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Financial Regulation

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This technical note has been developed in order to provide IESE Fintech students with an overview of some of the main financial regulations with which the FinTech companies and the Banking Industry are obligated to comply. The present document is not a comprehensive study of all the laws and rules of the financial regulatory framework.

An effective financial system is key for the global economy and the development of any country. Financial regulation is needed in order to ensure the good functioning of the financial system, to build trust in the banking sector all over the world, and to protect customers, ensuring the bank's resilience.

> Financial regulation refers to the rules and laws that must be followed by firms operating in the financial industry, such as banks, credit unions, insurance companies, financial brokers and asset managers. However financial regulation is more than just having rules in place – it's also about the ongoing oversight and enforcement of these rules[1].

European Regulation

Introduction: Single Supervisory Mechanism

The Single Supervisory Mechanism (SSM) is the banking supervision system in Europe. The European Central Bank (ECB) and the national competent authorities (NCAs) of the member states make up the SSM. All euro countries automatically participate in the SSM. Other EU countries that do not use the euro as their currency can choose to participate.

[1] "Explainer - What is financial regulation and why does it matter", Central bank or Ireland, 29 May 2019 https://www.centralbank.ie/consumer-hub/explainers/what-is-financial-regulation-and-why-does-it-matter

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The goals of the SSM include ensuring the safety of the European banking system; increasing financial stability; and ensuring homogenous supervision among member states. The ECB directly supervises the day-to-day activities of the larger European Banks while the NCAs are responsible for monitoring the remaining institutions.

While the SSM is responsible for supervising individual financial institutions, the European Banking Authority (EBA) supervises the performance of internal markets by ensuring correct, efficient and homogenous European supervision and regulation among its members.

To perform these tasks, the EBA creates regulatory and non-regulatory documents including binding technical standards, guidelines, recommendations, opinions and ad-hoc or regular updates that banks and financial institutions should follow.

Basel I, II and III

The International Bank of Payments (BIS) is an international institution whose objective is to promote global monetary and financial stability through international cooperation between Central Banks, and to serve as a bank for central banks.[2]

The BIS is divided into different working committees, among which the Basel Committee on Banking Supervision (BCBS) is responsible for establishing the global standard for banking regulation. Its mission is to strengthen the supervision and regulation of financial institutions all over the world in order to promote global financial stability. In addition to this, it encourages cooperation on banking supervisory matters.

Over past years, there have been three global regulatory agreements:

- Basel I: This agreement was established in 1988. It established common rules, measures, and definitions for credit risk and risk-weighted assets in order to determine each bank's capital requirement and improve banks' solvency. Banks were also required to report their off-balance-sheet items.
- Basel II: This second wave of regulations was approved in 2004. These regulations aimed to commensurate the risk a bank is exposed to with the number of capital requirements the bank needs to hold. It incentivizes the use of internal models to avoid capital discrimination between rating levels and unregulated liquidity. The Basel II agreement has three pillars:
  - *Pillar I: Minimum capital requirements:* capital requirements for each bank are calculated based on three different types of risk: credit risk, operational risk, and market risk. Each credit type is measured according to different methodologies and regulatory criteria.
  - *Pillar II: Supervisor review process:* Pillar II takes into consideration risks not included in Pillar I, such as liquidity risk, management criteria, concentration risk (and the corresponding risks of diversification), reputational risk, etc.
  - *Pillar III: Market discipline:* Pillar III's main objective is to increase transparency in the market and increase the available information to understand the bank's risk profile.

[2] "About BIS - overview" *BIS*, 29 May 2019, https://www.bis.org/about/index.htm?m=1%7C1

- **Basel III:** This agreement was established in 2010 in response to the 2008 global financial crisis. Its objectives are to strengthen bank capital requirements by increasing liquidity requirements and decreasing banks' leverage levels.

General Data Protection Regulation (GDPR)

Over the last few years, different scandals, such as Facebook[3] using its customers' data without customer approval, has led to regulatory and social concerns about personal/ individual data protection. Technological developments and globalization have brought new challenges for personal data management and protection.

For this reason, in April 2016 the European Parliament and Council approved regulation to create a stronger and more coherent data protection framework for the entire European area. Thus, natural persons have control of their own personal data. General Data Protection Regulation (GDPR) entered into force on 25 May 2018. GDPR applies to any organization operating within the EU, as well as any organizations offering services in the EU.

Some of its key aspects of this new regulation include:

- An increase in customer rights: right of information, right of access, right of rectification, right to be forgotten, right to data portability, right to object…
- Several obligations regarding the processing of personal data. Companies should ensure security, personal data security, impact assessment….
- An increase in the supervision of compliance with the regulatory framework, including fines in cases where the framework is not implemented.
- Principles of data processing: The controller shall ensure that personal data is:
    - Processed fairly and in a transparent manner.
    - Collected for specified, explicit and legitimate purposes.
    - Adequate, relevant and limited to the purposes for which they are processed.
    - Accurate and updated.
    - Provided appropriate security.

MiFID I and MiFID II

MiFID stands for the "Markets in Financial Instruments Directive" of the European Union. This regulation aims to homogenize the European regulation of investment services. MiFID's primary objective is to create a common European regulatory framework that protects investors and increases transparency. As stated by ESMA (the European Security and Market Authority) "This new legislative framework will strengthen investor protection and improve the functioning of financial markets, making them more efficient, resilient and transparent."[4]

[3] "Facebook's data-sharing deals exposed", BBC News, 19 December 2018, https://www.bbc.com/news/technology-46618582

[4] "MiFID II" European Security and Market Authority ESMA, 29 May 2019, https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir