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Digital Disruption in Financial Markets – Note by the EU

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More documents related to this discussion can be found at

http://www.oecd.org/daf/competition/digital-disruption-in-financial-markets.htm

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EU

1. Digital financial services and competition in the EU

1. The European Commission wants to foster a more competitive and innovative European financial sector and is supportive of digital transformation in view of the opportunities it provides for all market participants with competitive digital strategies.[1]

2. With the expansion of smartphones and e-commerce, consumers are accustomed to higher levels of digitally enabled services, particularly due to services offered by Big Techs. They therefore demand easy access, fast service and intuitive interfaces in financial services, too. For financial service providers this means providing 24/7 access beyond physical branches and online customer services with an increasing emphasis on mobile digital communication channels.

3. EU FinTech companies provide a range of services such as peer-to peer lending, algorithmic trading or InsureTech. And while the majority of non-cash payments are still carried out by card, technological change induces a move to online, mobile and instant payments. These new digital financial services increase choice and convenience for consumers and reduce prices.

4. Numerous FinTechs entered retail finance and the speed of this development, as well as investment in FinTechs, are increasing. By now, 20% of banking and payments institutions are new entrants, which in 2018 captured 7% of total banking revenue (and 33% of all new revenue since 2005). This shift in revenue will start to have a material impact on incumbent profits.

5. The FinTech entrants are both digital-only challenger banks without physical branches, which provide digital-based banking services holding a banking, payment or e-money license, as well as firms without a full banking license, which offer technology-enabled financial solutions. European operators are in particular active as digital-only banks, payments platforms, international money transfer service providers and as payment initiation, account information, credit scoring, instant lending and financial advice service providers. InsurTech solutions provide opportunities to better evaluate risk profiles and reduce costs and enhance efficiency compared to existing insurance models, but they are taken up more slowly.

6. Many new services disrupt traditional financial intermediation, putting significant competitive pressure on incumbents and their revenue streams. And while FinTechs might not deliver the degree of disruption some had anticipated,[2] BigTechs are making real inroads: they leverage their existing customer networks, proprietary data, established reputation, brands, earnings and access to capital markets to provide payment and other

[1] See conference of 17 January 2019: 'Shaping competition policy in the era of digitisation' and as outlined in the FinTech Action Plan: For a more competitive and innovative European financial sector, Commission Communication of 8 March 2018, COM (2018) 109 final.

[2] Due to the absence of a loyal customer base, limited access to information about potential customers, lack of reputation and higher capital cost (higher interest rates).

retail banking services. They focus on less regulated segments, avoiding costs related to banking regulation and compliance.

7. Incumbents indicate that the competitive pressure exercised by entrants is one of the main drivers for adaptation,[3] resulting in particular in higher R&D investments. There is a great variety between banks and Member States regarding this adaptation. While many incumbents offer fast-growing digital services such as mobile banking, some regional initiatives intensify: for example, a recently launched project set up by several Nordic banks aims at establishing a pan-Nordic payment infrastructure for instant payments and other services.

8. Today the predominant type of relationship between incumbent institutions and FinTechs is partnership and collaboration. Incumbents provide FinTechs with funding, banking expertise, brand visibility and a customer base, while FinTechs contribute innovative ideas and familiarity with emerging technologies. However, in addition to these synergies, such co-operation may also be a means to reduce competition pressure.[4]

9. Both FinTechs and incumbents raise competition issues related to digital disruption in financial markets. FinTechs are primarily concerned about effective market access. Incumbents argue they are treated asymmetrically by financial regulation, for example mandating access to incumbents' customer data while not mandating access to BigTech data.

10. As part of its competition policy enforcement in digital markets,[5] the Commission is closely monitoring digital developments in financial services and enforcing EU competition law, where necessary, to promote competition and prevent entry barriers. In this context, the Commission is looking at the role of incumbents, but also of Big Techs as ecosystems and gateways which cannot be easily dislodged and which may have incentives to engage in anti-competitive behaviour, in particular because of extreme returns to scale and network effects.

2. EU financial regulation and competition

11. The Commission is vigilant that markets remain contestable and that a level playing field is maintained, so that consumers will benefit from increased choice and competitively priced services. At the same time, the Commission ensures complementarity between competition policy and regulation.

12. **EU financial legislation** is aiming at removing barriers and ensuring strong consumer protection. Incumbent banks are subject to specific regulatory requirements due to their role in ensuring financial stability. However, that stems from activities performed and does not depend on the individual actor. All companies, which provide financial services such as lending, financial advice, insurance or payments, must comply with the

[3] Together with customer expectations, profitability concerns and regulatory changes: European Banking Authority (EBA) Report on the Impact of FinTech on Incumbent Credit Institution's Business Models, 3 July 2018, p 8.

[4] EBA Report, p 8.

[5] See expert report of 4 April 2019 by Jacques Crémer, Yves-Alexandre de Montjoye, Heike Schweitzer: Competition policy for the digital era.

same laws as incumbents offering those services.[6] The effects of EU financial regulation on competition is also addressed by explicit requirements to ensure effective competition, for example in the Interchange Fee Regulation and the Payments Services Directive.[7]

13. Further supervisory convergence toward technological innovation may enable innovative FinTech solutions to be rapidly rolled out across the EU and benefit from the scale economies of the single market. The European Commission has compared effects of **national regulation** on digital financial markets. In application of the FinTech Action Plan, the European Supervisory Authorities' report[8] sets out a comparative analysis of innovation facilitators and describe best practices for their design and operation. A lack of cooperation between EU financial regulators could impede cross-border expansion of FinTech services. Based on the ESAs' report, the Commission intends to present a report with best practices for innovation facilitators.

14. The Commission is also engaged in **advocacy** regarding FinTech, for example to ensure that standards such as application programming interfaces (APIs) for access to bank account data are compliant with financial regulation (PSD2), data protection and competition rules. The European Commission is monitoring the development of crypto-assets and initial coin offerings and will assess whether EU regulatory action is required. In its 2019 work programme, one of the key objectives of the European Securities and Markets Authority (ESMA) for FinTech is to achieve a coordinated approach to the regulation and supervisory treatment of new or innovative financial activities. EIOPA[9] set up the InsurTech Task Force (ITF) to analyse the use of big data by (re-)insurance undertakings and intermediaries, with a view to establishing efficient supervisory practices.

15. It is important to ensure that financial market **standards** comply with EU competition law. Cooperation between competitors for standardisation purposes is compatible with Article 101 of the Treaty if participation in the standard setting is unrestricted, the procedure for the adoption of the standard is transparent and effective access to the standard is provided on fair, reasonable and non-discriminatory terms.[10] These

[6] Examples for EU financial legislation imposing same requirements on all service providers carrying out certain activities, irrespective of the type of company (actor) concerned, include: **Directive 2000/31/EC on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market (***OJ L 178, 17/07/2000, p. 1-16),* **Directive 2002/65/EC concerning the distance marketing of consumer financial services (***OJ L 271, 09/10/2002, p.16-24),* Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions (OJ L 267, 10.10.2009, p. 7–17) or Directive (EU) 2015/2366 on payment services in the internal market ('PSD2', OJ L 337, 23.12.2015, p. 35–127).

[7] See Art 62(5) and 92(2)(c) PSD2 and recital (13) IFR.

[8] Report of 7 January 2019 by ESMA, EBA and EIOPA, FinTech: Regulatory sandboxes and innovation hubs.

[9] European Insurance and Occupational Pensions Authority

[10] See also Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal co-operation agreements (OJ C 11, 14/01/2011), para 280. Reflected in the FinTech Action Plan, p 7.

principles constitute the basis of the Commission's analysis when assessing standard setting in financial services.[11]

3. EU merger analysis in financial markets

16. Past incumbent acquisitions of Fintechs rarely met the EU merger thresholds or did not raise competition concerns. Examples include MasterCard acquiring VocaLink (assessed in the UK), CVC Capital Group and Blackstone jointly acquiring Paysafe (cleared in case M.8640), and the acquisition of Nets by US investment consortia.

17. The most significant merger case dealt with by the Commission in financial markets was M.7873 Worldline/Equens/Paysquare (2016). Both the acquirer and the target were FinTech companies, although active mostly in the 'traditional' area of payments rather than in the most innovative one. The framework of analysis was not specifically influenced by the nature of the companies or the technical nature of the parties. The regulatory set up was taken into account in particular for the market definition, amongst other factors. The Commission required remedies in two areas: 1) merchant acquiring in Belgium, where absent the merger would have eliminated the competition brought by Paysquare to the dominant incumbent Worldline (horizontal overlap). The remedy was the sale of Paysquare's activities, therefore removing the overlap; 2) merchant acquiring in Germany, where Worldline supplied a must-have platform to merchant acquirers including Paysquare (vertical overlap). An access remedy was required.

18. There are currently no pending merger cases related to banks acquiring newcomers. Recent transactions seem to focus on consolidation in the fast-growing payments industry, such as the 2018 merger Vantiv/Worldpay and mergers announced in 2019 (Fiserv/First Data and FIS/Worldpay).

4. Conclusion

19. Competition enforcers need to continue monitoring the activities of the main actors in financial services - incumbents, Fintechs and BigTechs - to ensure competition on the merits, in particular where competitive pressure is rising due to the concurrent entry of start-ups and BigTechs and where platform effects have to be considered. Where competition issues are identified, it is important to ensure that they are addressed in a timely manner to prevent lasting harm in fast-moving digital markets. This is also the case where competition enforcement is required to complement financial regulation. In addition, competition advocacy has an important role to play in making sure that legislation is designed and implemented in a pro-competitive way. This will allow European consumers to reap the full benefit from effective competition in financial markets in the form of lower prices, better quality and more choice and innovation.

[11] In antitrust case AT.39876 EPC, the Commission raised concerns that standardisation for e-payments carried out by the European Payments Council (EPC) could exclude new entrants and the standardisation initiative was withdrawn.