Balancing regulation and innovation

The current thinking around the potential impact of Fintech on the resolution of financial institutions

Post-credit crisis: Desire for resolution planning and the rise of FinTech

One of the great lessons learned from the credit crisis was the need for resolution planning for financial institutions and the desire for competent authorities to be equipped with resolution powers that would assist with financial stability. In the aftermath of the credit crisis, new rules for bank resolution were put in place across the EU in the form of the Bank Recovery and Resolution Directive (**BRRD**). Since the entry into force of BRRD on 2 July 2014 the banking industry has been shaken up by the emergence of new platform business models and many new financial technology (**FinTech**) entrants which have the potential to transform further the provision of financial products and services. Fintech is defined by the Financial Stability Board (the **FSB**) on a working basis as *"technologically enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services"*[1].

As a result, authorities in the EU and across the globe have begun to look at the impact of FinTech on the financial sector. This article focusses on the current thinking with regards the potential impact of FinTech on the resolution of financial institutions in the EU.

How are regulators responding to FinTech?

The rapid advance of FinTech is driving structural change in the financial sector. Whilst innovation in finance is not new, investment in technology and the pace of innovation have rapidly increased significantly over recent years.

In addition to providing better access to finance and greater operational efficiency and lower costs, Fintech could also help deepen and broaden the EU capital markets by integrating new business models through data driven solutions in investment intermediation and product distribution.

However, FinTech may also present challenges, such as cyber risks and regulatory and supervisory authorities face the challenge of continuously adjusting to these market developments.

In the EU, the European Banking Authority (**EBA**) is keen to contribute to the policy debate in this area given the potential influence of FinTech on its overall objective to maintain financial stability in the EU and safeguard the integrity, efficiency and orderly functioning of the banking sector. The EBA has produced a discussion paper on its approach to FinTech which highlights concerns with regards the influence of Fintech developments on the resolution of financial firms, as set out further below. In addition, the European Commission is working on an EU Action Plan on FinTech[2] which seeks to put in place supportive measures to ease the uptake of FinTech solutions and provide proactive measures designed to foster and stimulate new solutions and address risks that emerge. The aim is to harness rapid advances in technology to the benefit of the EU economy and foster a more competitive and innovative European financial sector.

At the international level, FinTech is a priority area for the G20 and the FSB is actively monitoring and assessing developments in FinTech.

1 http://www.fsb.org/what-we-do/policy-development/additional-policy-areas/monitoring-of-fintech/

2 https://www.eba.europa.eu/regulation-and-policy/other-topics/approach-to-financial-technology-fintech-/-/regulatory-activity/discussion-paper published on 4 August 2017

What are the EBA's concerns?

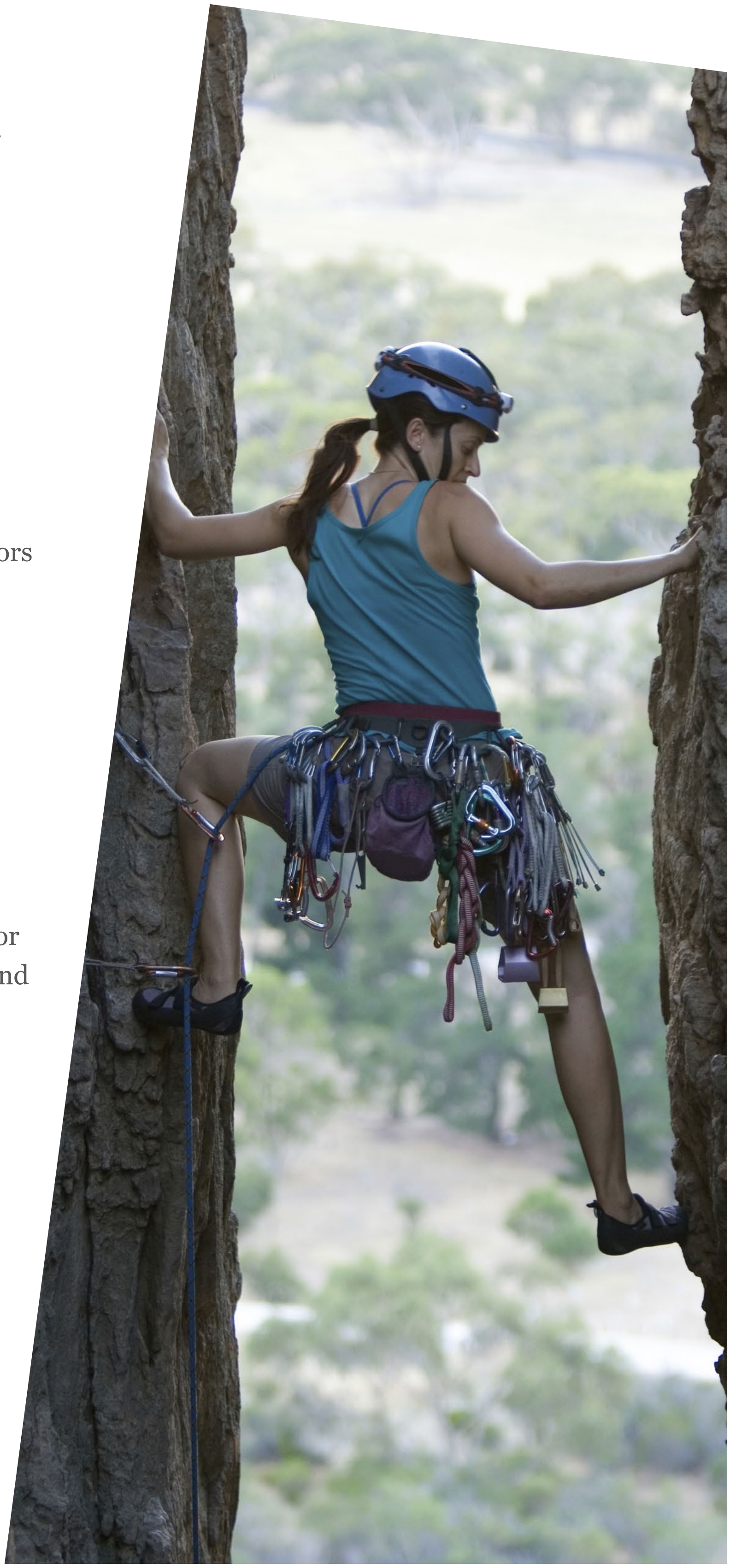
In its discussion paper, the EBA highlighted several concerns relating to the impact of FinTech on the resolution of financial firms, which are set out below.

More than half of the FinTech firms are not regulated under the EU regulatory regime

According to the EBA's preliminary findings, 31% of FinTech firms are not subject to any regulatory regime, 14% are subject to a national registration or authorization regime and the regulatory status of 8% of FinTech firms could not be identified. The EBA suggests that the divergent regulatory treatment of FinTech firms might need further investigation and that guidance could be provided to national supervisors to ensure more convergence between national regulatory regimes.

FinTech firms do not typically have resolution related requirements

Given that many FinTech firms are unregulated, resolution–related requirements on FinTech firms are not common. However, divergent practices are emerging across jurisdictions with regards the requirements for FinTech firms to have a resolution or recovery plan on the potential winding-up/pay-out and the continuity arrangements that must be in place.



Potential influence of FinTech firms on the resolvability of credit institutions

FinTech firms could have both a direct impact (by virtue of a credit institution being the shareholder or creditor of a FinTech firm) and an indirect impact (where FinTech firms enter the current market as competitors affecting profitability) on the resolvability of credit institutions.

The EBA notes that this will therefore require enhanced scrutiny in the near future.

Creation of innovative payment services may impact the execution of resolution

FinTech has led to the creation of innovative payment services developed particularly by credit institutions and through Target2[3]. Currently, the resolution of a failing credit institution must take place within very tight deadlines so that its resolution can take place over the weekend. The EBA raises concerns that the natural pause in payments that is currently available during the resolution weekend might disappear if payments happen in real time and continue during the resolution weekend, potentially leading to an outflow of deposits. This has implications for valuation and the extent to which resolution tools are used and may add another element to decisions around the timing of determining when an institution is failing or likely to fail.

Increased digitalization

Increased digitalization may also speed up the movement of deposits in a crisis situation, changing the behavioural patterns in relation to deposit runs.

Resolution powers may be difficult to apply to decentralized FinTech technologies such as Blockchain

Some FinTech technologies are based on decentralized technologies, such as Blockchain, which is a constantly growing chain of ordered information in which each block is linked to the previous block. The design physically cannot work with a single computer or point-of-connection. As the system cuts out the intermediary, it is questionable how the competent resolution authorities will be able to exercise their resolution powers to these new technologies if such technologies expand in the near future. It is also not clear how regulated firms that make use of such technologies will be able to ensure continuity of their business given that they are not able to control the system. Before FinTech firms are developed to be critical entities, they should be regulated by an adaptable legal framework to ensure that the relevant authorities have the required tools to control the financial system. Although blockchain technologies are still at an early stage, there are a number of challenges which need to be addressed to ensure operational and economic continuity during resolutions. On 1 February 2018, the European Commission launched the EU Blockchain Observatory Forum[4], which aims to monitor trends and developments and explore joint solutions and cross-border use cases over the next two years.

Does FinTech offer any opportunities for resolution planning?

The EBA acknowledges that FinTech may offer opportunities and facilitate meeting resolution objectives, for example by improving reporting and monitoring processes, thereby facilitating operational continuity.

3 Target2 is a payment system owned and operated by the Eurosystem that enables EU banks to process money transfers between each other in real time

4 http://europa.eu/rapid/press-release_IP-18-521_en.htm

Next steps

The EBA intends to examine further the impact that FinTech may have on resolution and resolution planning in order to determine what action, if any, should be taken. It remains to be seen whether, in the context of cryptocurrencies, regulated and unregulated FinTech firms would be required to take certain action in the event of a resolution.

The draft EU FinTech Action Plan states that further careful analysis is needed to assess the extent to which the current financial services legal framework is able to accommodate the new FinTech advances and where it cannot, the rules should be adjusted accordingly. The European Commission is keen to encourage innovation in the financial sector whilst still ensuring that financial stability is preserved, which is a key pillar of regulation in the post financial crisis environment. Cooperation within the EU but also at the global level will be crucial to monitoring the continued development of FinTech technologies and any likely impact on particular areas of the financial system, such as the resolution of financial institutions.

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