FINANCIAL INTEGRATION OF THE NEW MEMBER STATES – CASE STUDY OF EU'S REGULATORY INITIATIVE ON FINANCIAL TECHNOLOGIES

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Abstract: *New technologies are changing at a very fast course and reshaping the financial system significantly. FinTech is a relatively new term used for technology enabled innovation in the area of financial services and includes variety of products, applications, models and processes. FinTech provides new opportunities both for private sector and its consumers, increasing efficiency and integration of financial systems across Europe and worldwide.*

The above-mentioned trends have motivated the European Commission to initiate actions in order to promote technology enabled innovation in the area of financial services. The goal is to empower all market players in promoting new technologies such as blockchain and artificial intelligence while controlling risks and protecting consumers.

Based on the analysis of secondary data, this paper aims, first, to discuss the effects these measures will have on the financial markets across Europe, especially with regard to better regulation. Secondly, the objective is to research financial integration for the New Member States' financial markets with regard to new technologies and the access they provide for financial services and consequently efficiency improvement of the financial system.

Keywords: *Financial technologies, FinTech, Capital markets union, financial integration, New Member States*

1. INTRODUCTION

Current trends on the financial markets could be summarized as follows: financial products and services are based on information. Today, many financial transactions can be performed without physical interactions. IT costs and investments are uppermost in financial sector companies. FinTech companies are fundamentally changing financial systems and redefining ways in which financial services are being performed. Digitalization has changed consumer behaviour from physical interaction to online self-services, which has reduced significantly number of bank branches. Traditional financial institutions are outsourcing data processing and storage to cloud service providers, changing financial ecosystem. Regulatory authorities are engaging in new collaborative approaches towards FinTech companies to facilitate innovations (Gabor and Brooks, 2017; Arner, Barberis, Buckley, 2016; Puschmann, 2017). From 2010 to 2016, there has been more than $50 billion invested in almost 2,500 companies worldwide (Accenture, 2016). Just the UK's FinTech sector generates approximately £20 billion in revenues annually (Financial Conduct Authority, 2015, p.5).

FinTech is a term used to address technological innovations in financial sector. According to Schueffel (2106), there is still no consensus what the term Fintech means. His analysis of definitions in scientific literature resulted in a broad definition of the term FinTech as: "a new financial

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industry that applies technology to improve financial activities" (Ibid., p. 15). The European Commission uses the definition of the Financial Stability Board (2019) which defines FinTech as "a technologically enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services".

For decades now, there has been many different technological innovations with regard to financial services, for example automation in banking via automated teller machine (ATM), online banking and brokerage, etc. (Arner, Barberis, Buckley, 2016, p. 1274-1283). However, over the last decade, FinTech businesses have offered disruptive innovations, which are dramatically changing, and reorganizing the financial system, its institutions and the ways in which business is conducted. Puschmann (2017, p. 70-71) classifies phases of changes over the last decade as: (i) internal digitalization, in which the focus was on internal processes (e.g. payment transactions, portfolio management), (ii) provider-oriented digitalization, which provided outsourcing of business processes, and (iii) customer-oriented digitalization, which brought new channels of lending, such as peer-to-peer business models.

FinTech is making a revolution in the financial systems, democratizing financial services and becoming more consumer oriented. At the same time, it poses certain challenges, i.e. cyber and data related risks, which could have a far-reaching effect on consumers, investors and markets. The European Commission is keen to support FinTech operations across the EU, to provide scaling for FinTech companies, facilitate cross border investments and improve financial integration across European financial markets.

The purpose of this paper is to discuss the effects European Commission's measures could have on the financial markets across Europe, with special emphasis on regulatory issues and the New Member States, i.e. their financial markets with regard to new technologies and the access they provide for financial services and consequently efficiency and integration of financial systems. Following short introduction, the paper provides an overview of the Capital Markets Union and the FinTech Action Plan while the third part discusses new ways for governing FinTech. The fourth part examines potentials that FinTech innovations could have for New Member States' financial markets. Chapter five summarizes the main conclusions.

2. EU POLICIES FOR FINANCIAL SERVICES: THE CAPITAL MARKETS UNION AND THE FINTECH ACTION PLAN

The Capital Markets Union (CMU) was a term constructed by the President of the European Commission Jean-Claude Juncker as a plan for his presidency from 2014 to 2019 with a goal to boost investments and economic growth and create new jobs. His agenda included ten policy areas, one of them being a policy for deeper and fairer internal market with a strengthened industrial base. The attention was again on more integration in the area of the internal market. "Over time, I believe we should complement the new European rules for banks with a Capital Markets Union. To improve the financing of our economy, we should further develop and integrate capital markets. This would cut the cost of raising capital, notably for SMEs, and help reduce our very high dependence on bank funding. This would also increase the attractiveness of Europe as a place to invest" (Juncker, 2014, p. 8).

Free movement of capital is a cornerstone of the European single market and therefore has been a key priority for decades. Single market stands for significant market size and is very relevant factor for European competitiveness position with regard to other advanced economies of the world such as the USA for example. Integrated financial markets across Europe can create many benefits for all market participants: consumers, investors and companies by reducing the cost of raising capital and consequently increasing its allocation efficiency.

FinTech falls within a number of complementary regulatory and/or policy initiatives, namely, financial services and digital single market, i.e. Commission's Digital Single Market Strategy, EU's cybersecurity strategy, eIDAS Regulation, Consumers Financial Services Action Plan and the Capital Markets Union (European Commission, 2018, p. 2). FinTech was included in the Capital Markets Union's policy framework in 2017 Mid-Term Review, affirming its potentials in the capital markets areas such as: equity issuance, corporate governance, asset management, investment intermediation, product distribution, securities custody services, etc. (European Commission, 2017, p. 12-13).

Both the European Parliament and the European Council have stressed that a support to FinTech initiatives is a priority. "To successfully build a Digital Europe, the EU needs in particular … a sense of urgency to address emerging trends: this includes issues such as artificial intelligence and blockchain technologies, while at the same time ensuring a high level of data protection, digital rights and ethical standards… put forward the necessary initiatives for strengthening the framework conditions with a view to enable the EU to explore new markets through risk-based radical innovations and to reaffirm the leading role of its industry" (European Council, 2017, p.5). The European Parliament's Report on a Fintech (2017, p.21): "Urges the Commission, nonetheless, to shape its legislative measures in a manner leaving sufficient flexibility for firms to operate and arrange finance, as well as stimulating partnerships between banks and FinTech companies in the area of lending" and "calls on the Commission to identify and remove existing barriers in the single market that are currently preventing the advancement of digital services …". Finally, the European Commission (2018, p. 4-5), taking into consideration recommendations from the abovementioned institutions, along with conducted public consultation, has also concluded that there is no need at this stage for any kind of broad regulatory action, but instead the focus should be on actions and initiatives that enhance innovation in financial services.

The FinTech Action Plan proposed further actions for clear and consistent licensing requirements for FinTech firms. In particular, developing European passporting regime for firms within the European crowdfunding service providers (ECSP), many financial institutions that fall under the supervision of the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Central Bank (ECB) will remain under stricter rules due to financial stability issues. European Supervisory Markets Authority (ESMA) and the Commission will for time being monitor the developments in the areas of crypto-assets and Initial Coin Offering (ICO) and respond with regulatory actions if needed (ibid., p. 5-7). Attention is put on achieving common standards and interoperability between market players.

Another rather reformative way of looking at the role of regulator and/or supervisor has been put forward by disruptive character of innovative technologies. Number of national supervisory authorities have taken a brand new and modern approach to regulating innovative firms. They have established innovation facilitators: innovation hubs and/or regulatory sandboxes to provide more flexible and collaborative approach to innovative business models (further discussed in chapter 3.1). The Commission, along with European supervisory authorities (ESAs), confirms and supports the initiative (ibid., p. 8-9).

The FinTech Action Plan supports EU public blockchain initiative as well as removing obstacles for outsourcing to cloud services and using electronic identification and authentication cross-borders, taking into consideration anti-money laundering and data protection rules. Additionally, the Commission has set up an EU FinTech Lab for building national regulatory and supervisory competences and exchange of ideas about new technologies and proposed actions for developing comparable information platforms for European consumers of financial services. Finally, cybersecurity remains top priority for EU policy actions (ibid, p. 10-17).

Concluding, the EU has a goal to integrate European capital markets and promote mobility, cross border transactions and investments. Through different policy measures of the Capital Markets Union strategy the Commission continuously promotes more interconnected and interoperable capital markets to achieve economy of scale for European financial markets. It is an unceasing process to strike the right balance between integration and security in the EU, i.e. measures that have a goal to remove borders and obstacles to free movement of capital and financial services while preventing money laundering and terrorism financing.

3. GOVERNING THE FINTECH: REGULATION OR COLLABORATION?

The general purpose of the financial market regulation and supervision is to maintain stability, preserve integrity and secure fair play on the market while ensuring protection of the customers and investors. Times are changing; new and different types of businesses are entering the financial arena that used to be reserved for the big financial institutions, which operated under strict and traditional set of rules preventing incidents such as fraud, moral hazard and financial crisis.

There is an open question whether FinTech is operational issues, i.e. how to integrate new technologies to make financial services more efficient, or, do we need to take into account the legal issues. Some claim that FinTech uses different business models then financial institutions such as banks. They find that FinTech are spreading the risk to consumers, while the banks are accumulating the risks within their own institutions (Bromberg, Godwin, Ramsay, 2017). According to this group, regulation should be focused on the financial institutions rather than on FinTech companies.

The Governor of the Bank of England, Mr. Mark Carney stated in his address regarding FinTech: "Our starting point is that there is nothing new under the sun. We need to be disciplined about consistent approaches to similar activities undertaken by different institutions that give rise to the same financial stability risks. Just because something is new does not necessarily mean it should be treated differently. Similarly, just because it is outside the regulatory perimeter doesn't necessarily mean it needs to be brought inside" (Carney, Bank of England, 2017, p. 8).

Currently, regulatory framework is rather unclear with regard to FinTech, e.g. if a certain firm needs to apply for a license or not. This is primarily because FinTech stands for many different types of businesses that deal with variety of issues. They also differ greatly in the terms of size and significance for the market. Some authors propose flexible and alternative ways to regulate FinTechs such as "lean regulation", "algorithmic regulation", open source platforms, international standard bodies (see Brummer, Gorfine, 2014 and Treleaven, 2015). However, some authors warn about risks that Fintech present because they are less transparent to national authorities, more decentralized and therefor more susceptible to economic shocks (e.g. Magnuson, 2018).

It can be beneficial for both Fintech businesses and its consumers to have harmonized settings across European financial markets. It provides certainty and opportunities for both sides to engage in cross border transactions and scale-up across the EU. FinTech often have very high basic (fixed) costs of software and then much lower variable cots so they benefit greatly from the economy of scale, consequently providing better financial services at a lower cost for its customers. For this to happen markets should not be fragmented economically or legally.

Governing FinTech requires therefore a tailor-made approach. European and national financial regulatory and supervisory authorities agreed that FinTech businesses require supportive measures, primarily fast information and focused dialogue as early as possible in the innovation process, open interaction, willingness of authorities to understand their operations and help FinTech businesses figure out where and how they fit into the regulatory system. They have therefore started with an innovative way of governing through collaboration with the FinTech businesses using innovation hubs and regulatory sandboxes (European Commission, 2017a).

In recent years, the number of innovation facilitators has been growing. According to the latest ESAs Report, 21 EU Member States have established innovation hubs, while mostly Central and Eastern European countries have not yet established hubs, namely: Bulgaria, Czech Republic, Slovakia, Slovenia, Croatia, Malta and Greece. Innovation hubs are more of an "information desk", providing regulatory and supervisory guidance and licensing requirements support. So far, only 5 EU Member States have regulatory sandboxes: the UK, Denmark, Lithuania, Netherlands and Poland, and few more under way of establishing. Regulatory sandboxes (further discussed in chapter 3.1) are projects aiming to help testing new models in "regulatory laboratory" environment (European Supervisory Authorities, 2019, p. 7, 40-41).

Innovation hubs are generally open to all firms, which intend to adopt innovative products, services or business models on the financial market. National supervisory authorities provide experts - numbers of them vary from one to nine per national authority, while Italy and the UK reported over 30 experts dedicated exclusively to innovation hubs. They practice different forms of communication: e-mails, telephone calls or meetings. Some authorities publish their "preliminary guidance" in a form of Q&A. Several national supervisory authorities cooperate among each other, sharing the information and experiences. Enquiry volumes range from dozens to hundreds a month. Usually, enquiries are concerning: (i) authorization requirements, (ii) applicability of consumer protection regulation, (iii) regulatory and supervisory requirements and (iv) anti-money laundering issues (Ibid., p. 5-15).

4. REGULATORY SANDBOXES

The term sandbox has been taken from the children's playgrounds into digital world where it stands for testing playfield for new business models. Similarly, in Fintech it stands for developing modern and flexible regulatory frameworks for new innovative business models. Sandbox is therefore a mechanism for developing financial regulation that keeps pace with most advanced innovations. It has an ambitious task to facilitate modernization in financial services and enhance consumer protection at the same time. Beside the EU, several supervisory authorities (e.g. in Australia, Hong Kong, Singapore and Canada) have developed regulatory sandboxes (UNSGSA FinTech Working Group and CCAF, 2019; European Commission, 2018, p. 4).

British Financial Conduct Authority (FCA) is considered one of the most innovative regulators with regard to FinTech. The FCA initiated "Project Innovate" in 2014 (Financial Conduct Authority, 2019). In co-operation with the private sector, they have created regulatory sandboxes as "a 'safe space' in which businesses can test innovative products, services, business models and delivery mechanisms without immediately incurring all the normal regulatory consequences of engaging in the activity in question" (Financial Conduct Authority, 2015, p. 2, 11). Operationally, the firm in question is assigned with the CFA's case officer who provides technical assistance to the firm with regard to regulatory standards and provides guidance how this new business model could operate within existing legal framework (Financial Conduct Authority, 2017, p. 4).

There are quite a few operational challenges for innovation facilitators. National authorities have human resource difficulties in finding and keeping FinTech experts, FinTech often requires multidisciplinary approach of other national authorities (e.g. data protection) and cross-border cooperation between national authorities in the FinTech area has operational difficulties. This all could complicate FinTech projects to be accepted under one national jurisdiction and contested at another, which is damaging for the Internal Market prospects and cross-border transactions and financial integration in the EU. Therefore, it could be expected to have EU network of innovation facilitators in the future (European Supervisory Authorities, 2019, p. 34-35, 38).

Concluding, regulatory sandboxes represent fresh point of view on relationship between regulator and regulated party. It is a valuable learning platform for both institutions, for firms to understand regulatory and supervisory expectations and eliminate regulatory uncertainty and for supervisory authorities to learn more about innovations in financial services, their opportunities and risks ensuring that the best quality of products and services reaches consumers in a timely and secure manner.

5. FINTECH INNOVATIONS AND IMPLICATIONS FOR NEW MEMBER STATES

Emerging markets can progress rapidly because of FinTech innovations. For example, e-commerce platforms in China employ algorithms to analyze transaction and search data to improve credit scoring, which resulted in increase of available credits with low default rates (Carney, Bank of England, 2017, p.6). In Africa (most successfully Kenya and Tanzania), Fintech innovation of mobile money (M-Pesa) has bridged a gap from underdeveloped financial system to a system in which telecommunication companies pioneered an arrangement that provides efficient and secure payment and saving services through creation of e-money recorded on a mobile phone (Arner, Barberis and Buckley, 2016, p. 1295-1297).

In the UK, peer-to-peer lending has increased significantly, improving capital availability for the SMEs for which research shows that up to 50% would not be granted in a normal procedure through bank lending (Carney, Bank of England, 2017, p.6). This trend caused by FinTech is especially relevant to New Member States and their financial markets because they belong to bank-based systems (Demirgüç-Kunt, Levine, 1999). It means that banks are dominant financial institutions on the Continental Europe's financial markets, especially in the New Member States; therefore, companies' main source of capital comes from bank loans. Commission's ambitions from the end of 1990s with the Financial Services Action Plan (European Commission, 1999) was to empower capital markets in order to attain more options for capital raising opportunities, especially to SMEs due to their dynamic and innovative contribution to growth. In the case of New Member States, the growth potentials for capital markets are even higher due to their current underdevelopment status. New Member States count for 20% of Europe's population, 8% of GDP but only 3% of its capital markets (European Covered Bond Council, 2018, p. 85).

Chart 1 shows that in the EU, total volume of the FinTech market was above € 1 billion, excluding the UK (Demertzis, Merler, and Wolff, 2018). The UK's FinTech companies account for about 50% of Europe's FinTech. They generate about £ 20 billion in revenue annually, with total market of £ 3,6 billion in disruptive FinTech (Financial Conduct Authority, 2015, p.5). After the UK, within Europe the most active Fintech markets are in France, Germany and Netherlands. As seen on Chart 1, Central and Eastern European (CEE) countries have a very low volume, however trend is very positive because it shows more than 270% of increase in volume.

Empirical studies concerning Fintech have multiplied during last years, however only few studies have been made for the New Member States or Baltic and CEE countries (Deloitte, 2016; Stern, 2017; Kerényi, 2018; Demertzis, Merler, and Wolff, 2018). Most of new financial technologies have not yet reached its full potential in the New Member States. They operate mostly within area of financial services, where they co-operate with banks. Banks are also involved in financial innovations (e.g. mobile payment system in Croatia). Innovation in insurance sector is still underdeveloped in comparison to banking sector. Similar view holds for the asset management sector as well. Electronic payments are used mostly in: Estonia, the Czech Republic, Latvia and Slovenia, while e-money is not used very widely. With regard to financing, in new Member States peer-to-peer lending is generally more popular than crowdfunding, especially in: the Czech Republic, Estonia, Lithuania and Poland. These countries (except Poland) have introduced regulation for peer-to-peer platforms. Generally, all New Member States consider cybersecurity a priority (Ibid).

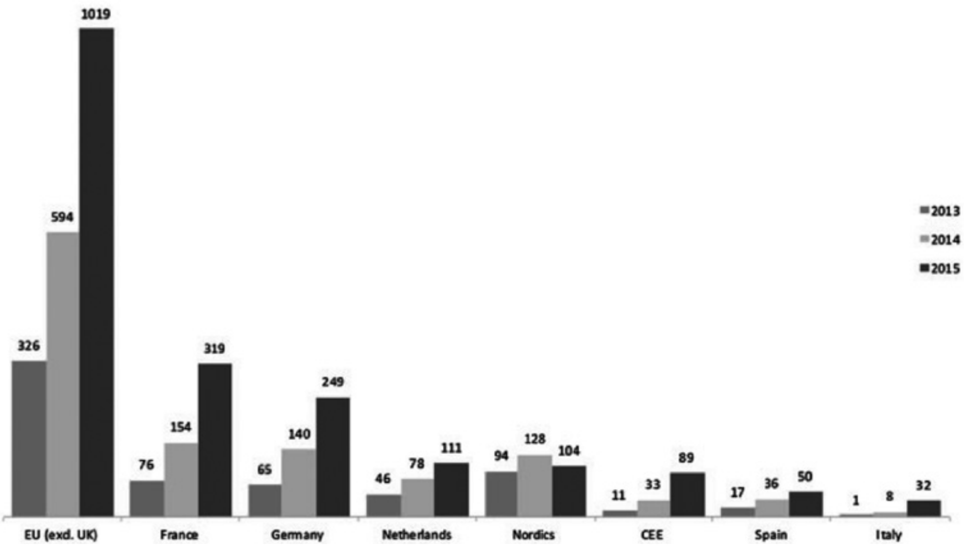

Chart 1. FinTech market volumes in Europe 2013-2015, in millions of EUR
Source: Demertzis, M., Merler, S., Wolff, G. (2018) Capital Markets Union and the FinTech Opportunity, Journal of Financial Regulation, Vol. 4, issue 1, p. 161.

As already mentioned in previous chapters, national regulatory authorities have initiated innovative approach to their regulatory activities with regard to FinTech. They want to fully support their innovative dimension, which leads to economic growth and development, and many of them across the EU have established innovation facilitators in a form of innovation hub or regulatory sandboxes. Unfortunately, level of development of FinTech industry correlates with the level of support from the national regulatory authorities in the new Member States. Innovation hub are running in: Estonia, Hungary, Lithuania, Latvia, Poland and Romania, while regulatory sandboxes are operating only in Poland and Lithuania, with Hungary planning to start one (European Supervisory Authorities, 2019, p. 40-41). Present experiences show that both parties have great use of innovation hubs and sandboxes. Therefore, innovation facilitators represent valuable value added to better growth and development of the FinTech industries in New Member States.

6. CONCLUSION

FinTech companies are fundamentally reshaping the whole financial system. Digitalization has changed the way financial services are organized, i.e. fewer physical interactions, more online activities and outsourcing data processing. The “old” financial institutions such as banks still have advantages of solid customer network, stability, regulatory expertise and capital for innovation spending. New FinTech companies are more flexible and can be very disruptive. Market research shows that old and new financial institutions operate as competitors but also as partners in innovative projects.

The EU is committed to promote Fintech for economic growth and development, taking into consideration consumer and data protection, as well as cybersecurity issues. The goal is to enable FinTech companies to scale-up across the EU, facilitate cross border investments and indorse financial integration of European financial markets. European Commission’s FinTech Action Plan is therefore focused on supportive measures rather than regulatory actions. Even regulators’ approach towards FinTech can be characterized as innovative. National regulatory authorities have established innovative facilitators, i.e. innovation hubs and regulatory sandboxes as a new way of communication between regulator and regulated parties, which is more collaborative in its nature. This does not mean lack of rules, but an approach with an open communication, willingness to understand and keep pace with technological revolution.

Emerging markets have great potential for progress through FinTech innovations. There are numerous examples around the world in which new technologies have democratized financial systems and gave more opportunities to customers through better and cheaper financial services and funding opportunities for SMEs. New Member States have very low market volumes in FinTech in comparison to Old Member States, however the trend is changing. FinTech companies can help decrease the cost of raising capital and bank dependence. This would stimulate investments and further develop and integrate capital markets. National regulatory authorities in New member States have lot to gain from implementing best practices of innovation hubs and regulatory sandboxes. To conclude, FinTechs are transforming the way we operate and do business in financial markets. They offer great opportunities for innovation and progress and hopefully the system in place will strike a right balance between innovation and financial stability.

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