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Capital Markets FinTech:
Beyond the hype

FINTECH

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Post-conference report

Opening keynote by *Jean-Paul Servais, Chairman, Financial Services and Markets Authority (Belgium) - Chair of ESMA's Financial Innovation Standing Committee, and Chairman of European Regional Committee, IOSCO*

In his opening keynote speech**, Jean-Paul Servais** stressed that while supervisors should support financial innovation, the approach must be very balanced taking into account the potential benefits, remaining alert to the risks and challenges that need to be properly addressed and engaging in an open dialogue with both traditional and new fintech players. From a regulatory perspective, it is important to understand whether the financial innovations would improve regulated services, create new services or challenge regulated entities. Various forms of fintech (e.g. distributed ledger, robo-advice, alternative platforms, big data) are very high on the agenda in international fora and competent authorities at both EU and national level. Moreover, a number of supervisory authority in Europe (e.g. BE, UK, CH) have put in place regulatory "sandboxes", by which they encourage businesses to test innovative products, services, business models and delivery mechanisms. Regardless of the type of financial innovation, the consumer must remain at the centre of all activities. One of the potential benefits of fintech is financial inclusion. Nonetheless, one should make sure that consumers are well equipped to make decisions in a digitalized world and additional safeguards are in place. He also shared from the FSMA's results of the on-site inspections and mystery shopping campaigns carried out at banks and other regulated companies in the past 5 years (3 topics: conflicts of interests, duty of care – product suitability, best order execution) and also ex-ante financial products approval. With respect to the post MiFID II world of investment advice and the impact on the distribution of investment funds, he indicated that national authorities have opted for a ban on inducements (UK, FI, NL), keeping a open landscape (BE) or maintaining the local presence (FR, DE). From a supervisor's point of view, there are no that many differences between classical and the online distribution channels. The main challenges include, for example, giving investment advice too early, or giving investment advice that does not sufficiently take account of the information about the client.

Session 1. Applications of financial services technology (FinTech) to investment services: Product manufacturing, distribution channels and advisory services

The financial sector is no stranger to innovation. Nevertheless, over the past few years, the exponential growth of FinTech companies suggests that more disruptive changes will be required in order to bring the financial system fully into the 21st century. Providers of investment services have begun to revisit their product portfolios and distribution channels, making massive investments in FinTech start-ups, accelerator/incubator programmes and even appointing chief innovation officers. Big data-driven intelligence powered by algorithms is improving the understanding of investors' needs and market offerings, gradually leading to more competitive pricing of financial services. These developments aim at giving greater choice (of both complex and non-complex products) and accessibility, with lower costs and reasonable returns. For example, robo-advisers have already entered the market, but are mostly based on exchange-traded funds (ETFs), due to their simplicity and flexibility. A growing number of online platforms offer investors access to a wide range of product manufacturers but not yet on a pan-European basis.

Note: This report was drafted by Cosmina Amariei (Researcher, European Capital Markets Institute). The content of this event report is not a transcript of the speakers' interventions and should instead be understood as the interpretation of their views by the author.

- ➢ Will FinTech companies succeed in enabling more investors to access financial products and services and increase their participation in financial markets?
- ➢ Will automated investment advice replace the traditional 'human' professional advice?
- ➢ Can the emergence of new technologies drive further competition between product manufacturers and distributors and improve cross-border access to retail financial products and services?
- ➢ Are the current retail distribution channels, i.e. closed versus open architecture, allowing for new technological changes to develop?
- ➢ Are some FinTech developments in investment services likely to create market failures? Or can they be entirely left to competitive market forces?

Panellists

- o **Matthieu Remy**, *Founder & CEO, Easyvest*
- o **Jeff Salway,** *Member, Financial Services Consumer Panel*
- o **Rhodri Preece**, *Head of Capital Markets Policy, CFA Institute*
- o **Jean-Paul Servais**, *Chair of ESMA's Financial Innovation Standing Committee*

Moderator: **Florencio Lopez de Silanes**, *Professor of Finance and Law and Director of Governance Research Program, EDHEC Business School*

Matthieu Remy explained that robo-advisors (or rather digitally-assisted advisors) provide their clients with investment portfolios that are smarter, simpler and more affordable than with a traditional financial advisor or private banker. Contrary to the popular belief, the field is populated with "hybrid" models combining the algorithm-based investment techniques with the traditional human professional advice. At present, most robo-advisors are based on exchange-traded funds, adding value on the advisory part and negotiating their costs with the relevant players in the investment value chain. With respect to the business model, he indicated that fintech companies will continue to partner with well-established financial institutions due to the possibility to raise capital more quickly, use their customer base and distribution channels and knowledge of the relevant regulatory frameworks. In his view, the sandbox initiatives may lead to a two-speed regulation. He would rather prefer the regulators to hire internal consultants to help fintech start-ups to manoeuvre the regulatory maze and to proactively suggest business model adaptations in such way they could achieve their commercial vision whilst being compliant with regulation.

Rhodri Preece presented the findings of a recent CFA Institute Member Survey. 70% of the respondents consider that automated financial advice tools will impact positively mass affluent investors in terms of reduced costs, improved access to advice, and better product choices. It is also highly unlikely for automated financial advice tools to gain traction for the other end of the advice market. Institutional investors and ultra-high net worth individuals with large portfolios and complex investment needs will continue to favour tailored, personalised human advice. These results reveal a bifurcation in the advice market and allude to the fact that the mass market is underserved at present, a gap that can be filled in by robo-advisers. Nonetheless, flaws in the algorithms, mis-selling risks and privacy and data protection concerns could negatively impact the take up of automated financial advice. In his view, the automated advice could increase the cross-border distribution/access to investment products but for the benefits to materialise some obstacles need to be overcome.

Jeff Salway argued that while robo-advice represents a low-cost, accessible and particularly good option for non-complex investment portfolios, there are some big potential downsides too, including the prospect of systematic mis-buying and/or mis-selling if one algorithm is not working properly. There are also serious questions as to whether the risk profiling and product suitability tools used by some firms are fit for purpose and concerns over how knowledgeable are the people who enter in such type of transactions (e.g. understanding how the information is used and how much it will influence the eventual outcome). This is compounded by a lack of clarity around consumer protection. He also stressed that the lines between (regulated) financial advice and guidance are very blurred with lots of automated advice services being really guided invested sales and not offering financial advice. The challenge for the regulators is to get the balance right. When it comes to traditional financial advisors, he believes that robo-advisors represent actually an opportunity of engaging with the tech-savvy, younger generation.

Jean-Paul Servais indicated that FinTech firms are designing automated tools to meet different customer needs: financial planning, product information, fund management. Automated advice tools can be used to provide advice on a fully automated basis or as a tool for a human advisor to use. At present, a small share of customer assets advised/managed by automated tools. Nonetheless, the significant interest shown by large established firms suggests a larger market growth ahead. Amongst the potential benefits of the automated advice, he referred to the increased access to advice and products (also on a cross-border basis), lower charges and the emergence of new entrants, business models. However, it may be harder to accurately assess the client's understanding without the interactive dialogue with an advisor. Algorithms may also miss relevant information, which can result in portfolios that don't match with the specific situation of client. Lastly, increasing exposure to IT/ cyber security risks should be duly taken into account.

Session 2. Distributed ledger technology: The impact on securities transaction lifecycle and value chain

Distributed ledger technology (DLT) has the potential to bring issuers and investors into direct contact, leading to further disintermediation in the securities industry. It can achieve greater efficiency, transparency and even 'democratisation' of finance (financial inclusion). Trading and post-trading operators have already started to test blockchain technologies and to integrate them into their business models. Potential savings for investors could be significant. Clearing, settlement and other post-trade processes currently cost the global financial industry well in excess of €50 billion per year. DLT can result in nearly instantaneous clearing and settlement upon trade execution. Questions emerge, however, around the robustness of the underlying technology, i.e. its ability to handle large transaction volumes, but also security issues and the governance of a technology that should ensure interoperability and the possibility to be scrutinised by public authorities. Collateral management, record of ownership and securities servicing are also other areas where the technology is most likely to bring useful changes.

➢ What are costs and benefits of DLT? Would DLT deliver on multiple objectives, e.g. investor protection, market integrity and financial stability?
➢ Is a gradual or even full-scale deployment of DLT feasible? Is there a need for common standards/protocols and stricter requirements to access the network?
➢ What is the impact of DLT on incumbents, such as banks and investment firms, exchanges, CCPs, CSDs, custodians, etc.?
➢ Will the infrastructure based on DLT co-exist with the legacy infrastructure? How will these two systems be interoperable?
➢ Should these new infrastructures operate under two different legal regimes?

Panellists

o **Frank Versmessen**, *Head of Regulatory Affairs, Swift*
o **Jenny Knott**, *Chief Executive Officer, Post Trade Risk and Information, ICAP*
o **Pinar Emirdag**, *Non-Executive Director, Clearmatics*
o **Rhodri Preece-Jones**, *Head of European Development, Nasdaq*

*Moderator: **Svi Rosov**, Analyst, CFA Institute*

Frank Versmessen explained that multiple DLT solutions (or "distributed database") covering various segments in the securities transactions value chain will continue to emerge in the next 2-3 years and be subjected to proof-of-concept testing. The main driver for industry participants will be the potential to achieve operations and cost efficiencies. Because the financial services is a network industry and in order to avoid an increasing fragmentation, the adoption of DLT will require common business rules, further standardisation, and new governance arrangements. With respect to the implementation of DLT, he outlined challenges related to three business layers: infrastructure, data and behavioural aspects. It is not only about digitising assets (and assuring adequate protection) but also corporate actions, roles and responsibilities. In his view, DLT is inherently more secure; the distributed nature of the ledgers and no single point failure may mitigate the risk for a cyber-attack to materialise. Nonetheless, a flaw in the network endpoints might trigger wider consequences.

Pinar Emirdag stressed the need for the industry participants to build a business case before running experiments with different financial technologies, i.e. to identify the problem, the benefits and the risks, what they want to achieve in terms of processes and operations at different points in the business cycle and how can technology help in this respect. The current design of the financial infrastructure is a far too siloed and this results in significant data fragmentation. Streamlining the infrastructure will enable a better distribution of products to more people across geographies. Rather than automating existing processes as they are, the participants will need to redesign some of the business flow; anything short of this approach would be a missed opportunity. This approach will create new business opportunities as well as improved efficiencies. In her view, there will be no single piece of technology that market participants are going to use, multiple solutions will be developed and deployed and one should insure interoperability with the existing networks. Regulators will have to put in place an appropriate legal framework while the financial institutions will be dealing with their own challenges in integrating the new technologies given the multiple layers of approval embedded in their organisational culture.

Jenny Knott indicated that the only way forward for the financial services industry is to embrace the emerging technologies in order to address the already long-standing operational inefficiencies and enable further simplification, standardisation and transparency. In her view, the financial services industry should engage in collaborative efforts to modernise and streamline core processes, practices and protocols and disrupt their own services. Another desirable outcome would be to create a trusted "golden source" of data for the financial ecosystem, which is unchallengeable in its accuracy and authenticity (transactions are confirmed, validated and reconciled) and can be shared in real time with 'permissioned' participants, including supervisory authorities. As for the DLT (and its application to the post-trade services), she stressed that it is not about automating but eliminating, i.e. doing things better, cheaper, faster. The next 2-5 years will be very important in terms of experimenting and building confidence in the DLT.

Rhodri Preece-Jones emphasized that one should not believe that blockchain technology is a panacea for everything. It is indeed a catalyst for change that could bring about both disruption and innovation in financial markets. Nonetheless, the promise is still to be realised. The impact will depend on how it's going to be implemented in the next 5-10 years (primary issuance, secondary trading, clearing and settlement, safekeeping of assets and record of ownership, collateral management, securities lending). Nasdaq has been one of the earliest firms to explore potential uses of blockchain and currently looks into developing a portfolio of business tools to support the full trade life-cycle and hence allow their clients to stay ahead. For example, the firms that want to stay private already have the option to replace their general ledger, to have an immutable record of who owns what part their company. In his view, the blockchain technology could accelerate the use of smart contracts and enable more disintermediated transactions.