technology and the details of its implementation. The second aspect is agility. Sandboxes have been put in place, as well as different communication channels for smaller and larger tech companies, but there is a need to accelerate the feedback loop between regulators and tech companies in order to adjust regulation faster .

The pace of innovation is indeed accelerating and the impact of technology on different players also needs to be taken into account and can often only be seen once it has been implemented.

2.2 Activity vs entity-based regulation

An official emphasised the disruption created from the increasing role of bigtechs and fintechs in finance, as well as the need to define a regulatory response that may allow to obtain all the benefits that bigtechs and fintechs bring to the financial system, while mitigating the potential risks that these evolutions may generate for consumers and the financial system. The Bank for International Settlements (BIS) and the Financial Stability Institute (FSI) are both working on this The key question is whether the current activity based financial regulation is appropriate for addressing the financial services provided by bigtechs, or if another approach is needed.

The official acknowledged that the financial entities of bigtechs are subject to the same activity-based regulations as financial institutions when they offer financial services like payments or wealth management. They need to hold a licence and to comply with the corresponding rules, which are designed to apply to different types of providers offering the same service. There could be some loopholes in the current framework that could benefit non-banks in areas like consumer protection, AML and combatting the financing of terrorism (CFT), but those types of loopholes have more to do with the implementation and supervision of existing rules. Thought is however needed on whether that activity-based approach is sufficient to address the risks posed by bigtechs operating in the financial services market, which run a unique business model based on data and technology, allowing them to benefit from strong network externalities. This gives rise to new challenges concerning the possible concentration of market power and data governance, which may not only affect market competition, but also eventually increase the vulnerability of the financial system. The official added that most of the risks that bigtechs generate and that may potentially become systemic are associated with interactions and possible spill-over effects across the different products and services that they offer such as e-commerce, payment services or credit underwriting. Those risks cannot be addressed solely by piecemeal activity regulation and a 'same activities, same regulation' approach. There is therefore a strong case for completing existing activity-based rules with entity-based rules for bigtech groups as a whole, aiming to address the implications of the combination of activities that they perform. Several jurisdictions are considering entity-based rules for bigtechs. In the US for example the House of Representatives has recommended in a recent report the introduction of specific obligations for large technological companies. In China, regulators are now enforcing specific anti-trust rules for bigtechs that involve mandating large bigtechs that offer several financial services to become financial holding companies subject to a specific regulatory remit. The case for entity-based rules will be further strengthened, the official felt, if the plans pursued by some bigtechs to implement global stablecoins crystallise, as this may potentially disrupt payment systems worldwide and affect the ability of central banks to properly control the monetary system.

As for the EU, the recent Digital Financial Package contains a number of newly created entity-based rules that will apply to bigtechs, the official observed. The Digital Markets Act proposal includes specific requirements to prevent market abuse by firms that are considered to be 'gatekeepers' and establishes specific obligations for bigtech platforms to protect users' rights and prevent their misuse for illegal purposes. In the area of operational resilience, the DORA proposal addresses the increased reliance of financial institutions on critical third-party technology providers. While these proposals are moving in the right direction, the possibility of introducing a more comprehensive regulatory framework for the operation of bigtechs taking into account the impact of potential disruptions to the operational continuity of their services on the economic and financial system needs to be considered. This is likely to be a focus of the international regulatory debate in the future.

An industry representative considered that a holistic approach to bigtech entities is the right one. A significant step forward has been to examine financial conglomerates or holdings and see whether they should be regulated on a total entity level. In recent years there have been negative examples in Germany in particular, where banks part of a technology holding could not be properly regulated.

An official explained that the US is engaged in a similar effort. President Biden has tasked Treasury through an executive order to examine the competition from entry of large tech firms and other non-banks into consumer finance products in particular and a report is being developed on this for 2022. These evolutions give rise to important questions for financial authorities, including the operational resilience and financial stability risks that may be created, the role of financial regulation in addressing these risks and the type of regulation needed, the expertise necessary to supervise these requirements, and how that competence may be built up.

The official added that the US Treasury is working together with other members of the Financial Stability Board on third-party service providers, including a toolkit on supervisory approaches. The US Treasury is promoting a risk-based and outcomes-based approach to these issues. The elements of vendor choice and financial institution responsibility are being emphasised. Policies should provide regulated firms with clear expectations for risk management and due diligence in the selection of their suppliers. It is also important that there is continued responsibility for compliance within financial institutions. It is a delicate balance when the main benefits of third-party use arrive from specialisation of that third party, while many of the risks are associated with the possible loss of accountability by the financial institution. The official concluded that when jurisdictions consider policies in this area that they seek to avoid any unintended consequences on other jurisdictions such as data localization, that could have negative effects on operational resilience, innovation, and other policy objectives.

A regulator noted that in the past the entity versus activity-based regulation debate in other areas of the non-bank sector such as asset management, has not been very helpful because it created a stigma effect. The international regulatory community should focus on risks, whether they are appropriately identified and how to tackle them from a financial stability perspective. In addition, it is important to consider that the regulatory debate concerning fintechs and bigtechs has moved from concerns mainly around the level playing field with financial institutions to the tackling of more practical challenges related to the emergence of new tech players. A pragmatic approach that is working for supporting innovation in a safe way is the European Forum of Innovation Facilitators (EFIF), which is a hub of all the sandboxes operating in Europe. The EFIF conducts tests at a cross-border level in order to help tech entities to scale up their operations across the EU in the context of a supervised framework.

An industry representative considered that bigtechs could become too big to fail at some point, which has to be examined very carefully from a financial stability perspective. Any issues that create potential risks for consumers either through the direct provision of financial services by bigtechs or by the provision of third-party services should also be addressed very carefully. What is needed is the development of more fintech unicorns, particularly in Europe. It is therefore important that the possible regulation of large tech companies does not have negative impacts on innovation and on the scaling up potential of fintechs.