Proceedings of ICEMGD 2025 Symposium: The 4th International Conference on Applied Economics and Policy Studies
DOI: 10.54254/2754-1169/2025.BJ24015

Fintech and Financial Regulation: Current State of Development and Interactions

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Abstract: The rapid rise of financial technology(fintech) is changing the traditional financial landscape and bringing new challenges while leading to financial innovation. Financial regulation faces the contradiction between tradition and innovation and needs to find a balance between development and risk. This paper combs through the core technology of fintech and analyzes its impact on traditional finance. Secondly, it explores the dilemma of the current regulatory framework, examines innovative models such as sandbox regulation, and summarizes the global experience of differentiated regulation. Next, this paper explores the mutual dual impact between fintech and financial regulation. Finally, this paper puts forward the future direction of regulation, emphasizing preventive regulation and technology-enabled regulation. This paper hopes that by deeply analyzing the dynamic relationship between fintech and regulation, exploring to understand the regulatory model that adapts to the development of fintech, providing ideas for building an agile and robust regulatory ecology and promoting the healthy development of the financial industry.

Keywords: Fintech, Financial Regulation, Suptech

1. Introduction

As a product of the deep integration of finance and science and technology, financial technology(fintech) is rapidly emerging and profoundly changing the pattern of the traditional financial industry, and its rapid development has become the core driving force for the change of the global financial industry. Under the integration of various emerging technologies and traditional financial services, FinTech has significantly improved some of the problems existing in traditional financial services, significantly improved the efficiency and penetration rate [1], and extended the boundaries of financial services while reducing costs[2]. However, the rapid development of financial technology has also brought many new challenges and risks [3].

Financial regulation, as an important means to maintain the stability of the financial market and protect the rights and interests of investors and consumers, is therefore facing unprecedented challenges and opportunities. On the one hand, the traditional financial regulatory framework appears to be overwhelmed in dealing with the innovative and dynamic nature of fintech, and various problems are becoming more and more prominent [4]; on the other hand, fintech also provides new tools and methods for the innovation of regulatory instruments [5]. Therefore, how to find a balance between encouraging the sustainable development of FinTech and preventing financial risks has become the core topic of current financial regulation.

DOI: 10.54254/2754-1169/2025.BJ24015

The purpose of this paper is to explore in depth the complex relationship between fintech development and financial regulation by systematically combing the existing literature. First of all, this paper will analyze the impact and opportunities of fintech on the traditional financial system. At the same time, this paper focuses on summarizing the practical experience and theoretical innovation of financial regulation in responding to the challenges of fintech. Finally, this paper explores the possible paths for the synergistic development of fintech and financial regulation in the future.

2. Overview of Fintech and financial regulation

2.1. Overview of FinTech

FinTech refers to the change and development of financial services through technological innovation. In recent years FinTech has risen globally and become an important force in the financial field, applied to all aspects of the financial field.

Many emerging technologies have been applied to the financial field. Big data technology can enable financial institutions to more accurately understand customer needs, assess credit risk, and significantly improve risk management capabilities by mining and analyzing data [6]. Artificial intelligence technology can learn patterns from data and can significantly improve the efficiency and accuracy of investment decisions [7]. The popularity of the Internet also allows users to access some financial services anytime and anywhere, promoting the popularization and convenience of financial services [8]. Cloud computing provides powerful computing power and data storage capacity, and financial institutions can use cloud services on demand, significantly reducing the operating costs of financial institutions [9].

Fintech also has a huge impact on the traditional financial system. First, the decentralized characteristics of fintech make the provision of financial services no longer strongly dependent on traditional financial institutions, posing a threat to the core business of traditional financial institutions [9]. Secondly, FinTech makes the market competition pattern production turbulent, and traditional financial institutions face the risk of market share being eroded by FinTech companies. Similarly, the development of FinTech has gradually blurred the boundaries between the financial industry and other industries, exacerbating the complexity of market competition [10]. Finally, FinTech has led to the emergence of many new types of financial risks, as FinTech relies on information technology, cyber-attacks or data leaks can lead to serious financial losses [8].

2.2. Overview of financial regulation

Financial regulation refers to the supervision and management of financial institutions and financial markets by relevant organizations through the implementation of a series of means. Its core objective is to balance the relationship between financial innovation and risk prevention to ensure the long-term stable development of the financial market.

The current financial regulatory system mainly consists of macro-prudential regulation and a unified regulatory model. Macro-prudential regulation focuses on the overall stability of the financial system rather than the safety of individual financial institutions. Its objective is to identify and mitigate systemic risks and reduce the “pro-cyclicality” of the financial system [11]. On the other hand, the unified regulatory model emphasizes the comprehensive regulation of financial markets, breaks the limitations of sectoral regulation, and responds to the cross-cutting nature and complexity of financial business under the trend of mixed business operations [12]. On these bases, with the tide of globalization, international regulatory cooperation is also a part that cannot be ignored. International regulatory cooperation aims to build a unified global financial regulatory standard to cope with the cross-border risks brought by financial globalization [13].

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However, the current financial regulatory system also faces many challenges and dilemmas. First, small-sized and medium-sized financial institutions may be difficult to regulate on time due to their small size and relatively low business complexity, and insufficient allocation of supervisory resources, which results in regulatory blind spots as their risks are difficult to be regulated promptly. Furthermore, market complexity leads to an increasingly complex regulatory system, and regulators need to constantly update their regulatory techniques and policies, which increases costs significantly [14]. In addition, different countries have different levels of financial development and differences in regulatory objectives and legal frameworks, making it difficult to form unified global regulatory standards, leading to information asymmetry and regulatory arbitrage, and increasing the risk of global financial markets [15].

3. Interaction between fintech and financial regulation

Fintech and financial regulation have an increasingly profound influence on each other with the development of technology. On one hand, the development of fintech has a profound impact on regulation; on the other hand, financial regulation also has a double impact on the development of fintech.

3.1. Positive impact of fintech development on financial regulation

The positive impact of fintech development on financial regulation is mainly reflected in three aspects: promoting regulatory innovation, enhancing market transparency and strengthening risk identification.

The rapid development of fintech has promoted the emergence and wide application of regulatory technology (RegTech). By utilizing cutting-edge technological means such as big data analysis, artificial intelligence, and machine learning, regulators are able to significantly improve the accuracy and timeliness of regulation [2], which not only enhances regulatory efficiency but also provides strong support for the stable operation of the financial market [16].

In addition, fintech enhances the transparency of the financial market through the application of blockchain technology [2]. The distributed ledger characteristic of blockchain technology makes financial transaction records tamper-proof and easy to trace, eliminating the possibility of data counterfeiting and information tampering from the source. It not only reduces information asymmetry, but also enables investors and consumers to more accurately assess the risks of financial products and services [17].

Finally, the development of fintech provides regulators with richer data resources and more advanced analytical tools. With the help of big data analysis and artificial intelligence algorithms, regulators are able to acquire and process massive financial data more quickly, thus enhancing the ability to identify systemic and market risks, which helps regulators better prevent financial risks and maintain the stability of the financial market [1].

3.2. Negative impacts of fintech development on financial regulation

Similarly, fintech also brings problems to financial regulation, mainly regulatory lag and regulatory arbitrage problems, data security and privacy protection problems and regulatory complexity problems.

First of all, the development of fintech and the blurring of the boundaries of the financial market make it difficult to adapt to the traditional regulatory framework, which brings a huge challenge to traditional financial regulation, and the difficulty of regulation rises significantly [1]. At the same time, the innovation speed of fintech exceeds the reaction speed of regulators, resulting in the increasingly prominent phenomenon of regulatory lag, and speculators take advantage of regulatory

DOI: 10.54254/2754-1169/2025.BJ24015

gaps or regulatory differences to carry out regulatory arbitrage and avoid regulatory constraints, thus affecting the stability of the financial market [2].

Secondly, the development of fintech relies on the collection and processing of large amounts of data, which poses significant challenges of data security and privacy protection [10]. The risk of data leakage and misuse not only jeopardizes consumer rights but also may trigger a crisis of trust in the financial market. In addition, fintech companies usually need to cooperate with multiple third parties, and data are also prone to security breaches during transmission and sharing.

Finally, the widespread use of fintech has led to closer ties between financial institutions and a significant increase in the complexity of financial markets. This complexity not only increases systemic risk, but also makes it more challenging for regulators to identify and prevent systemic risk [18]. Moreover, fintech firms are usually involved in a variety of business areas, and the innovation and complexity of their business models have created new challenges for regulators.

3.3. Positive impact of financial regulation on fintech

Consistent with the above, financial regulation also brings many positive impacts on fintech, mainly in three aspects: regulating market order, guiding and promoting the healthy development of fintech and preventing financial risks.

Above all, reasonable financial regulation can provide a stable and fair market environment for the development of fintech. By formulating clear laws, regulations and regulatory frameworks, regulators can prevent market disorder and unfair competition [1], protect the rights and interests of consumers and investors from fraud and unfair transactions, help enhance investors' trust and confidence in the financial market, and promote the healthy development of the financial market [19]. This regulated market environment also contributes to the healthy growth of fintech enterprises.

Furthermore, by guiding and encouraging fintech companies to focus on social needs and serve the real economy, financial regulators have promoted fintech to play an active role in financial inclusion and financial inclusion [4], which helps fintech companies focus their innovation direction on areas that are in line with national policy guidance and social needs, and promotes the sustainable development of fintech [1].

At last, one of the core objectives of financial regulation is to prevent financial risks. Regulators can ensure that the business models of fintech companies are sufficiently risk-resistant through stress testing and risk assessment. Such risk prevention measures help to safeguard the healthy operation of the entire financial system and prevent the occurrence of systemic risks [2].

3.4. Negative impacts of financial regulation on fintech

However, not all that financial regulation brings to fintech is positive; limiting innovative vigor, hindering market access and increasing business operating costs are its three main negative impacts.

Undoubtedly, overly strict financial regulation will have a certain inhibiting effect on the innovation vigor of fintech enterprises. Strict compliance requirements and cumbersome approval procedures may limit the room for innovation and flexibility of firms. Such regulatory pressure is not only detrimental to the rapid development of fintech, but may also hinder the overall innovation process of the industry [20].

In addition to this, complex regulatory procedures and high regulatory thresholds may make it difficult for some potential fintech startups to enter the market due to a lack of sufficient capital and resources to fulfill regulatory requirements [13]. This hindrance is not only detrimental to the innovation and development of the fintech industry, but may also lead to the market being monopolized by a few large institutions, affecting the quality and efficiency of financial services [21].

DOI: 10.54254/2754-1169/2025.BJ24015

What's more, there are differences in financial regulatory policies between different countries and regions, and the implementation of regulations requires fintech firms to invest more to meet the compliance requirements. Fintech firms may need to hire specialized compliance teams and develop complex compliance systems to ensure that their business meets the regulatory requirements in different regions. This increase in compliance costs not only adds to the burden of the firm, but may also affect its profitability [3].

4. Development of fintech regulation

With the rapid development of the fintech industry, its impact on the traditional financial system has become increasingly significant, prompting regulators around the world to continuously explore and adjust regulatory strategies. This paper will explore fintech regulation from two aspects: existing regulatory practices and possible future development directions.

4.1. Existing regulatory practices

The rise of fintech has deeply changed the way financial services are supplied and the mode of operation of financial markets. Therefore, how to build an effective fintech regulatory system has become a major challenge for global financial regulators. Globally, different countries have explored diversified fintech regulatory models based on their own national conditions and development needs.

The UK's innovation-friendly regulation mainly implements sandbox regulation, principle-based guidance, and open banking approach. It enables fintech companies to test innovative services and products in a controlled environment, provides room for trial and error, and gives them greater flexibility, to achieve the consolidation of London's position as a global financial center. At the same time, it ensures that the UK has a leading position in the competition in the fintech market and avoids willful innovation due to over-regulation [20].

China, however, implements a strict control type of regulation. It is mainly implemented in the form of dynamic adjustment of the regulatory system and penetrating regulation, on the basis of which it isolates fintech from finance. It restricts fintech companies from getting involved in financial business and prevents disorderly capital expansion, to achieve the goal of balancing innovation and risk, ensure financial sovereignty and social stability, and avoiding systemic risks caused by excessive innovation [13].

The United States, on the other hand, is centered on functional regulation and federal-state decentralization, emphasizing regulation based on the type of business rather than the type of institution, in order to prevent systemic risks and protect investors' rights and interests [3]. The EU, on the other hand, emphasizes principle orientation and data protection to ensure the legitimate rights and interests of consumers through the development of a unified regulatory framework. Singapore implements license classification regulation to reduce compliance costs for startups and improve the relevance and effectiveness of regulation through a differentiated licensing system [20].

4.2. Future direction of fintech regulation

In the future, financial regulation will focus more on the shift from “containment” to “taming”, emphasizing preventive regulation and the application of regulatory technology. Meanwhile, international cooperation and coordination will become an important trend to deal with fintech cross-border risks. By analyzing the existing literature, this paper discusses the possible future development direction of financial regulation.

Traditional fintech regulatory strategies are mostly “accommodating”, aiming to provide space for fintech innovation by relaxing regulatory restrictions. However, this strategy has brought many risks while promoting innovation. In the future, therefore, regulators will increasingly adopt a “taming”

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strategy, requiring fintech business models to comply with regulatory standards, even if this may hinder innovation to some extent. This strategy will focus more on preventing public harm than on remedying it once it has occurred [5].

On the other hand, Suptech will be an important development in the future of fintech regulation. Regulators can utilize advanced technologies to process large amounts of information and improve regulatory efficiency and transparency. For example, the use of APIs to obtain data from financial institutions in real time to achieve dynamic regulation of fintech companies can not only improve the accuracy of regulation, but also effectively reduce the cost of regulation and improve the effectiveness of regulation [5].

In addition to this, in the future, regulators will pay more attention to preventive supervision and reduce the public harm that may be caused by fintech innovations by formulating risk assessment and contingency plans in advance. By strengthening the risk monitoring and early warning mechanism for fintech companies, discovering potential systemic risks in a timely manner and taking appropriate measures to prevent them, not only can they effectively reduce the risks brought by fintech innovation, but also provide a strong guarantee for the healthy development of fintech [13].

Finally, international cooperation and coordination will become an important trend in future regulation. Regulators from various countries need to strengthen information sharing and experience exchange and work together to develop unified regulatory standards to deal with the cross-border risks brought by fintech. Establishing a cross-border regulatory coordination mechanism to ensure that the business activities of fintech companies in different countries are effectively regulated will not only help maintain the stability of the global financial market, but also promote the healthy development of fintech nature and effectiveness [20,22].

5. Conclusion

This paper systematically combs through the relationship between fintech development and financial regulation, analyzes the impact of fintech on the traditional financial system and the opportunities it brings, summarizes the challenges faced by financial regulation and innovative practices, and explores the possible ways of synergistic development of fintech and financial regulation in the future.

Through the study, this paper finds that the development of fintech itself has a double impact: on the one hand, fintech significantly improves the efficiency, penetration and inclusiveness of financial services through a variety of emerging technologies, and promotes the innovation and transformation of many traditional financial fields; on the other hand, the rapid development of fintech has also brought about the problems of systemic risk, data security vulnerability, regulatory arbitrage, market monopoly, etc., which poses a serious challenge to the traditional regulatory framework. On the other hand, the rapid development of fintech also brings systemic risks, data security vulnerabilities, regulatory arbitrage, market monopoly and other issues, posing serious challenges to the traditional regulatory framework.

Under such circumstances, financial regulation is facing difficulties and has made many improvements and innovations to cope with them. Traditional compartmentalized regulation and its lagging nature make it difficult to cope with the dynamic nature of fintech, leading to many problems such as regulatory gaps and rising compliance costs. Therefore, countries around the world have explored differentiated regulatory models, such as the UK's “regulatory sandbox”, China's “penetrating regulation” and the US's “functional regulation”, in an attempt to balance innovation and risk prevention, and have achieved good results. The “penetrating regulation” in China and the “functional regulation” in the United States are attempting to balance innovation and risk prevention, and have achieved good results.

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The interaction between fintech and financial regulation is a problem that must be faced in order to continue the rational development of fintech and the transformation of financial regulation. Therefore, the transformation of regulatory strategy is something that needs to be accomplished in the future. From "inclusive regulation" to "preventive regulation", the regulatory framework can be dynamically adjusted to identify and prevent emerging risks in advance. At the same time, the use of artificial intelligence, blockchain and other technologies to improve regulatory efficiency, real-time data monitoring and risk early warning, to achieve the rational use of regulatory technology. Finally, strengthening international cooperation and balancing innovation and stability are also aspects that must be considered.

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