



# The ECB clarifies its approach to licensing (fintech) credit institutions

**The ECB has granted licences to 37 credit institutions between 2014 and 2016.**

## Introduction

On 21 September 2017, the European Central Bank (ECB) published two consultation documents<sup>1</sup>:

- a draft 'Guide to assessments of licence applications – licence applications in general' (the 'general guide'). The document sets out the general process and the requirements for the assessment of licence applications by the ECB. These include initial authorisations for credit institutions, applications from fintech companies, authorisations in the context of mergers or acquisitions, bridge bank applications and licence extensions; and
- a draft 'Guide to assessments of fintech credit institution licence applications' (the 'fintech guide'), directed specifically at entities with a 'fintech business model'.

The documents are accompanied by some frequently asked questions (FAQs). The deadline for submitting comments is 2 November 2017. The ECB will hold a public hearing at its premises in Frankfurt am Main on 26 October 2017.

Though the guides will not be legally binding once finalised, they are important as the ECB is the competent authority for licensing credit institutions in the eurozone, regardless of whether they will be directly supervised by the ECB. In particular, UK banks that need to establish a new credit institution in the eurozone (or extend the licence of an existing eurozone bank) in the context of Brexit will be affected.

The two guides aim to make the application process more transparent and easier. They also aim to harmonise licensing procedures and requirements for credit institutions across the eurozone. Naturally, many of the requirements specified in the guides will also be relevant for ongoing compliance with regulatory requirements and influence ongoing supervision.

Both guides will apply to the authorisation of new credit institutions and licence extensions for existing institutions. Thus, there will be no reassessment of authorisations already granted. While the general guide will be relevant for all (prospective) banks, banks with a 'fintech business model' will need to take into account the fintech guide too.

That said, the ECB stresses that the fintech guide could still be relevant to banks with more traditional business models. In this context, the FAQs mention the skills and knowledge of management bodies relating to technology.

<sup>1</sup> [https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/licensing\\_and\\_fintech.en.html](https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/licensing_and_fintech.en.html).

In addition, the ECB points out that authorised banks (including fintech banks) will need to comply with the requirements set out in the guides on an ongoing basis. It is not entirely clear whether this means that existing banks must also adhere to the new requirements set out in the guides. But they should carefully consider whether the new guidance could apply, taking into account their business models.

## The general guide

### Definition of the term 'credit institution'

The Capital Requirements Regulation (CRR) defines a credit institution as 'an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account'.

The ECB has found that member states of the Banking Union have interpreted this definition differently and has produced interpretative guidance, which remains well within accepted limits of legal construction. Regarding 'taking deposits or other repayable funds from the public', the ECB refers to the (broad) interpretation of the ECJ in the *Romanelli* case<sup>2</sup> and the EU Deposit Guarantee Scheme Directive<sup>3</sup>. For 'granting credit for own account', the ECB stresses that the credit institution must become the creditor of the customer and the credit/loans that it grants must become its assets. It clarifies that the types of credit include those covered by activity 2 listed in Annex I to the Capital Requirements Directive IV (CRD) as well as overdraft facilities.

However, the ECB indicates that it will critically assess whether an entity proposing to take deposits and engage in lending will 'sufficiently develop' both activities, or whether another regulatory regime would be 'more appropriate'. Accordingly, the ECB appears to adopt a substantive (rather than formal) interpretation of the term 'credit institution'. This may allow it to decline applications for authorisation because the entity does not meet the definition of 'credit institution' even though it intends to engage in both constituent elements. This is in addition to the ECB being able to refuse approval because of more substantive concerns, such as the applicant not having the governance or risk management structures needed for conducting any of these activities.

### Scope of the ECB's licencing powers

The ECB made it clear in its letter to banks dated 31 March 2017<sup>4</sup> that it interprets its competence to grant licences for credit institutions in a very broad fashion. If the entity wishes to pursue deposit taking and lending, but also other licensable activities, the ECB will include these other activities in its authorisation decision. This applies not only to activities that are subject to mutual recognition as listed in Annex I of the CRD IV but also to business that is licensable under autonomous national law only (i.e. under national law that does not transpose EU law), as long as the relevant activities 'underpin a supervisory function under EU law'.

The general guide confirms this approach and further elaborates on instances where the ECB will take a licensing decision even where licence requirements are only triggered by autonomous national law.

<sup>2</sup> C-366/97, ECLI:EU:C:1999:71, holding that the term 'other repayable funds' refers not only to financial instruments that possess the intrinsic characteristic of repayability, but also to those that, although not possessing that characteristic, are the subject of a contractual agreement to repay the funds paid.

<sup>3</sup> Directive 2014/49/EU on deposit guarantee schemes. Article 2(1) point (3) of the Directive defines a deposit as a 'credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution is required to repay under the legal and contractual conditions applicable, including a fixed-term deposit and a savings deposit'

<sup>4</sup> SSM/2017/0140, available at [https://www.bankingsupervision.europa.eu/banking/letterstobanks/shared/pdf/2017/Letter\\_to\\_SI\\_Entry\\_point\\_information\\_letter.pdf?abdf436e51b6ba34d4c53334f0197612](https://www.bankingsupervision.europa.eu/banking/letterstobanks/shared/pdf/2017/Letter_to_SI_Entry_point_information_letter.pdf?abdf436e51b6ba34d4c53334f0197612).

**The ECB encourages prospective applicants to engage in pre-application discussions with supervisors.**

These include, for instance, national provisions requiring a licence for a change in activity or a change in legal form of the credit institution.

The ECB also confirms that licences cannot be transferred from one entity to another and, in particular, that licences are not automatically transferred in case of a merger. For instance, the licence of a credit institution that is the transferring entity will cease to exist as a result of a merger, and the receiving entity will need to have in place all required licences.

### Contents of application

The general guide elaborates on some aspects of the information that needs to be submitted with applications (as required by CRD IV and the European Banking Authority's draft Regulatory Technical Standards<sup>5</sup>). For instance, it clarifies that the ECB will apply the criteria set out in its May 2017 guide to fit and proper assessments<sup>6</sup> when assessing the management body, while stressing that flexibility may be appropriate for appointments in bridge banks.

It also explains that the applicant's shareholders will be assessed according to the criteria applicable for qualifying holdings (if they exist). Where there are none, the 20 largest shareholders will be assessed.

The ECB will add specific guidance on the assessment of capital and the programme of operation (Article 10 of CRD IV), ie the business plan, towards the end of 2017.

### The application procedure

The ECB views the application process as being divided into three distinct phases:

- 1. Pre-application phase:** the prospective applicant is encouraged to engage early in discussions with the authorities, who can raise concerns from a prudential perspective. The first port of call will normally be the national competent authority (NCA), but the ECB may also be involved.
- 2. Application phase:** this starts with the formal application being submitted to the NCA, which may either reject the application or submit a draft proposal for a decision to the ECB. The phase ends with a decision (by the NCA or the ECB) to reject the application or (by the ECB) to grant the authorisation. It should last no longer than 12 months, starting when the applicant submits a properly completed application, as defined by national law.
- 3. Hand-over to ongoing supervision:** in particular in the initial stages after authorisation, the ECB and NCA may want to closely monitor the institution's compliance with the terms of the licence, particularly the ancillary provisions and adherence to the business plan.

### The authorisation decision

The ECB stresses that it can attach ancillary provisions (conditions, obligations and recommendations) to authorisation decisions. This confirms the principles set out already in the guide on fit and proper assessments and the draft guide to on-site inspections and internal model investigations<sup>7</sup>. The main ancillary provisions are as follows:

- **Conditions** need to be fulfilled before the authorisation decision becomes effective

<sup>5</sup> Draft Regulatory Technical Standards under Article 8(2) of Directive 2013/36/EU on the information to be provided for the authorisation of credit institutions, the requirements applicable to shareholders and members with qualifying holdings and obstacles which may prevent the effective exercise of supervisory powers, EBA/RTS/2017/08, 14 July 2017.

<sup>6</sup> [https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap\\_guide\\_201705.en.pdf](https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705.en.pdf).

(condition precedent). Non-compliance will prevent the credit institution from commencing its business.

- **Obligations** are additional requirements or restrictions applying to the credit institution on an ongoing basis. Non-compliance does not automatically end the authorisation, but may lead to supervisory (enforcement) measures and sanctions.
- **Recommendations** are non-binding suggestions, the breach of which may nevertheless trigger further supervisory action (in particular the passing of a binding decision).

Commitments made by the applicant prior to the authorisation decision being adopted may comprise both conditions and obligations. They take the form of a written statement signed by the applicant and are presented in the authorisation decision as 'agreed conditions or obligations' (rather than being contained in a separate agreement between the applicant and the ECB). Similar commitments may naturally also play a role in other ECB procedures, such as the qualifying holding procedure, where they would normally be given by the acquirer.

Before any conditions or obligations are imposed, the ECB must normally give the applicant the right to be heard. The same applies to the right to access files. Interestingly, however, the ECB seems to imply that the right to access the application file only applies after the final decision has been made. This restriction does not follow from Article 41(2) of the Charter of Fundamental Rights, Article 22(2) of the Single Supervisory Mechanism (SSM) Regulation or Article 22 of the SSM Framework Regulation.

### Specific rules for fintech applicants

The fintech guide contains rules that are particularly relevant for the licensing procedures of so-called 'fintech companies'.

The ECB stresses that 'fintech' is an umbrella term encompassing a wide variety of business models. Accordingly, for the purposes of the fintech guide, the term is defined very broadly to refer to business models in which the production and delivery of banking products and services are based on technology-enabled innovation.

This definition captures existing banks intending to integrate fintech solutions (eg blockchain technology and mobile lending) as well as new market participants and existing financial services providers such as payment or e-money institutions planning to extend their business. Interestingly, the ECB clarifies that the rules will be no less strict for fintech firms than for other credit institutions, ie there will be no 'regulatory sandbox'.

### Fitness and propriety of members of the management body

The ECB explains that, for fintech companies, technical skills are generally as important as banking knowledge given that their business models are technology-driven. Accordingly, applicants should expect the ECB to focus on whether the management and the supervisory functions can prove they have the requisite technical knowledge. Against this backdrop, fintech banks should consider appointing a chief technology officer as a member of the executive board.

### Suitability of shareholders

The ECB also explains that shareholders of fintech companies should have management and technical competence in the area of financial activities, including financial

<sup>7</sup> [https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/osi/ssm.osi\\_draftguide.en.pdf?c545ba56129bf07158420cc9b436dedb](https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/osi/ssm.osi_draftguide.en.pdf?c545ba56129bf07158420cc9b436dedb)

**'Ex-ante commitments' by applicants will likely play an increasingly important role in the licensing process.**

**The ECB has granted licences to six fintech companies since July 2016.**

**No 'regulatory sandbox' system.**

**Additional requirements for fintech banks will also need to be considered by banks with traditional business models.**

services.

It appears that this requirement is intended to account for the fact that shareholders of start-up undertakings, particularly in the early stages, often have considerable influence on the management of the undertakings they sponsor. However, it should not be assumed that venture capital providers for fintech institutions always have experience in financial services.

In addition, shareholders usually have no management responsibilities. If they do, they should be assessed as managers, not shareholders. The approach suggested by the ECB seems to blur the boundaries between the assessment of the reliability of shareholders (which focuses on their financial soundness, their influence on the ability of the institution to comply with applicable laws and their effect on supervision by competent authorities) and the fitness and propriety of managers (which includes an assessment of their knowledge, skills and experience to perform their duties).

It remains to be seen how this new 'shareholder fitness requirement' will be applied in practice, and whether it will be extended to banks following other business models.

### **Capital and liquidity**

The start-up phase of a fintech bank typically involves a greater risk of financial loss than more traditional business models. Therefore, the ECB considers imposing additional (initial) capital or liquidity requirements where necessary. Shareholders should inform the ECB of their plans for providing support to the fintech bank over and above the required initial capital.

In addition, the institution will need to explain how it would change its business model in response to specific market needs, sudden customer reactions (such as the withdrawal of deposits) and the effect of extended periods of non-profitability on the availability and conditions of refinancing.

### **Structural organisation**

As fintech companies tend to outsource material parts of their business operations, the ECB will focus on the applicant's credit decision-making process and credit scoring.

In addition, the ECB will look at the applicant's systems and procedures for controlling IT-related risks, outsourcing arrangements (eg cloud outsourcing) and data governance (specifically cyber risks and data security).

### **Exit plan**

The ECB proposes to introduce a new requirement for fintech banks to prepare an exit plan.

Forming part of the general business plan, the exit plan must demonstrate that the fintech bank is able to voluntarily cease its business operations in an orderly manner. The exit plan will only need to be presented if requested by the regulators, taking into account the institution's specific business model.

The ECB clarifies that the exit plan is not the same as recovery and resolution plans.

While resolution plans are drawn up by the competent resolution authorities and recovery plans must include measures to recover from a financial crisis, fintech banks are encouraged to prepare their own exit plan, which should include a procedure to wind down the bank without causing disruption and losses to depositors. The exit plan must also contain a forecast for the start-up losses in the first three years of activity and financial forecasts for the period up to the break-even point.

The ECB will assess whether the fintech bank holds sufficient capital and its own funds cover potential costs to operate the business in the first three years of activity.

The ECB has said it will do a follow-up inspection one year after its licensing decision.

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