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Forming a Cohesive Fintech Agenda for the G20

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Abstract

Technology-enabled innovation is transforming the financial services. There are two major categories actors that perform activities that are traditionally performed by the banks through better implementation of technology: Fintechs are independent non-bank institutions, Techfins are big global technology companies. The emergence of Techfins as data intermediaries expanding into the financial services industry resulting in regulatory risks and challenges. The G20 should therefore prioritize development of fintech as an agenda item. To this end, we propose the G20 to establish regulatory principles to enable better cooperation of the Fintechs and the banks, provide best practices for the establishment of financial regulatory sandboxes and government-led investment and cooperation schemes. The G20 can establish a G20 Fintech Working group to lead this agenda.

Challenge

Fintech, *as an activity,* refers to technology-enabled innovation that transforms financial services. Fintech, *as an entity,* refers to "a non-bank institution that use advanced technologies to perform traditional banking activities."[1] These are usually startups started around consumer pain points in the financial services industry. "Techfin" –again as an entity-- refers to a company that starts with collecting consumer data for resolving a consumer pain point in a non-financial area, and then utilizing the same data to move into financial services. Fintechs are financial intermediaries, whereas Techfins are data intermediaries[2]. Techfins include American big-tech companies such as Apple, Amazon, Microsoft, Google, Facebook, new unicorns like Uber, as well as Chinese big-tech such as Alibaba, Tencent, and Baidu. Ant Financial, the financial services arm of Alibaba reached 150 billion USD valuation –on par with Unilever or Pepsi—in 2018 by building its services on the e-commerce data of its parent company.

Those being said about Fintechs and Techfins, the backbone of the financial systems is still dominated by the banks. An important principle under which the banks operate is "territoriality." Although many banks have cross-border investments, each of the national units are regulated locally. Banks are the major tools through which monetary and macroprudential policy-making is conducted.

In contrast, Techfins generally act as if "they are on par with, not subordinate to, the countries that try to regulate them" and in a sense provide a global neutral environment to their users -- they are sometimes called "Digital Switzerlands"[3]. The power of Techfins stem from the trust they create in other consumer industries in which they collect vast amounts of consumer data. Amazon, for example, is the secondmost trusted institution in the United States,

[1] OECD (2017). Fintechs and the Financial Side of Global Value Chains.

[2] Dirk Zetzsche, Ross Buckley, Douglas Arner, and Janos Nathan Barberis (2017), "From Fintech to Techfin: The Regulatory Challenges of Data-Driven Finance," European Banking Institute Working Paper No. 6.

[3] Eichensehr, Kristen (2019), Digital Switzerlands. University of Pennsylvania Law Review

after the military[4].

The popular trust to the banking system is so low that on in June 2018, Switzerland's electorate voted on a referendum calling for the country's commercial banks to be banned from creating money. Although the outcome was negative, even the fact that the center pillar of modern macroeconomic policy is questioned by the electorate in one of the most important banking hubs of the world is telling. Techfins can increasingly make it harder to conduct financial policy-making and increase the financial risks, especially for the countries that they are born in.

The emergence of giant global technology companies as data intermediaries expanding into the financial services industry resulting in regulatory risks and challenges, and brings an imperative to put several issues regarding fintech on the G20 agenda. The G20 should form a cohesive agenda around the effective regulation of fintech in order to enable its global development and mitigate risks to the global financial system. Below we propose the elements of this agenda.

Proposal

1. ***Outline optimal regulatory principles that would enable banks and Fintechs work together***

Fintechs, instead of building business models based on existing data repositories, generally start with customer pain points in a nation. Instead of transferring trust from another industry's customer relations, Fintechs build trust by solving customer problems – usually creating totally new markets that have not been served by the banks so far and creating platforms for other entrepreneurs to tap in and grow. Fintechs provide a wide range of services to customers that traditionally a bank undertakes -- usually in a more innovative and customer-centric fashion and by making better use of technology-enabled

[4] Baker Center for Leadership and Governance at Georgetown University (2018). The American Institutional Confidence Poll. https://bakercenter.georgetown.edu/aicpoll/

innovation. This is sometimes called "unbundling of a bank" as illustrated in the figure above.

Banks generally perceive Fintechs as competitors. Nevertheless, banks have some of the most traditional institutional structures, putting procedures ahead of consumer pain points, and data and ideas inside siloes of different departments. Given limited agility and the risk-averse culture banks have., it is unlikely that they can win the race of financial innovation with the Techfins. One way for the banks of staying ahead of the curve is, instead of approaching Fintechs as competitors, exploring ways of cooperating with them to foster innovation. Such a strategy would be a win for Fintechs as well, by providing them access to customer scale, brand reputation and domain expertise. Some banks are already pioneers in collaborating with Fintechs. For instance, Bank Santander, which is based in Spain with a significant amount of operations in emerging markets, invests in Fintech companies, including Ripple, a blockchain-based global financial settlement platform, and Kabbage, a leading automated credit provider to SMEs.

Source: CB Insights

Regulatory change and guidance is key incentivizing (and sometimes forcing) banks to cooperate with the Fintechs. Without proper regulatory incentives, banks are likely to act with short-term incentives to keep their balance sheets profitable, until the Techfins step in. It is worth noting that Google got an EU-wide e-money and payment services licenses as of January 2019.

The G20 should *discuss and outline optimal regulatory principles that would enable banks and Fintechs work together.* The new version of the Payment Services Directive in the EU (PSD2) is a case in point. It obliges banks to provide open access to their data and use transparent pricing schemes and avoid price discrimination in infrastructure services they provide[5]. In addition, the EU interchange fees regulation, which entered into force in 2015, aims to enhance competition in payments markets by setting an upper limit to fees and increasing transparency.

2. *Publish a G20 Best Practice List for the Fintech regulatory sandboxes.*

It is now customary for Fintechs (or any tech startup) to apply the "lean start-up," to start and grow their business. Lean startup is based on rapid prototyping, and conducting many user trials to receive feedback. It favors experimentation over elaborate planning, customer feedback over intuition, and iterative design over traditional "big design up front" development[6].

Regulatory sandboxes "able to conduct certain transactions and services within defined threshold limits, which in turn allows them to innovate while protecting consumers and the integrity of the financial system. The rationale involves businesses being required to fully comply with financial regulation after the testing phase is complete (by which time the business is more established)"[7]. The "regulatory sandbox" resonates with the lean startup methodology – how otherwise would it be possible, under the regulations

[5] Mounaim Cortet, Tom Rijks and Shikko Nijland (2016). PSD2: The digital transformation accelerator for banks

[6] Steve Blank (2015). Why the Lean Start-Up Changes Everything. Harvard Business Review. May.

[7] Bromberg, Lev, Andrew Godwin and Ian Ramsay (2017). Fintech sandboxes: Achieving a balance between regulation and innovation. Journal of Banking and Finance Law and Practice, Vol.28, No. 4, pp. 314-336.

established for incumbent players with mature business models, to test a minimum viable product with a limited set of customers before developing and scaling to a full product?

Regulatory sandboxes are becoming popular with financial regulators –there are sandboxes in more than 20 jurisdictions around the world.

Some regulators that do not set up sandboxes establish "*innovation hubs*", which "provide a dedicated point of contact for firms to raise enquiries with competent authorities on FinTech-related issues and to seek non-binding guidance on the conformity of innovative financial products, financial services or business models with licensing or registration requirements and regulatory and supervisory expectations."[8]

The dissemination of regulatory sandboxes and innovation hubs to different jurisdictions is essential for the spread of fintech. That being said, it is also important that the regulatory sandbox competition does not turn into a "race to the bottom" through which regulators end up taking extensive risks that may in turn reduce the reputation of and trust in Fintechs. The design of the regulatory sandboxes should put the priority to the fact that if the sanbox "fails to prepare firms to join the regulated market will not foster firms that succeed long-term," as pointed out by Christopher Woolard, the head of strategy and competition at Financial Conduct Authority, the UK's financial regulator[9].

Given the above discussions, it is essential that a cross-country perspective on regulatory sandboxes is formed. To take the lead, *the G20 publish a G20 Best Practice List for the Fintech regulatory sandboxes, possibly with the assistance of OECD and Financial Stability Board.*

[8] ESMA, EBA, EUIPA (2018) FinTech: Regulatory sandboxes and innovation hubs. https://www.esma.europa.eu/sites/default/files/library/jc_2018_74_joint_report_on_regulatory_sandboxes_and_innovation_hubs.pdf

[9] Finextra (2017). UK calls for global fintech regulations https://www.finextra.com/newsarticle/30417/uk-calls-for-global-fintech-regulations

3. *Establish a forum to identify best practices of government-led investments and cooperation schemes for the development of Fintechs.*

Development of Fintechs is reliant upon a number of critical infrastructures, usually developed by the governments. Some of these infrastructures are country-spesific. One such infrastructure is digital identification[10], which enables electronic know-your-customer applications or payment applications through the ID cards. For example, India's Aaardhar system provided digital identification to 1.2 billion people. Another relevant infrastructure is Legal Entity Identifier (LEI), a unique global code for legal identities to increase financial stability by tracking the beneficial ownership of companies, mandated by the G20 Cannes Summit of 2011[11]. The privacy and ethical issues should also constitute a part of the G20 discussion around government-led interventions.

Some of the relevant infrastructures are, by their nature, cross-border. One major cross-border area is remittances. For example, Transferwise, established in 2014, is a Fintech company that enables cross-border money transfers at almost eight times cheaper cost than traditional channels, by eliminating the banking intermediaries and their fees. The issues to license foreign-based service providers are likely to be increasingly become controversial. Another critical cross-border area is Anti-money laundering (AML). While it is important for Fintechs to comply with cross-border AML rules, the artificial intelligence and blockchain technologies implemented by Fintechs also provide opportunities to apply these rules effectively.

The G20 should *establish a forum to identify best practices of around government-led infrastructure investments for the development of Fintechs, including country-specific investments as well as cross-border collaborations.*

4. *Establish a G20 Fintech Working Group to lead the fintech agenda*

Finance constitutes the core of the G20 – the G20 started as a finance ministers' meeting in 1997. Innovation and digital are relatively new themes at the G20 –

[10] World Economic Forum (2016). A Blueprint for Digital Identity The Role of Financial Institutions in Building Digital Identity

[11] Gateaway House (2018). LEI, a gold standard for financial transparency. https://www.gatewayhouse.in/lei-financial-transparency/

the first innovation theme was adopted by the Think 20 Turkey in 2015, innovation became a priority of Chinese G20 Presidency in 2016, and Germany brought the digital economy ministers together first time in 2017.

Fintech brings finance and innovation together. Yet, the G20's involvement in the fintech has been limited as well. To date, the G20 touched the fintech from financial inclusion[12] and consumer protection[13] angles. Only recently, a report by the Financial Stability Board discussed the financial stability implications[14]. In addition, crypto assets have been on the agenda of the Leaders Summit in Buenos Aires in 2018. Think 20 had discussed the regulatory aspects of the crypto assets[15]. Nevertheless, it is possible to point out that none of these discussions has a focus on the proposals in this note regarding the development of fintech and the relevant regulatory measures.

It is now time to bring the finance and innovation themes together in a G20 Fintech Working Group to make the development of fintech a major agenda item in the G20.

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[13] OECD (2018). G20/OECD Policy Guidance Financial Consumer Protection Approaches in the Digital Age. https://www.oecd.org/finance/G20-OECD-Policy-Guidance-Financial-Consumer-Protection-Digital-Age-2018.pdf

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