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Bank-Fintech Partnerships, Outsourcing Arrangements and the Case for a Mentorship Regime

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Abstract

Fintech firms, once seen as ‘disruptors’ of the traditional banking world, are now increasingly seen as attractive partners for established financial institutions. Such partnership agreements come in different forms and contexts, but most share the goals of outsourcing key banking functions and facilitating market entry for new market players while overcoming relatively tough regulatory hurdles.

Yet such arrangements, while generally to be welcomed, pose a number of regulatory problems, in particular concerning the effective supervision of fintechs that operate outside of the direct purview of regulatory authorities. Questions of enforcement and effective supervision emerge, which may ultimately result in problems regarding market stability and systemic risk. Regulatory sandboxes represent one attempt to address these problems but may fail to do so and are often ineffective or unavailable. Other similar solutions, such as fintech charters and umbrella firms, may help but, similarly, provide an imperfect solution.

Against this backdrop, we make the case for a ‘mentorship regime’, which provides for a reliable regulatory framework for partnership agreements between fintech firms and established banks. This would allow for a de facto ‘private sandbox’ where experienced firms could mentor new startups and help them to cope with a complex regulatory process. At the same time, a state-backed mentorship plan would clear up the allocation of responsibilities, supervision competences, and liability questions and thus overcome problems of arbitrage and abuse. Ultimately, a mentorship regime may show the way to a new and more reliable future system of banking, making the well-established contractual practice of outsourcing banking services more reliable.

Keywords: fintech, banking licence, outsourcing, regulatory sandbox

JEL Classifications: G21, G23, G28, K22

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I. Introduction

Amid global competition to build the perfect financial ecosystem, governments worldwide are seeking ways to best harness the potential of new financial technology firms. These fintechs were once seen as 'disruptors,' potentially displacing established banks and paving the way for more innovative business models. More recently, both types of players have begun to appreciate various forms of collaboration.[1] The willingness of consumers to switch from traditional banks to newcomers had probably been overestimated, and this has reinforced the case for collaboration rather than directly enticing customers away from the established players.[2]

Partnership arrangements between banks and fintech firms may take on various forms, including simple joint ventures, but they may also involve more advanced technology-based ways of integrating new business models or services in the established bank's portfolio. The main reason for the proliferation of partnership arrangements is the many advantages they bring to both parties. When cooperating with an established bank, fintechs can take advantage of certain banking services or infrastructure, which saves them significant costs and decreases time-to-market. With a bank's cooperation (and licence), they can develop and test products and bring them to market without the need to apply for a separate banking licence, while at the same time developing their own brand and enjoying direct client access. Moreover, access to client data brings them opportunities with respect to entering new markets and offering innovative products. Hence, such collaboration boosts fintechs: they can compete with banks by offering services without having to build all of the products and processes that would ordinarily be needed from scratch. At the same time, as banks feel obliged to digitalize their business models as they search for new clients, many new market segments are opening up for fintechs and third-party providers. Fintechs can offer specialized services to, or build up the infrastructure of, a bank. In addition, collaborating with bigger market players earns reputational benefits and know-how transfer, thereby helping fintechs to increase their market share.

Conversely, by collaborating with fintechs, banks are able to extend their product range and gain access to new markets by making use of third-party-provider platforms and services.

[1] Financial Stability Board, 'FinTech and Market Structure in Financial Services: Market Developments and Potential Financial Stability Implications' (14 February 2019) <www.fsb.org/2019/02/fintech-and-market-structure-in-financial-services-market-developments-and-potential-financial-stability-implications/> accessed 29 July 2020.

[2] World Economic Forum, 'Beyond FinTech: A Pragmatic Assessment of Disruptive Potential in Financial Systems' (22 August 2017) <www.weforum.org/reports/beyond-fintech-a-pragmatic-assessment-of-disruptive-potential-in-financial-services/> accessed 29 July 2020.

Moreover, they can outsource processes to third parties, saving them money and making them more flexible and agile with regard not only to product development, but also to changes in the market or regulatory environment. Finally, by outsourcing certain processes or services, banks can concentrate on, or specialize in, more profitable business areas that more closely match their expertise.

Both players are also likely to be motivated to join forces to counter the entry of 'bigtech' firms.[3] From a social perspective, collaborations between banks and fintech firms may ultimately increase innovation by facilitating and speeding up new entrants' market access.

Such arrangements are generally to be welcomed but also pose regulatory problems, particularly concerning the effective supervision of fintechs operating outside of the direct purview of regulatory authorities. Questions of enforcement and effective supervision emerge, which may ultimately result in problems regarding market stability and systemic risk. In response, regulatory sandboxes and fintech charters may help to address these problems, but these are neither available everywhere nor can they always achieve the goal of attracting fintechs into the regulatory framework.

As an additional tool to facilitate this intermediate regulatory goal, we suggest that policymakers introduce an optional regime, complementary to the regulatory sandbox and / or the fintech charter, where fintech startups may gain a licence to operate as regulated businesses by having a regulated entity (eg, a bank) agree to 'extend' its own licence to them in the framework of a 'mentorship' agreement.

The licence extension would take the form of a communication from the incumbent to the supervisor, specifying the information usually given in the context of authorization proceedings. In addition, the incumbent would state that it is satisfied that the startup meets the requirements for the granting of the licence and that it takes responsibility for the fintech startup's compliance with the regulatory framework. The startup would be jointly liable for its own breaches.

This paper lays out the case for a mentorship regime by, first, setting out the various forms and terminology of partnership arrangements between banks and fintech firms (Part II). Next, it contrasts these arrangements with the regulatory framework, which classifies the vast majority of these co-operations as outsourcing arrangements, through which the bank outsources some of its functions to another entity, namely the fintech firm (Part III). Under the applicable regulatory framework in Europe, the outsourcing bank is consequently subject to a range of requirements,

[3] Financial Stability Board, 'BigTech in Finance: Market Developments and Potential Financial Stability implications' (9 December 2019) 20 <www.fsb.org/2019/12/bigtech-in-finance-market-developments-and-potential-financial-stability-implications/> accessed 29 July 2020.

whereas the outsourcee fintech does not directly fall within the supervisor's perimeter. That, as Part IV argues, may lead to some supervisory shortcomings. Part V then explains why regulatory sandboxes, fintech charters, and appointed representative regimes, useful as they may be, are imperfect solutions to the problems identified in Part IV. This leads us to propose the 'mentorship' regime, which we discuss in Part VI, before a conclusion is provided in Part VII.

II. The Incumbent/Fintech Collaborative Space

The fintech industry has an ambivalent relationship with incumbent banks, and vice versa. On the one hand, according to a previously strongly-held belief, fintechs are 'disruptors' that may replace incumbent players. On the other hand, incumbents may be the main customers of fintech products,[4] important suppliers of services covered by licensing requirements,[5] and, thanks to their customer base, effective distributors of fintechs' products.[6] In addition, given their superior knowledge of the industry, incumbents may act as corporate venture capitalists to fund fintech projects.[7] Finally, incumbents may also become the acquirers of successful fintech firms further down the road.[8] Hence, there is ample scope not only for competition but also for collaboration and 'co-opetition' between incumbents and fintech insurgents. In fact, there are already plenty of examples of strategic alliances between banks and fintech firms.[9]

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[4] See Chris Brummer and Yesha Yadav, 'FinTech and the Innovation Trilemma' (2019) 107 Georgetown Law Journal 235, 276-77: '[fintech] firms may offer services and products that complement those offered by incumbents to create innovative supply chains for financial products. In scenarios such as these, entrant firms may wish to take advantage of the customer networks, access to capital, and expertise offered by incumbents with a long pedigree').

[5] Max Bömer and Hannes Maxin, 'Why Fintechs Cooperate with Banks—Evidence from Germany' (2018) 107 Zeitschrift für die gesamte Versicherungswissenschaft 359, 372-73 (noting how obtaining a licence can be prohibitively costly for a fintech start-up).

[6] See eg, European Banking Authority, 'Report on the Impact of Fintech on Institutions' Business Models' (3 July 2018) 26 <https://eba.europa.eu/file/28458> accessed 29 July 2020.

[7] Brummer and Yadav (n 4) 277 ('prominent financial firms serve as incubators for fintech talent, putting new companies through their paces and offering pathways to partnership for those that come up with successful products and proofs of concept'); Milan F Klus et al, 'Strategic Alliances between Banks and Fintechs for Digital Innovation: Motives to Collaborate and Types of Interaction' (2019) 21(1) Journal of Entrepreneurial Finance 1, 3.

[8] Alberto Fraile Carmona et al, 'Competition Issues in the Area of Financial Technology (FinTech)' (European Parliament, 9 July 2018) 43-46 <www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_STU(2018)619027> accessed 29 July 2020.

[9] Benedict J Drasch, André Schweizer, and Nils Urbach, 'Integrating the 'Troublemakers': A Taxonomy For Cooperation Between Banks and Fintechs' (2018) 100 Journal of Economics and Business 26 (showing that strategic alliances are much more common than acquisitions, incubations, and joint ventures); Lars Hornuf et al, 'How Do Banks Interact with Fintechs? Forms of Alliances and their Impact on Bank Value' (2018) Cefifo Working Paper 7170, 6 <www.econstor.eu/handle/10419/185368> accessed 29 July 2020.

Such collaboration has multiple mutual advantages. Banks, as the incumbents with legacy issues and cumbersome internal processes, may not be well-suited to developing new products and may thus prefer to buy them from third parties.[10] On the other hand, fintechs' superior technology may allow them to make better use of banks' troves of data.[11] In some areas, such as compliance, incumbents may transfer valuable knowledge (and culture) to fintech firms,[12] while the latter may instil greater entrepreneurial, innovation- and customer-oriented attitudes in their banking partners' organizations.[13] In addition, banks' customer bases may allow startups to benefit at an earlier stage from economies of scale,[14] and the incumbents' reputation as reliable institutions may spill over onto their new fintech partners.[15] Last but not least, incumbents may act as facilitators in the relationship between fintech startups and supervisory authorities, by bridging the cultural and knowledge gaps between the two.[16]

Over recent years, two main forms of collaboration between banks and fintech startups have emerged that are of interest here: (1) a bank gives its fintech partner's clients access to banking (or other financial) services (known as banking-as-a-service); and (2) a fintech provides a software product to the bank to improve the bank's product portfolio or customer experience (software-as-a-service).[17] In the former case, the key justification for the partnership is regulatory: it is often too costly for the startup to obtain a banking licence. At the same time, the core non-regulated, or lighter-regulated (bundle of) services that fintech startups offer often include an ancillary (and yet essential) banking component, such as a current account and/or a payment system (eg a debit card) attached to a current account.[18] In the case of software-as-a-service, fintech startups, given their customer-centred culture, can be assumed to be better at finding technological solutions that clients will appreciate in terms of simplicity and, more generally, customer experience.

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[10] Klus et al (n 7) 9-10. See generally: Clayton Christensen, *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail* (Harvard Business School Press 1997).

[11] Sean Hunter, 'Innovation or Disruption: Not Always Black and White' in Janos Barberis, Douglas W Arner, and Ross P Buckley (eds) *The RegTech Book* (Wiley 2019) 122, 124. See also Gregor Dorfleitner and Lars Hornuf, *FinTech and Data Privacy in Germany* (Springer 2019) 89.

[12] Hunter (n 11) 124.

[13] Dorfleitner and Hornuf (n 11) 89. Klus et al (n 7) 9-11.

[14] Hornuf et al, (n 9) 7.

[15] Dorfleitner and Hornuf (n 11) 89. Klus et al (n 7) 12-13.

[16] Bömer and Maxin (n 5) 371.

[17] ibid.

[18] ibid 373.

Especially where regulatory obstacles have proved surmountable, as is the case within the EU (and the UK), fintech startups have become banks themselves. In addition to servicing their own final clients, they act as one-stop-shops for both banking-as-a-service and software-as-a-service. One such example is the German bank N26, a mobile bank with a business model centred on the use of application programme interfaces (APIs) to serve other financial services providers, fintech firms, (online) retailers, and final banking services customers. Originally, when it was a startup itself, N26 was the junior partner of Wirecard, using the latter's banking licence.[19] Likewise, when N26 debuted in the US in 2019, it used Axos Bank's white-label services to access the American market.[20]

In Europe, long equipped with its own banking licence, N26 has now created an ecosystem where it uses many third-party providers' services to enrich its own banking services and customer experience, while at the same time supplying software-as-a-service and banking-as-a-service products to licensed financial institutions, fintech firms and non-financial market players, such as online retailers. Banking-as-a-service allows the fintech in the relationship (an e-money institution, for instance) to provide basic banking services (typically, a current account and a debit card) to its clients. The presence of a separate bank services provider may either be made explicit, with separate branding for the banking services, or be hidden from the clients, in the sense that they may only find out about it if they read the terms and conditions. In the latter case, the authorized entity operates as a 'white-label bank'[21] whereby banking services clients have the impression that they are dealing exclusively with the fintech firm on the eponymous phone app they use and may have no knowledge whatsoever of the existence of a third-party bank in the relationship.

While N26 is still traditional in the sense that it mostly appears as the brand in direct contact with retail customers, other institutions have pushed this business model to the extreme. Banks like Solaris or Fidor have made 'banking-as-a-platform' their sole business model. For example, Solaris, which holds a full banking licence, does not engage in any direct client contact itself. Its core business is to 'sell' its banking licence to fintech startups, which can provide and disseminate their services under Solaris's wings: its marketing effort is directed at fintechs (or other banks, for

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[19] Fintec Systems, 'White Label Banking: Driver of Growth for FinTechs or Sustainable Business Model?' (23 August 2018) <https://knowledge.fintecsystems.com/en/blog/white-label-banking-driver-of-growth-for-fintechs-or-sustainable-business-model> accessed 29 July 2020.

[20] Romain Dillet, 'N26 Launches its Challenger Bank in the US' (*TechCrunch*, 11 July 2019), <https://techcrunch.com/2019/07/11/n26-launches-its-challenger-bank-in-the-u-s/> accessed 29 July 2020. N26 said they would consider applying for a banking licence once they hit 1 million to 2 million users.

[21] Bömer and Maxin (n 5) 376.

instance from third countries[22]) that ‘rent’ the regulatory licence for a fee. In fact, Solaris is actively advertising itself as ‘empower[ing] you to become a financial pioneer’ while asking customers to ‘choose from our API accessible services to create your own fully licensed state of the art financial solution.’[23] In this way, Solaris—along with competitors such as Fidor Bank or Revolut—is an online bank which positions itself at the centre of an ecosystem of smartphone- and web-based financial and software products servicing mainly fintech and online services providers. In contrast to the traditional model, there is no single (monolithic) bank running all processes and providing all services, but rather a web of (smaller) interlinked players offering (bundles of) financial services. In some cases, the fintech serviced by the bank acts as a ‘front-end neobank’,[24] that is, as an entity supplying banking services and looking like a bank to any customers who have neglected to read the small print. For instance, Penta is a German fintech which according to its homepage offers ‘[f]ast online banking for startups and SMEs.’[25] Its answer to the question ‘Why Penta?’ is: ‘Penta is the best account for everyday banking.’[26] Yet, Penta itself is not a bank. Only by scrolling down to the bottom of its ‘About us’ page (a hyperlink which is found at the bottom of the homepage) does one realize that Penta’s banking services are ‘[p]owered by Solaris.’[27]

Traditional banks may themselves be part of bank-fintech ecosystems, in that they may purchase ready-made software-as-a-service solutions to improve their customer experience. Yet other traditional banks, such as BBVA’s subsidiary in the US and Intesa Sanpaolo in Italy, have created their own platforms to be at the centre of their own respective ecosystems.[28]

The banking-as-a-platform model is an evolution of the cooperation that originally developed in the US between fintechs and incumbent banks. In order to cover the entire territory of the US without obtaining either a federal charter or a licence from 50 states, peer-to-peer lenders opted for a cooperative arrangement with fully-licensed state banks: the fintech controls the process that leads to a borrower getting funds for the platform, but the loan is originated by a licensed bank, which then sells the loan to the fintech firm or the peer-to-peer lenders using its

[22] See James Bessenbach, ‘How Banking as a Service Can Open the Doors to Europe’s Mobile Banking Market’ (*Solarisbank Blog*, 14 March, 2019) <www.solarisbank.com/blog/how-banking-as-a-service-can-open-the-doors-to-europes-mobile-banking/> accessed 29 July 2020.

[23] Solarisbank, ‘Discover Our Services’ <www.solarisbank.com/en/services/> accessed 20 July 2020.

[24] Front-end neobanks are fintech companies acting as the interface of customers of banking services that they distribute. See Rachel Green, ‘The Global Neobanks Report’ (*Business Insider*, 6 December 2019) 9 <www.businessinsider.com/global-neobanks-report> accessed 29 July 2020.

[25] See Penta <https://getpenta.com/en/> accessed 20 July 2020.

[26] ibid.

[27] Penta, ‘About’ <https://getpenta.com/en/about/> accessed 20 July 2020). In Australia, the same business model is followed by Up; see Up, ‘About’ <https://up.com.au/about/> accessed 20 July 2020).

[28] See BBVA Open Platform <https://bbvaopenplatform.com/> accessed 20 July 2020; Banca 5 <https://apidevelopers.banca5.com/> accessed 20 July 2020.

platform. In form, the licensed bank is the entity conducting the banking activity (originating the loan), but all the activities leading to the loan's issuance are the responsibility of the peer-to-peer platform acting as an outsourcee of the licensed banks. In substance, of course, it is the bank that is used as an outsourcee by the platform. And yet, from a regulatory perspective, the bank is the outsourcer and the fintech the outsourcee.

The same qualification applies within the EU to relationships between banks providing fintechs with banking-as-a-service functionalities: while the customer often perceives the fintech as its unique counterparty, the banking services component of the relationship with the customer is provided by a bank that formally outsources to the fintech much of the customer management relationship, from client-onboarding to terminating the relationship. As a consequence, the relationship between the bank and the fintech is much more complex than a purely commercial arrangement in which a standardized (financial) product is an ancillary element of a broader customer relationship between the fintech and its clients. Outsourcing critical banking functions implies compliance with the bulky requirements of the EU's bank outsourcing regime, to which we now turn.

III. The Regulatory Framework: The Rules on Bank Outsourcing

From a regulatory perspective, the partnerships between banks and fintechs we described in Part II are classified as 'outsourcing' arrangements.[29] Regardless of how the cooperation came about, and whichever business case may have driven it, from a regulator's perspective it is always the bank that is 'outsourcing' some of its activities to a non-regulated entity. Put differently, the two scenarios described above—the fintech uses the bank's licence to operate independently and under its own name on the market; and the bank draws on the fintech's services to complement its offerings—would both count as a regulated firm outsourcing some of its activities to a third party.[30]

[29] In the context of MiFID, 'outsourcing' is defined as 'an arrangement of any form between an investment firm and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the investment firm itself.' See Article 2(3) of Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive [2017] OJ L87/1.

[30] To be sure, the EBA Guidelines are far from clear in drawing the line between mere purchases of third-party services and outsourcing arrangements. The test is whether the function 'is performed on a recurrent or an ongoing basis by the service provider and whether this function … would *normally* fall within the scope of functions that would or could realistically be performed by [banks], even if the [bank] has not performed this function in the past itself': see European Banking Authority, 'Final Report on EBA Guidelines on Outsourcing Arrangements' (25 February 2019) (hereafter, 'EBA Guidelines') para 26 <https://eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-outsourcing-arrangements> accessed 29 July 2020 (emphasis added). After providing a list of specific services that

Regulation abounds in many countries to ensure that such contractual arrangements do not impair the supervisory function of market regulators.[31] The key idea underpinning such regulation is that any outsourcing arrangement is subject to the general framework governing the risk management of banking institutions. Supervisors will thus make sure that sensitive areas that are essential for the carrying out of core banking or financial services will not be contractually moved to another firm without appropriate safeguards.

To this end, regulation delves deeply into defining the contents of the outsourcing relationship. For example, banks may not outsource their key managerial responsibility and must always ensure that the integrity of their business organisation is unimpaired.[32] In addition, a decision to outsource a particular activity may not result in the bank escaping from its responsibility for the activity. The bank has therefore to ensure that the outsourced activity is performed in the same way as it would have been 'in house.' Typically, the law provides for more stringent requirements where the outsourced activity is 'material' or 'critical or important';[33] however, the decision on whether an outsourcing operation is material or not is for the bank to take, based on an individual risk assessment.[34] This is against a background in which there is typically neither an ex ante screening mechanism for outsourcing arrangements, nor an obligation to notify them to the supervisor pursuant to the EBA Guidelines.[35] Rather, the bank normally decides on the outsourcing arrangements under its own responsibility and takes appropriate steps as part of its general risk management policies and procedures.[36]

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are not considered outsourcing, such as market information services, global network infrastructures, and corresponding banking services, they exclude from the definition 'the acquisition of services that would otherwise not be undertaken by the [bank] …, goods … or utilities': see EBA Guidelines para 28(g). Software is not listed among the services or goods that exemplify such residual category of non-outsourcing services. Yet, the general criterion of normality in self-production can be used to exclude that some of the software services can be deemed to be outsourced. No one expects a bank to write the code for its own word-processing software. But the boundaries become hazier when it comes to software performing risk management functions. In addition, if normality is the test, the more banks buy software from third parties, the less can they 'realistically' be expected to develop the software themselves.

[31] See eg EBA Guidelines; Office of the Comptroller of the Currency, 'Third-Party Relationships: Risk Management Guidance' (OCC Bulletin 2013-29, 30 October 2013) <www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html> accessed 29 July 2020; Financial Conduct Authority, *FCA Handbook* SYSC 13.9 'Outsourcing' <www.handbook.fca.org.uk/handbook/SYSC/13/9.html> accessed 29 July 2020; BaFin, *Mindestanforderungen an das Risikomanagement* (Circular 09/2017 (BA)) (hereafter, 'MaRisk'); and KWG §25b.

[32] EBA Guidelines paras 35, 36; MaRisk AT 9 para 4.

[33] See EBA Guidelines para 29; KWG § 25b.

[34] MaRisk AT 9 para 2.

[35] The situation may be different at the member state level. For instance, under the Italian regime, any material outsourcing arrangement needs to be notified to the Bank of Italy. See Banca d'Italia, Circolare No. 285/2013, Part I, IV.3.28. The same is true in the UK. See *FCA Handbook* SYSC 13.9.2.

[36] Before MiFID I was implemented, German law had provided for an obligation to disclose any outsourcing arrangement to the market supervisor.

Where the outsourcing operation is material (or 'critical' or 'important'), a number of additional requirements apply.[37] For example, the outsourcing institution is required to carry out appropriate due diligence to ensure that the outsourcee is suitable and has, inter alia, the business reputation, expertise and capacity to perform the outsourced functions.[38] A written outsourcing agreement is mandated, following a detailed set of requirements.[39] Amongst other things, this agreement has to provide that both the bank and the supervisory authority are in a position to effectively monitor the outsourcee, including having access to its premises, as well as having examination and information powers.[40] Still, the key responsibility for overseeing the outsourcee appears to rest with the outsourcing bank, rather than with the market supervisor.[41] Accordingly, the supervisor will focus its efforts on monitoring the outsourcing institution, and whether the outsourcing arrangement is undermining the institution's activities.[42] This is consistent with the general distribution of responsibilities, as described above, according to which the supervisor is generally responsible for overseeing the licensed bank, and the bank is responsible for, and will monitor, any outsourcing activity under its own responsibility.

Finally, a key aspect of the outsourcing regime is that functions relating to core banking services, namely the taking of deposits and loan-making, and payment services cannot be outsourced other than to entities that are authorised or somehow allowed to carry out those services.[43] More precisely, the outsourcee is prohibited from having decision-making authority with respect to the acquisition of a new customer (depositor or borrower). So long as such decisions are left to the bank, related functions can still be outsourced.[44]

IV. Policy Implications

[37] One helpful definition of 'materiality' is as pertaining to 'services of such importance that weakness, or failure, of the services would cast serious doubt upon the firm's continuing satisfaction of the threshold conditions or compliance with the Fundamental Rules.' See Prudential Regulation Authority, *PRA Rulebook* <http://www.prarulebook.co.uk/> accessed 29 July 2020.

[38] EBA Guidelines paras 69-73.

[39] ibid paras 74-75.

[40] ibid paras 85 ff.

[41] See ibid paras 100-105.

[42] ibid para 109.

[43] ibid para 62.

[44] See Philipp Maume, 'In Unchartered Territory—Banking Supervision Meets Fintech' (2017) 11-12 Corporate Finance 373, 377-78.

The many dimensions of partnerships between banks and fintech firms, combined with the regulatory framework we have sketched out in Part III, have several implications. On the positive side, as we have seen in Part II, having the support of an established bank will help new players to access the market much faster than if they had to go through the entire regulatory authorisation process by themselves. The possibility to piggyback on the established bank's regulatory licence is a contractual means of ensuring that new ideas can be realised despite high regulatory hurdles.

Some supervisors, such as the German BaFin, seem to encourage this trend.[45] A reason for this may be that when banks provide support, know-how and even their licence, regulators save significant resources (as some of these tasks would otherwise need to be handled by them). Regulators may also limit their own liability if they can successfully outsource their responsibility to the private sector. Especially in white-label banking, banks typically conduct a thorough due diligence (certainly in their own interest) of the fintech that is seeking to use their licence. However, this passive 'outsourcing' regulation/licensing to the private sector may also carry the risk of regulatory arbitrage, open up opportunities for abuse and, ultimately, jeopardise financial stability.

1. Microprudential Risks

The key downside of the existing collaboration arrangements between banks and fintechs lies in the proposition that a contractual agreement between the two market participants is a poor substitute for effective regulatory scrutiny. Such contractual agreement appears not to allow for the effective monitoring of the fintech by the supervisor. This, in turn, may give rise to regulatory loopholes, arbitrage, and enforcement problems that may ultimately pose a threat to financial stability.

To explain the weakness of contractual solutions in our context, imagine a partnership agreement between bank B and unregulated fintech F whereby B provides F with a banking licence and access to its client base against a monthly fee. Now suppose that F does not comply with some serious regulatory requirements that concern, for example, money laundering. The key problem lies in the fact that F as the firm responsible for the legal infringement does not fall directly under the regulatory scrutiny of the relevant supervisor, which only has the power to supervise and sanction B. Under the EU framework, the supervisor can obtain documents and also inspect the

[45] See also World Economic Forum (n 2) 143: 'Regulators are comfortable with increased outsourcing of core business functions.'

outsourcee F,[46] but has no direct power of early intervention or sanction vis-à-vis F. Of course, it may ban the outsourcing bank from retaining its relationship with a delinquent outsourcee, but that may be too drastic or too untimely a solution compared to a scenario in which the outsourcee is fully within the regulatory perimeter.

One may expect that the contract between B and F could serve as an adequate private substitute to supervisory monitoring. And indeed, at first sight, B has an incentive to ensure F's compliance with regulatory requirements: since F is acting under B's responsibility, using the latter's licence, B may face regulatory sanctions for any infringement deriving from F's conduct. However, it is easy to imagine situations in which the contractual solution does not provide optimal outcomes. For example, B and F may disagree as to whether F's conduct constitutes an infringement of legal rules. Furthermore, B may have an incentive to delay or to obscure detection of the infringement, particularly where the violation of legal rules works in their favour. This may be even more problematic where different employees within B have diverging incentives resulting in governance problems: simply put, compliance officers may work according to very different incentives compared to those who are responsible for the commercial success of the fintech-bank partnership. Finally, B may have become aware of an infringement but may be hesitant to rectify the situation because the infringement is so substantial that the continuation of F's business is at risk, which may put their collaboration into jeopardy and even threaten the continuity of B's own business.[47]

Anecdotal evidence confirming that such problems are serious abound in the context of software-as-a-service agreements. For example, there have been cases where established banks were facing serious reputational and financial problems due to a partnering firm's computer failures. Several years ago, a retail bank left millions of customers unable to withdraw funds or view their balances due to a computer failure, which occurred as one of the bank's IT suppliers was performing a software update.[48] This failure proved costly as it resulted in the paralysis of critical banking functions. Another bank had to compensate thousands of customers whose personal information had been stolen and sold illegally. The data had been stored by a partnering firm on a USB stick which was subsequently 'lost'.[49]

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[46] EBA Guidelines paras 87, 110.

[47] Banks are required to provide so-called 'exit plans' to anticipate this problem (EBA Guidelines, para 107); however, it is doubtful how reliable these are.

[48] Angelos Deftereos and James Tuplin, 'Banks: The Benefits and Risks of Outsourcing' (Axa XL Insurance/Reinsurance, 10 October 2016) <https://axaxl.com/fast-fast-forward/articles/banks-the-benefits-and-risks-of-outsourcing> accessed 29 July 2020.

[49] ibid.

More generally, the UK PRA has stated that it is aware of the risk that confidential, important or sensitive data which are outsourced to third parties may not always be secure and accessible to firms and regulators.[50] This may become particularly problematic during or following an operational disruption of the fintech's business.[51]

Although not exactly the same situation, the recent collapse of Wirecard, the German payments group that relied on partnering with firms in its Asian markets, also put a spotlight on the frailty of contractual arrangements. Wirecard entered into partnership contracts in jurisdictions where it did not have its own market licence such as Dubai, Singapore and the Philippines.[52] According to what we know about the scandal as we write (July 2020), the difficulty for regulators to detect the wrongdoing and the missing funds may have been aided by the opaqueness of these contractual relationships, which contributed to Wirecard's downfall.

All these risks will obviously be exacerbated once the bank is not just partnering with one single fintech but, indirectly, with several fintechs simultaneously. It is common practice that outsourcees may further outsource functions to their own contractual partners, which may result in a potentially troublesome chain of sub-agreements.[53]

To conclude, the operational risks all banks run, and which are the source of the market failures justifying regulation and supervision, also characterize the relationship between banks and fintechs. Because of the supervisor's indirect focus and weaker reaction tools vis-à-vis the (unlicensed) fintechs, the operational risks of these cooperation arrangements are bound to be magnified.[54]

2. Negative Effects on Innovation

Where banks are taking their liability risk seriously and are stepping up their efforts to ensure compliance on the part of their partners, contracts between banks and fintechs may become so pervasive as to be perceived effectively as a straitjacket by the latter. For example, when N26 was itself still a young startup and the junior partner in an arrangement with Wirecard, the contract between them appears to have been perceived by N26 as unbearably restrictive with regard to its

[50] Prudential Regulation Authority, 'Outsourcing and Third Party Risk Management' (Consultation Paper 30/19, 5 December 2019) para 1.10.

[51] ibid.

[52] Dan McCrum, 'Wirecard Relied on Three Opaque Partners for Almost All its Profit' *Financial Times* (London, 24 April 2019).

[53] Brummer and Yadav (n 4, at) 275-78.

[54] See Cheng-Yun Tsang, 'From Industry Sandbox to Supervisory Control Box: Rethinking the Role of Regulators in the Era of FinTech' (2019) University of Illinois Journal of Law, Technology, and Policy 355, 365-66.

range of actions:[55] N26 did not control a large part of its value chain. For example, the contractual terms meant that it was not allowed to partner itself with other startups; and it was not in a position to build its own financing products, such as savings accounts, investment products and credit offerings.[56] Furthermore, most bank-fintech agreements, at least in Europe, appear to be drafted with a rather short time horizon and for a limited target pool of customers.[57] In other words, the contractual solution appears not to grant fintechs the flexibility they need to grow, which indirectly may serve as a hindrance to innovation.[58] In extreme cases, white-label banking partners may seek to 'micromanage' their fintech partners, prescribing them which customers to take on, and which strategic goals to pursue. Such straightjacket terms may make partnerships unsustainable and may lead to the abandonment of innovative business ideas.

To be clear, this problem does not arise specifically as a consequence of the prudential rules concerning the outsourcing arrangement, but rather stems from the fact that the fintech is outside the regulatory perimeter and is therefore not allowed to develop its own business ideas and pursue its own objectives, such as finding new clients, independently. The perceived straightjacket is thus the result of the bank having to remain ultimately in charge of (and therefore liable for) those business decisions. As a consequence, it appears that drawing fintech firms into the regulatory perimeter could grant them more leeway to experiment with their own business models and make the balance of powers within the bank-fintech partnership more of a business function than a regulatory consideration.

3. Macroprudential Risks

Beyond the individual firm-level problems discussed above, outsourcing arrangements may also lead to complications for the financial system as a whole.

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[55] Romain Dillet, 'Number26 is now a True Bank as it now has a Full Banking License' (*TechCrunch*, 21 July 2016) <https://techcrunch.com/2016/07/21/number26-is-now-a-true-bank-as-it-now-has-a-full-banking-license/> accessed 29 July 2020.

[56] ibid.

[57] N26 CEO Valentin Stalf is cited as saying 'The deals that you get in the U.S. for white-label banks are much more favorable than in Europe. […] It's a setup for the longer term. It's good for a couple million customers.' See Dillet (n 20).

[58] See the statement about the eventual acquisition of a licence: 'It was clear that the license would be key to keep fuelling innovation—it would enable us to develop and implement state-of-the-art technologies, launch new products for our customers quickly, and be more flexible towards internationalization.' Alex Weber, 'Against All Odds: The Trials of Getting our Banking License' (18 July 2018) <https://n26.com/en-eu/blog/2-years-banking-license-n26> accessed 29 July 2020.

First, interconnections between banks and new non-licensed players, such as front-end neobanks, can complicate the topography of the financial system. If front-end neobanks become key distributors of banking products, non-regulated entities could become key nodes in the distribution of core financial services.

While the experience so far has been that, as they grow sufficiently, front-end neobanks tend to convert into fully-licensed banks, often by acquiring existing banks, the risk of them developing as large and systemically significant shadow banks cannot be ruled out.[59]

An intuitively much more serious source of risk is that of the interconnections between financial institutions on the one hand, and non-regulated software-as-a-service providers (especially bigtech firms) on the other.[60] The same may indeed hold true for cloud services.[61] In these contexts, a single service provider, or a small number of service providers which are very difficult to replace, may come to dominate the provision of certain outsourced and third-party services to numerous banks.[62] This may constrain banks' ability to exit outsourcing arrangements without incurring serious disruption and/or significant costs; a phenomenon that has been described as 'vendor lock-in.'[63] Relatedly, the development may lead to the concentration of crucial functions among market-dominating service providers (who contract with many banks simultaneously).[64] A major disruption, outage or failure at one of these service providers could create a 'single-point-of-failure' with potentially adverse consequences for financial stability.[65]

Conversely, special attention should be paid to systemically important financial institutions' (SIFIs) outsourcing practices.[66] Where such institutions do not appropriately manage risks associated with third-party outsourcing at the firm level, systemic operational and

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[59] Giorgio Barba Navaretti, Giacomo Calzolari, and Alberto Franco Pozzolo, 'Fintech and Banks: Friends or Foes?' (2017) 3(2) European Economy—Banks, Regulation, and the Real Sector 9, 27-28 <https://european-economy.eu/book/fintech-and-banks-friends-or-foes/ accessed 29 July 2020> accessed 29 July 2020; Xavier Vives, 'The Impact of Fintech on Banking' (2017) 3(2) European Economy—Banks, Regulation, and the Real Sector 97, 104 <https://european-economy.eu/book/fintech-and-banks-friends-or-foes/ accessed 29 July 2020> accessed 29 July 2020.

[60] Financial Stability Board (n 3) 15-17; Miguel de la Mano and Jorge Padilla, 'Big Tech Banking' (2018) 14(4) Journal of Competition Law & Economics 494, 510; Tsang (n 54) 366-67.

[61] Jon Danielsson and Robert Macrae, 'Systemic Consequences of Outsourcing to the Cloud' (*Vox CEPR*, 2 December 2019) <https://voxeu.org/article/systemic-consequences-outsourcing-cloud-0>.

[62] Financial Stability Board (n 3) 2.

[63] Prudential Regulation Authority (n 50) para 1.12.

[64] Basel Committee on Banking Supervision, 'Outsourcing in Financial Services' (The Joint Forum, February 2005) 12.

[65] Prudential Regulation Authority (n 50) para 2.48.

[66] The Financial Stability Board maintains a list of global SIFIs. The most recent version is available at <www.fsb.org/wp-content/uploads/P221119-1.pdf> accessed 29 July 2020.

cybersecurity risks may arise for the financial system as a whole.[67] As a result of such risk mismanagement, SIFIs may also become less easily resolvable in times of crisis, which may further contribute to systemic risks.

An additional dimension to consider is the limited jurisdictional reach of supervisory power. Encouraged by regulatory arbitrage opportunities, banks may be incentivised to outsource major functions to partners that are resident in offshore financial centres or in light-touch jurisdictions, where regulatory standards are lax. This may exacerbate the problematic side of the outsourcing process by adding political risks and challenges regarding enforcement to the equation picture.[68]

Ultimately, an extensive use of outsourcing and partnership arrangements bears the risk of the emergence of 'virtual' banks that are not regulated as such, if at all. Regulators' explicit prohibition of outsourcing banks becoming 'letterbox' entities or empty shells may be insufficient to avert the risks outlined in this section.[69]

All of this does not substantiate the conclusion that partnerships of the kind described above ought to be prohibited. Rather, we argue that it would be safer if fintech firms were attracted into the regulatory perimeter as soon as reasonably possible.

V. Existing Tools to Bring Fintechs Inside the Regulatory Perimeter

The previous part highlighted the risks of current forms of bank-fintech partnerships when the fintech is outside of the regulatory perimeter or is more lightly regulated than would be consistent with the risks posed by such partnership arrangements. A draconian measure would be to require fintechs integrating banking services into their products suites to convert into a bank or to be ipso facto subjected to some form of supervision by prudential and conduct regulators. That would render the scope of the regulatory framework excessively wide, and therefore wasteful, and would burden new firms with potentially prohibitive costs. A more proportionate reaction would seem to be to ease the transition from non-regulated entity to regulated entity for fintechs. Three existing regulatory instruments can serve that very function to a varying degree: regulatory sandboxes, fintech charters, and appointed representative regimes. We now briefly describe these tools and

[67]Financial Stability Board (n 1) 3-4; Financial Stability Board (n 3) 24.

[68] Basel Committee on Banking Supervision (n 64).

[69] European Banking Authority, 'Consultation Paper: EBA Draft Guidelines on Outsourcing Arrangements' (EBA/CP/2018/11, 22 June 2018) para 31 <https://eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-outsourcing-arrangements> accessed 29 July 2020.

acknowledge how they may fail to fully achieve the desired goal of bringing fintechs into the regulatory perimeter.

1. Regulatory Sandboxes

One useful tool applied in many jurisdictions since the mid-2010s that could help to achieve the goal of drawing fintechs into the supervisory framework is the regulatory sandbox.[70]

A regulatory sandbox is 'a controlled space in which businesses can test and validate innovative products, services and business models, and delivery mechanisms with the support of an authority for a limited period of time.'[71] Its main goal is to promote innovation and competition.[72] To achieve this, financial regulators will solicit applications to the programme, based on their promise in terms of innovativeness, potential for increased competition, greater financial inclusion, and so on.[73] Admission to the programme allows fintechs to start providing licensed services with guidance from the regulator. In addition, the regulatory regime can be adapted to allow for experimentation of a product that does not fully square with the existing rules. In the process, they facilitate the transition from outwith to within the regulatory perimeter.

Yet, helping a fintech in its transition to a regulated entity is not the primary rationale of regulatory sandboxes. While they are primarily concerned with promoting innovation and competition, guiding startups to transition to become a fully-regulated entity is only a secondary, indirect goal of the sandbox. It is therefore unsurprising that, whatever their intrinsic merits, regulatory sandboxes would be insufficient to achieve that particular goal.

First of all, admission to regulatory sandbox programmes is selective,[74] and the selection is also based, at least in the UK, Australia, and some other jurisdictions, on the degree of innovativeness of the fintech products.[75] It may well be that the fintech partner's business model is simply to provide a better customer experience thanks to its application's slickness rather than

[70] See generally Dirk A Zetzsche et al, 'Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation' (2017) 23(1) Fordham J Corp & Fin L 31, 64-68 , and Buckley et al, 'Building Fintech Ecosystems: Regulatory Sandboxes, Innovation Hubs and Beyond' (2020) 61 Washington University Journal of Law & Policy 55, 85-98 (for a list of regulatory sandbox initiatives around the globe).

[71] Wolf-Georg Ringe and Christopher Ruof, 'Regulating Fintech in the EU: The Case for a Guided Sandbox' forthcoming, European Journal of Risk Regulation 1, 4 (available at <https://doi.org/10.1017/err.2020.8>).

[72] Buckley et al (n 70) 76.

[73] See eg Lev Bromberg, Andrew Godwin, and Ian Ramsay, 'Fintech Sandboxes: Achieving a Balance Between Regulation and Innovation' (2017) 28(4) Journal of Banking and Finance Law and Practice 314, 317-19 (describing the UK and the Australian regulatory sandboxes).

[74] In the first two and a half years, the FCA admitted 118 firms to its sandbox programme, out of 375 applications. See Financial Conduct Authority, 'Regulatory Sandbox' <www.fca.org.uk/firms/innovation/regulatory-sandbox> accessed 29 July 2020.

[75] Buckley et al (n 70) 61-64.

using advanced technology such as machine learning or distributed ledgers. Hence, many such partners may not even aspire to be admitted to the programme.

In addition to that, some programmes, such as that of the UK, are very short for an individual fintech firm.[76] The regulatory advantage for firms admitted to the UK FCA's programme is to last only six months,[77] after which it is either up (full authorization) or out: that may well be an insufficient period of time in which to fully adapt to the new regime.

To be successful, the sandbox also requires substantial resources and the presence of flexible, committed, business-friendly staff at the supervisory authority administering the programme, which is arguably something that cannot be expected in many jurisdictions. In fact, while sandboxes have become a standard feature of jurisdictions competing to attract fintech firms,[78] many of them are largely symbolic 'window dressing' exercises; they are sandboxes in name only, with inadequate staff and insufficient openness to novel business models.

Finally, regulatory sandboxes (and innovation hubs generally)[79] may admit just a fraction of banks' fintech partners, due to their focus on innovativeness and their size limits, and at the same time be excessively lenient in granting waivers and reprieves. That is because regulators setting up sandboxes are also competing to attract fintech firms and may thus lower their standards to achieve that goal.[80]

As a consequence, regulators may let in some participants under a special regime that may only later prove to pose threats to financial markets.[81] Given the fintech's interconnections, such threats may well materialize outside of, and far more broadly than within, the controlled environment of the sandbox.[82]

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[76] ibid 68.

[77] Hillary J Allen 'Regulatory Sandboxes' (2019) 87 George Washington Law Review 579, 596.

[78] See Buckley et al (n 70) 71-76.

[79] See ibid.

[80] Allen (n 77) 614-15.

[81] Brummer and Yadav (n 4) 278-80 ('the design of fintech products and services – although anchored by vast troves of big and brand new types of data – introduces steep informational uncertainty for regulation' and 'endogenous, computerized learning sets up the prospect that algorithms use internal processing and validation mechanisms whose reasoning and outputs are unpredictable ex ante and difficult to correct in real time, representing a kind of 'black-box' for regulators').

[82] Brummer and Yadav (n 4) 296. Jemima Kelly, 'A 'Fintech Sandbox' Might Sound Like a Harmless Idea. It's not' (*FT Alphaville*, 5 December 2018) <https://ftalphaville.ft.com/2018/12/05/1543986004000/A--fintech-sandbox--might-sound-like-a-harmless-idea--It-s-not/> accessed 29 July 2020.

2. Fintech Charters

In some jurisdictions, special licences for fintechs have been envisaged or already put in place. In the US, for instance, the Office of the Comptroller of the Currency (OCC) has declared its intention to grant a banking licence to fintechs engaged in at least one of three identified core activities: taking deposits, paying checks, and making loans.[83] Yet, the OCC has made no attempt to ease the transition from non-regulated entity to licensed bank. What makes the fintech charter special is the clarification that the licence can also be given to fintechs that carry out just one of those three core activities, meaning that it is not obligatory for a fintech-chartered entity to take deposits. The prize for fintechs obtaining the special licence to operate as federal banks is that cumbersome state-level regulations, such as anti-usury laws, would no longer apply to them.[84] In any event, there is currently no fintech to have obtained a special fintech licence from the OCC whose fintech charter policy has been challenged before federal courts.[85]

In Switzerland, a fintech licence regime came into force at the beginning of 2019, which is tailored, more specifically, to companies specializing in new payment services and crowdfunding.[86] It allows fintechs to operate a deposit-taking business under special, more lenient rules than for banks, provided that they stay below a deposit cap of CHF 100 million (approximately €93.5 million).[87]

Banking requirements on liquidity, capital, and organisation are alleviated for these firms because they are prevented from engaging in maturity transformation: they cannot engage in lending or in investing depositors' money.[88] In addition, they may not pay interest on deposits.[89] While licencees are exempted from having to join the Swiss deposit guarantee scheme, they must

[83] Office of the Comptroller of the Currency, 'Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters' (31 July 2018) (available at <https://www.occ.gov/news-issuances/news-releases/2018/pub-other-occ-policy-statement-fintech.pdf>).

[84] David Zaring, 'Technologizing the Bank Charter' (draft manuscript on file with the authors) 19.

[85] ibid 7.

[86] Baker McKenzie 'The New Swiss FinTech License' (21 March 2019) <www.bakermckenzie.com/en/insight/publications/2019/03/new-swiss-fintech-license> accessed 29 July 2020.

[87] If the threshold is exceeded, the Fintech licensee must report to FINMA within 10 days and submit a bank licence application. Art 1b 'Innovation funding', Federal Act on Banks and Savings Banks (Switzerland).

[88] Swiss Financial Market Supervisory Authority (FINMA), 'Guidelines for FinTech Licence Applications Pursuant to Article 1b of the Banking Act' (3 December 2018) <www.finma.ch/en/authorisation/fintech/fintech-bewilligung/> accessed 29 July 2020.

[89] ibid.

segregate the deposits from their own assets or at least earmark them in their books so that they can at any time be identified.[90]

Licencees are still subject to capital adequacy requirements in order to ensure a level of loss-absorbency for the deposits, but the ratios are significantly less strict than they are for banks.[91] Governance and anti-money laundering requirements have also been simplified, especially for smaller institutions of low-risk profile and maximum gross income of CHF 1.5 million.[92] According to the Swiss banking regulator (FINMA), thanks to the laxer regulatory requirements, these licences can be obtained much more quickly than full banking ones.[93]

Whatever the specific design, fintech licences may suffer from the drawback that a high number of different licence types may create regulatory arbitrage and unlevel the playing field in that they create different legal standards for the same type of activities.[94]

3. Appointed Representative Regimes

With respect to a defined set of financial services, the UK allows some firms to operate without a licence while at the same time being subject to the relevant regulations and the supervisory powers of the competent authority. Such firms may do so by acting as 'appointed representatives' of an authorized firm.

An appointed representative is a firm or person that performs regulated activities and acts as an agent for a principal firm directly authorised by the FCA. The principal firm takes full responsibility for ensuring that its appointed representatives comply with the FCA's rules and is accountable for any breaches committed by them. Provided the contract between the appointed representative and the principal firm meets the requirements set out in the Appointed Representative Regulations and the principal accepts responsibility in writing for the authorised

[90] PwC 'The Swiss Fintech Licence: A Brief Introduction' (January 2020) <www.pwc.ch/en/publications/2020/The%20swiss%20fintech%20license_EN_web.pdf> accessed 29 July 2020.

[91] Fintech licensees must maintain capital in the value of 3% of the deposits at all times and never less than CHF 300,000. This means that the initial capital of the fintech licensee to operate is CHF 300,000, while banks are subject to a much stricter capital requirement of at least CHF 10 million. FINMA holds the discretion to alter this requirement depending on individual cases and the risks associated with the business. See Baker McKenzie (n 86).

[92] Swiss Financial Market Supervisory Authority (FINMA), 'FinTech Licence: FINMA Sets out Details of Anti-Money Laundering Due Diligence Requirements' (10 December 2018) <www.finma.ch/en/news/2018/12/20181210-mm-fintech-bewilligung/> accessed 29 July 2020.

[93] PwC (n 90).

[94] See Aurelio Gurrea-Martínez and Nydia Remolina, 'Global Challenges and Regulatory Strategies to Fintech' (SMU Centre for AI & Data Governance Research Paper No. 2020/01, 15 April 2020) 26 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3576506> accessed 29 July 2020.

activities carried out by the appointed representative, the latter will be exempt from the need to obtain an authorisation.[95]

The Financial Services and Markets Act sets out the business activities for which an appointed representative may enjoy an exemption, such as arranging a home finance transaction, credit broking, and debt collection / administration.[96] Appointed representatives may also act as MiFID2 tied agents, and remain exempt from licensing requirements, provided they satisfy certain additional conditions.[97] In 2015 the FCA even toyed with the idea of introducing an 'umbrella' licence, built on the appointed representative regime, where the principal would be a non-profit organisation.[98]

The ongoing compliance costs of appointed representatives are likely to be considerably lower than for authorised firms, as the former benefit from the authorised status of their principal. For instance, neither capital nor professional indemnity insurance requirements apply. The principal must ensure that the contract it enters into with the appointed representative requires it to comply with the relevant rules. Amongst other responsibilities, the principal firm is responsible for the products the appointed representative sells or arranges, any advice it gives to customers, and for ensuring that it delivers the six FCA 'treating customers fairly' outcomes, as would be required of a directly authorised firm.[99]

The appointed representative regime has given rise to a cottage industry of specialized 'umbrella firms' whose sole business is to act as principals on behalf of unlicensed firms in financial services such as insurance and mortgage brokerage, investment management and investment services.[100] This may result in so-called appointed representatives 'networks.'[101] Some fintechs, such as crowdfunding platforms operators, have accessed the regulatory perimeter as

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[95] General guidance by the FCA is available at Financial Conduct Authority, 'Appointed Representatives and Principals' <www.fca.org.uk/firms/appointed-representatives-principals> accessed 29 July 2020.

[96] See Financial Services and Markets Act 2000 s 39, and also *FCA Handbook*, 'Supervision' (hereafter 'SUP') s 12.2.7(1), for a clearer view.

[97] See SUP s 12.2.7(2).

[98] Financial Conduct Authority, 'Regulatory Sandbox' (November 2015) para 4.7 <www.fca.org.uk/publication/research/regulatory-sandbox.pdf> accessed 29 July 2020. See on this in detail Zetzsche and others (n 70) 85 ff.

[99] See Financial Conduct Authority (n 95).

[100] See Nish Dissanayake and Kimberly Everitt, 'FCA Finds "Significant Shortcomings" in Review of Principal Firms (Including AIFM Hosting Services) in the Investment Management Sector' (Lexology, 23 May 2019) <www.lexology.com/library/detail.aspx?g=bee06aa7-10fd-414d-a8d5-1b401f8a7192> accessed 29 July 2020.

[101] Financial Conduct Authority (n 95).

appointed representatives of such firms.[102] While the UK FCA has played with the idea of replicating this model in a sandbox context, it has left the initiative to the financial industry,[103] which appears to have dropped the ball.[104]

A review carried out in 2019 revealed a number of serious shortcomings in the system, for example relating to under-developed governance arrangements and poor onboarding practices.[105] Moreover, there appears to be an issue with so-called ‘phoenix firms’—firms that seek to become an appointed representative to get back into the industry after having rid themselves of old liabilities in their previous guise.[106]

VI. A Complementary Solution: The Mentorship Scheme

The regulatory sandbox may help to attract fintechs into the regulatory perimeter, but its availability is limited and the strategy carries its own risks, given the deviations from generally applicable rules. The fintech charter, where available, has a potentially broader scope, but again its main attraction is in the relaxation of some of the otherwise applicable rules. That is not the case with the appointed representative regime, which, however, has a limited scope where it exists and makes the principal liable for all aspects of the representative’s (in our case, the fintech’s) activity. We therefore suggest complementing these tools with what we call a ‘mentorship scheme’—a template to govern the relationship between banks, fintechs and regulators which, similar to the three experimented tools we have briefly described in Part V, attracts fintechs into the regulatory perimeter but without some of the limitations of those three tools.[107]

1. The Idea

A fintech mentorship programme would let startups enter the market more easily by making the regulatory licence one component of the partnership agreement between incumbents and fintechs. In exchange for consideration (eg, an equity stake, an exclusivity agreement, or a fee), the

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[102] See Robert Wardrop and Tania Ziegler, ‘A Case of Regulatory Evolution – A Review of the UK Financial Conduct Authority’s Approach to Crowdfunding’ (2016) (CeSifo DICE Report 14(2)) 23, 25, and 30-31 <www.ifo.de/en/node/28339> accessed 29 July 2020.

[103] Financial Conduct Authority (n 74) 13.

[104] cf Industry Sandbox, ‘A Development in Open Innovation Industry Sandbox Consultation Report’ (May 2017) 42 <http://industrysandbox.org/wp-content/uploads/2017/05/Industry-Sandbox-Consultation-Report-Full.pdf> accessed 29 July 2020.

[105] Financial Conduct Authority, ‘Review of Principal Firms in the Investment Management Sector’ (20 May 2019), <www.fca.org.uk/publications/multi-firm-reviews/review-principal-firms-investment-management-sector> accessed 29 July 2020.

[106] Financial Conduct Authority (n 74).

[107] For a comparison of the various tools, see VI.3 below and especially Table 1.

incumbent extends its own regulatory licence to the fintech firm.[108] To do so, after becoming satisfied that the fintech is in line with all the requirements to obtain the relevant licence, it would only need to communicate its decision to the regulator, which could not refuse or delay authorisation. Once inside the regulatory perimeter, the fintech firm[109] would be subject to the full force of regulation and supervision like any other licensed firm.

Yet, the regime would allow (and, in fact, require) the fintech to outsource its compliance and internal control systems to the incumbent, which would be responsible vis-à-vis the regulator in case of violations on the part of the fintech, resulting in a joint and several liability regime.[110] Incumbents would thus have the incentive not to be too bland with their licensing decisions.

Fintech firms would start developing their products and services under exactly the same requirements as incumbents, but with two main advantages: first, in the process of the transition to becoming a regulated entity, they would interact with their partner bank rather than with the supervisory agency, which should make the transition smoother; and, second, they would be able to outsource relevant compliance and risk management functions to the incumbent and benefit from greater expertise and easier ongoing interaction with the supervisor.

2. Supervisory Consequences

The key advantage of the scheme would be that the fintech partner would fall under direct supervisory scrutiny. This would be markedly different from the status quo. As seen above, under the existing rules, the supervisor is primarily focused on the bank as its first port of call and has limited powers vis-à-vis the fintech firm—merely to examine it and receive information therefrom.[111]

Under a mentorship agreement, by contrast, the supervisor would have direct responsibility for supervising the fintech too. This would include the exercise of direct intervention powers, for

[108] In addition, this arrangement could also be used to facilitate incumbent groups' subsidiaries operating in the Fintech space. For a practical example see Allen (n 77) 589-90 (Venmo using authorizations held by parent PayPal, comparatively an incumbent. See Venmo, 'PayPal State Licenses' <https://perma.cc/25RN-YBKK> accessed 29 July 2020).

[109] There is no reason to restrict the regime to 'fintech' firms, however defined: financial services, which are about information and information management (see Barba Navaretti, Calzolari, and Pozzolo (n 59) 18) are now necessarily technology-based, so arguably the fintech tag can apply to any new entrant in the financial services market.

[110] Note that existing rules provide for banks' liability for third-party service providers to which banks' functions are outsourced, including, of course, for integrated fintech services. See US Department of the Treasury, 'A Financial System that Creates Economic Opportunities. Nonbank Financials, Fintech, and Innovation' (July 2018) 73-77. Hence, it is already the case that collaboration between incumbents and fintech firms gives rise to banks' liability for fintech's violations etc.

[111] See above part III.

example to limit or halt a particular activity, which presently only extend to the outsourcing bank. The mentorship arrangement would grant the supervisor the power and the obligation to intervene directly in the fintech.

Two consequences would flow from this. First, supervisory *efficiency* would markedly improve. Under the mentorship template, the supervisor would be able to act more quickly and more effectively when things go wrong on the fintech side of the partnership. Rather than first addressing the bank to remedy the situation, which would then in turn have to address its fintech partner, the supervisor would be able to intervene directly at the source of the problem. In addition, the supervisor would be able to tap the full potential of its intervention powers:[112] this would significantly improve the current arrangement under which the bank is only able to act according to the limited contractual terms of its outsourcing contract.

Secondly, the mentorship arrangement would also create a corresponding *obligation* for the supervisor to intervene. In other words, even though the outsourcing arrangement remains part of the bank's general risk management system, the supervisory responsibility would be expanded from overseeing almost exclusively the bank to monitoring the bank as well as the fintech.

A further advantage of the mentorship scheme would be that the incumbent mentor could act as a facilitator in the ongoing interactions between the fintech and the regulator. The incumbent is likelier to share the same vocabulary as, and have a more similar mindset to, the regulator, which would enhance communication and understanding. That may in itself be helpful in cases where the regulator is called to vet new products or to identify the right regulatory framework for a 'new' (if only in terms of technology) product or service.

3. Key Benefits

What are the overall advantages of the mentorship regime? We see its main contribution to be making advances in pursuit of the goals of putting bank-fintech partnerships on more reliable ground and ensuring a more effective supervisory regime while at the same time making the transition from unregulated fintech to regulated fintech more practicable. This, in turn, will allow fintechs to operate as fully licensed entities and therefore experiment with innovative ideas within the limits of the existing regulatory framework.

[112] Importantly, for countries, such as the UK, where a senior manager regime exists of special accountability rules for top officers and directors of a supervised entity, the relevant rules would apply to fintech's representatives, unlike under the appointment representative regime.

The mentorship regime would differ from the other solutions discussed above in that it has the clear objective of attracting fintech firms into the full regulatory perimeter. In doing so, it markedly diverges from the limited scope of a fintech charter, for example, which may constrain the fintech's range of activities. It also differs from the status quo, where fintech firms partner with banks on the basis of contractual agreements that may prove unnecessarily restrictive in some situations. Under the current regulatory framework, as we explained above, the bank is ultimately responsible and liable for *any* business decision such as the onboarding of new clients or the development of new innovative ideas. Granting fintechs the benefit of a full licence overcomes this limitation.

Revisiting the starting point of this paper, the mentorship regime would ensure that there is an easy, straightforward way of facilitating direct access to licensed services for fintech firms. The established bank would be able to extend its regulatory licence (or part of it, such as payment services only) to the fintech, and the latter would not have to undertake the burdensome task of applying for a licence itself.

In our view, the mentorship regime would be an attractive complement to the regulatory status quo. Not only would it grant the fintech startup a more reliable regime, with clearer allocation of responsibilities, but a more effective supervisory regime should also be welcomed by the mentoring bank. This enhanced certainty, and the broader freedom afforded to the fintech should also be reflected in a more attractive consideration being paid to the bank in exchange for granting its regulatory licence. In addition, the bank may secure reputational gains by partnering with a fintech, and helpfully complement its range of offerings towards its own clients with more and innovative products.

To be sure, since the incumbent bank is jointly and severally liable, together with the fintech, in the event of compliance violations by the latter, there remains a strong incentive for the bank to be careful when selecting its fintech partners: the bank should therefore carry out a thorough due diligence, implement adequate risk management processes within the fintech, and monitor the fintech on an ongoing basis to avoid incurring liability.[113] Yet, its liability for the fintech's wrongs would not be as broad as for an appointed representative's principal. Similar to that regime, specialised incumbents, such as neobanks acting as platforms (think of Solaris) could populate a niche market of mentorship services for fintech startups with an appetite for accessing regulated services where regulatory sandboxes, fintech charters and appointed representative

[113] This should be monitored by the supervisor, see below VI.4.

regimes are unavailable or unsuited to their specific needs and circumstances. Table 1 highlights the differences between the various regimes that we discussed in Part V above.

Table 1

Comparison of Tools to Attract Fintechs into the Regulatory Perimeter

	Regulatory Sandbox	Fintech Charter	Appointed Representative Regime	Mentorship Scheme
General availability	No	Potentially yes.	Potentially yes, subject to principal availability	Potentially yes, subject to mentor availability
Easier transition to inside the regulatory perimeter	Yes (although not its main objective)	Potentially yes (but not in the US experience)	Yes	Yes
Incumbent involvement	Dependent on sandbox features (but usually not)	No	Yes (with broad liability for the representative's wrongs and obligations)	Yes (with liability restricted to compliance violations)
Special rules	Yes, but limited in time	Yes, permanently	No (other than as a consequence of the fintech not holding a licence itself)	No (other than to allow outsourcing of compliance functions, if needed)
Position with respect to regulatory perimeter	Dependent on sandbox features	Inside	Outside as an entity, inside as regards activities performed	Inside

It is important to emphasise that the mentorship regime would not replace any of the pre-existing schemes or override them. We rather see it as a complementary device that could enrich the facilities available to nurture financial technology by fostering partnerships between fintechs and established players. In the process, it could address many of the deficiencies of the existing, outsourcing-based status quo.

To be sure, if it became widely used, the mentorship regime may negatively affect competition in the financial services industry: mentorship arrangements might absorb many fintechs into the control of incumbents and limit the emergence of stronger challenger banks over time. The trend to equip financial market authorities with an explicit competition mandate, such as the UK FCA, would however give regulators sufficient flexibility to address this problem.[114] In addition, at least so long as fintechs will have access to cheap venture capital finance, it is predicted that the mentorship regime will appeal rather to fintechs whose business model will be symbiotic

[114] See Financial Conduct Authority, 'FCA Mission: Our Approach to Competition' (December, 2017) <www.fca.org.uk/publication/corporate/our-approach-competition.pdf> accessed 29 July 2020.

with traditional banks' rather than to disruptors, who will be wary of braiding their fate with incumbents to begin with.

4. Implementation

Implementing a mentorship regime would not be without difficulties, particularly in a multi-layered legal regime like the EU. As large parts of the regulatory regime for financial institutions have now been moved to the EU level, it could appear to be attractive to advocate for a corresponding EU-wide mentorship regime that would operate across the Union. This might be pertinent to the pursuit of the existing goal of fostering stronger integration of the Single Market for financial services (in particular, the Capital Markets Union), and the European Commission's efforts to build a pan-European fintech space.[115]

However, building a common mentorship regime across Europe runs into a number of problems. One conceptual difficulty is that supervisory practice and responsibilities, especially as regards smaller entities, still largely rest with national supervisors. One of the benefits of such a decentralised system is the incentive for experimentation and innovation at the national level. Consistent with this, mentorship initiatives at the Member State level could lead to a discovery process for what particular design is most attractive to both fintechs and banks. While at the EU level it would probably be necessary to implement some changes in the framework to allow for Member States' individual decisions to adopt a mentorship regime, a decentralised regime also appears more flexible, and easier and faster to implement. It would also be simpler to update and revise once adopted. We could imagine mentorship regimes being realised at the Member State level while including the EU in a coordinating role.[116] In that way, the interplay between the two levels could improve mutual learning and develop best practices while safeguarding against the potential downsides, in particular any macroprudential concerns.

One specific design problem—that national supervisors will have to deal with—is ensuring that banks are employing all reasonable efforts with regard to quality control, in particular at the stage of entering into the agreement but also during the subsequent mentoring phase. It is especially important to learn from the negative experiences with the UK's appointed representative

[115] European Commission, 'FinTech Action Plan: For a More Competitive and Innovative European Financial Sector' (COM(2018) 109 final, 8 March 2018), available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC0109>.

[116] Similar to Ringe and Ruof (n 71).

regime, where lax due diligence procedures have recently come to light.[117] One possibility to address this issue would be to impose ample documentation obligations onto the mentor, who would have to be prepared to demonstrate efforts undertaken with respect to selection and monitoring at all times. Supervisors could support this requirement with best-practice guidelines and extensive control measures. Ultimately, regulators will have ample room to learn and to develop a credible regime.

VII. Conclusion

Fintech firms are no longer the enemy of incumbent banks but have rather morphed into trusted partners, bringing a fresh wind and innovative ideas. Established institutions have therefore entered into partnership arrangements with them, which brings advantages for both sides. Banks may ordinarily suffer from legacy issues and cumbersome internal processes, and therefore benefit from fintech firms' superior technology to develop new business ideas. At the same time, a bank's broad customer base may allow a startup to benefit at an earlier stage from economies of scale and facilitate market entry, while fintechs may also enjoy reputational spill-overs from partnering with an established institution.

This paper has explored the various types of partnership arrangements—including banking-as-a-service and software-as-a-service frameworks, white-label banking, and front-end neobanks. From a regulatory perspective, all of these arrangements fall under the rubric of 'outsourcing' arrangements, where regulated entities outsource some of their functions to third parties, be they regulated or unregulated. The present practice and the regulatory frameworks encounter a number of regulatory problems, in particular concerning the effective supervision of fintechs that operate outside of the direct purview of regulatory authorities. Questions of enforcement and effective supervision emerge, which may ultimately result in problems regarding market stability and systemic risk.

A number of regulatory tools have been created or proposed to facilitate fintechs' entry into the supervisory perimeter, but they are imperfect. For instance, regulatory sandboxes are more geared towards creating and stimulating innovation rather than addressing the regulatory status of

[117] See above part V.3. Note, incidentally, that the appointed representative regime appears to be more prone to lax market practices and supervisory slack, because, unlike the fintech in the mentorship scheme, the appointed representative does not become a separate fully supervised entity for which the supervisory agency is responsible, but rather remains a sort of satellite per se unregulated entity. In the mentorship scheme framework, subsequent full supervisory responsibility and enforcement of due diligence obligations should lead to better screening by the incumbent ex ante.

fintechs. Other tools, such as fintech charters and umbrella firms, can be helpful in some respects but are similarly imperfect.

We have proposed here an additional, complementary tool: a ‘mentorship regime,’ which provides for a reliable regulatory framework for partnership agreements between fintech firms and established banks. Such a regime would allow for a sort of private sandbox, where experienced firms could mentor new startups and help them to cope with a complex regulatory process. At the same time, a state-backed mentorship plan would clear up the division of responsibilities and supervision competences, and the liability questions and thus help to overcome problems of arbitrage and abuse. Ultimately, a mentorship regime may contribute to a new and more reliable system of banking that puts the well-established contractual practice of outsourcing banking services on a more reliable footing.

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