

EUROPEAN REGULATION OF FINTECH

Andrea LABANCZ¹

DOI: <https://doi.org/10.34135/svpmvpIV.191023>

Abstract

The study deals with the topic of FinTech. There is a widespread view in the EU that FinTech, so that technology-based financial innovations, may contribute to the intense development of the digital economy. Recognizing the benefits of these solutions, a FinTech policy has been developed in the EU. Despite the positive approach of the EU, several FinTech solutions are undefined, uncategorized and unregulated. One need only think of cryptocurrencies, ICOs or crowdfunding to see that the absence of any FinTech legal definition or theoretical analyses could easily lead to legal uncertainty. Given the above, the study deals with the interpretation and theoretical analysis of FinTech. In order to be able to contribute to the better understanding, the study categorizes FinTech solutions by focusing on their special characteristics. By doing so, it makes difference between regulated and unregulated FinTech solutions and establishes a possible taxonomy of FinTech.

Key words: *FinTech, financial crisis, financial technologies*

Introduction

The financial crisis in 2008 has affected the European Union. As the aftermath of the crisis, reduced confidence in the banking sector should be considered. Given that, trust has a significant role in the economy, mainly in the financial sector, possible decrease of trust may lead to harmful effect of the economy. According to the survey of Edelman Trust, consumer confidence in financial institutions has declined, while confidence in technology institutions' financial services has increased significantly recently (Edelman, 2019). The changed consumer trust and habits may be related to the rise of technological innovation and digitalization. As a result of technological development, digitalization and the widespread use of the Internet, the financial sector has undergone significant transformation. The economic crisis in 2008 should be considered a catalyst for innovation in the financial sector. After the crisis, new, innovative and mainly unregulated financial products, services, technologies provided by new, innovative and mainly unregulated financial market players have emerged. All of this has led to the latest stage in the financial system innovation process and maintained the emergence of the so-called FinTech, so that financial technologies.

Materials and methods

Given that, FinTech may serve as a basis for the future digital economy, it is necessary to define what FinTech means. The aim of the study is to introduce FinTech by providing the scope of it. In order to reach the target, the study is based on analysing several EU institutions documents on the topic of FinTech, EU directives, regulations and proposed regulations on FinTech as well. In

¹ dr. Andrea Labancz, assistant lecturer, Institute of Business Law, Faculty of Law and Political Sciences, University of Szeged, Bocskai Street 10-12, Szeged, 6721, Hungary, E-mail: labancz@juris.u-szeged.hu

addition to and on the basis of the above, the study establishes a possible theoretical taxonomy of FinTech. By doing so, the study may contribute to the better understanding.

Results and discussion

The term ‘FinTech’ was first used in a Citigroup project in the early 1990s, when the bank tried to improve its reputation by initiating technological cooperation with non-industry players (Kerényi–Molnár, 2017). Despite the early recognition, the focus of attention on FinTech became widespread after the financial crisis in 2008. Potential economic effects of FinTech were recognized by the European Union which started a public consultation in 2017, entitled ‘*Public consultation on FinTech: a more competitive and innovative European financial sector.*’ The purpose of the consultation was to get knowledge of national stakeholders’ opinions on FinTech to be able to develop the Commission's approach towards financial technological innovation (EU Commission, 2017). As it can be read in the summary of this consultation, the responders evaluated FinTech positively, but the risky side of these innovations were also noted, i.e. cybersecurity-, data protection and money laundering issues (EU Commission, 2017).

Based on the results of the public consultation, the European Commission adopted an Action Plan on FinTech in March 2018. The Action Plan covers 19 steps that the Commission intends to take to enable innovative business models to extend at EU level, support the uptake of new technologies in the financial sector and increase cybersecurity and the integrity of the financial system (EU FinTech Action Plan, 2018).

The Action Plan names the most significant FinTech innovations. These are:

- in the area of finance, the crowdfunding and initial coin offering (ICO),
- in the area of financial assets, the crypto-assets (also called cryptocurrencies or virtual currencies),
- in the area of explicit technology blockchain and distributed ledgers technologies, artificial intelligence and machine learning, cloud services, application programming interfaces and open banking standards, smart contracts, digital identification and authentication technologies, mobile application and Big Data analysis,
- and innovative business models, FinTech businesses (EU FinTech Action Plan, 2018).

A FinTech policy was also established, which is categorized under the Banking and Finance Policy of the EU. According to this policy, ‘*FinTech is the term used to describe the impact of new technologies on the financial services industry. It includes a variety of products, applications, processes and business models that have transformed the traditional way of providing banking and financial services*’ (FinTech Policy, s.d.). On the basis of the above, a possible taxonomy of Fintech may be established. According to the FinTech policy, it covers financial products, applications, processes and business models. This approach may lead to the consequence, that two main categories should be considered when interpreting FinTech. These are the subject and the parties of such innovations. Referring to products, applications and processes, the category of the *subject* should be taken into account. In case of the financial sector, the subject is closely related to traditional financial and auxiliary financial services.

In case of traditional financial services and auxiliary financial services, *inter alia*, collecting deposits and accepting other repayable funds from the public, granting credit and cash loans, providing of payment services, issuing electronic money and paper-based cash substitute payment instruments, intermediating financial services, operating payment systems or credit counselling may be considered (Gál, 2013). Comparing these services to FinTech services, it can be stated that some FinTech services are designed as an alternative to certain traditional banking services, as follows. The crowdfunding and P2P lending may be interpreted as alternatives to providing

credit and cash loans; cryptocurrencies may be interpreted as alternatives to providing payment services; blockchain may be interpreted as an alternative to operating a payment system and the use of AI or robot consulting may be interpreted as alternatives to credit counselling. The common characteristics of these FinTech innovations that they offer an option over the traditional services. Referring to business models, the category of parties should be considered as follows. Traditional financial services provided by traditional financial institutions, f. e. credit or investment institutions. The said business models are linked to these financial institutions. These institutions are strictly regulated and must meet several requirements to be able to provide financial services.

Comparing these institutions to FinTech businesses, it can be stated that FinTech businesses are designed as alternatives. These institutions cover those businesses which provide alternative financial services, such as the Ripple or the Revolut, and existing IT and/or social media companies with a great customer base, such as the Facebook that provides Messenger Payments in the USA, the ApplePay or the SamsungPay (Kerényi–Molnár, 2017). All of this could lead to the conclusion that FinTech should be interpreted as a technology driven development of the entire financial sector that meets the consumer needs. Based on a technology innovation-driven approach, FinTech may be defined as a combination of technical, organizational, financial and commercial operations to improve the efficiency, profitability of economic activities, and to achieve positive social and consumer impacts, or as a new or substantially modified product, process or service in the financial sector. Given that, FinTech covers a wide range of financial innovations, it is also necessary to introduce the scope of its regulation and the opinion of the EU on it. In the area of *payment services*, the Directive 2015/2366 on payment services in the internal market (PSD2) were established. The primary purpose of PSD2 is to foster innovation, strengthen customer confidence and effectively protect financial services security. In addition, it aims to create a favourable environment for the development of digital financial services and to support the entry of new service providers into the financial markets. As a result of PSD2, new providers, such as Account Information Service Providers (AISP), Payment Initiative Service Providers (PISP) and Card Based Payment Services Providers (CISP), may enter the financial services market through a simplified procedure. The PSD2 enables the so-called third-party providers (TPPs), such as AISP, PISP, CISP, to access the financial institutions' account management system and the data stored in it through application programming interfaces (PSD2, 2015).

Regarding to *financial assets*, the legal status of cryptocurrencies is controversial. The FinTech Action Plan identifies cryptocurrencies, the new types of financial assets, risky. Among strong volatility characterizing cryptocurrencies, fraud, and operational weaknesses and vulnerabilities at crypto-asset exchanges, money laundering and terrorist financing issues were also assessed (EU FinTech Action Plan, 2018). In 2017, the three ESAs issued a joint warning on virtual currencies by highlighting the potential detriments of buying virtual currencies (EBA, 2018). The EBA and the ESMA have conducted surveys, those in which cryptocurrencies possible regulation are examined (EBA, 2019; ESMA, 2019). From the approach of money laundering and terrorist financing, the regulation of virtual currencies was established in the Anti-Money Laundering Directive 5 (AMLD5). In the AMLD5, the scope of virtual currencies is defined. According to the Directive, virtual currency means 'a digital representation of value that is not issued or guaranteed by a central bank or administrative body, is not necessarily linked to or subject to legal status, but is accepted by a natural or legal person as exchange value and electronically transferable, it can be traded electronically' (AMLD5, 2018). In addition to cryptocurrencies, custodian wallet providers are also regulated by the AMLD5.

From a positive approach of *finance*, a proposed regulation of crowdfunding has been established as a part of the FinTech Action Plan. Crowdfunding is an alternative form of finance where the financée is usually a business entrepreneur, and the financier is not a financial institute but a group

of persons. The proposed regulation would cover only two types crowdfunding, lending and equity, the so-called business types where there is a financial return for financiers. The regulation would allow for online platforms to apply for an EU passport based on a single set of rules. The proposal provides rules on information disclosures for project owners and crowdfunding platforms, rules on governance and risk management and a coherent approach to supervision. (Crowdfunding proposal, 2018). From a negative approach of finance, a warning was issued by the ESMA on ICOs. ICO is an innovative way of raising money from the public, using so-called *coins* or *tokens*, where a *financée* issues tokens and puts them for sale in exchange for fiat or virtual currencies (ESMA, 2017).

In the area of *innovative technology*, blockchain and distributed ledgers may be used in a wide range. In 2018, the EU Blockchain Observatory and Forum was established to monitor trends and developments, and to provide solution for issues regarding the said technologies. The European Commission has also initiated blockchain for industrial transformations (EU FinTech Action Plan, 2018). The Commission has established the EU FinTech Lab to raise the level of regulatory and supervisory capacity and knowledge about new technologies. Such technologies are authentication and identification technologies, specific cases for using distributed ledger technology, cloud technology, machine learning and artificial intelligence, application programming interfaces and open banking standards (EU FinTech Action Plan, 2018). Technology regarding the payment services is also fall under the scope of the PSD2 and the 2018/389 Regulation on regulatory technical standards for strong customer authentication and common and secure open standards of communication (RTS, 2017).

On the basis of the above, a possible taxonomy of FinTech may be made. In this taxonomy, FinTech solutions may be classified according to whether they are explicitly regulated and therefore allowed, unregulated and therefore tolerated, or prohibited/not advised financial innovations. By using the said EU institutions' documents, it can be stated that several financial innovations can be interpreted under the first category, so that under the category of regulated and therefore allowed FinTech solutions. These are the FinTech payment service providers and their services regulated by the PSD2, certain technologies under the RTS and virtual payment instruments or cryptocurrencies under certain circumstances regulated by the AMLD5. It should also be noted that among the categories of regulated and unregulated FinTech innovations, an interim category should be established. Under this category, proposed regulation of FinTech solutions may be classified. These are the crowdfunding solutions (lending and equity). Unregulated but not explicitly prohibited therefore tolerated FinTech solutions include crowdfunding (donation, reward), P2P lending, blockchain, distributed ledger technologies, AI and machine learning. Those that were found to be extremely risky and therefore not advised or warned to be risky are the ICO and crypto-assets.

Conclusion

There is a widespread view that a high level of contaminated assets, bad loans and high levels of non-repayable loans should be considered as indicators of the crisis (Kosztopolosz, 2012). As a part of the recovery process, an intensive crisis management attitude has characterized the EU. The financial crisis has also affected the monetary policy of the European Union, that has become increasingly active, interest rates have been cut and quantitative easing measures have been introduced. (Kerényi–Molnár, 2017). The EU has adopted numerous reforms to secure financial stability and improve the supervision of financial markets. According to the said view, the crisis has led to the widespread use of FinTech that covers a wide scope of innovation-based financial technology. In connection with the expanding of FinTech, the Banking and Financial Services Policy of the EU was also broadened. It contains regimes on the capital markets union, the banking union, the financial supervision and risk management, the consumer finance and payments, the

financial markets, the insurance and finance, the auditing of companies' financial statements, the company reporting, the green finance and the FinTech. On the basis of the referred interpretation, and regulation and opinions of Fintech in the EU, a possible taxonomy may be made.

References

- COMMISSION DELEGATED REGULATION (EU) 2018/389 of 27 November 2017 supplementing Directive (EU) 2015/2366 of the European Parliament and of the Council with regard to regulatory technical standards for strong customer authentication and common and secure open standards of communication
- Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC
- Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU
- EBA 2018. *ESAs warn consumers of risks in buying virtual currencies*. [cit. 14-11-2019] <<https://eba.europa.eu/esas-warn-consumers-of-risks-in-buying-virtual-currencies>>
- EBA 2019. *EBA reports on crypto-assets*. [cit. 14-11-2019]. Available at: <<https://eba.europa.eu/eba-reports-on-crypto-assets>>.
- EDELMAN 2019. *Trust Barometer, Financial Services*. [cit. 14-11-2019]. Available at: <https://www.edelman.com/sites/g/files/aatuss191/files/2019-04/2019_Edelman_Trust_Barometer_Financial_Services_Report_1.pdf>.
- ESMA 2017. *ESMA highlights ICO risks for investors and firms*. [cit. 14-11-2019]. Available at: <<https://www.esma.europa.eu/press-news/esma-news/esma-highlights-ico-risks-investors-and-firms>>.
- ESMA 2019. *Advice, Initial Coin Offerings and Crypto-Assets*. [cit. 14-11-2019]. Available at: <https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf>.
- EU COMMISSION s.d. Banking and financial services. [cit. 14-11-2019]. Available at: <https://ec.europa.eu/info/policies/banking-and-financial-services_en>.
- EU COMMISSION 2017. Summary of contributions to the 'Public Consultation on FinTech: a more competitive and innovative European financial sector' [cit. 14-11-2019] Available at: <https://ec.europa.eu/info/sites/info/files/2017-fintech-summary-of-responses_en.pdf>.
- EU COMMISSION 2018. FinTech Action plan: For a more competitive and innovative European financial sector. Brussels, 8.3.2018 COM(2018). [cit. 14-11-2019]. Available at: <<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0109>>
- FINTECH POLICY s.d. [cit. 14-11-2019]. Available at: <https://ec.europa.eu/info/business-economy-euro/banking-and-finance/fintech_en> .
- GÁL, E. 2013. *Hitelkérelem, banki ismeretek*. [cit. 14-11-2019] <https://www.tankonyvtar.hu/hu/tartalom/tamop412A/0007_d3_hitelkerelem_jav_scorm/2_2_a_penzugyi_intezmenyek_csoportositasa_6h1h2Amg68UaOy3o.html>.
- KERÉNYI Á. – MOLNÁR J. 2017. A FinTech-jelenség hatása – Radikális változás zajlik a pénzügyi szektorban? In *Hitelintézeti Szemle*. [online]. 2017, vol. 16, no. 3, [cit. 14-11-2019]. Available at: <http://real.mtak.hu/65106/1/kerenyi_adam_molnar_julia_u.pdf>.
- KOSZTOPULOSZ, A. 2012. A pénzügyi válság és következményei: monetáris politikai és szabályozási kihívások. In Farkas, Beáta (ed) *Válság: mérföldkő az európai integrációban?* Szeged: Szegedi Tudományegyetem Gazdaságtudományi Kar 2012. ISBN: 978-963-306-155-8.