The new Swiss fintech licence – a licence for the future?

Daniel Flühmann and **Peter Hsu** of **Bär & Karrer** unwrap the new Swiss fintech licence and test its implications at a macro and micro level

The beginning of 2019 saw the introduction of a new regulatory licence category into Swiss law with the aim of facilitating or enabling novel business models in the financial marketplace. Figuring in the law under the term "promotion of innovation" (*Innovationsförderung*), the new licence has been informally dubbed the "fintech licence" or "banking licence light". The entering into force of the legal framework of the fintech licence marks the completion of a three-pillar fintech programme initiated by the Swiss Federal Council (the federal government of Switzerland) in November 2016 with the goal of adapting Swiss financial regulation to the business needs of the fintech industry, while adhering to the concept of a technology-neutral regulatory regime, as far as possible.

Fintech licence holders are allowed to accept deposits from the public on a professional basis – an activity previously limited to banks – subject to a deposit ceiling of CHF100 million (currently approx. USD99 million), but are precluded from investing those deposits, paying interests on them or otherwise conducting traditional commercial banking business. In turn, they profit from significantly relaxed regulatory requirements when compared to those applicable to holders of a fully-fledged banking licence. The lowering of the market entry barrier for eligible businesses seeking to establish operations in Switzerland is intended to further stimulate the strong Swiss fintech ecosystem. That said, the new licence is available to any business fulfilling the applicable requirements irrespective of the level of innovation or use of technology.

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The three-pillar approach

The Federal Council's three-pillar fintech programme revolved around various aspects of the regulated activity of deposit-taking in the context of typical fintech business models, such as payment services and crowdfunding. Specifically, the goal was to create a broader space within which such businesses can operate without triggering a full banking licence requirement (the latter being perceived as a "showstopper" for most companies in start-up mode). The two previously implemented pillars of the fintech programme referred to: (i) the extension of the maximum holding period for third-party funds in so-called settlement accounts (ie the time period during which such

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funds do not yet qualify as deposits) from seven days to a much more useful span of 60 days; and (ii) the establishment of a regulatory sandbox for innovative companies to test out their business model within clearly limited boundaries outside of a prudential licence requirement. Both measures were put into effect on August 1 2017 through amendments of the Federal Banking Ordinance (BankO). The fintech licence in addition required an amendment of the Federal Banking Act (BankA) and constitutes the third and last element of the programme.

Implementing the fintech licence within a comprehensive financial law reform

The Swiss regulatory framework for financial services is currently undergoing a major overhaul revolving around two major new federal acts adopted in June 2018: the Federal Financial Services Act (FinSA) and the Federal Financial Institutions Act (FinIA). The introduction of the new laws will bring with it a variety of additions and amendments to the existing framework of financial regulation to accommodate and integrate the new rules, some of which have been modelled after EU legislation such as Mifid II. Separately, the legislative process of the FinSA/FinIA project has been used as a fast track to implement the fintech licence. The legal basis for the new licence category was created by introducing a single new provision, the new article 1*b*, into the BankA, allowing the latter to be applied analogously to persons active in the financial sector that have a business need to accept limited deposits from the public, but do not engage in traditional commercial banking. The specifics of the new licence are detailed in a revised BankO. Both article 1*b* BankA and the new fintech licence provisions of the BankO entered into force on January 1 2019, a full year ahead of the FinSA and FinIA, which are expected to follow in 2020 together with their implementing ordinances. At that point, among other potential implications, fintech licence holders may depending on their business model also qualify as "financial services providers" and become subject to duties of conduct and other regulatory obligations pursuant to the FinSA.

New regulatory architecture for professional deposit-taking

The fintech licence bridges the gap between the practical needs of certain financial innovators (and other businesses) and the former Swiss regulatory concept of only permitting banks to accept deposits from the public on a professional basis (ie from more than 20 depositors or even less if one would publicly solicit deposits). As the Swiss financial marketplace evolved, more and more business models emerged that would in some shape or form rely on accepting and holding, at least temporarily, third party funds in varying amounts and from varying sizes of client constituencies. At the same time, these businesses would typically *not* look at offering traditional commercial banking services, eg by using the short- and medium-term deposits for long-term lending or investment purposes (maturity transformation). Typical examples are electronic payment services providers, e-money or e-wallet providers or crowdfunding platforms that collect the contributions and hold on to them until the funding goal is reached. The risk profile of these businesses significantly differs from that of a bank.

Under the former licensing regime, operating such business models at scale without a prudential licence would often prove difficult, as the exemptions from the definition of what constitutes deposit-taking from the public are very narrow and there was no licence type available that would allow for professional deposit-taking other than the fully-fledged banking licence. Most fintech providers would not go down the route of applying for a banking licence given the demanding standards, in particular the exigent capital requirements, associated with obtaining and maintaining that status. Furthermore, violation of a licence requirement may lead to regulatory enforcement proceedings and criminal sanctions under Swiss law.

The sandbox pillar of the fintech programme alone does little to alleviate this dilemma, as it only allows a person to hold up to CHF1 million in deposits (irrespective of the number of depositors, but provided that the deposits are neither invested nor bear interest) at any given moment; too little for fast-growing fintechs and scarcely enough for real life testing of a business model. The settlement accounts pillar of the fintech programme had a more profound impact. Being able to hold on to an unlimited amount of third party funds from an unlimited number of clients on settlement accounts for

a limited period of 60 days, without such funds counting as deposits from the public, opened up a broader spectrum of activities for fintechs to pursue without requiring a banking licence (though an SRO registration for AML purposes may still be required). However, certain business models were still limited by the lack of an intermediate licence; in particular, payment services or money remittance providers that would like to allow their clients to hold an e-money account to store value for future purchases or transfers or that hold on to funds for longer periods of time before making an aggregate payment for efficiency reasons. This gap has now been mitigated by the fintech licence.

Specific features of the fintech licence

The specific rights and permissions granted by the fintech licence on the one hand, and – as a counterweight – the limitations to the permitted activities on the other hand, may be characterised as follows: a fintech licence holder is permitted to accept and hold for an unlimited period of time deposits from the public up to a maximum amount of CHF100 million on a commercial basis, irrespective of the number of depositors. To balance the risk profile in light of the less exigent regulatory requirements – compared to a banking licence – fintech licence holders are prohibited from investing the deposits, or from paying any interest on the deposited amounts. Hence, businesses that merely accept and hold – and then forward or return as instructed – funds from third parties and that do not engage in the commercial banking business with maturity transformation, are eligible for the fintech licence.

Where multiple legal entities form a group, the CHF100 million cap in principle applies on a group-wide basis, subject to case-by-case exemptions if individual group companies are demonstrably independent. The prohibition to invest the deposits covers a broad range of activities, including any lending activities of the fintech licence holder for own account using the deposited funds or, in principle, the investment in securities or other financial instruments for own account. The fintech licence holder must segregate the deposits from its own assets or at least earmark them in its books so that they can at any time be identified. In the latter case, the licence holder becomes subject to an ordinary financial audit requirement. Other than as sight deposits with a commercial bank, with the Swiss National Bank (SNB) or with another fintech licence holder, it is also allowed to hold the deposits in the form of category 1 high-quality liquid assets (HQLA) in the meaning of the Swiss (Bank) Liquidity Ordinance. The currency in which the assets are deposited must be the same as the one in which the reimbursement claims of the clients are denominated.

Licensing requirements in general

The competent body for the granting of a fintech licence, as well as for the ongoing supervision of licence holders, is the Swiss Financial Market Supervisory Authority FINMA. FINMA already before the end of 2018 published guidance regarding the form and content of fintech licence applications. While the guidance document is on its face substantially similar to its counterpart for a fully-fledged banking licence, and while many of the supporting documents required by FINMA are the same, the substantive requirements for a fintech licence are significantly less burdensome. Simplifications, disapplications or specifically tailored requirements (in comparison to the requirements for a banking licence) apply to regulatory matters such as audits, corporate governance, capital and liquidity requirements and depositor protection.

Organisational and audit requirements

A fintech licence holder must be organised as a company limited by shares, a partnership limited by shares or a limited liability company. Its domicile and actual management must be located in Switzerland. A cooperative is not eligible as a fintech licence holder. This is remarkable as banks organised as cooperatives have traditionally played a significant role in Switzerland.

Compliance and risk management functions must be established and must be independent from the company's profit-oriented business. On a case-by-case basis, FINMA may grant relief from the independence requirements if the fintech licence applicant/holder generates a gross income of less than CHF1.5 million and demonstrates a low-risk business model. Fintechs may outsource the monitoring of compliance and risk management to third parties, while regulated banks may be more limited in this regard depending on their supervisory categorisation by FINMA.

The audit and financial reporting requirements for banks and fintech licence holders differ: fintechs have to appoint a regulatory auditor recognised by FINMA in the same way as banks, but there are reduced eligibility criteria for fintech auditors. In addition, the accounts of a fintech licence holder must be prepared in accordance with Swiss corporate law only, rather than the substantially more involved accounting provisions for banks. The guidance document published by FINMA does not specify whether the application dossier for a fintech licence must be examined by a separate recognised audit firm for the benefit of FINMA's review process. FINMA has reserved its discretion on this aspect of the application process and it cannot be excluded that it will in practice, in individual cases, require a licence application audit depending on the fact pattern. This leaves some uncertainty for potential applicants as to timing and cost of the process.

Corporate governance requirements

If required by the company's purpose or volume of business, both banks and fintechs must establish a governing body (board of directors) that must be at least three members strong. The board of directors of a fintech licence holder need not be entirely independent from the senior executive management – as is the requirement for banks – but still a minimum of one third of the board members must not concurrently be part of management. FINMA may grant further exemptions from the organisational requirements for fintechs in individual cases.

In addition to the members of the board and management, any persons who hold 10% or more of the equity or voting rights of, or by other means have a significant influence on the business of, a fintech or a bank (such persons are referred to as "qualified participants") must enjoy a good reputation and it must be ensured that their influence does not negatively impact the fit-and-proper conduct of business of the fintech or bank.

Capital requirements

Fintech licence holders will have to provide for a minimum capital of 3% of the amount

of deposits accepted from the public, but in any event no less than a fully paid-up capital of CHF300,000. Further, FINMA may require higher amounts if the risks associated with the business necessitate it. Banks are subject to much stricter capital requirements, for example the fully paid-up minimum capital must be a least CHF10 million (in practice often higher) and, depending on the scope of the business, the regulatory capital requirement might be much higher.

The use of the minimum capital by fintechs is subject to certain restrictions. It must for example not be returned to related parties in the form of loans nor invested in participations controlled by related parties. That said, fintechs are not subject to the provisions of the Capital Adequacy Ordinance and the Liquidity Ordinance (which transpose the Basel III accord into Swiss law), a major simplification and cost-saving aspect compared the banking regime.

Simplified anti-money laundering setup

As prudentially regulated financial institutions, fintech licence holders are subject to the Anti-Money Laundering Act (AMLA) and in particular to the duties of due diligence, documentation, reporting and record-keeping provided for therein. To address the generally lower risk profile of fintechs, FINMA revised the FINMA-Anti-Money Laundering Ordinance (AMLO-FINMA), introducing simplified organisational requirements.

No depositor protection; information duty

Fintech licence holders are not part of the Swiss depositor protection scheme *esisuisse* and the deposits with them do not profit from this safeguard in the event of an insolvency. The rationale for this is that fintechs are limited to holding the deposits in liquid form (including HQLA), which minimises the relevant risk exposure.

As an additional protective measure, fintech licence holders must inform their clients sufficiently in advance (before entering into a contractual relationship) in writing or otherwise in the form of text, but not in general terms and conditions only, (i) about the risks associated with the business model, the services provided and the technologies deployed, and (ii) about the fact that the deposits are not covered by any depositor protection scheme.

Participation in the SIX Interbank Clearing (SIC) system

The Federal Council refrained from taking a position in the explanatory report on the BankO revision as to whether a fintech licence holder should be eligible for a sight deposit account with the SNB and for participation in the SIX Interbank Clearing (SIC) system, noting that these decisions are in the sole competence of the SNB. Shortly after the entering into force of the legal basis for the fintech licence, in a press release dated January 11 2019, the SNB announced that it would grant sight deposit accounts and SIC access to those applicants that: (i) significantly contribute to the fulfilment of the SNB's statutory tasks; and (ii) do not bring any major risks into the system. The SNB focuses on fintech licence holders in the area of payments whose business model significantly contributes to the functioning and facilitation of cashless Swiss Franc payment transactions. The spirit of the press release is positive and promising as it indicates that fintechs are under certain circumstances eligible as SNB accountholders and for participation in the SIC. However, the press release does not provide any further guidance and it remains to be seen how applications to SNB will be dealt with in practice.

(Un-)level playing field concerns

Swiss financial regulation takes a fairly liberal stance on the provision of Swiss inbound cross-border financial services. Indeed, many, if not most, domestic financial laws and regulations do not apply to fintech (and other) businesses that are domiciled abroad and serve customers in Switzerland on a pure cross-border basis, ie without employing persons permanently on the ground in Switzerland. As a consequence, foreign fintechs may offer their services to clients in Switzerland without a Swiss regulatory licence and without being subject to ongoing prudential supervision in Switzerland, provided that they have not established any relevant formal or *de facto* physical presence in Switzerland. While the regime is similar for other financial service providers, its liberal nature is of particular relevance in the area of fintech. Fintech services are typically rendered to customers via online channels and are by their very nature not location-dependent. Hence, many fintechs do not require a physical presence to do business in Switzerland and are further encouraged not to establish such presence by the lack of regulation for inbound cross-border services.

This particularity of the Swiss system raises some concerns. For one, there is no legal basis and no practical means for the Swiss authorities to ensure that foreign fintechs active in Switzerland on a cross-border basis are subject to adequate supervision in their home jurisdiction, potentially exposing Swiss based clients to an elevated risk of financial harm. Furthermore, there is the potential of unbalancing the competitive playing field because foreign fintechs may address customers in Switzerland on a cross-border basis and, in doing so, do not have to comply with Swiss law requirements. Domestic fintechs, on the other hand, are often much more limited in becoming active outside the Swiss borders as other jurisdictions are rarely as liberal with regard to inbound financial services.

Laying the foundations

The new regulatory licence type lays the groundwork for the further development of the promising fintech marketplace in Switzerland and shows the agility of the Swiss legislator in focus areas. It is supplemented by further legislative projects in the distributed ledger and blockchain space, with proposals expected already for the first quarter of 2019.

Switzerland is committed to remaining at the top of the fintech landscape and to position itself as a welcoming jurisdiction for fintech projects. The Swiss approach of a non-specific licence type allows the fintech licence to be, within intended limitations, what the creative minds in the fintech industry will make of it. This distinguishes Switzerland, for example, from the EU, with its more specific licence types for e-money institutions and payment services providers. The principle-based approach of Swiss financial regulation further ensures flexibility in the application of the law and protects it from immediately becoming outdated in this fast-paced world.

The coming months will show how the new licence type will be received by the industry, both on the start-up level and by established players that may be interested in setting up separate innovation labs. Despite having its limitations, the future of the fintech licence looks promising.