The Fintech phenomenon. October 2016

The so-called **Fintech phenomenon** is one of the most relevant issues which are currently attracting the attention of the financial services sector.

The **Financial Stability Board** -FSB- defines Fintech as the financial innovation endowed with the technical capacity to develop new business models, undertake different financial applications, processes or products which involve substantial associated impact on the markets, on financial entities, and on the provision of financial services.

The Fintech phenomenon is not a new one in the Securities Market. Thus, as an example, both professional and retail investors´ direct electronic access to the secondary markets. Even more notorious and having called on more attention by regulators regarding a potential negative impact on the markets is the so-called *High Frequency Trading* -HFT-, a type of highly sophisticated algorithmic trading (an example, due to the US Stock Exchange´s flash crash in May 2010).

The term FinTech often refers to -exclusively- new companies holding a solid technological basis which are born as rivals of traditional financial institutions, offering innovative alternative solutions to face new or existing needs, albeit, to date, such have been exclusively addressed by traditional financial institutions, i.e., banks, insurance companies and investment firms.

The following are basically four of the most noteworthy Fintech innovations among those pertaining financial investment services sector:

– Crowdfunding.
– Automated Financial Advice or Robo-Advice.
– Distributed Ledger Technology, also known as DLT or Blockchain.
– Big Data.

A brief description of each one and what they consist of, as well as the work of international and European organizations regarding the Fintech phenomenon, is described below.

For further information, please click here.

Crowdfunding is a new means of financing innovative companies, generally start-ups. As a matter of fact, although crowdfunding was initially destined to finance charitable projects, it currently has extended to business ventures and to venture capital. In Spain, crowdfunding is regulated under *Act 5/2015, of 27th of April, for the promotion of business financing,* and is defined as authorized entities whose activity consists in bringing into contact, professionally, natural or legal persons -investors- that are looking for investment, in order to obtain a monetary return, with entities or persons -promoters- that are seeking funding for a project, usually via on-line platforms or other electronic means.

Automated Financial Advice may be defined as investment advisory services via automated tools, where

human intervention is non-existent or very limited.

Likewise, **Distributed Ledger Technology,** or DLT, emerged with virtual currencies, as Bitcoin, which is exchanged using a new technology, named Blockchain. It actually consists of an assets database where the change of ownership is controlled by using keys and signatures via DLT technology. In fact, information security and precision are attained by the use of cryptography.

Hence, the abovementioned characteristics have lead Distributed Ledger Technology to be considered as a highly price-wise competitive tool among the Fintech ecosystem when rendering financial services. Accordingly, and even if, initially, its greatest potential was regarded for post-trading activities, i.e., settlement, clearing and registration for financial transactions, it may also be applicable to the trading activities.

Finally, the **Big Data** phenomenon consists of high speed management of a great amount of complex data through advanced techniques and innovative technologies which allow a great deal of information to be captured, stored, distributed, managed and analyzed.

WHY IS THE FINTECH PHENOMENON DEVELOPING SO QUICKLY?

Most noteworthy to mention is the fact that in the Fintech realm the term “consumers” is not used, albeit, **financial users.** The main difference is that while consumers are understood to be passive and hold high customer loyalty to their financial institutions, the latter are known to be active and change -in no time- entity/supplier, depending on price/service factors; they are also willing to try new means of access to financial products and services, even try new products which may satisfy their underlying financial needs.

Such trend has been enhanced by the recent financial crisis, which has contributed to decrease consumer confidence in traditional financial institutions, and hence, their loyalty to them. Additionally, this trend is being exacerbated by the arrival of new generations of consumers, the so-called *Millennials* -those born from 1980 to 2000-, who are used to operating in the digital environment.

Finally, many small IT solutions developers/suppliers have found in the financial sector a wide field where they can introduce innovative products, services and processes´ improvement. For example, some HFT suppliers have gone up the investment decision chain by rendering portfolio management tools, i.e., becoming what is currently called Automated Financial Advice.

THE WORK OF EUROPEAN AND INTERNATIONAL AGENCIES REGARDING THE FINTECH PHENOMENON.

International agencies are devoting many resources on the follow-up, understanding and identification of risks concerning Fintech innovations.

THE FINANCIAL STABILITY BOARD (FSB)

The FSB has included the Fintech phenomenon as one of its top 6 priorities for 2016. Its aim is to assess the impact such technological innovations have on the stability of the financial system as a whole, as well as its systemic risks.

In the letter dated 19th July 2016, that the Chairman of the FSB addressed to G20 Finance Ministers and Central Bank Governors, he indicated that, in this respect, the regulatory framework must ensure that it is able to manage any systemic risks that may arise from technological change without stifling innovation.

In this regard, the FSB, and the various international standard-setting bodies, have set work to analyse the financial system implications of financial technological innovations. The FSB has agreed a framework for categorising the innovations and their potential financial stability implications, and is now analysing specific

applications together with the standard-setting bodies.

By early 2017, the FSB and the standard-setting bodies will report on the Fintech case studies underway and surface issues that may merit policy attention.

The FSB has initially concentrated its analysis on innovations such as DLT and *"Peer to peer lending"*, and is expected to publish a report shortly.

Other such innovations subject to an in-depth analysis, in a near future are:

i) "Equity Crowdfunding".
ii) Automated Financial Advice.
iii) "Machine learning", as Big Data.

INTERNATIONAL ORGANISATION OF SECURITIES COMMISSIONS (IOSCO)

Likewise, IOSCO has been several years working on these matters. It published July 2014 its follow up report on social networks and automated advice -*"Report on the IOSCO Social Media and Automation of Advice Tools Surveys"*-. It published, December 2015, a statement on crowdfunding regulation -*"Statement on Regulation of Crowdfunding"*– which covers different regulations that are operating at an international level regarding this phenomenon.

Additionally, in April 2016 it has published a report on cybersecurity in the securities markets -*"Cyber Security in Securities Markets- An International Perspective"-.*

EUROPEAN COMMISSION (EC)

At a European level, the EC is also conducting a follow-up on Fintech, and it is expected to publish a report by fall this year, in which it will express its support to the creation of **"innovation hubs**" and **"sandboxes"** -among other matters- to promote the Fintech industry, such as the ones already put in place by several European Supervisory Authorities, as the *FCA -the UK Financial Conduct Authority-.*

EUROPEAN SECURITIES MARKETS AUTHORITIES (ESMA)

ESMA is also monitoring very closely different innovations related to Fintech through its Financial Innovation Standing Committee -FISC-.

The FISC work has focused on the following matters:
i) Crowdfunding;
ii) DLT;
iii) Big Data;
iv) Automated Financial Advice.

Crowdfunding:

ESMA began to look into crowdfunding by 2013, and it was in December 2014 when it published its first opinion on the subject. ESMA's **Opinion** -*"Opinion Investment-based crowdfunding"*- was addressed to the competent national authorities. In this Opinion, ESMA presented how the crowdfunding business model, its principal actors and risks associated to such innovation fitted within the EU legislative framework.

Simultaneously, ESMA published an **Advice** -*"Advice. Investment-based crowdfunding"-*, addressed to the EU institutions with the aim of attaining a greater regulatory and supervisory convergence within the EU.

In May 2015, ESMA published a **Report,** *"Investment-based crowdfunding insights from regulators in the EU"*. In such report, ESMA pointed out the differences in crowdfunding regulations among EU member states.

Later that year ESMA published June 2015 *"Questions and Answers: Investment-based crowdfunding: money laundering/terrorist financing"* on investment based on crowdfunding and risks associated to this phenomenon regarding money laundering and terrorist financing.

Additionally, the **European Crowdfunding Stakeholder´s Forum (ECSF)** was created in June 2015 in order to share experiences among national authorities with responsibilities regarding matters of authorization and/or supervision of crowdfunding platforms, being ESMA in charge of its coordination. The ECSF´s objective is to promote a cohesive and efficient supervision of crowdfunding entities within the EU. ESMA´s Council has granted an extended deadline for ECSF to July 2017. The work performed by the ECSF since 2015 has provided the basis for the European Commission Report on this matter -*"Crowdfunding in the EU Capital Markets Union"*-, published in June 2016.

Automated Financial Advice:

The **Joint Committee of European Supervisory Authorities** -ESMA, EBA and EIOPA- published, December 2015, *"Joint Committee Discussion Paper on automation in financial advice"*. The abovementioned document sought to collect stakeholders opinion on the importance of having the automated advice follow the same regulation as that which is not automated, as well as the consequences deriving from automated advice for an investor´s appropriate protection.

The consultation finalized March 2016, having received 69 answers on behalf of the three sectors involved -Banking, Securities and Insurance-. ESMA shall publish by the end of 2016 its final report with a feedback statement in relation to the consultation, as well as its conclusions on such phenomenon.

Distributed Ledger Technology (DLT):

ESMA published June 2016 a Discussion Paper on DLT technology applied to the securities market –"*Discussion Paper. The Distributed Ledger Technology Applied to Securities Markets*"– aiming two objectives:

i) to bring attention to the sector on ESMA´s interest in initiating a discussion on this matter, with an outlook on expounding a potential regulation in a near future;
ii) to welcome market´s views regarding different technological related issues, such as possible applicable realm, benefits, risks, challenges and it fitting within the EU´s current regulation.

The consultation finalized September 2, 2016. ESMA shall take into consideration answers received with the purpose of publishing an opinion regarding the use of DLT technology in the Securities Market, and by which it will deem the need to offer a regulatory response to this phenomenon at a European level.

Big Data:

The FISC has recently created a work group to study this innovation. Similarly, the European Supervisory Authorities Joint Committee, has set up a dependant *"Subcommittee on Consumer Protection and Financial Innovation -SC CPFI"* entrusted with the task of drafting a discussion paper regarding this matter that is due to be published by the end of 2016.

The objective of such paper is to collect information from the industry and the related stakeholders in regards to the use of Big Data.