Regulatory Newsflash

European Banking Authority reports on prudential risks and opportunities of FinTech, and its impact on incumbent business models

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Introduction

On 3 July 2018, the European Banking Authority (EBA) published a report on the prudential risks and opportunities arising from FinTech, and a report on the impact of FinTech on incumbent credit institutions’ business models.

These thematic reports are the first products of the EBA’s FinTech Roadmap issued in March 2018, and fall under the then established EBA FinTech Knowledge Hub. As such, they form part of the EBAs ongoing work to raise awareness and enhance knowledge sharing on FinTech topics within the supervisory community and the industry.

Report on the impact on incumbent business models

The analysis of the impact of FinTech on incumbent business models was already touched upon in the [EBA's Discussion Paper on FinTech] in 2017, as detailed in our [dedicated newsflash]. This report is one of the steps towards understanding this impact, as it explores the potential threat FinTech firms may pose to traditional business models, the sustainability of strategies and the relation between incumbent institutions and new FinTech players.

The report identifies four main drivers inducing incumbent institutions to rethink their business models: changes in customer expectations and behaviour, profitability concerns, increasing competition and regulatory changes – notably PSD2 and GDPR.

The degree to which incumbent institutions' business models are threatened is viewed to be determined by the degree to which they are subject to competition from new entrants, the flexibility of legacy ICT systems, the operational capabilities to implement the necessary changes, the access to and maintenance of talent staff and – most importantly – the aptitude of an institutions' digitalisation strategy.

Although these digitalisation strategies vary, most incumbent institutions are found to be keen on integrating new technologies in their operations and activities. Based on the level of adoption of innovative technologies, they can be categorized as either (i) proactive / front-runners, (ii) reactive or (iii) passive. The EBA notes that both front-runners and passive institutions could be exposed to new risks: rapid adoption of new technologies may not be backed by a clear strategy or adapted governance- and risk frameworks, whereas passive institutions could see part of their services executed and taken over by other (new) players.

Institutions looking to adopt new technologies do so mainly through partnerships with FinTech firms, rather than by investing in new entrant FinTechs through venture capital funds and direct acquisitions, or by developing solutions internally. Such partnerships are considered beneficial for both parties, with the incumbent institution gaining quick access to innovation expertise whilst providing the smaller FinTech firm with banking expertise (including legal and compliance knowledge), financing and market reach.

The EBA notes that FinTech firms are currently not in direct competition with incumbent institutions, but that BigTech firms are increasingly looking to increase their footprint in the financial sector. These firms – GAFA (Apple, Amazon, Facebook, Google) and the likes – could compete with incumbent institutions and alter the financial intermediation ecosystem.

Report on prudential risks and opportunities

The report explores how technology could improve process efficiency and customer experience in the financial sector, noting the prudential risks associated with such solutions. As changes to a firms' operation could entail new risks or exacerbate existing risks, firms should be ready to review their risk management frameworks and strategies.

The EBA concentrates its analysis on seven use-cases, each featuring a different innovative technology:

- **Biometrics**, used to enhance the security of mobile payment solutions. The use-case focuses on the use of fingerprint recognition for customer authentication.

- **Robo-advisors** could offer fast and low-cost investment advice, opening up such services for mass customers at a lower cost than the existing offerings. On the other hand, robo-advice is currently subject to legal uncertainty as well as conduct, reputation and ICT risks.

- **Big data and machine learning** are predominantly used to improve credit scoring. Enhanced data processing and tapping into new data sources could increase the quality of credit portfolios, but could also generate legal, regulatory and reputation risks (GDPR);

- **Distributed Ledger Technology (DLT) and smart contracts for trade finance** have the potential to streamline labour-intensive asset transfer processes and reduce the risk of errors. The immaturity of the technology, the required buy-in from all involved parties, legal and prudential uncertainties as well as possible difficulties in designing an appropriate governance framework could hamper further adoption.

- **DLT to streamline customer due diligence (CDD) processes**, by sharing identification data of clients between institutions – thus taking advantage of the immutability, security and transparency between participants inherent to distributed ledgers. However, such a solution could require the standardisation of customer identification and verification across multiple jurisdictions, and may involve data privacy and other compliance concerns.

- **Mobile wallets with the use of near-field communication (NFC)** are used to facilitate contactless payments, improving customer experience. On the other hand, allowing third parties to access customers' bank accounts might affect aspects of ICT security risk and data protection.

- **Outsourcing core banking / payment systems to the public cloud** allows the provision of services to a larger number of customers in a flexible and highly automated manner, all within a lower-cost environment. Yet a migration of services to the cloud could imply ICT change risks, as well as ICT outsourcing risks and legal risks linked to the jurisdictional location of data.

As of yet, the EBA did not observe a significant implementation of sophisticated technologies. The report does note a growing shift towards operational risk as incumbent institutions integrate new technologies and services, along with an increased reliance on third party providers and an accentuation of IT risks.

Conclusion

These thematic reports further outline the EBAs view on the use of innovative technologies in the financial sector, in line with the positions set out in the EBA FinTech Roadmap.

The EBA will continue to monitor these and other developments in the FinTech space. As appropriate, it will conduct additional work to effectively police the regulatory perimeter and foster neutrality in the regulatory and supervisory approaches to new technologies.

Contact

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