ADAPTING THE FINANCIAL FRAMEWORK TO DIGITALISATION

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Fintech regulation: how to achieve a level playing field

The emergence of fintechs and big techs constitutes a major source of disruption in the market for financial services. There is already some consensus that we need a comprehensive policy approach, particularly for big tech platforms that offer a large variety of financial and non-financial services – and that this comprehensive framework should aim at minimising competitive distortions.

A slogan which has gained much traction and has often been presented as the basis for the regulatory reform is "same activity, same regulation". This suggests moving from a framework of designing requirements for entities with a specific licence or charter – what we call entity-based (EB) regulation – to rules that address specific activities, ensuring that they apply homogenously to all types of entities performing each activity – what we call activity-based (AB) regulation.

However, achieving a level playing field in a particular market is not a highest-priority objective for policymakers, although it is a relevant one. In some policy areas, like consumer protection or anti-money laundering and combating the financing of terrorism (AML/CFT), there does not seem to be a rationale (based on primary policy objectives) to discriminate across providers of a particular financial service. By contrast, in other areas, like prudential policies or competition, specific EB rules are required. In general, this is the case when risks emerge not only from the performance of a particular activity, but also from the combination of activities that entities perform.

Therefore, regulatory discrepancies across entities performing a specific activity may sometimes, although not always, be justified on superior policy grounds. The current regulatory framework offers mixed signals on the extent to which unwarranted regulatory discrepancies remain.

In AB policy areas, like AML/CFT or consumer protection, it is hard to find discrepancies in the requirements imposed on commercial banks as opposed to other providers of financial services. However, in areas where an EB approach is adequate, there may not be sufficient rules that address the specific risks generated by big techs. This is the case in the area of operational resilience, where a comprehensive approach for big tech groups may be warranted, as is currently the case for banks. Moreover, there are strong arguments for imposing ex ante constraints on big techs' practices concerning data use and different sources of discrimination across actual or potential participants in the platform.

There are indeed some initiatives in different parts of the world (notably in the US, the EU and China) which seem consistent with the need to develop new EB rules for large, big tech platforms. In particular, in the EU the European Commission proposals for a Digital Markets Act and a Digital Services Act contain far-reaching regulatory requirements for big techs.

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Regulatory crossroads in digital finance

The EU needs vibrant and sustainable capital markets. Achieving this goal depends crucially on the ability of its financial sector to continuously adapt to faster innovation cycles and evolving business models, to new technological infrastructures and instruments and to fair and responsible use of digital data.

This challenge is recognised both by the new CMU action plan and the Digital Finance Strategy and will only be met if the regulatory and supervisory frameworks strike a balance between ensuring a level playing field that promotes innovation and safeguarding other objectives such as protection of consumers or competition. This, in practice, means we will need pragmatic approaches to the "same activity, same risk, same rules" principle.

In fact, mixing "activity-based" and "entity-based" rules will be necessary both to promote and control innovation in the digital era.

Take BigTechs for instance - although their footprint is still limited in EU's asset management and non-banking financial intermediation (but already relevant in the payments sector), it is wise to consider "entity-based" rules that might deal with possible impacts of their huge market power on financial stability, operational resilience, data protection or competition, together with "activity-based" rules.

On the other hand, and although "activity-based" rules are essential for a proper level playing field between incumbents and newcomers, we should simultaneously ensure that we clearly understand the true nature and implications of new proposals before we classify them and tie them to specific activity rules. This is especially relevant when we deal with completely new realities emerging from the confluence of Artificial Intelligence, Big Data, Cloud Services and DLT.

To face these challenges, regulatory sandboxes and innovation hubs might prove to be useful tools both for regulators and innovators, by helping to reduce information asymmetries and regulatory costs, as several studies have shown. EU-wide initiatives, such as the DLT pilot regime for market infrastructures are, therefore, welcome. This said, possible risks and the relevant differences between these two types of innovation facilitators should be considered.

We will need to keep a pragmatic approach to financial innovation regulation and supervision.

From the experience and information gathered in Portugal FinLab, the innovation hub of the three Portuguese financial regulators (CMVM, Bank of Portugal and ASF), innovations hubs seem to be particularly adequate for projects in seed or pre-seed phases that tend to have few resources allocated to the regulatory framework; while regulatory sandboxes might be better suited for more mature firms with innovation proposals.

As regards risks, at least three should be highlighted: given the level of regulators' resources required by innovation facilitators, regulators' focus might be diverted (and even biased) towards the selected projects, hindering a more comprehensive approach and strategy for innovation.

Additionally, regulators might also end up prioritising innovation over other objectives such as consumer protection. Finally, there is a "race to the bottom" risk in what regards this regulatory framework. A clearer single regulatory rulebook and stronger supervisory convergence within the EU for innovation facilitators might help.

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Digital age in European asset management: a revolution to come?

The Asset Management industry has always taken technological innovations on board. However, for the last decade, the acceleration of FinTech has required to adapt very quickly to this phenomenon to stay ahead of the curve, in order to reduce costs, improve efficiency and possibly explore new fields of investments.

In which areas does the financial framework need adapting to make it fit for leveraging the new opportunities offered by digitalisation in the asset management sector?

What is critical is to avoid keeping an existing set of regulations regarding a fully new area. In particular, the organisation of the Pilot Regime for market infrastructures based on DLT clearly requires the adaptation of the current rules applicable to CSDs and MTFs to facilitate decentralization, competition and lower costs for new infrastructure players.

On the other hand, some high-level principles should remain the same, for instance ensuring the digital operational resilience of those new players to preserve the safety of the whole value chain. The Pilot Regime should also allow for a wider range of eligible assets to make that regime develop sufficiently fast and widely, thus facilitating the amortization of entry costs by new market infrastructures - to the ultimate benefit of end-users.

What are the main regulatory obstacles to the further digitalisation of asset management activities?

For AXA IM, digitalization has already started, e.g. making use of Artificial Intelligence and Machine Learning. But to go further, regulatory obstacles remain and currently relate to DLT – while with DLT, we aim to reduce our costs and therefore those of our clients, as well as increase our efficiency, both in the settlement of assets and distribution of funds.

Does the DFS put forward the main regulatory and supervisory changes that are needed for reaping the benefits of digitalisation in the fund management and distribution area?

The DFS is indeed an excellent initiative proposed by the Commission to ensure the EU remains competitive within an adapted regulatory framework and to set a minimum harmonization among Member States in such a fast-developing area. For instance, regarding DORA, we support the minimum regulatory framework set around critical ICT service providers, in order for users like us to benefit from a higher safety on behalf of our end clients.

However, regarding supervision, on DORA we have some concern about the leading authorities which might be the recipients of incident reports: while our natural competent authorities are securities regulators, considering the risks of hacking which currently exist and which recently hit financial regulators such as the US SEC, we would favor giving that role to the dedicated information security agencies, such as ENISA – which would then share reports with securities regulators as a second step.

In terms of EU legislative process, one key challenge remains ahead of us: how to conciliate the usual pace of negotiation, adoption, implementation and review of EU legislation with such a fast developing area? We know that 20 years ago the Lamfalussy process aimed at speeding up that pace to adapt legislation quickly, but will it be sufficient for topics such as DLT and MiCA? It is difficult to say at this stage.

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Thoughts regarding the delivery of European financial products in the Digital Era

The pace of technological change continues to rise and as a result the impact of technology on people's lives is getting greater. The pandemic has clearly brought technology further to the forefront of our minds and is accelerating changes in consumer behaviour.

As new operators and business models emerge, it is essential to consider all of the new and different players in the financial ecosystem from the end user's perspective. For instance, as a broader range of firms from a diverse range of sectors seek to offer retail and potentially wholesale financial products, there is a need to ensure that consumers are provided with the same level of protections, and that all those participants who offer the same service, undertake the same activity, or expose consumers to the same risk are subject to equivalent regulatory requirements on a proportionate basis.

Without this, consumers will face an inconsistent experience, with the potential customer detriment counteracting the benefits of greater competition and creating potential risks for market integrity and potentially also financial stability.

Despite the rapid technological changes and the emergence of new digital players, large and small, regulation has developed to respond to the traditional 20th century business model, which regulates based upon product, manufacturer and issuing or distributing entity. This creates a narrow regulatory perimeter applicable to these industries. However, a 21st century "platform company" does not need to create the underlying financial product or service to become a leading digital aggregator and distributor of those products and services. This can – in the case of financial services - create a substantial financial marketplace to complement a non-financial services marketplace. In other words, in the connected economy, a position of strength in one market, led by data, can readily be used to access another very different product market.

Looking forward, as the number and type of business able to access consumer spend data increases due to Open Banking and PSD2 this is likely to have further transformational effects on the composition of the new financial ecosystem and therefore critical components of financial markets infrastructure. The increase in competition for consumers is to be welcome, but there is a need to address how we collectively provide for the protection of consumers and clients and also to ensure a fair playing field for all market participants.

Looking at the ecosystem from a consumer perspective, it will be increasingly difficult for consumers to understand the risk profiles of products attached to different entities and the associated protection they may or may not enjoy without further assistance from regulators. Understandably, a consumer sees products that are interchangeable for their needs, rather than considering in detail their regulatory regimes. There is a significant risk that an industry defined approach to regulation will fail to recognize emerging risks posed by the market changes noted above, and result in customer detriment.

In addition, a key barrier to innovation for firms is the lack of regulatory clarity regarding how 'new' and 'emerging' technologies, such as distributed ledger technology (DLT) and artificial intelligence (AI) may apply to financial sector use-cases. The current regulatory frameworks across the globe were not written with these technologies and the wider ecosystem in mind, and therefore they may not be fit for purpose. Whilst the principle of technology neutrality is important it is also essential that regulations consider the technologies where relevant. In addition, with global regulatory and supervisory direction constantly evolving, one of the main barriers results from some of the inconsistencies from one jurisdiction to another and resulting fragmentation.

Quite apart from this, there is a lack of consistent regulation of underlying products, with some at a more advanced stage unified regulation at the European level (e.g. the UCITS directive, which creates a harmonised framework for investment funds that can be sold to retail investors throughout the EU using a passporting mechanism), and other, substantial areas such as mortgages remain mostly regulated at the national level.

Similarly, investments and trading have been tackled effectively at the European level, with the creation of ESMA; but while such "asset-side" regulation has been advancing, the "liability-side" (borrowing and lending) has yet to achieve the same level of harmonisation. This creates a further gap in safeguarding customers' interests at the European level and in completing the single market.

These issues are recognised by the regulatory community. Steps such as the European Commission's Digital Finance Strategy, which aims to amend the regulatory framework to make it fit for the digital era and achieve a level playing field across entity types, will be crucial in helping solve these challenges. Further, given the cross-border nature of innovation, collaboration by policymakers in different jurisdictions is essential. Regarding underlying product areas, the European Commission recognises the continuing fragmentation of credit markets, and while the Mortgage Credit Directive was a good first step towards an EU-wide mortgage credit market with a high level of consumer protection, it needs to act as a foundation and not an end-point.

This is all the more important in an age of digital delivery of financial services.