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- Contribution from Spain -

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Session I: Competition, Fintechs and Open Banking

– Contribution from Spain –

Executive summary[1]

1. The Comisión Nacional de los Mercados y la Competencia (Spanish National Markets and Competition Commission, CNMC) conducted a study on the process of digitalisation in financial markets, otherwise known as fintech (CNMC, 2018). This is a hugely important topic, given the key role the financial sector plays in promoting investment and growth, as well as in boosting competition in the economy as a whole by financing the entry of new companies into different sectors.

2. The financial sector is highly regulated to ensure its stability, but such regulation can limit competition. It is therefore essential to find the right balance between stability and competition. This level of regulation is justified by information asymmetry, externalities and market power, and is divided into prudential, business conduct and systemic regulation.

3. The main purpose of financial intermediaries is to match the needs of suppliers and demanders of funds, using information as a basic resource and managing risks and information asymmetry. And, thanks to financial innovation, the allocation of financial resources can be improved. Fintech therefore represents a disruption that can improve efficiency in financial exchanges and solve information problems through new technologies and digital platforms. This innovation makes it possible to customise financial services to meet the individual needs of users, increasing financial inclusion and competition in various sectors. However, fintech also poses challenges, such as the risk of concentration in digital platforms or a rise in volatility due to the use of new products or algorithms.

4. The study concludes that fintech enhances competition and efficiency in the financial market, benefiting both consumers and businesses. It can also mitigate market failures by proposing a review of existing regulation. Recommendations include regulating activities rather than entities, taking advantage of the regtech phenomenon to modernise regulatory oversight, adopting a regulatory "sandbox" for dynamic regulation, and applying principles of technological neutrality and non-discrimination.

5. Since the study's publication, reforms have been adopted in line with its recommendations, including a successful fintech regulatory sandbox in Spain and the European Commission's Digital Finance Package. Both of these initiatives harness the potential of fintech while managing risks.

[1] This contribution has been prepared by the technical staff of CNMC and does not necessarily reflect the official view of the institution except where it refers precisely to CNMC official documents and resolutions.

1. Introduction

6. The digitalisation process that economies are currently undergoing has its own particular form in the financial markets. This is known as "fintech". In 2018, CNMC published a study on the impact of new technologies on competition in the financial sector (fintech), looking specifically at the extent to which they promote competition (CNMC, 2018). One of the fundamental reasons for conducting this study was not only the fact that the financial sector is of significant quantitative and qualitative importance in any market economy, but also that having a robust and competitive financial system is key to allowing newcomers in other economic sectors to thrive and compete with companies already in the market.

7. However, in all modern economies, the financial sector is characterised by a huge amount of regulation that seeks to address a series of market failures (such as information asymmetry and externalities) that jeopardise the stability of financial institutions. It is without a doubt one of the most regulated sectors in any economy, and achieving that level of financial stability comes at the cost of restricting competition, both in terms of access for new entrants and the ability and incentives to compete. Therefore, it is particularly important that financial regulation, which presents this potentially anti-competitive bias, observes the principles of good financial regulation (principles of necessity and proportionality). It is worth remembering that promoting efficient and competitive markets in general is essential to achieving a more prosperous economy, which boosts growth and innovation, as well as the purchasing power of the population, including those at lower income levels.[2]

8. In terms of promoting efficient economic regulation, with the fintech study, CNMC put the spotlight on the financial sector for the first time. The novelty of fintech and the fact that it is not yet specifically regulated offered a window of opportunity to join in the debate on what could be the ideal regulatory framework for these types of potentially disruptive activities. And it is this disruptive nature that is the defining feature of the fintech phenomenon. Fintech is in fact a relatively recent phenomenon and lacks a universally accepted definition. Therefore, the study defined fintech as the disruptive application of new information and telecommunications technologies (ICT) to the financial system (CNMC, 2018).

9. But this in turn begs the question: what exactly makes the fintech phenomenon disruptive? To answer this question, we need to look at financial activity as a whole, the theoretical foundations of which often go unnoticed.

2. Analysing the financial industry from an industrial organisation perspective

10. Adopting an industrial organisation theory approach, the financial industry tries to match suppliers' and demanders' needs for funds or capital. In order to carry out this task efficiently using the relevant fintech, the financial industry will develop different products – both financial instruments and services – for which the essential resource or input is information.

11. Indeed, any financial product (from a bank deposit to an insurance contract) essentially represents a promise of future payment or repayment of capital, between a

[2] For more information, please see the CNMC guides "The benefits of competition for consumers" (CNMC, 2021) and "Competition against inflation: How competition and efficient regulation help protect the purchasing power of consumers" (CNMC, 2023).

creditor party (the provider of funds, who holds the right of collection or asset) and a debtor party (the claimant or party that incurs the payment obligation or liability). Because of their fiduciary nature, or the expectation to fulfil a future commitment, all financial products involve a greater or lesser degree of risk. Therefore, when assessing their value, all relevant information that affects expectations should be considered on an ongoing basis.

12. Such uncertainty around the fulfilment of future payment commitments is plagued by information asymmetry. In other words, there are situations in which only one of the parties to an exchange holds private information that is relevant in evaluating the financial instruments and services being transacted. This poses an obstacle to the proper functioning of financial markets, as these asymmetries erode the ability to trust that financial obligations will be fulfilled. There is, therefore, a growing need for accurate information about counterparties. Lack of such information can lead to suboptimal situations in which many potentially mutually beneficial exchanges between suppliers and demanders of funds fail to materialise. Interestingly, the financial industry's raison d'être is precisely to minimise this inefficiency, since it constitutes an opportunity for private agents, through a profitable business activity, to mitigate existing asymmetries between supply and demand, particularly information asymmetries (Freixas & Rochet, 2008), as well as frictions in match-making (Boot, Hoffmann, Laeven & Ratnovski, 2020). More specifically, certain agents – in this case financial intermediaries – specialise in collecting and analysing information on suppliers and demanders of capital, as well as in monitoring and selecting them. This is with a view to minimising adverse selection and moral hazard, so that suppliers and demanders of funds can delegate these activities to them (Diamond, 1984).

13. Historically, the process of financial innovation – through the development of new activities, tools and instruments – has fostered progress in using available information in order to better allocate capital. However, this has in turn generated new failures and costs on many occasions. In this sense, fintech can be seen as a disruption that aims to minimise information asymmetry in a productive way, through the application of new technological developments that provide for better use of all available information in order to make financial exchanges more efficient. Fintech can also act as a disruption that helps solve communication or match-matching problems, thanks to the development of new distribution channels such as digital platforms (Boot, Hoffmann, Laeven & Ratnovski, 2020).

3. The interaction between financial regulation and fintech

14. Having described the fintech phenomenon, the study analysed financial regulation in order to identify not only the possible obstacles facing fintech firms as potential entrants, but also how fintech may affect the case for financial regulation as a whole.

15. From the standpoint of economic and competition analysis, fintech has the potential to impact the same market failures that are used as justification for public intervention in the financial industry. The theoretical literature has identified three market failures (Goodhart, Hartmann, Llewellyn, Rojas-Suarez & Weisbrod, 1998; Llewellyn, 1999) as theoretically necessary conditions for public intervention in the financial sector. These include the information asymmetry already mentioned; the presence of externalities (manifesting as episodes of contagion among financial agents, regardless of their health or soundness); and market power (as a result of structural costs and strategic behaviours).

16. Financial regulation is usually divided into three broad categories: prudential regulation, business conduct regulation and systemic or macroprudential regulation (De Haan, Oosterloo & Schoenmaker, 2015). In one way or another, all of these types of

regulation have significant impacts on competition, typically reducing it, both directly (for example, through imposing licences to operate and other barriers and entry requirements), and indirectly (through restrictions on activities and the regulatory burden of complying with oversight). However, in certain cases regulation may also encourage (possibly inefficient) entry. For example, certain conduct regulations turn the financial regulator into a guarantor of the health of financial institutions, which reduces incentives for customers of financial institutions to monitor their soundness (moral hazard). In some cases, this may lead to an excessive increase in certain business segments with particularly high risks.

17. In summary, from the perspective of efficient economic regulation, the common denominator of the various types of financial regulation is the existence of a trade-off between financial stability and competition. In other words, ensuring the safety and soundness of financial institutions (either individually or as a whole) leads to restricting entry and diminishing or distorting the ability of, and incentives for, firms in the sector to compete. In this regard, some authors point out that financial regulation may also contain a regulatory failure (De Haan, Oosterloo & Schoenmaker, 2015; Vives, 2016), as the gains lost through lack of competition may not be offset by greater financial stability.

4. Fintech's challenges and opportunities

18. The study identified numerous opportunities posed by the fintech phenomenon, the first being that it constitutes a dual innovation, both in terms of process and product. Fintech can be seen as a process innovation as it potentially provides for better use of the financial industry's most important input: information. Fintech allows us to not only better exploit the information that was already being used in the financial industry, but also to start exploiting new available information. Moreover, better use of information can help reduce the information asymmetry that is rife in financial activity. Fintech can also be considered a product innovation, through the emergence of new financial products or services that were previously severely restricted by the aforementioned information problems.

19. This double innovation gives rise to "customer centricity" (Nicoletti, 2017): in other words, the personalisation or adaptation of financial services to meet the individual preferences and needs of their users, as these preferences and needs can be inferred from users' behaviour (such as purchase history) and their objective characteristics (such as sociodemographic variables). As a result, fintech can offer financial products with a set of features that are more in line with user preferences.

20. In terms of the economy as a whole, the increase in new financing channels as a result of fintech would allow new companies to emerge and enter many different sectors of industry, thus increasing competition within these industries, with potentially significant ripple effects in terms of greater economic welfare. Big Tech companies play an important role here as they can start with an advantage as product innovators in the financial sector. In fact, these companies often have access to relevant information about clients beyond the financial sphere and have accumulated experience in analysing and exploiting this information in their non-financial activities, which could improve their financial assessment of clients.

21. In addition, new fintech competitors may challenge traditional financial institutions in their markets. This increased competitive tension can foster efficiency through greater market discipline. In fact, it could even lead to a significant change in the structures of sectors and entities. For example, through the process of unbundling, whereby financial institutions, especially banks, which currently tend to be large (often "too-big-to-fail") corporations providing a wide range of services, become separated into smaller institutions

that are more specialised in different activities. If so, fintech could help mitigate the moral hazard problem of systemic institutions.

22. Finally, fintech can increase financial inclusion in both developed and developing countries. In industrialised countries, small customers (low- to middle-income households and small and medium-sized enterprises [SMEs]) often do not have access to the full range of financial services that large customers have at their disposal (Zetzsche, Buckley, Arner & Barberis, 2017), such as personal finance management. The potential efficiency gains resulting from fintech may therefore take the form of demand for financial services being more widely met. Moreover, this potential improvement is even more significant for developing countries that generally lack consolidated financial markets.

23. At the same time, however, fintech poses challenges that largely stem from the novel nature of these activities. First, new risks may arise in terms of the impact on competition. In particular, some of the new fintech services are based on digital platforms (such as microfinance) and networks, which currently show a tendency towards high concentration and even single platforms emerging as monopolists. This is due to the complex effects of "multi-sided" markets, including direct and, in particular, indirect network effects. One by-product of this growing digitalisation of businesses (and not only in the financial sector) is the possibility of applying personalised prices, thanks to the huge amount of information collected and big data. This price discrimination generates among consumers both winners (through the effect of "market expansion" to new users) and losers (through the effect of surplus "appropriation"). This makes it difficult to determine its impact on aggregate economic welfare in advance (Bourreau & De Streel, 2018). In addition, fintech firms' use of algorithms leads to a lack of transparency around the logical mechanism that underpins business decision-making (including pricing decisions). This is especially significant when these decisions may be anti-competitive (for example, if several competitors' algorithms "learn" to tacitly collude [Ezrachi & Stucke, 2016]). Further risks to competition are posed by the emergence of large companies (including Big Tech) in the financial market, which may extend the market power they hold in their markets of origin to the financial markets they decide to enter, through leverage.

24. Second, the emergence of fintech companies could pose a risk to the stability of the banking sector, a segment of financial activity that is particularly prone to instability. We do not know what impact increased competition in this segment would have on the stability of these entities as we know them today, and there is considerable unresolved academic debate on the competition–stability interplay (Vives, 2016). It may be that we see an increase in these stability problems as a result of the wider and easier access to customers (mobile Internet) that new technologies provide. This potential risk could arise both from the fact that these are novel financial activities, whose aggregate effects are, at present, unknown to those who oversee them, and from a possible increase in opportunistic or even fraudulent behaviour by certain operators. In this case, and in the absence of regulation to address it, consumers should at all times be fully informed about and aware of the risks they are taking on when contracting with fintech entities.

25. Finally, given the unstoppable process of digitalisation in the financial sector (and inherent in the fintech phenomenon), cybersecurity risks may increase. This would make the financial sector more prone to cyberattacks and cybercrime. This concern gives rise to a new form of financial regulation focused on safeguarding financial stability in this area (González-Páramo, 2017).

5. Conclusions and recommendations of the study

26. Following this analysis of the impact of fintech on the financial industry (including its sectorial derivatives: distributed ledger technologies, payment systems, crowdfunding, financial management and advice, and Insurtech), the fintech study (CNMC, 2018) reached two major conclusions.

27. First, fintech boosts competition and efficiency in the financial market, offering more and better services that are more personalised and affordable. This benefits not only the end consumers, but also the companies that require financial services as essential intermediate goods, boosting competition throughout the economy.

28. Second, fintech can mitigate market failures (especially information deficiencies) that were one of the main reasons used to justify regulation. Fintech therefore offers an opportunity to reflect on the role of this regulation.

29. This has led to two immediate recommendations. First, authorities should accommodate the fintech phenomenon in view of its aforementioned positive impact on competition and efficiency. Second, they should re-examine the scope of regulation, to the extent that fintech can address some market failures.

30. In addition, the study made four further recommendations. First, taking the same approach that looks at market failures linked to each activity, it proposed regulating activities (not entities) and avoiding activity reserves. Second, it recommended taking advantage of the regtech phenomenon; in other words, using new information technologies to assist with regulatory oversight and compliance (Arner, Barberis & Buckley, 2017), in order to modernise and lighten the burdens of financial regulation and supervision and regulatory compliance. Third, it recommended that consideration be given to adopting a regulatory testing environment (sandbox) that would provide for a dynamic regulatory approach. This would involve looser entry requirements (within a controlled environment) at the early stages of developing business models, allowing us to predict their possible implications before adopting a definitive regulatory response. Fourth, it suggested opting for principles of technological neutrality and non-discrimination (open banking and insurance).

6. Fintech development and the regulatory response to the study

31. Since the study was approved and published, some regulatory reforms and proposals have been made to legal frameworks in line with the study's recommendations. In Spain's case, the most typical example has been the introduction of a regulatory sandbox, under Act 7/2020 of 13 November, for the digital transformation of the financial system. This sandbox, or "controlled testing space", is an excellent opportunity to, among other things, implement the principles of efficient economic regulation, thanks to a better understanding of new business and financial service models among regulators and supervisors. From the eight different cohorts of projects registered as having been accepted into the sandbox scheme up to July 2024, a very heterogeneous fintech ecosystem emerges. Companies within it are specialising in particular niche activities that would primarily seek to complement and collaborate, rather than compete, with the traditional financial companies that are in place.[3] In contrast, it would be the large fintech (Big Tech) players

[3] See https://www.tesoro.es/sandbox/cohortes

who would be in a position to effectively compete with the big players in their markets, as is the case in the payments sector.

32. At the supranational level, one example is the European Commission's Digital Finance Package (2020). The entire package of measures is based around facilitating fintech solutions, promoting the increasing digitalisation of financial services while mitigating its potential risks, as well as introducing new rules around investor protection, cybercrime and money-laundering.

33. One of the specific priorities of the Digital Finance Strategy, part of this package, is to "adapt the EU regulatory framework to facilitate digital innovation". In particular, it aims to ensure that an adequate legislative framework is always in place, through regular legislative reviews and interpretative guidelines. This will reduce the chances of the EU regulatory framework for financial services becoming obsolete in a rapidly evolving sector. This proposal for "regulatory dynamism" is in line with the basic principles supporting the promotion of competition, necessity and proportionality in economic regulation.

34. The Strategy also considers the application of the principle of "same activity, same risks, same rules", meaning that prudential and conduct regulation and supervision in the EU must be adapted in line with the new financial ecosystem, which encompasses both traditional regulated financial institutions and technology providers offering financial services.

35. Another of the priorities of the Strategy, also advocated by the study, was the development and application of new technologies to regulatory and supervisory activity (regtech and suptech). This has recently materialised under the Strategy in the form of monitoring data on financial services in the EU (COM/2021/798), which provide for various interventions to adopt new information technologies in financial regulation and supervision.

36. Also included in this package is a proposal to regulate a pilot scheme for market infrastructures based on distributed ledger technology (COM(2020)0594, currently undergoing approval), as is also promoted in the study.

37. Finally, the Retail Payments Strategy within the package establishes a new open finance framework, which is more ambitious than the open banking recommendation proposed by the study. This is in addition to a revision of the Payment Services Directive or PSD2 (initiated in 2022 with an evaluation of the Directive).

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