FinTech Regulatory Challenges

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BANCO DE MÉXICO

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1 Introduction

The application of new technology and its application in novel ways on the provision of financial services is increasing extraordinarily. Innovation grows exponentially, and so do the possibilities of bringing benefits to users. There are many factors contributing to this innovation. Some of them, for example, are:

From the demand side:

- Higher customer expectations with regard to convenience (speed, anytime 24/7 and anywhere).
- Lower costs.
- User-friendliness.

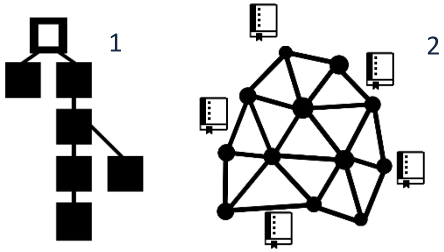
From the supply side:

- Advances in technology related to Internet, big data, mobile technology, and computing power.
- Withdrawal of traditional financial firms, opening the market for new entrants.
- Changes in regulatory and supervisory requirements.
- Cost cutting through new products such as distributed ledger.

1 Introduction

Financial innovation is not only being developed on new infrastructure. Technological advances offer the possibility of innovating on existing financial infrastructure.

- Innovation
  - Existing financial infrastructure
    - Cards
    - Wire transfers and others
  - New infrastructure
    - *Blockchain & distributed ledger*
    - Others ?



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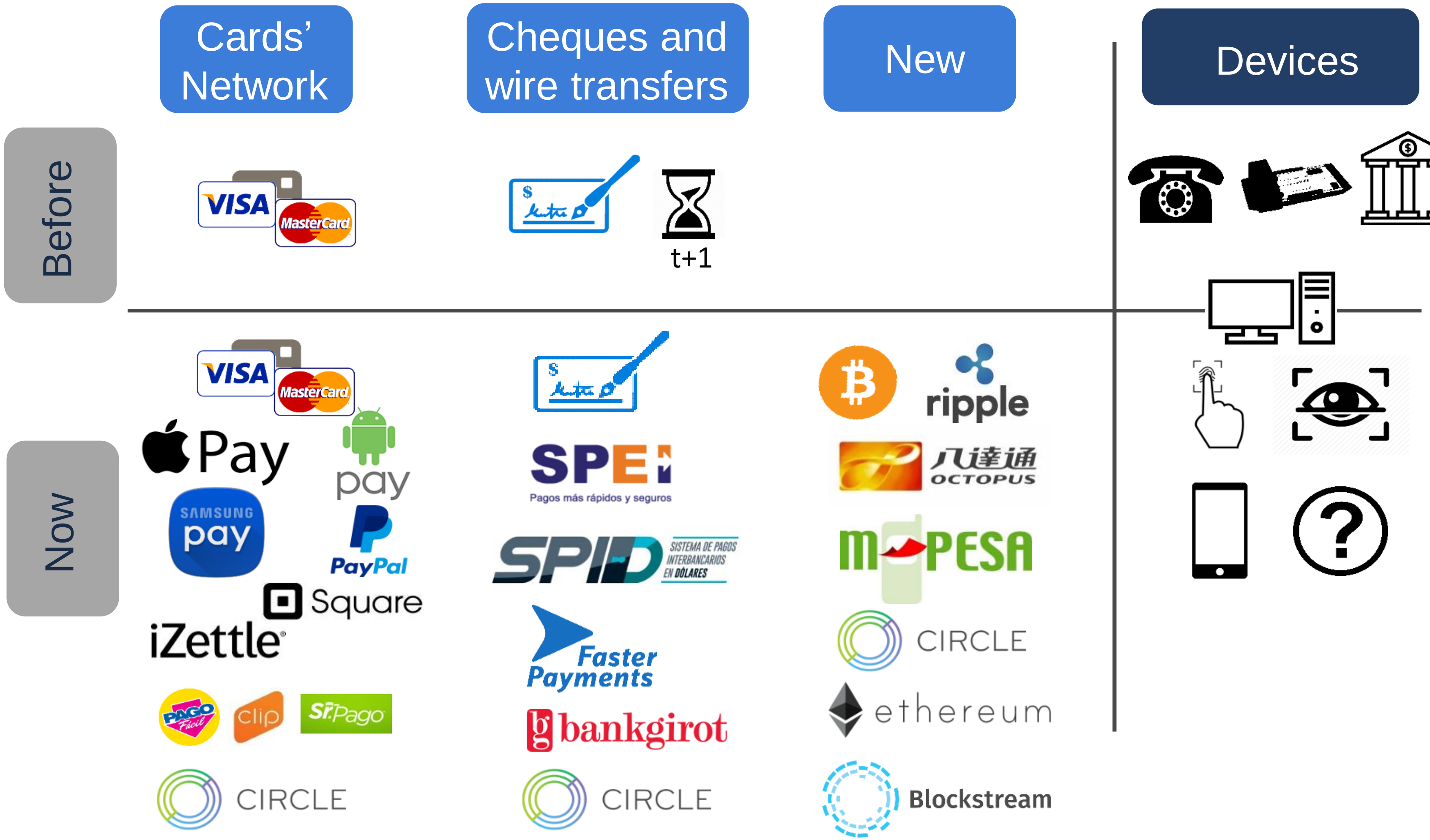
2: a partir de Nick Bluth y Brennan Novak

1 Introduction

Which is changing the landscape of financial services.



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1 Introduction

Financial innovation in any product or service, allows:

- **Fixed costs reduction**: which translates into lower entry barriers, a greater number of businesses offering payment services as well as lower prices for end users.
- **Border expansion**: which allows the entry of new or better payment services and better user experience (for example, paying easily and safely), the entry of new participants that in turn leads to greater competition and diversity of participants.

From the above, other benefits are derived such as:

- Greater **financial inclusion**.
- Creation of new services that allow existing clients to expand their use.

2 Regulatory challenges

FinTech firms have broken down the process of delivering financial services into stages and have incorporated new technologies in the provision of their services. Difficulty encountered in classifying FinTech firms into existent regulatory framework systems from the fact that these high specialized firms participate just in few stages in the process.

Therefore, **it is important to have a regulatory approach that does not hinder innovation while leave no risks unchecked**. A way to achieve this goal is by designing **regulation focused on services and activities rather than institutions**. It is important to preserve the following principles when setting the rules:

- Financial inclusion
- Financial Stability
- Financial integrity
- Consumer protection
- Competition

2 Regulatory challenges

Regulation should not leave space for regulatory arbitrage, but **authorities should balance the rules in such a way that a tighter regulation does not hinder innovation**. Particularly, authorities should seek a balance between:

- Risk and Innovation
- Economies of scale and Competition
- Standardization and Diversity
- Efficiency and Safety
- Privacy and Security

Considering this balances, authorities should create consumer protection policies, establish a set of rules that mitigate risks related to money laundering and financing of terrorism and risks that could undermine financial stability such as credit and liquidity risk.

3 FinTech regulation in Mexico

Mexican financial authorities have analyzed services provided by FinTech businesses within the country and abroad, focusing on identifying the potential benefits and risks that these new technologies and intermediation practices may pose for users and the financial system.

Authorities identified several types of services that require regulation

- **Crowdfunding and P2P lending**
- **Electronic money services**
- **Virtual assets**
- **Application programming interfaces (APIs)**

In addition, Mexican financial authorities have been analyzing other regulatory tools such as **Regulatory Sandbox to allow the implementation of new technologies** in the provision of regulated financial services.

To achieve an harmonized and comprehensive approach to the supervision and regulation of innovative services, authorities have worked in a new **Bill for Financial Technology Institutions**.

3 FinTech regulation in Mexico

The Bill is intended to **regulate according to the risks associated to each FinTech activity**, in particular when they perform activities authorized only for existing financial entities.

This approach allows for the entrance of new participants that only need comply to **requirements proportional to the risks they pose** and **levels the playing field** for all participants providing these services while reducing the regulatory burden.

In this regard, the Bill for Financial Technology addresses this need with the following main objectives:

- **Provide legal certainty** to the participating businesses in this market;
- **Establish the necessary risk mitigation standards** to cope with the risks derived from the activities of these companies, maintaining a regulatory equivalence between new participants and traditional financial institutions;
- **Establish the necessary conditions for the development of a competitive environment** in the provision of financial services and payments; and
- **Provide transparency in the provision of these services**, as well as establish protection measures for users.

3 FinTech regulation in Mexico

Crowdfunding institutions

The purpose of these institutions is to channel small amounts of money contributed by a large number of people in order to directly fund projects, businesses, personal loans and other needs of the public through internet platforms.

Three types of project financing are considered:

- **Debt**, for example, credits or financing causing a liability to the applicants;
- **Capital**, in which investors acquire securities representing the capital stock of moral persons acting as applicants; and
- **Co-ownership or royalties**, in which the investors acquire a share in a present or future good or in the income, profits or losses derived from an activity or project of an applicant.

These activities will be exempt from legal prohibitions to carry deposit taking activities and public securities offerings.

3 FinTech regulation in Mexico

Crowdfunding institutions

Regarding crowdfunding institutions, the Bill seeks to mitigate operational risks, AML/CFT risks and risks for the investor. Different requirements were established, such as:

- **Obligation to inform investors of the selection criteria and risks of the projects**, as well as the obligation to obtain a statement from their clients in which they declare that they know the risks they incur in;
- Ensure the participation to all types of investors and applicants, who will be subject to **financing limits**;
- **Prohibition to guarantee returns** to investors;
- **Segregation of funds** from clients and those of the crowdfunding institution;
- Obligation to have **operational risk controls and cyber security policies**;
- Reception of resources only through electronic transfers of funds. Operations with cash will require prior authorization;
- **Standards to prevent money laundering and financing of terrorism**;
- Prohibition to the shareholders of the crowdfunding institution and people related to them to obtain financing through said institutions.

3 FinTech regulation in Mexico

<u>Electronic payment funds institutions (electronic money services)</u>

These institutions issue electronic payment funds (**e-money**) that the Bill defines as those funds referred to a certain amount of **national currency**, or with the prior authorization of Banco de México, **in foreign currency, or a certain number of virtual assets** authorized by Banco de México.

Electronic payment funds institutions may also:

- Issue, sell and manage electronic payment funds instruments.
- Provide money transfer services (remittances).
- Perform operations with virtual assets, as well as buy, sell or, in general, transfer virtual assets on their own behalf or their clients' and intermediate between third parties in order to facilitate the purchase, sale or any other transmission of virtual assets.

3 FinTech regulation in Mexico

Electronic payment funds institutions (electronic money services)

Regarding electronic payment funds institutions, the Bill seeks to mitigate the risks derived from their activities by establishing **certain requirements among which stand out**:

- Obligation for electronic payment funds institutions to **be at all times in the possibility to return to their clients the amount of the funds registered in their electronic payment funds accounts**;
- **Prohibition to pay interests related to the balances that the clients maintain** as electronic payment funds;
- **Segregation of funds** from clients and those of the electronic payment funds institution;
- Requirement to **maintain clients' funds in bank deposits, trust funds or highly liquid instruments;**
- They must have operational **risk controls and cyber security policies**;
- Limits for receiving cash, prior authorization.

3 FinTech regulation in Mexico

Virtual Assets

The Bill refers to *virtual asset* as the representation of value registered electronically and generally used as a means of payment for the acquisition or use of goods or services and whose transfer can only be carried out through electronic means.

The **financial technology institutions** (crowdfunding and electronic payment funds institutions) **and credit institutions may carry out transactions with virtual assets** under the conditions and restrictions established by Banco de México. It is important to mention that **these institutions can only operate with those virtual assets that Banco de México establishes** as such in secondary regulation**, prior authorization** of the Central Bank.

Among the obligations of the financial technology institutions and credit institutions regarding the use of virtual assets, are:

- Must **be able to deliver the virtual assets to their clients or their equivalent amount in national currency** at all times;
- **Prohibition to sell, transfer, or compromise the virtual assets** that institutions maintain on behalf of their clients;
- Obligation to return the money that the institution receives for the purchase of virtual assets in the event that the operations are not carried out within a certain period; and
- **Disclose all the risks** related to the operation with these assets.

3 FinTech regulation in Mexico

Application programming interfaces

Financial technology institutions, financial institutions, money transmitters and clearing houses will be required to establish standardized computerized application programming interfaces (APIs) to enable connectivity and access to other interfaces developed or managed by other institutions or third parties in order to share the following data:

- **Open data**, non-confidential information about the products and services offered to the general public;
- **Aggregate data**, including aggregated statistical information on the operations institutions carry out; and
- **Transactional data**, such as the transactional information of the institutions' clients, with their prior authorization.

Financial authorities will establish the authentication mechanisms that institutions have to comply with to access the APIs.

Likewise, to guarantee the functioning of the APIs, authorities will establish minimum required standards for connectivity and interoperability.

3 FinTech regulation in Mexico

Regulatory Sandbox

The Bill contemplates **temporary authorizations** of no more than two years to businesses other than financial institutions and financial technology institutions, and no longer than one year **to financial institutions and financial technology institutions that intend to carry out any financial regulated activity through innovative models for which authorization is required**.

Businesses other than financial institutions and financial technology institutions to which a temporary authorization is approved, must carry out the necessary actions to obtain the definitive authorization during the time of said temporary authorization.

Any temporary authorized institution or business, will have certain limits for risk mitigation such as:

- Maximum number of clients;
- Maximum amount they can receive from each client; and
- Maximum amount they can receive during the temporary authorization.

4 Conclusion

Recently, **new ways of providing financial and payment services have emerged**, and **sometimes these are beyond the scope of current regulation**.

For this reason, it is **important to establish a legal framework that considers the adoption of technological innovations in the provision of these services** and **mitigates the risks associated** with the activities carried out by new participants in the financial services market.

The **Financial Technology Institutions Bill addresses this need, since it provides legal certainty to financial technology institutions and their users**, maintaining a regulatory equivalence with traditional financial institutions.

In this way, the Bill **establishes the necessary conditions for the development of a competitive environment** for the provision of financial services, favoring transparency and protection for the users of these services.

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