

Regulating financial services in the age of FinTech

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New technologies are revolutionizing how financial services are provided to users across the world. Tangible changes continue to disrupt the payment service industry by lowering costs and increasing the competitive pressure on incumbents. Even more disruptive changes in securities issuance and settlement have been predicted for some years now, but very slowly being delivered by the Blockchain's underlying Distributed Ledger Technology (DLT). The consensus-based infrastructure underlying the DLT creates opportunities for smart contracts to reduce transaction costs, including litigation costs. Artificial intelligence (AI) and cloud computing are also disrupting the provision of investment services and insurance, among others, via new advisory tools. The result is, on the one hand, an increasing pressure on margins through greater competition and, on the other hand, the gradual move from competition among specialised financial firms to a competitive landscape where financial groups increasingly struggle against BigTechs, which are able to capitalise on the competitive advantage that big data and a larger scope of commercial activities produce. As it is happening in small markets, like crowd-investing and peer-to-peer lending, financial services will be increasingly provided by one-stop-shop platforms that will be able to offer multiple funding tools, from equity and corporate bond issuance to loans. The recent move by Facebook, with the launch of Libra, is also a first step in that direction. The growth of Initial Coin Offerings (ICOs) has also showed that the widespread tokenisation of securities issuance is not so far down the road.

The opportunities brought about by financial technologies cannot be a call for complacency of both supervisors and regulators. Many concerns are still hanging over these new technological developments. Among those, the concentration and related operational challenges that come with the one-stop-shop platforms offered by BigTechs create significant idiosyncratic risks (such as cybersecurity or scalability issues). For instance, the new Facebook Libra claims that will serve 2.8 billion network users with a permissioned DLT network that will be able to process 1,000 transaction per second. Assuming that 1,000 transaction per second would be enough in all circumstances for so many potential users, this claim does not match a reality in which (permissionless) DLT networks out there are currently able to process a few dozen transactions per second. For means of payment, scalability may become a serious issue that may lead to a 'run-like' event in a crisis situation. Challenges also arise on how effective monetary policies will be in a context with limited control over the monetary base. Moreover, fraud and money laundering risks are very high with tokenisation of digital assets that are a replication of investment-like instruments (like shares), but with no rights attached and often issued directly by individuals, so making it harder to identify the liable person. More work needs to be done to identify the real gatekeepers, such as the platforms that convert virtual into fiat currencies, which should bear the burden of key anti-money laundering checks. The integration of internet-based services in the whole financial services value chain also raises concerns that cyber-attacks can produce widespread damages and thus destabilise the financial system.

When it comes to regulating financial services, national and international regulators and organisation (like the FSB, IOSCO and the European Commission) have taken a very prudent approach, by trying to first understand the nature of the change and thereupon to check how equipped is the current regulatory framework to face it. In some cases, especially at early stages, some regulators have been using sandboxes, with limited or no licensing requirements but with a strictly monitored perimeter of

activities, to understand how these services/instruments are deployed on the market and spot potential regulatory loopholes. The European Commission, in its first consultation on FinTech, expressed a clear view that financial services legislation should be technology neutral and proportionate.[2] As EU financial services legislation is mostly activity-based, an approach based purely on how this activity or service is delivered would be altering this (fragile) harmony. Meanwhile, the European Securities and Markets Authority (ESMA) has highlighted the importance of distinguishing between digital assets that are payment and investment-like, which are mostly falling under the current legislative framework in some way, from other digital assets (like utility-like and some dispersed virtual currencies) that are not currently covered by a comprehensive framework. Nonetheless, the definition of transferable security in Europe remains a national prerogative, so the end result may vary significantly across Member States. Complexity also arises in regulating diffused virtual currencies, like Bitcoin and potentially the newcomer Libra. If not captured as financial or money market instruments, the closest definition in EU regulation for virtual currency could be e-money, but some may argue that the storage of value function foreseen in article 2.2 of Directive 2009/110/EC is not necessarily met, if we consider how volatile Bitcoin has been in recent years and how Libra plans to reinvest money in short-term assets and other currencies. According to the Securities and Exchange Commission (SEC), while diffused cryptocurrencies, like Bitcoin and Ether, fail the 'Howey test' mostly because of the lack of expectations of a financial return, many cryptocurrencies are now considered securities in the US. But new case law may reopen this discussion at some point. This new financial services infrastructure also makes some legal requirements not applicable at all and may call for new regulatory requirements, such as in the case of settlement finality in relation to the transfer of tokens of ICOs, or potential safekeeping obligations on providers of digital wallets for DLT networks, where only one key to access the asset is available and held by the ultimate beneficiary on his/her own laptop. In particular, several organisational requirements, including some in the Markets in Financial Instruments Directive, would probably need re-calibration to fit new modalities on how financial instruments, means of payments, and investment services (among other) are being offered/provided.

To conclude, regulators across the world are facing a daunting task in regulating new complex areas, like DLT-based financial services or AI in investment advice. Considering the high risk of circumvention, regulators across the world need to work together to find common grounds as we further move into the unknown.

[1]The views expressed in this contribution are personal and do not represent the views of the European Commission to which the author is also affiliated.

[2]See European Commission, Consultation Document on FinTech: a more competitive and innovative European financial sector, April 2017, see https://ec.europa.eu/info/sites/info/files/2017-fintech-consultation-document_en_0.pdf