CENTER FOR ADVANCED STUDIES

ON THE REGULATION OF THE NATIONAL FINANCIAL SYSTEM

NEASF

REPORT ON 13th MEETING OF THE CENTER FOR ADVANCED STUDIES ON REGULATION OF THE NATIONAL FINANCIAL SYSTEM

FGV DIREITO RIO

OPENING REMARKS

On March 11, 2022, the Center for Advanced Studies on Regulation of the National Financial System (NEASF), part of the Center for Research in Law and Economics (CPDE) at Fundação Getulio Vargas' Rio de Janeiro Law School, held its 13th meeting (exceptionally online).

NEASF's main objective is to contribute to better regulation of the national financial system through research and analysis that make it possible to diagnose problems and identify opportunities to improve Brazil's financial sector. NEASF is a multi-stakeholder organization involving representatives of academia, the markets and government. Through debates and roundtable discussions, its members discuss topics related to regulation of the national financial system, contributing to broader understanding of the sector, trends, risks, any regulatory gaps and their implications.

The chosen subject of NEASF's 13th meeting was "Regulatory Asymmetry Between Financial Institutions and Fintechs."

Regulatory asymmetry is currently one of the main topics of debate in the national financial system. This phenomenon occurs when different agents compete in the same regulated subsystem but are subject to different and asymmetric regulations.[1]

This subject came to prominence due to recent clashes between financial institutions and fintechs (payment institutions in particular). On the one hand, it is argued that financial institutions are subject to stricter regulatory requirements than other agents operating in the financial markets. Along these lines, it is argued that promoting competitiveness and encouraging reductions in barriers to entry into the financial markets may have caused disproportionate regulatory treatment between institutions that essentially provide the same services but are subject to different regulatory regimes. Therefore, certain business models could amplify risks to the stability and health of the national financial system, which are not adequately addressed by regulations.

On the other hand, it is argued that the activities performed by fintechs do not pose the same risks as those of financial institutions, so there is no justification for establishing symmetric regulation between financial institutions and fintechs. Furthermore, imposing more stringent requirements would result in higher compliance costs for fintechs, discouraging innovation and harming competitiveness in the national financial system.

In order to contribute to the debate and understand different perspectives on the subject, the meeting was structured into three parts: (i) distinction between regulatory asymmetry

[1] GUERRA, S. Regulação estatal e novas tecnologias ("State regulation and new technologies"). **Interesse Público**, v. 100, 2016

and asymmetric regulation, focusing on theoretical aspects related to regulation; (ii) an economic view of asymmetric regulation, including activities carried out by participants and possible risks to the national financial system's stability; and (iii) operational and tax aspects of asymmetric regulation, including the need to regulate from a functional point of view and to rethink the taxation applicable to activities performed by financial institutions and/or fintechs in the national financial system.

The statements made by Fundação Getulio Vargas staff and guests who participated in the meeting exclusively represent their respective opinions and not necessarily FGV's institutional position.

DISTINCTION BETWEEN REGULATORY ASYMMETRY AND ASYMMETRIC REGULATION

The first part of the meeting looked at the concept of regulatory asymmetry from a theoretical perspective. In Regulation Theory, "regulatory asymmetry" is understood to mean differentiated rules for actors in the same sector or in the same sector chain.[2] Among other objectives, this can favor the entry of new participants in a given market to correct a situation of imperfect competition.[3] Thus, "regulatory asymmetry" refers to those situations in which the legal system allows an activity to be undertaken in different legal/regulatory regimes.[4]

To begin with, in the context of this theoretical discussion, a distinction between "regulatory asymmetry" and "asymmetric regulation" was pointed out. It was said that some people might mistakenly assume that the first term is the same as regulatory arbitrage, which occurs when an economic agent may opt for a certain legal regime not because of the nature of the services provided, but because of the regulatory regime, which is more beneficial to them.

Meanwhile, the term "asymmetric regulation" is used around the world in the Theory of Regulation, in all markets, and the term "regulation" originated in an idea of equilibrium. In order to understand how asymmetric regulation is transposed to markets, it was noted that the word "symmetry" is of Greek origin and it consists of the combination of "sym" (together) and "metron" (measure), thereby meaning "having a common measure." So, in this case, symmetric regulation would express the notion of regulations for activities with similar characteristics.

Two assumptions for establishing "regulatory symmetry" were presented. First, the activities must be the same, with no difference in nature, without barriers and with no distinctions in terms of risks, including systemic ones. Second, all companies must be able to compete on equal terms.

However, it was pointed out that completely symmetric regulation is unlikely in a situation of imperfect markets. Thus, the expression "asymmetric regulation" was adopted, as it is deemed to more accurately convey the idea that differences in regulatory treatment can be justified by market failures, requiring a regulatory agent to act to mitigate them proportionately.

After that, it was emphasized that asymmetric regulation is provided for in the Federal Constitution, in its preamble, in article 5[5] and in Section VII, which concerns the Economic and Financial Order, highlighting the role of the state as an inducer of regulation.

Some examples of asymmetric regulation as a tool for creating a collaborative ecosystem

[2] MARQUES NETO, F. de A.; ZAGO, M. F. Limits of regulatory and contractual asymmetries: the case of Brazil's airport infrastructure. **Administrative Law Review**, Rio de Janeiro, v. 277, n. 1, 2018, p.175-201.
[3] FRISON-ROCHE, M.-A. Asymmetry: asymmetric regulation / asymmetry of information. Journal of Regulation & Compliance. Available at: <https://thejournalofregulation.com/en/article/asymetrie-regulation-asymetrique-asymetrie-dinform/>. Accessed on: April 16, 2022.
[4] LYON, T. P.; HUANG, H. Asymmetric regulation and incentives for innovation. **Industrial and corporate change**, v. 4, n. 4, 1995, p. 769-776.
[5] Article 5 – All persons are equal before the law, without any distinction whatsoever, Brazilians and foreigners residing in the country being ensured of inviolability of the right to life, to liberty, to equality, to security and to property.

and encouraging competition were cited. For example, it was noted that in the 1990s, the telecommunications sector underwent a restructuring, whereby the market was opened up to competition and the state stopped directly providing these services. Some operators acquired the existing network (infrastructure and customers) and, in order to neutralize this competitive advantage, they were subject to regulatory requirements regarding universalization and continuity of service. Asymmetric regulation was established for incoming operators to ensure greater competitiveness in the telecommunications sector. Accordingly, new entrants operated under the "authorization" regime and they were not subject to tariff regulation and the same obligations imposed on operators in the "concession" regime.

Likewise, it was mentioned that the National Telecommunications Agency (Anatel) uses the concept of "significant market power" to determine the application of certain obligations on operators (as seen in Anatel Resolution 600 of 2012, amended by Anatel Resolution 694 of 2018, for example).

Unbundling was also mentioned as another successful case of asymmetric regulation. Unbundling consists of the duty for telephone operators to share their networks with local service providers, thereby expanding customers' range of services and boosting competition in the sector. This allowed new competitors to enter the market, breaking the monopoly in Brazil, while the regulator was responsible for determining the conditions for this to occur.

While discussing successful cases of asymmetric regulation, the meeting's participants also mentioned the power, airline, railroad and port sectors. Considering differences in agents' nature, risks and activities, it was pointed out that asymmetric regulation can promote competition by establishing an "artificial competitive advantage" to benefit certain categories, to the detriment of others.

In the financial sector, the differentiated treatment of payment institutions and financial institutions was cited as an example of balance generated by asymmetric regulation. This is justified by the fact that financial institutions have their own specific features and risks so they warrant stricter regulation. For example, it was said that only financial institutions can broker or invest their own or third-party financial resources, pursuant to article 17 of Law 4,595 of 1964.[6] This means that financial institutions can effectively create currency (scriptural money) through the fractional reserve system, as they are only required to keep a fraction of these deposits in reserve at the Brazilian Central Bank and they may lend the rest. For this reason, total currency in the economy is a multiple of the monetary base.[7]

As a result of this specific economic function, which is fundamental for the functioning of the market economy, financial institutions are subject to a stricter regulatory regime compared to other financial market agents. The creation of special credit lines during the COVID-19 pandemic was cited as a characteristic example of the distinction between payment institutions and financial institutions. In this context, the meeting's participants mentioned the need to separate payment institutions' activities and financial institutions' activities and discussed this

[6] Article 17. For the purposes of current legislation, financial institutions are deemed to be public or private corporate persons whose main or accessory activity is the collection, intermediation or investment of their own or third-party financial resources in national or foreign currency, and custody services for assets belonging to third parties.
[7] PINHEIRO, A.; SADDI, J. Direito. **Economia e Mercados**, Elsevier, 2005, p. 449.

subject's relationship with Brazilian Central Bank Public Consultation 78.[8]

The example of regulatory sandboxes was also pointed out. This is a type of regulatory asymmetry that encourages innovation, as experiments with more beneficial regulations for new entrants in the financial markets generate new models in the sector, improving the economy's efficiency. It was also said that the Brazilian Central Bank has been moving toward inducing proportional models of regulation and encouraging financial and technological innovation.

The possibility of carrying out a public policy evaluation to verify the effectiveness of regulatory asymmetries was also discussed. The importance of economic impact assessments to investigate possible scenarios, mitigate possible issues related to increased competition in the national financial system and put the emergence of new technologies on the agenda was also raised. It was also said that payment institutions can generate new business for financial institutions, insofar as they allow people without traditional bank accounts to participate in the financial system. This demonstrates the existence of complementarity and cooperation between these institutions, in addition to competition.

To illustrate this, it was mentioned that despite competition with payment institutions, the average return on assets of Brazil's three largest private sector banks has remained stable. This seems to indicate that regulation has been successful. The same applies to average return on equity and profit margin.

It was then said that the growth of payment institutions is not solely related to the issue of regulation, because they have been growing across the world, while the regulations applicable to payment and financial institutions are not homogeneous in all countries. In this context, the growth of fintechs is not unique to the Brazilian market and is not only due to regulation.

Finally, two subjects that seem relatively neglected by Brazilian academics were raised: (i) asymmetry in terms of the market power of technology platforms, which are global and pose considerable systemic risks; and (ii) cryptocurrencies.

It was then said that the existence of asymmetric regulations is a well-grounded fact, but this does not mean that such regulations do not need to be treated in accordance with their possible advantages or disadvantages. However, there are many regulations that are not asymmetric, but rather structural deficiencies of our markets, which also need to be addressed because they impose a loss of competitiveness and efficiency on certain institutions. Thus, good asymmetric regulation is based on the pursuit of market balance, which has been the Brazilian Central Bank's focus of attention.

Likewise, it was pointed out that the great challenge for asymmetric regulation is the radical transformation that the national financial system has been going through, caused by technological evolution and changes in consumer behavior, as well as a very active regulator in this area. Thus, the financial system is likely to be profoundly different from the traditional one in the near future. In theory, this is considered a positive thing that should not be artificially limited. However, the presence of inefficiencies could cause regulatory targets in the national financial system to be missed, if efforts to improve competitiveness and efficiency and to meet consumers' needs are not prioritized.

[8] Public Consultation held in 2020, regarding "a series of regulatory proposals to harmonize the prudential treatment applicable to payment services." It gave rise to Brazilian Central Bank resolutions 197, 198, 199, 200, 201 and 202.

According to one of the meeting's participants, in order for this objective to be achieved, it is essential to keep in mind that nowadays there are risks of a different nature, different risk combinations within the same institution and in some cases a lack of differentiated risk profile combinations. However, traditional segmented regulation is not in line with the current financial system, as it was designed to suit the structure of large vertical conglomerates. The Brazilian Central Bank is considering new types of regulations, which would have the following advantages: (i) treatment of specific risks; (ii) permission for incumbents to work in the same innovation arena, which is different from the traditional banking structure; (iii) measures to resolve some existing inefficiencies; and (iv) the possibility of regulating Big Tech and other institutions that are currently outside the national financial system but perhaps ought to be controlled, considering the nature of the activities they carry out in the financial markets.

ECONOMIC VIEW OF ASYMMETRIC REGULATION

Potential regulatory asymmetry was then analyzed from an economic angle, beginning with the Diamond-Dybvig Model.[9] This model uses game theory to explain the impacts of the actions of two types of people at two moments in time. There are people who need resources immediately and others who can wait to use these resources in future. The model seeks to explain how financial institutions can transfer resources from agents with surpluses to agents with deficits, while keeping liabilities more liquid than assets. During the meeting, it was argued that this maturity transformation function justifies the regulations imposed on financial institutions, while payment institutions deserve different regulatory treatment, as they do not perform this activity and naturally are not exposed to the risks arising from it. In this context, central banks play a regulatory role, "allowing investors with demand for liquidity to carry out their investments through commercial banks, instead of acquiring securities directly in the capital markets." In the case of Brazil, the country's central bank plays the role of lender of last resort.

Thus, it was pointed out that patient agents are able to wait to use resources in the future and they prefer to invest now. In this context, the fractional reserve system is a way for banks to grant loans that exceed their cash reserves, generating illiquidity and potential risks. The main risks include the possibility of bank runs, given that if all patient people were to decide to withdraw their funds at the same time, banks would have to liquidate their long-term assets, which are worth less than their liabilities.

In short, it was concluded that a fractional reserve banking system can simultaneously provide insurance against agents' liquidity shocks and induce an optimal amount of long-term investment in technology. Thus, there will be an equilibrium induced by a banking system with fractional reserves in which the best possible allocation will be generated.

Accordingly, it was noted that central banks emerged in order to provide this function of lender of last resort and mitigate these risks and costs. In other words, a bank can use its liabilities to meet the immediate liquidity needs of its customers and invest in long-term assets. However, these measures could lead to riskier behavior on the part of banks. Therefore, one solution could be ex ante prudential regulation, meaning the imposition of minimum capital rules on financial institutions.

On the other hand, it was mentioned that payment institutions carry out activities of a different nature, such as: (i) issuance of electronic money, which does not involve maturity transformation or the possibility of a bank run, nor contagion to other institutions; (ii) capture of payment transactions, restricted by the fact that at any given moment, the amount payable is less than the amount receivable, and receivables cannot be leveraged either; (iii) "direct credit company"

[9] This macroeconomic model represents a theory about the actions of people and institutions to predict systemic behavior and to think about how the fractional reserve regime can generate an efficient allocation of resources in the economy, but also poses risks of bank runs. The model was proposed by Douglas W. Diamond and Philip H. Dybvig in a now-classic article in the Journal of Political Economy, v. 91, n. 3, 1983, p. 401-419.

activities financed by equity, which also do not pose the aforementioned risks due to their form of financing.

With regard to financial conglomerates, possible concerns about payment and financial institutions merging were discussed. In the view of those present, this would not cause any compound risk, regardless of organizational format, as the merged institution's risks would be equivalent to the sum of individual risks, so there would be a neutral effect from a systemic risk point of view. In short, merged conglomerates would not affect the overall risks faced by society and the markets in general.

As an example of an unjustified regulatory asymmetry, it was mentioned that financial institutions employ 1% of the economically active population in Brazil but they account for around 27% of payroll tax revenue. Another unjustified asymmetry, according to those present, is the different treatment of Brazilian and foreign institutions and credit unions.

One participant then highlighted the need to differentiate between the various activities carried out by payment institutions, such as the issuance of electronic money, narrow banking[10] and other activities that do not generate risks similar to those that financial institutions pose and that are therefore subject to special regulations. Regarding postpaid transactions, it was argued that it is necessary to distinguish between card issuance and loan issuance.

It was also said that, in general, innovation comes before regulation and regulators are risk averse. However, in the case of financial regulation in Brazil, there have been many initiatives in which the regulator played the role of inducer (as occurred in the case of Law 12,865 of 2013). This type of action by the regulator allowed concrete innovations in the payments market, such as the PIX instant payment system.

Furthermore, it was emphasized that the role of regulation is to try to ensure that institutions participating in the financial markets internalize negative externalities arising from their activities. For this purpose, the principle of activity-based regulation can be used, which considers that similar activities should be subject to similar rules (same risk, same regulation). However, there is also another approach, called entity-based regulation. In Brazil, the regulator uses both types of instruments. Finally, it was mentioned that regulation and taxation ought to have a neutral effect on the national financial system's structure of incentives.

[10] "In short, the financial system is divided into two groups: banks that are fully guaranteed (by deposit guarantee insurance mechanisms, usually state-owned) and banks without any type of coverage. From a regulatory point of view, performance bonds are extended to a part of the financial system that is less vulnerable to risk and volatility, with the counterpart of greater supervision and control by the central bank. The institutions are obliged to buy only government bonds, ensuring that assets are liquid and certain, so liabilities will be completely guaranteed." SADDI, J. Notas sobre a crise de 2008: o modelo do Narrow Banking. **Valor Econômico**, November 6, 2008, p. A15.

OPERATIONAL AND TAX ASPECTS OF ASYMMETRIC REGULATION

The last topic discussed in the meeting was operational aspects of asymmetric regulation. To begin with, a distinction between regulation and taxation was drawn, given that their theoretical frameworks are considerably different. From a functional perspective, factors justifying the regulation of financial institutions and minimum capital requirements were debated. It was said that the main reason to regulate them is to transform potential public costs into private costs (internalization of externalities) and to avoid systemic risks. Based on this, a prudential regulation model can be justified, whereby regulatory capital is allocated ex ante to these institutions, to try to prevent them from having problems that would generate costs for society. It was said that this also applies to other rules involving financial institutions, such as those governing extrajudicial liquidation, which is completely different in the case of non-financial institutions.[11]

It was said that since the 1929 crisis, all financial market crises have involved an attempt by financial institutions to remove risks from their balance sheets (off-balance-sheet risk). Therefore, prudential regulation should always be functional, focusing on where risks materialize. In other words, it should respect the purpose for which it was created, without being bound by the legal form of the institution or activity that generated the risk. It was also emphasized that this should be done sparingly, addressing the risk in question. To sum up, the main focus of debate is not whether or not payment institutions are involved, but the way in which risk is transmitted between conglomerates or between other institutions operating in the financial markets.

It was also observed that business models change over time and regulators should be attentive to this evolution and adjust the regulations accordingly. Thus, it is necessary to consider that creating credit and providing credit are two different business models and accounting rules must reflect this.

Bearing this in mind, it is unlikely that a payment institution will remain only a payment institution. Due to the profitability of operations involving credit, there is a tendency for them to expand into activities in the credit market. Thus, prudential regulation must look at this from an economic point of view and understand the economic nature of risk over time. The institution's form is less important and insufficient to determine liquidity and capital requirements, among other things. Due to the foregoing, it was said that form is not a decisive factor regarding compliance with certain regulatory requirements.

An explanation was then given to differentiate between the nature of different taxes. Considering the constitutional distinction between taxes whose primary purpose is to raise revenue and other taxes, there is no reason for tax asymmetries between them. It was argued that in the case of taxes whose primary objective is not to raise revenue, it ought to be easier to modify them, such as by means of a decree, while taxes aimed at raising revenue ought

[11] Law 6,024 of 1974 versus Law 11,101 of 2005.

to go through the entire financial cycle before they are instituted. In view of this, a misunderstanding of tax asymmetries involving taxes aimed at raising revenue was raised: when such a tax is treated asymmetrically, there is a direct increase in bank spread and consequently in the costs incurred by financial institutions' customers.

Regarding the relationship between taxation and regulation, it was noted that the spread/tax multiplier for the economy is very high and it was argued that regulation and taxation should not affect incentives or the way in which entities are organized. For example, the tax system should not induce people to have several small companies instead of one large one, because this means giving up economics of scale in order to pay less tax. This point is frequently raised by economists.

In this regard, it is important to clarify the tax differences between financial institutions and payment institutions. Brazilian Central Bank resolutions 197, 198, 199, 200, 201 and 202 transposed the idea of reference equity to payment institutions, which would be internal to financial institutions. This is based on the idea that financial institutions have to meet stricter capital requirements and they are subject to a higher tax burden than payment institutions. For example, fintechs pay less tax than financial institutions. It so happens that the idea of reference equity emerged within the scope of the Basel Committee for financial institutions and became a concept internalized in Brazil by National Monetary Council Resolution 3,444 of 2007, which established risk monitoring calculation parameters.

However, payment institutions do not grant loans on the basis of bank deposits. As a result, it was noted that there is no risk of a bank run involving a payment institution, unlike in the case of financial institutions.

Therefore, in order for regulation to improve structural aspects of the national financial system, it is necessary to understand that excessive taxation affects the bank spread and cost of credit in a country. The Credit Cost Indicator and the Credit Cost Indicator Spread were developed to serve as indicators of regulation's ability to meet the objective of improving the business environment in the Brazilian financial markets. According to Brazilian Central Bank Technical Statement 45, the Credit Cost Indicator "is intended to estimate the average monthly cost for families and companies that have taken out loans in the national financial system." The Credit Cost Indicator Spread "corresponds to the difference between the Credit Cost Indicator Spread and its funding rate." This second indicator "allows us to identify the factors that determine the cost of credit for borrowers, leaving out the effects of market conditions related to the cost of raising funds," according to the Brazilian Central Bank's latest Banking Economics Report.[12]

Considering that spread is the difference between what a financial institution pays and the interest it charges borrowers, the higher the cost of credit, the greater the pass-through to borrowers. Thus, a higher tax burden for financial institutions is evident and it could end up contributing to an increase in spread, transforming the tax revenue-raising purpose into a cost for final customers.

Therefore, it was said that the favorable treatment of other entities authorized to operate by the Central Bank or the non-regulation of other companies can generate a distortion in the financial markets and

[12] 2020 Banking Economics Report, p. 84. Brazilian Central Bank.

increase the bank spread. Consequently, taxation should be guided with a revenue-raising purpose, focusing on a certain area of activity.

The importance of analyzing an institution's business model was also mentioned. This makes it necessary to understand how institutions evolve over time. Another factor to be considered is the requirement to analyze regulation and competition jointly. It was said that the Brazilian Central Bank is very attentive to this.

Finally, it was said that the Brazilian Central Bank is currently at the cutting edge of regulation. Brazil was the first country in the world to issue provisioning rules, for example. This induction role is seen as positive and in line with the understanding that the relationship between the state and private sector needs to change so that the flurry of new entrants into the national financial system is not considered a problem.

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