FinTech regulation for banks

Between a rock and a hard place?

Dr. Alexander Glos, 21 May 2019

Freshfields Bruckhaus Deringer

Agenda

1. Regulatory pressure on Bank IT
2. Regulatory barriers for the use of (third party) IT
3. Regulatory barriers for the investment in crypto-assets
4. Regulatory treatment of new competitors
5. Regulatory incentives for investing in software

Regulatory pressure on Bank IT

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Legal framework

Article 74 of CRD IV (2013/36/EU) - Robust governance arrangements

Requirement to establish:

- Clear organisational structure
- Well-defined, transparent and consistent lines of responsibility
- Effective processes

In order to:

- identify
- manage
- monitor
- report

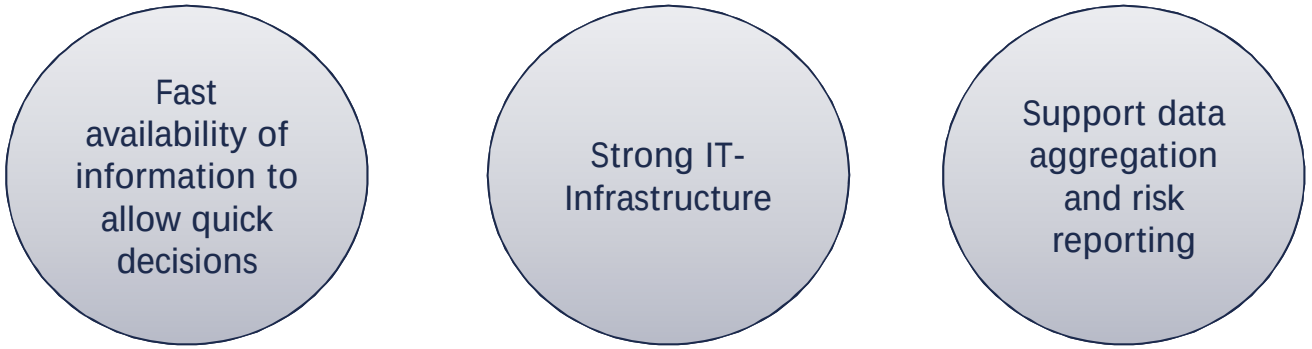
risks the bank is exposed to

Information and Communication Technology (ICT) risks, including cyber incidents, to be managed within existing risk management frame-works, incl. crisis management and business continuity – not an isolated IT concern, but holistic bank approach.

Regulatory pressure on Bank IT

Legal framework

Basel Commitee on Banking Supervision's Standard number 239 (2013) sets out IT-requirements regarding data aggregation and risk reporting:



Regulatory pressure on Bank IT

SSM activities

Requirement for a CIO	SSM focus areas of supervision building on current key drivers of banking sector risks, including cybercrime and IT disruptions:	
- Clear responsibilities - Knowledge of ICT risks - Adequate access to management body to ensure proper reporting	On-site inspections on IT risk	Cyber incident reporting: - Collect information on cyber incidents impacting banks - Facilitate fast supervisor reaction in the event of a major incident affecting one or more banks

Regulatory pressure on Bank IT

Regulatory development

Joint Advice of the European Supervisory Authorities identified threats to cyber security:

- Potential impact of cyber-attacks increases
- Frequency of cyber-attacks increases

This leads to:

- Danger to consumer and market trust
- Threat to financial stability

Regulatory pressure on Bank IT

Regulatory development

ESA propose new legislative and delegated acts to improve operative resilience in the banking sector:

- Contingency plans
- Business continuity plan
- Aim is to continue services without disruption
- Changes to CRD and PSD2
- Specially address the concentration risk regarding outsourcing to cloud-outsourcing providers

Regulatory barriers for the use of (third party) IT

Regulatory barriers for the use of (third party) IT

Outsourcing and Cloud-outsourcing

EBA Guidelines on outsourcing arrangements:

- Outsourcing does not delegate responsibility
- No lower suitability requirements – competent management still needed within the undertaking
- Institutions shall maintain sufficient substance
- The outsourcing of critical or important functions is to be met with special attention

Regulatory barriers for the use of (third party) IT

Outsourcing and Cloud-outsourcing

EBA Guidelines distinguish between different functions being outsourced:

General Rules – applies to all functions

Rules applying to critical or important functions

Regulatory barriers for the use of (third party) IT

Outsourcing and Cloud-outsourcing

General requirements set out in the EBA Guidelines:

- Define Outsourcing Policy as a framework and monitor outsourcing on an oversight basis regarding concentration risk
- Management regarding conflicts of interest
- Internal audit plan and program to monitor individual outsourced functions
- Outsourcing register including all outsourced functions
- Due Diligence and assessment before outsourcing services
- Special requirements regarding the outsourcing agreement

Regulatory barriers for the use of (third party) IT

Outsourcing and Cloud-outsourcing

Special requirements set out in the EBA Guidelines with regards to critical or important functions:

- Business continuity plan to prevent a disruptions in case of failure or even insolvency by provider of outsourced services
- Restrictions to sub-outsourcing
- Inform competent authority

Regulatory barriers for the use of (third party) IT

Cloud-outsourcing

Specific aspects for cloud-outsourcing:

- Data protection is more important – increasing threats due to global distribution of data
- Business continuity plan and contingency plan need to reflect information security standards
- Concentration risk has to be considered, as the market for cloud-outsourcing-services is dominated by few providers

Regulatory barriers for the investment in crypto-assets

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What are crypto-assets?

Crypto-assets are digital assets, that use strong cryptography and work on a distributed ledger technology (usually block chain).

There is no common taxonomy of crypto-assets.

Payment/Exchange/ Currency Tokens	Investment Tokens	Utility Tokens
May partially substitute classic currencies.	Provide rights for investment purposes	Access to a product or service

There is no regulatory framework for the treatment of crypto-assets in the EU.

Regulatory barriers for the investment in crypto-assets

Investment in crypto-assets

Points to consider:

- Market participants' requirement for a licence to issue, broker, trade and advise on crypto-assets
- Applicability of other financial market rules (prospectus requirement, market abuse, custody, ...)
- Possibility to invest in crypto-assets for regulated entities
  - Basel Framework does not set out criteria for the exposure to crypto-assets
  - Treatment for "other assets" applies with minimum requirements

Regulatory barriers for the investment in crypto-assets

Investment in crypto-assets

- BCBS Statement on crypto-assets:
  - Due Diligence: conduct comprehensive analyses and maintain relevant expertise
  - Governance and risk management: risk management for crypto-assets within regular risk management. Due to the high degree of risk the senior management is expected to be involved in overseeing the risk.
  - Disclosure: publicly disclose exposure to crypto-assets
  - Supervisory Dialogue: inform authority of actual/planned crypto-asset exposure

Regulatory barriers for the investment in crypto-assets

ECB Crypto-Assets Task Force

Crypto-assets do not fit in existing regulatory framework, as they are not:

- Electronic money (EMD2)
- Financial instrument (MiFID)
- Regulated by PSD2

"Risks [...] are limited or manageable."

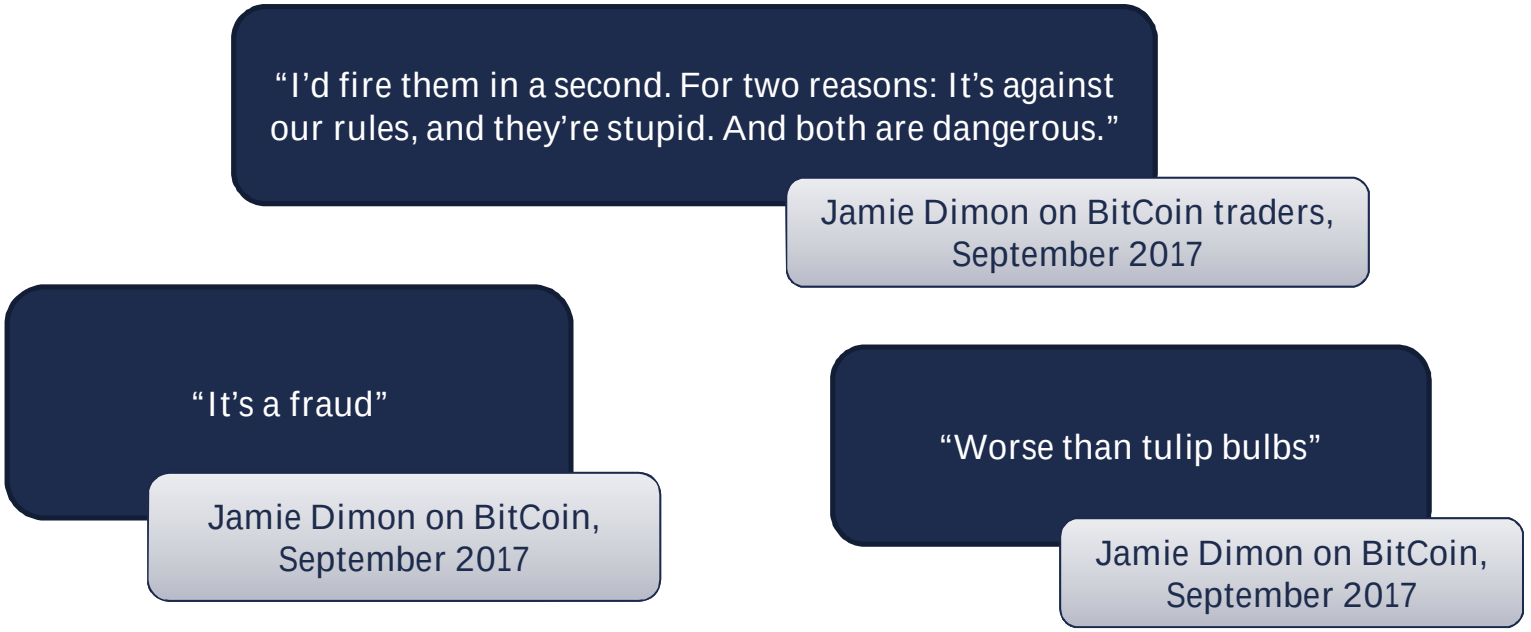
ECB Crypto-Assets Task Force, May 2019

"The sector [...] requires continuous careful monitoring since crypto-assets are dynamic and linkages with the wider financial sector may increase to more significant levels in the future. "

ECB Crypto-Assets Task Force, May 2019

The ECB proposes to deduct crypto-assets from the Tier 1 Capital because of their high volatility. This would create in incentive to refrain from investing in crypto-assets.

Regulatory barriers for the investment in crypto-assets



Regulatory treatment of new competitors

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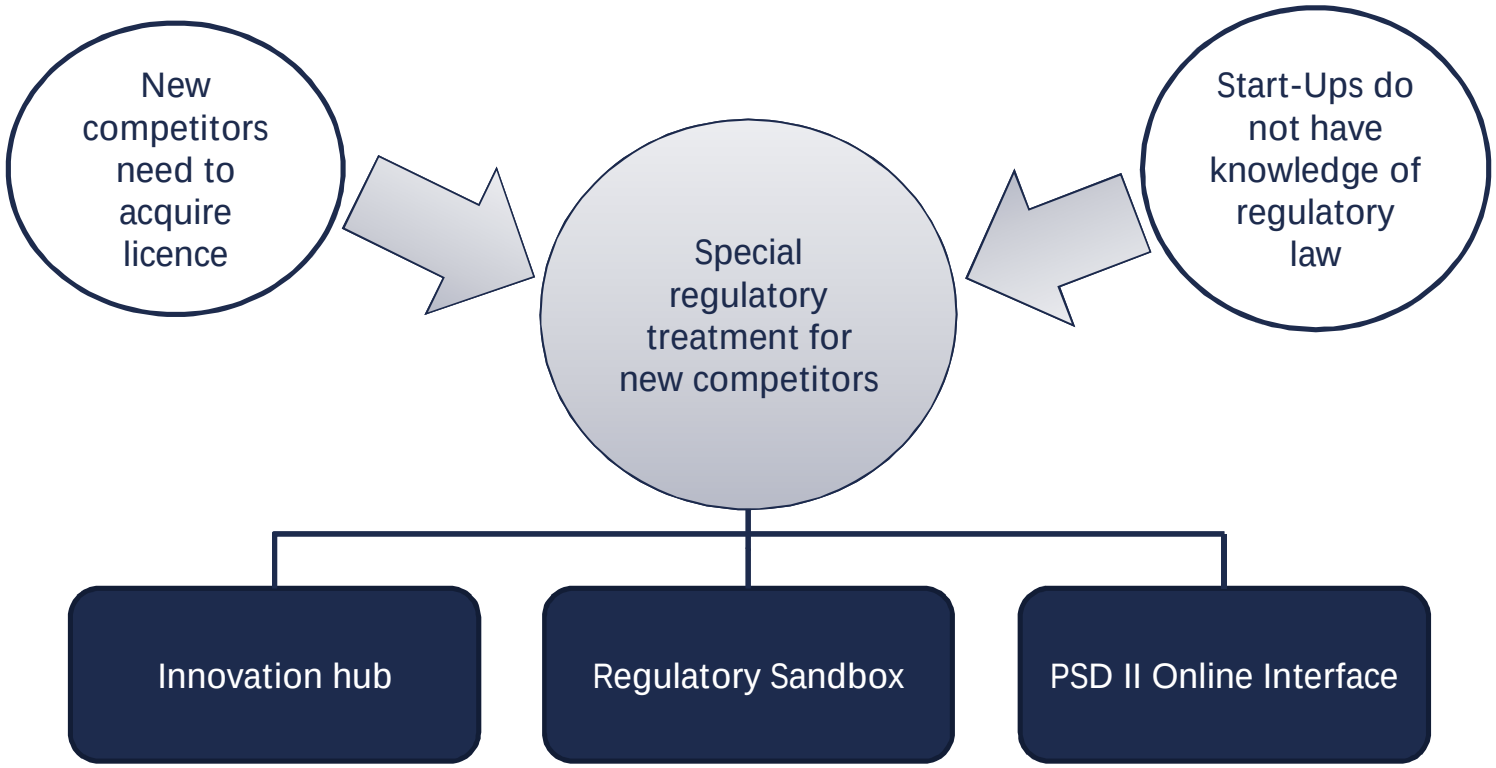


Regulatory treatment of new competitors

Innovation Hub

- In 24 EEA-States
- First established in 2014
- Majority established in 2016 and 2017
- Objective and scope vary slightly
- Tech-Experts within the authority act as a first contact point

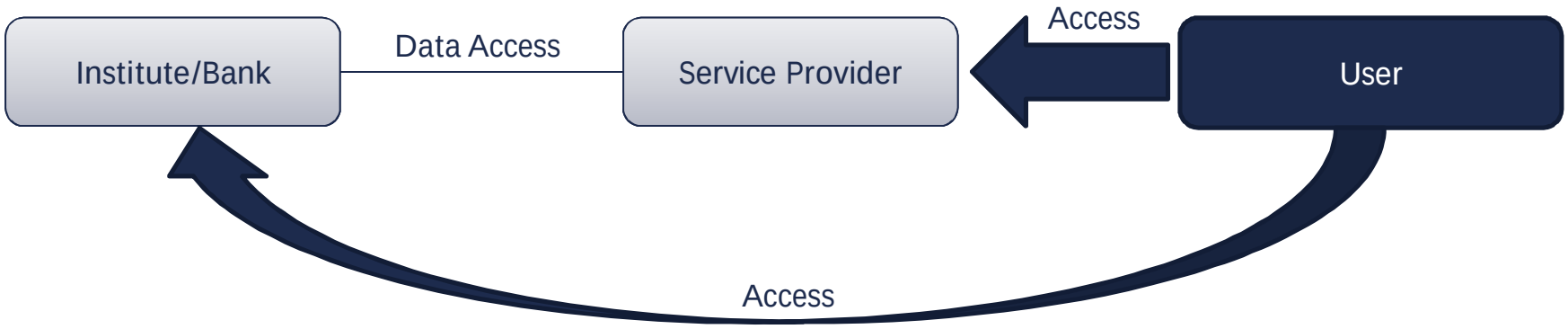
Regulatory Sandbox

- In 5 EEA-States
- First established in 2016
- Objective in the essence similar, but single jurisdictions have a further objective
- Test innovation (closely monitored) in the market

Regulatory treatment of new competitors

PSD II Online Interface

- Banks need to create online interfaces, for specific service providers
- Provide information on a payment account
- Accounts are easier accessible by user (through special service providers)
- Banks might lose direct customer-contact



Regulatory incentives for investing in software

Regulatory incentives for investing in software

- Software is a form of intangible assets
- Deduction of intangible assets from Tier 1 Capital under CRR I

- CRR II will include exemption for prudently valued software assets
- Such software-assets shall not be deducted from Tier 1 Capital

Regulatory incentives for investing in software

IFRS (IAS 38) recognises intangible assets (software) under certain circumstances:

Separate acquisition	Internally generated
- Purchase price reflects the markets expectations - Costs can be measured reliable through the purchase price	- Expected future economic benefits - Reliable determination of the cost of the asset (including development, but no reasearch)

Regulatory incentives for investing in software

- Prudently valued software assets:
- This requires, that the value is not negatively affected by resolution, insolvency or liquidation of the institution
- Amortization
- Realised sales of such assets/software

- The EBA shall draft regulatory technical standard to specify the application of this deduction.

Thank you