ESMA REGULAR USE

FinTech: ESMA perspective

Patrick Armstrong

In this presentation

1. Financial innovation and FinTech
   - Examples
   - Characteristics and drivers
   - The role of regulators: regulatory tipping points

2. Financial innovation monitoring within ESMA
   - Monitoring markets and link with Product Intervention
   - ESMA's Financial Innovation Scoreboard

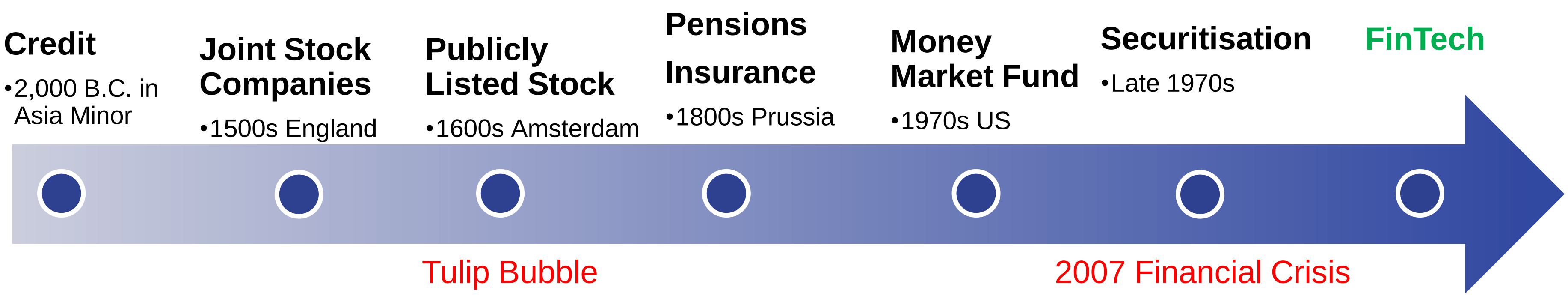
3. European Commission's FinTech Action Plan

Part 1 – Financial innovation and FinTech

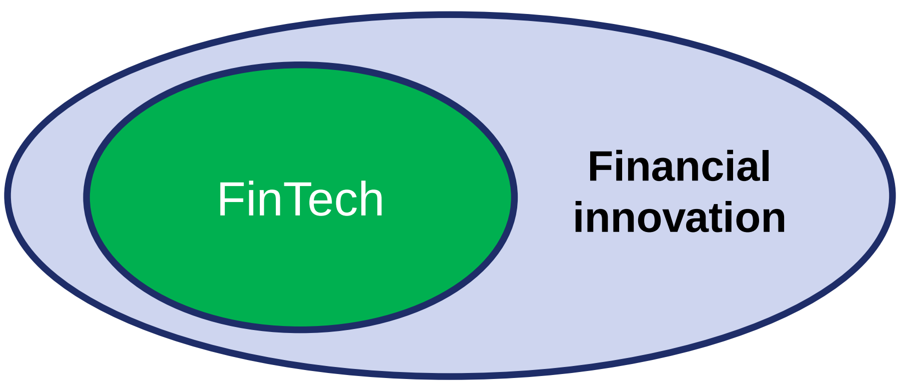
Financial innovation and FinTech

Characteristics

- In finance, **innovation** is the act of creating and then popularising new financial instruments, financial technologies, institutions and markets



- **FinTech** is financial innovation that relies on **IT technology** (internet, computer)



Financial innovation and FinTech

Characteristics: market structure

- ‘Fintech’ is also used as shorthand for the (often start-up) firms that develop FinTech products/technologies

- Fintechs focus on developing technologies with applications in finance (e.g. investor platforms); may **target** specific products (e.g. P2P equity):

Start-up firms → New technology → New system or product

- FinTechs are ‘disrupting’ the financial sector via **disintermediation**
  - Promotes competition, which may bring benefits to consumers
  - Established firms are increasingly partnering with new entrants

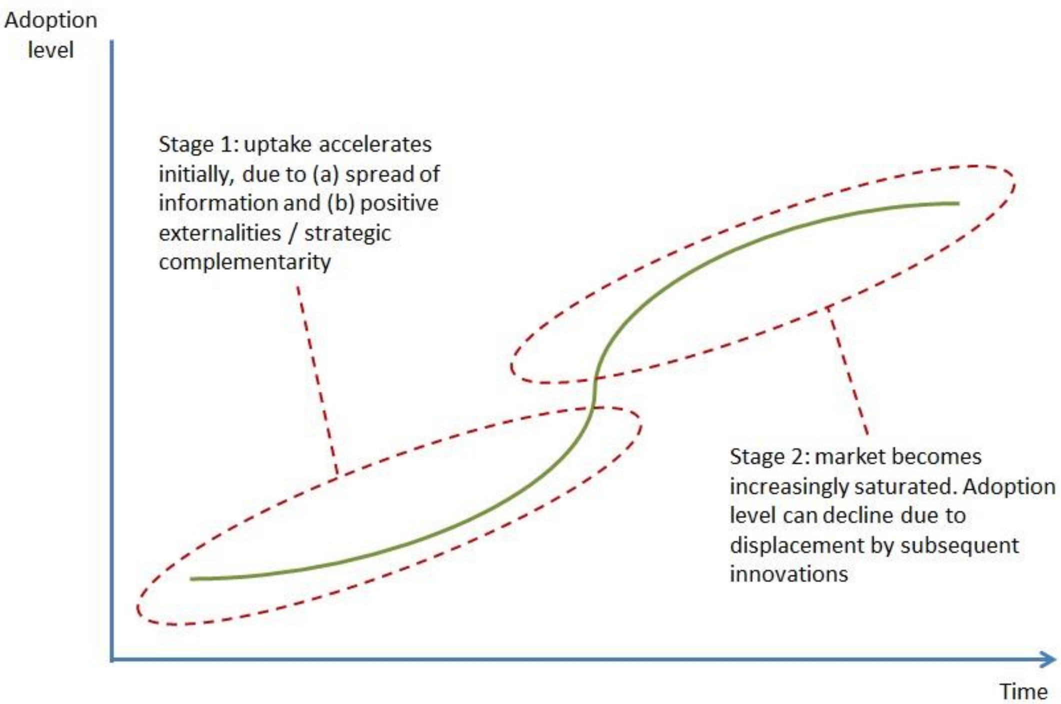
- Further disruption from ‘TechFins’, i.e. large established technology companies providing financial services

Financial innovation and FinTech

Characteristics: dynamics of adoption

- Uptake often follows similar pattern across financial and non-financial markets

Adoption pattern **S-shaped** for successful innovation:



Risk: exits by a few can lead to a stampede, if behaviour changes others' beliefs

Particular markets have different dynamics.

Authorities may have **time to observe** before intervening

Example: ETFs initially adopted by institutional investors. Now in US (but not EU) around half of ETFs by volume are retail

Financial innovation and FinTech

Long-term drivers

1

"Regulatory dialectic": regulation and financial innovation continually adapt to each other (Kane, 1981)

- Innovation driven by regulation: first money market funds were response to interest cap
- Regulation responding to innovation: regulation of CRAs following the crisis

2

"Innovation spiral": one innovation lays the foundations for another

- Both successful and unsuccessful innovations may be basis for subsequent successes
- Evaluation of the stand alone impact of an innovation thus often complex

3

Fluidity of financial sector innovation

- Although sector is highly regulated, **patents** almost absent (in comparison with, for example, pharma industry)
- While financial innovation can evolve quickly, its benefits and risks are not immediate
  - e.g. compare evaluating a new drug with evaluating a pension fund

Technologies may facilitate new products/systems in **unforeseen** ways:

- DLT started out as Bitcoin but has further applications in clearing
- HFT developed after introduction of electronic trading platforms

Financial innovation and FinTech

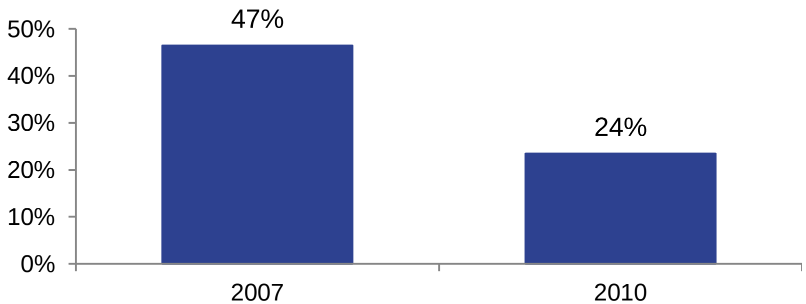
Recent drivers

Stylised fact: FinTech has appeared later than internet-driven innovation in other sectors (eBay, Amazon)

4 Lower sector-specific barriers to entry

- Creating trust had been a key barrier to entry; crisis reduced trust in banks
- Consumers may now be more willing to switch to smaller new entrants that use a “niche strategy” (drives disintermediation)

Crisis impact: drop in bank trust



Source: 2010 Edelman Trust Barometer and ESMA

Data for EU and US

5 Post-crisis economic and regulatory changes

- Regulatory arbitrage: new capital regulations incentivise new products (e.g. CoCos)
- Focus on cost-cutting may spur innovation (e.g. DLT reducing settlement cycles)

6 Increase in technological capabilities

- Lower hardware and software costs
- Internet developments (open source, cloud computing, …)
- Increased analytical powers (big data, …)
- Demand driven (need for more efficient, faster, better, tailored services)

Financial innovation and FinTech

General role of regulators

- Vital role to play: design and supervise the rules
  - Consultation and supervisory work inform rulemaking
  - Firms value clarity and certainty in rules and communications

- Regulators face a balancing act
  - Important not to stifle innovation that will benefit consumers and markets
  - But need to be vigilant against new risks
  - Where are the ‘tipping points’?

- Ever-increasing need to coordinate internationally
  - Technological advances have made business more mobile
  - Firms may operate in a borderless manner across several jurisdictions

Part 2 – ESMA’s work on financial innovation

ESMA's work on financial innovation

Guiding principle: a balanced approach

- Assess and analyse innovations objectively
  - Recognise positive effects of financial innovation as well as risks

- Develop knowledge using a range of sources
  - Gain insight from NCAs, industry, academia and professional services

- Work closely with other ESAs on cross-sectoral issues
  - Also build relationships with regulators and policymakers internationally

ESMA's work on financial innovation

Market monitoring and Product Intervention powers

- ESMA has a responsibility to monitor financial markets
- This is especially relevant to its Product Intervention powers.
  - MiFIR gives ESMA and national competent authorities power to ban/restrict the distribution of financial products or practices that create risks to ESMA's objectives
- ESMA product intervention measures in relation to Contracts for Differences and Binary Options were introduced in 2018; currently still in force
  - ESMA measures are renewable on a 3-month basis

ESMA's work on financial innovation

Financial Innovation Scoreboard

- Which innovations should we focus on from a research and policy perspective?
- In some cases, receive mandate from European Commission
- We have developed the Financial Innovation Scoreboard, a framework for monitoring & analysing financial innovations
- No method is perfect, but we find it useful in prioritising work and identifying risks
- Covers both products and processes
- Not always perfect! Important to recognise what scoreboard is for. If we think a high score overstates risks, presses us to explain why, in a structured way
- Better to have 'false positives' than 'false negatives'

ESMA's work on financial innovation

Financial Innovation Scoreboard: process

Identify
- Internal sources: NCAs, CWG, public institutions
- External sources: data providers, market participants, press

Initial research
- Summarise key features of innovation, relevant market trends in a background note

Filter
- **'Score' innovation against list of criteria (first individually, then confer as a team to agree final score**

Analyse
- Determine which innovations to research in greater depth

Advise
- FISC advises other SCs, BoS and European Institutions

Part 3 – FinTech Action Plan

European Commission's FinTech Action Plan
ESMA mandates

Mandate 1: Licensing requirements for FinTech firms
- **Objective**: Foster clear and consistent licensing requirements for FinTech firms across EU
- **Tasks**: ESAs to map current licensing regimes of FinTech firms across EU, and if necessary issue guidelines on approaches and/or make recommendations on need to adapt legislation

Mandate 2: Crypto assets and ICOs
- **Objective**: Improve understanding of the applicability of EU regulation to crypto assets and ICOs
- **Tasks**: ESAs to assess risks and applicability of existing rules

Mandate 3: Innovation facilitators
- **Objective**: Promote an open dialogue between supervisors and market participants through innovation facilitators at both national and EU level
- **Tasks**: ESAs asked to identify best practices among supervisors

Mandate 4: Cloud computing
- **Objective**: Facilitate the use of cloud computing
- **Tasks**: ESAs asked to explore costs and benefits of guidelines to cloud service providers

Mandate 5: Cyber resilience
- **Objective**: Strengthen the cyber resilience of the EU financial sector
- **Tasks**: ESAs asked to assess risks and applicability of existing rules

European Commission's FinTech Action Plan

1. FinTech Licensing

- The AP aims to promote FinTech and create conditions for more competitive and innovative financial markets
- ESMA is mandated to assess whether current EU rules are adapted to new technologies (e.g. distributed ledger technology, artificial intelligence)
- Action Plan asks ESMA to:
  - map current authorising and licensing approaches for innovative FinTech business models; and
  - explore how proportionality and flexibility in the financial services legislation are applied by national authorities

European Commission’s FinTech Action Plan

1. FinTech Licensing

- ESMA will submit to the EC and publish a report in 2019Q1
- ESMA’s work with NCAs has
  - emphasised crypto-assets, ICO and DLT as areas that Member States call the Commission to address; and
  - confirmed that most innovative business models could work under existing EU rules, as EU legislative framework provides room to apply proportionality in authorisations
- More work to be done on how proportionality and flexibility are applied by NCAs and how licensing requirements that affect FinTech firms diverge across countries
  - The principle of proportionality prescribes that the action of the EU must be limited to what is necessary to achieve the objectives of the Treaties. In other words, the content and form of the action must be in keeping with the aim pursued.
  - Flexibility implies that when the Commission and the co-legislators choose directives as the appropriate legislative instrument, they should ensure that sufficient consideration is given to the need for flexibility for national authorities regarding their implementation. More proportionate and less burdensome provisions provide to MSs flexibility to implement legislation taking into account national specificities.

European Commission’s FinTech Action Plan

2. Crypto assets: background

- In November 2017 and February 2018, ESMA issued two Statements on Initial Coin Offerings (ICOs) and a joint-Warning on Virtual Currencies (VCs) together with EBA and EIOPA

- Following these publications, ESMA set up a Task Force on ICOs and crypto assets with a view to promote a convergent approach to their regulation/supervision

- Task Force has assessed the business models of ICOs and crypto assets, their potential risks and benefits and the way in which they map to the existing regulatory framework

European Commission’s FinTech Action Plan

2. Crypto assets: findings and next steps

- ESMA published report in January 2019
- Wide variety of crypto assets (>2,000); no ‘one size fits all’. Rather, a ‘case by case’ approach is needed to legally qualify crypto-assets
- ESMA does not anticipate material financial stability risks from crypto-assets at this point considering their relative small size (c. EUR 150bn) but we are concerned about the risks they pose to investor protection
- Where crypto-assets qualify as MiFID financial instruments, full set of EU financial service rules is likely to apply. However, in some areas may be need forl interpretation or re-consideration of specific requirements
- Where regulation does not currently apply to certain types of crypto-assets and related activities, regulators need to consider whether it should, considering the risks involved, and if so how

European Commission's FinTech Action Plan

3. Innovation facilitators

- FinTech Action Plan mandates ESAs to take stock of existing innovation facilitators in the EU with a view to promote common best practices.

- ESMA published Report in January 2019

- Report provides a comparative analysis of the existing innovation facilitators in the EU, namely 5 regulatory sandboxes and 24 innovation hubs, sets out best practices with regard to their design and operation and suggests approaches to foster further cooperation and coordination across national initiatives

European Commission's FinTech Action Plan

4. Outsourcing of Cloud services

- ESMA is exploring the need for guidelines on Cloud in this area
- Cloud brings benefits, mostly related to increased scalability, but also some risks beyond those of traditional IT outsourcing
- As with outsourcing generally, supervised entities remain responsible for complying with regulatory requirements

European Commission’s FinTech Action Plan

5. Cybersecurity

- ESMA has worked with NCAs to understand existing regulatory and supervisory practices in cybersecurity

- ESMA is coordinating with the other ESAs in its response to the EC’s request on possible legislative improvements to promote cyber security, as well as on the cost-benefit analysis for cyber resilience testing frameworks