FINTECH AND ITS IMPLICATIONS FOR COMPETITION AND REGULATION

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1. INTRODUCTION

The financial sector plays a key role in our societies. It is responsible for the efficient allocation of capital, which is indispensable for the proper functioning of market economies. The financial industry channels funds (capital) from savers to investors, seeking to allocate them to their most efficient purposes.

However, the functioning of the financial system is far from smooth or frictionless. Apart from operating in a context of high uncertainty, financial activities are beset by numerous market failures:

- Asymmetries of information between parties of financial transactions, thereby exacerbating the key role of information as an input in financial activities;
- Externalities, particularly the possibility of contagion from distressed agents to healthy ones;
- Market power, especially given the trend towards higher integration and concentration in some financial activities (i.e. banking) in the aftermath of the past global financial crisis;
- Public good characteristics, as the benefits of financial stability can exhibit non-excludability and non-rivalry (i.e., once provided, financial

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stability benefits everyone and it is not possible to prevent any agent from enjoying it even if they did not contribute to its provision).

As a result, the financial industry is one of the most heavily regulated sectors in advanced economies, since financial regulation seeks to address these market failures on efficiency grounds.

Against this backdrop, some new business models have emerged based on the application of new information and communication technologies (ICT) to the financial sector in a disruptive way. This phenomenon is the so-called Fintech.

2. FINTECH'S CHALLENGES AND OPPORTUNITIES

This new phenomenon of Fintech has both benefitted from a window of opportunity and represents an opportunity itself.

On the one hand, the Fintech phenomenon has taken advantage of the window of opportunity posed by economic factors, following the aftermath of the global financial crisis and the weakening of the traditional banking channel, and technological ones, such as the development of ICT in the areas of artificial intelligence, big data, cloud computing, cryptography or mobile internet. Furthermore, the massive corpus of (in some cases new) regulation and the trend towards integration and concentration stimulated the possibility to enter profitably niche activities subject to lighter regulation (e.g. if one does not take deposits). An example of these activities are account aggregators, that gather information on different financial accounts of the same client, often with different financial companies, and present it in a single page or application.

On the other hand, Fintech also poses a window of opportunity. This is true as those new technologies at the foundations of the phenomenon allow for a better use of information, the key input in financial activities, both by incumbents and new entrants. As a result, Fintech may give rise to new services unavailable thus far, such as robo-advisors or platform-based businesses such as crowdfunding and crowdlending, as well as enhanced versions of traditional services, such as payment services, open banking and insurtech. From the perspective of competition, Fintech may ensure more competitive tension in financial markets thanks to the presence of new entrants and higher degrees of contestability.

These opportunities are being exploited both by newly created firms (start-ups) and by incumbents in the financial sector, in what is labelled as "Fin-Tech in a narrow sense". But the Fintech phenomenon is much wider, since other firms are also entering the financial industry relying on their comparative advantage in ICT gained outside the financial arena, in what is tagged as "TechFin". The main example of the latter is the disruptive (potential or actual) emergence in this sector of BigTech: the main global digital platforms active in search engines, social networks, content aggregation, online retailing and mobile ecosystems. The entry of technological firms in finance offers opportunities in three (interwoven) aspects:

- Technological firms enjoy typically a light cost structure combined with scale economies, implying that they can provide financial services very competitively. This is enhanced by their widespread coverage of the population, which, relying on network effects, allows them to reach groups whose financial needs were traditionally unmet, increasing financial inclusion.
- Digital platforms possess a big amount of users' data (in terms of volume and variety) and the appropriate technology and skills to exploit them, creating a competitive advantage through learning economies (especially due to the improvement of algorithms and artificial intelligence). For instance, by accumulating data, platforms can infer consumer needs better, improve and automate credit scoring (ultimately reducing the cost of borrowing for consumer and firms), etc. Furthermore, by including financial services within its range, platforms do not only exploit these learning effects (dynamic economies of scale) driven by data accumulation, they also reinforce scope economies. For example, online retailers can offer immediate payments or credit solutions, social networks and search engines can target advertisement of products combined with financial facilities, etc. Digital platforms can offer these services as matchmakers (linking the consumers to the most attractive and tailored financial products in the market) or eventually as direct providers.
- Digital native firms tend to be very oriented to user satisfaction, since they are aware that keeping a wide base of agents is key to internalize network externalities. This helps to enhance the principle of customer centricity in financial services, increasing quality and differentiation and laying the groundwork for the unbundling of financial services (in comparison with the traditional one-stop shop model by which traditional

banks used to bundle services, which in some cases consumers had not demanded).

But the Fintech phenomenon, and specifically the emergence of (normally big) technological firms in this sector, can also raise concerns: dynamics of concentration and market power driven by network effects, the use of big data to charge excessive (personalized) prices or its role as a barrier to entry for competitors, the leveraging of market power into other sectors, etc. All these issues require a careful assessment from the standpoint of competition and regulation.

3. FINTECH'S IMPLICATIONS ON COMPETITION AND REGULATION

From the point of view of competition, Fintech offers promising opportunities but also some challenges. This warrants the typical case-by-case approach in competition, all the more so because caution is particularly advisable taking into account that many activities and firms are still incipient. An erroneous decision could stifle investment, innovation and competition in a sector where these are very much needed.

Actually, regulators in general should follow this same approach and welcome the Fintech phenomenon from different perspectives (as stated in the CNMC's "Market Study on the impact on competition of technological innovation in the financial sector", published in November 2018):

- Regulators should apply the principles of good regulation to Fintech. In other words, new Fintech business should only be restricted when it is necessary (e.g. there is a market failure) and through proportionate means (by finding the least distortive intervention and ensuring that benefits outweigh costs). For instance, one measure which should be on the agenda is the adoption of a "regulatory sandbox" regime, by which there is a controlled and limited trial period for the regulation of a new activity (so that the potential impact is assessed) before adopting a definitive response. This could be reinforced by "innovation hubs" through which regulators and firms learn from each other in interpreting regulations and business models, reducing regulatory uncertainty.
- In this regard, it is important to recall that Fintech is an opportunity to revisit all the already existing pieces of regulation affecting the financial sector. Since the new technologies and business models may help

to tackle (at least partially) some market failures (notably, information asymmetries), there is room to reassess the motivation of many of the existing requirements (physical presence, rules on internal organization, etc.). Therefore, the possible set-up of a lighter and more rational regulatory framework is an opportunity both for new entrants and incumbents.

- One of the principles for this new mindset in the financial sector is a functional approach to regulation. Since market failures are connected to activities (not to entities, despite the focus of traditional regulation on these), the same activity should carry the same regulation, regardless of the legal form, the technology used, etc. In this same vein, "reserves of activity" should be avoided to the maximum extent possible, since they preclude the exploitation of scope and network economies.
- Another opportunity to reformulate regulation is the Regtech phenomenon, which is a subsegment of Fintech consisting in applying ICT to the compliance with financial regulation and supervision (in order to improve and automate the process and, ultimately, reduce costs). Therefore, watchdog authorities should revamp regulation and supervision so that compliance and monitoring is streamlined, taking advantage of new innovations.
- Finally, this overhaul of financial regulation should include the principles of open banking (and insurance), notably technological neutrality and interoperability. These are actually a reality in the EU (thanks to the Payment Services Directive, PSD2), although their implementation can be challenging. Therefore, regulators must ensure that these principles are enacted so that competition on the merits is not distorted and new business models flourish and develop, especially in the area of payments.

The adoption of this response to the Fintech phenomenon from the standpoint of good regulation can help to grasp the opportunity to improve competition in the financial sector and to improve efficiency and welfare in the overall economy.