The Financial Inclusion Centre

Financial markets that work for society

FINTECH - BEWARE OF 'GEEKS' BEARING GIFTS?

A FINANCIAL INCLUSION CENTRE DISCUSSION PAPER - SUMMARY

- There has been much hype recently about the potential for fintech[1] to transform financial services, and improve consumer welfare. But, there have been few *objective* assessments of the potential impact. Therefore, we thought it was timely to produce a discussion paper to generate better informed debate. We consider: what ***is*** changing and ***not*** changing in financial services due to fintech; the potential benefits and risks; and conclude with a set of policy questions which need to be answered to ensure the benefits are harnessed, and risks mitigated.

WHAT IS *NOT* CHANGING, WHAT *IS* CHANGING?

- Financial services perform a number of primary roles for households and real economy firms: providing banking and payment services; channelling resources to the real economy; credit provision and deposit taking; and providing insurance and risk management services.
- Those roles are supported by activities including: information processing, financial research and analysis, financial advice, marketing and promotions, asset management services, trading, product development, clearing and settlement of transactions, accounting and auditing.
- Those primary roles will ***not*** fundamentally change, and those activities will still need to be undertaken. But, what is changing is ***how*** these roles and activities are carried out. The complex ecosystem of financial institutions and financial professionals will change and new types of organisation, roles, and professionals with different skill sets are emerging. Consumers will be forced to change, too, and they will have to develop new skills.
- All the main retail financial sectors (banking and payments, credit, pensions and asset management, life and general insurance) are being 'disrupted' by fintech – some more than others. The huge capital, wholesale, institutional and reinsurance markets that make up the global financial system and markets and sit behind more visible retail finance are also affected. Fintech is also becoming an economic success story for the UK – particularly the City of London.
- But we cannot assume fintech is beneficial just because it is new and exciting. We must objectively consider: the potential risks and benefits; and whether fintech will improve the economic and social utility of financial markets and services by enabling those primary roles and activities to be undertaken more effectively for the benefit of households and real economy.

POTENTIAL BENEFITS

- Proponents have been almost evangelical in their beliefs about fintech – and there will be real benefits for *some* consumers able to access better value, more suitable, personalised products and services. Transactional banking should become more flexible, responsive, and convenient.

[1] According to Wikipedia, the most comprehensive study of the definition of fintech concludes that: 'fintech is a new financial industry that applies technology to improve financial activities'. On-line financial services have been with us for some time (for example, on-line banking, and comparative information websites). But, fintech goes further. When we refer to 'fintech' we include the full range of digital finance technologies, big data analytics, artificial intelligence/ machine learning, algorithmic trading, distributed ledger technology and so on.

Financial Inclusion Centre, 6th Floor Lynton House, 7-12 Tavistock Square, London, WC1H 9LT, 0207 241 2864
info@inclusioncentre.org.uk, www.inclusioncentre.org.uk

- If used properly, fintech should allow information to be gathered, analysed, and shared more cost effectively. If cost reductions are passed on, this should increase the number of consumers who are commercially viable for financial providers (including non-profit providers) so aiding financial inclusion. Fincapps[2] could be deployed intelligently to improve financial behaviours to bolster financial capability and financial resilience. Fintech also has the potential to help consumers better understand how their money is invested to promote more sustainable markets and hold corporates to account.
- Perhaps the greatest claims have been made about blockchain technology which is supposed to benefit everything from back office efficiency, to establishing property rights, to remitting money overseas, to improving compliance and anti-money laundering checks.
- But, despite the claims about fintech, not much tangible benefit has emerged yet. At the *aggregate* level, so far we see little reason to believe fintech will produce the same stepchange as, for example, the humble ATM, debit card, and direct debit. To be fair, it's early days. We hope we are wrong and fintech delivers the much needed transformation of retail financial services. But the hype does not match even a cursory objective assessment of the potential.

POTENTIAL RISKS AND DETRIMENTS

- It could be argued that the only people who will suffer if fintech fails to deliver are shareholders in fintech ventures. But, the hype has drowned out meaningful, realistic assessment of the risks to consumers. Moreover, there is a risk regulators will yet again pin their hopes on innovation and competition and ease up on regulation needed to make markets work.
- It could also be argued that fintech is just an evolution of what we have already with on-line banking and comparative information websites - and there is no additional cause for concern. But, the combination of the new digital finance technologies and big data analytics could significantly change market dynamics and the relationships between providers, intermediaries and end-users. Add into the mix a huge amount of investment which needs to generate returns for investors and we have a recipe for major detriment.
- There are numerous potential risks and detriments which we group into: outright scams and fraud; greater difficulties with rights and redress; higher costs, greater value extraction; major conduct of business risks[3]; transition risks, disruption of established financial services; greater financial exclusion and discrimination; corporate governance, cultural risks; and regulatory risks.

<u>Scams and frauds</u>

- These come in two main types: unauthorised/ illegal financial transactions and data breaches. While the *types* of scam and fraud might not change, there will be more opportunities for fraudsters to target consumers - more intermediaries in the supply chain, more points of entry, greater complexity and confusion for scammers and fraudsters to exploit. These risks apply to fintech generally but the introduction of Open Banking and coming into force of the PSD2[4] on 13th January 2018 presents an imminent risk. The publicity surrounding Open Banking/ PSD2 could help fraudsters as consumers will be primed to be approached by genuine third party

[2] Financial inclusion and financial capability apps
[3] It is important to note that these conduct of business risks will be an issue in wholesale and institutional markets, not just retail financial services
[4] 2nd Payment Services Directive

intermediaries. Not enough has been done to warn consumers about the risks, or establish robust consumer protection measures[5].

Even less effective competition, higher costs, greater value extraction, less transparency

- Fintech will create more, not less, complexity, fragmentation, opacity and spurious choices – always the enemy of *real* competition in financial services. The interjection of more fintech intermediaries into the supply chain could extract further value from consumers' limited finances. Intermediaries' business models have to be paid for in one way or another. Consumers may be either charged fees for services which offer no value (or cost more than the value created), pay commission to intermediaries, or pay for it indirectly by having their data sold on[6]. Conversely, dominant providers could further consolidate their position and extract more value.
- Fintech is not a panacea for fixing the perennial problems of information asymmetries and sub-optimal consumer behaviours and decision making. If anything, fintech provides more opportunities to exploit embedded consumer behavioural biases and utilise confusion marketing and cross-selling techniques to charge higher prices and extract more value.

Conduct of business risks in retail financial services

- There is a heightened risk of: outright misselling of unsuitable/ inappropriate products and services; and consumers misbuying products and services they don't need or understand. Manipulation and abuse of personal data will become more common.
- The risks are heightened due to a combination of: even more opaque business models/ conflicts of interest; a more complex, fragmented financial ecosystem; greater information asymmetries; more sophisticated confusion marketing; firms/ intermediaries utilising data analytics to manipulate consumer behaviour, exploit consumers' behavioural biases, and manufacture fears. Far from levelling the playing field for consumers, compared to 'analogue' financial services, fintech could make it harder for consumers to make effective decisions and choices.

Transition risks and disruption to established financial services

- The probability of fintech 'disruptors' displacing the 'dinosaurs' of finance (to the extent that fintech evangelists hope) is low. But, established financial providers will adopt and adapt fintech to their own needs[7]. Established players with legacy corporate structures and IT infrastructures face a huge task managing the transition to a digital finance[8] world on top of other priorities[9]. Boards and senior managers only have so much 'bandwidth'. Mistakes will happen.
- If established players do manage the transition successfully (from the perspective of shareholders that is), this will have consequences for access to financial services for consumers and local economies (see below) and, of course, for financial services employees.
- If, in the long term, the disruptors do consign established business models to history, this carries major transition risks for customers, employees and shareholders and the wider financial system. 'Creative destruction' might sound exciting but it is not necessarily a good idea when critical financial services are involved. Standing back and allowing nature to take its course is not an option, any transition must be managed.

[5] There is a parallel here with the recent pensions freedom and choice reforms which was also intended to 'liberalise' the pensions decumulation market. The effect has been to introduce more complexity into the pensions market while the publicity created opportunities for scammers to target consumers with offers to liberalise them from restrictive, poor value products with offers of too-good-to-be-true alternatives.
[6] As the saying goes, 'if you're not paying for it, you're the product'
[7] From the consumer perspective, not a bad thing if it leads to established players providing more accessible, responsive, better value financial services but harmful if they use fintech to further consolidate their dominant position and extract further value
[8] One bank refers to itself as a digital finance company with a balance sheet attached
[9] Some sectors are struggling with legacy misselling cases, low returns on equity and of course they have Brexit to deal with

- The other scenario is that the 'BigTech' giants enter financial services in a major way – this *could* be a game changer. The level of control already exercised by BigTech over our lives is a major concern - allowing them control over our financial data would take these concerns to a whole new level. There have been some tentative signs but so far it is not clear how interested BigTech firms are given the necessary conduct and prudential regulation in financial services.

Greater financial exclusion and discrimination, economic and social justice

- On balance, we think fintech could increase financial exclusion and discrimination. Geographical access problems caused by the growth of on-line banking could be exacerbated. Potentially the biggest problem involves customer segmentation and profiling – a key cause of exclusion and discrimination. The combination of fintech, behavioural finance insights and big data analytics means firms and intermediaries can identify with greater precision more profitable/ more desirable/ less risky consumers and less profitable/ less desirable/ more risky/ more vulnerable consumers. This creates the conditions for greater exclusion and/ or exploitation of large groups of consumers raising fundamental questions of economic and social justice. Moreover, commercial firms are in a better position to exploit fintech than non-profit providers.
- It is in the nature of markets that more confident, savvy consumers gain at the expense of less confident, less financially capable consumers. If fintech leads to aggregate efficiency gains, vulnerable consumers will benefit (even if they lose out in relative terms). But, if as we fear, fintech leads to less efficiency (or no overall change) at the aggregate level, vulnerable consumers will lose out in absolute terms – they will be in an even worse position(unless alternative solutions are developed or policy measures implemented to mitigate this).

Financial markets and infrastructures

- Again, there will be some benefits in the wholesale and institutional markets, and payment, clearing and settlement systems. But, despite the amount of 'innovation', so far we can see little evidence that fintech will: cause financial markets to better allocate resources to productive economic activities; improve the value provided by the notoriously inefficient asset management industry; make a major difference in helping real economy firms (especially SMEs and micro-enterprises) get access to the finance they need; or significantly enhance risk management in the financial system and wider economy. In short, fintech is unlikely to meaningfully improve the overall economic and social utility of financial markets and services.
- But, fintech will also create more opportunities for fraud, market manipulation, and misconduct in these fast moving markets. So far, the main use for blockchain technology seems to be criminal activity and speculation. The distinction between unsophisticated consumers (retail) and supposedly 'sophisticated' institutional clients such as pension funds is artificial and unhelpful. Spuriously complex and opaque financial products and strategies remain an intrinsic feature of markets except this is now combined with unimaginably fast processes based on complicated computer algorithms and AI/ machine learning that only a handful of experts truly understand. These conditions could enable flawed processes and decisions being replicated more quickly, and create opportunities for rapacious market practitioners to rip off less savvy institutional clients or sell them complex products and strategies they do not understand.

Corporate governance and culture risks

- We detect a culture gap between those who run financial institutions[10] and those who develop fintech[11]. The conditions we describe above means that misselling scandals must be considered inevitable. Boards and senior managers of financial institutions will have to be alert to the risk of 'classic' misselling (which usually stem from conflicts of interest in the supply chain but this time in more complex, faster moving environments). But, boards and senior managers will also have to be alert to the risk of marketeers and product developers[12] using insights gained from big data to exploit behavioural biases and fears to sell consumers unsuitable products and services. Due diligence, treating customers fairly, and exercising duties of care will be very difficult in fragmented markets with complex supply chains.
- Corporate governance and risk management will be an issue in the wholesale and institutional markets, too. It is evident that boards and senior managers of many financial institutions did not understand what the 'rocket scientists' who devised complex and opaque derivatives based products, instruments, and trading/ investment strategies were doing in the run up to the financial crisis in 2007/08. The difficulty exercising due diligence and fiduciary duties of care to clients in dynamic fintech-powered markets does not need to be spelt out.

Regulatory challenges

- Top regulatory priority is dealing with the immediate risks created by the introduction of Open Banking and PSD2. We are concerned that regulators, the banking and payments industry, and consumers are not prepared. Consumer protection is split between the Financial Conduct Authority (FCA) and the Information Commissioner's Office (ICO) introducing confusion into the process of exercising rights and redress. Moreover, there are concerns that the ICO[13], may not have enough resources to also deal with Open Banking/ PSD2 related risks.
- Regulators will also have to find better ways of communicating with consumers so they understand their rights and how to get redress in a more complex, fragmented fintech market.
- The FCA particularly will face a more difficult challenge ensuring firms have the right governance structures and culture in place to prevent consumers being exploited by the combination of fintech and big data analytics. Complex, fast moving fintech markets will be a big test for the Senior Managers and Certification Regime (SMCR)[14]. Supervising markets and determining culpability for breaches will be more challenging. Fintech will present a difficult test for the FCA's product intervention and governance powers.
- Financial regulators always face an uphill struggle keeping up with innovation in wholesale and institutional markets. Technology keeps evolving but human behaviours don't – fear and greed remain the dominant emotions in markets with huge sums of money at stake. The temptation to manipulate markets will still be there and fintech will create more opportunities to do so. Regulators are likely to lose this new technology arms race. Alternative approaches to regulation, supervision, and enforcement in these markets will be needed.
- The FCA has done some very good work recently on vulnerable consumers, and is re-thinking the boundary between its statutory regulatory remit and wider social policy issues such as

[10] Older/ middle aged, experienced in traditional financial services, who after years of misselling scandals now have an understanding of conduct of business regulation works and what regulators expect (certainly in the analogue financial services world) - but with limited understanding of how fintech works and associated risks
[11] Younger, more ambitious, impatient for change, who may have come from other less well-regulated industries and may consider regulation to be a burden or stifling innovation
[12] Beware of geeks bearing gifts!
[13] Which also has to deal with the introduction of the huge General Data Protection Regulation (GDPR) in May 2018
[14] The SM&CR is intended to reduce harm to consumers and strengthen market integrity. One of the key ways it aims to do this is by making sure senior managers can be held accountable for misconduct within their area of responsibility.

financial exclusion[15]. The FCA will need to enhance conduct of business rules and supervision to prevent exploitation of, and discrimination against, vulnerable consumers. The FCA cannot mandate provision of services to excluded groups – that is the job of the government. But the FCA can, and should, play a more important role in highlighting the ways fintech and big data analytics contribute to exclusion and make recommendations to government for action.

CONCLUSION AND NEXT STEPS

- Growth in fintech use is inexorable so it is time to inject some objectivity into the debate. Growth isn't occurring because fintech is guaranteed to generate beneficial creative destruction or is truly 'progressive'[16]. Nor will it be consumer demand led. Rather, fintech will grow because so many opinion formers and influencers (investors, fintech developers, policymakers, regulators, media, and consumer groups) believe in it. The fintech genie cannot be put back into the bottle but it should be contained. The challenge now is to harness the potential for good, and identify more precisely how risks will materialise in different sectors, the scale of the risks (which all depends on take up), and how to manage the risks. To do that, we need to address the following questions:
- How do we communicate the risks to consumers? How do we help consumers understand their rights (including how to obtain redress) in a more complex, fragmented fintech world? Open Banking/ PSD2 is an immediate priority if we are to avoid a repeat of the pensions freedom and choice debacle.
- We cannot rely on competition to make financial services work, so how do we stop firms and intermediaries exploiting complexity and fragmentation to push up costs, extract more value, or sell consumers products and services they don't need?
- Similarly, information provision and financial education are not effective at dealing with information asymmetries. So how do we help consumers get good deals and avoid being ripped off – especially less capable, confident, savvy consumers?
- How do we protect consumers from serious conduct of business risks arising from the use of fintech, big data analytics, and exploitation of behavioural biases and fears? Can we build 'break points' into the sales process to ensure consumers consider decisions carefully?
- If fintech does radically 'disrupt' financial services, what are the consequences? The impact on critical sectors such as banking and insurance could be profoundly destabilising.
- What measures are needed to tackle economic impacts and greater financial exclusion and discrimination? What are the impacts on jobs in the industry? How do we help non-profit organisations harness fintech to promote financial inclusion and local economic resilience? Can fintech be used to promote positive financial behaviours and financial resilience? Do we need to rethink social policy mandates to protect vulnerable consumers and communities?
- How do we improve corporate governance and risk management in firms? How do we address the culture gaps in firms between those who run firms and those who develop fintech?
- Overall, the key regulatory challenge is: how do we upgrade analogue regulation for a digital finance world? A great deal of further work is needed to fully answer those questions and develop policy solutions to mitigate those risks. We look forward to working with partners on this over the coming year.

[15] See for example: https://www.fca.org.uk/publications/corporate-documents/our-future-approach-consumers
[16] In that it will significantly improve the financial and social welfare of households and the efficiency with which financial markets serve the real economy – although we are at pains to emphasise there will be **some** benefits