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Executive Summary of the roundtable on Digital Disruption in Financial Markets

Annex to the Summary Record of the 131st Meeting of the Competition Committee held on 5-7 June 2019

5 June 2019

This Executive Summary of the OECD Secretariat contains the key findings from the Roundtable on Digital Disruption in Financial Markets held during the 131st meeting of the Competition Committee on 5-7 June 2019.
More documents related to this discussion can be found at
http://www.oecd.org/daf/competition/digital-disruption-in-financial-markets.htm

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Executive Summary

By the Secretariat*

At its 131st meeting, the Competition Committee held a roundtable discussion on Digital Disruption in Financial Markets.

Considering the background note prepared by Professor Xavier Vives from the IESE School of Business (Barcelona), the expert interventions, the written contributions, as well as the discussions by delegates and expert panellists at the Competition Committee, the following key points emerged:

1. We have seen a first wave of disruption in the financial services market and we are now waiting for the second wave of disruption.

Digital disruption in the financial sector is having a significant impact on competition, on consumers and on regulation. Retail banking is moving from the high street and on to smartphones. The use of algorithms, big data, block chain, peer-to-peer lending and crowdsourcing, means that the role of the intermediary is changing: banks now face competition to their core business from so-called FinTechs (businesses using financial technology) and large platform-based competitors, the so-called Big Techs. While changing the provision of services in the sector, digital disruption may also be solving some of the previous competition problems in financial markets, such as high switching costs, or high transaction costs. The topic is rapidly growing in visibility as FinTech or 'neobanks' are gaining market share.

The first wave of disruption was caused by the regulatory tightening after the financial crises, as well as the advent of new technology, such as the fast-rising use of smartphones, which is enabling easier user access while also changing consumer expectations. Younger consumers are used to easy and friendly interfaces and quick and cheap access to services across all sorts of markets whether transport, accommodation or entertainment. As traditional banks have been loaded with the high cost of compliance with new stringent regulations, these trends have enabled challenger or neo-banks to rapidly enter the market for financial services and achieve a substantial market penetration (14% market share in UK, 7% of all profits in the EU, 2018 data). We are now waiting for the second wave of disruption, as Big Tech enter the market for payment services and other financial services in Europe and the Americas. In Asia, large platform-based conglomerates are well-established in the markets for payment services.

For consumers, there is clearly a huge benefit in the shape of easy and fast access and new ways of using financial services. Technology has significantly reduced the cost for consumers, for instance, by lowering switching costs. However, we are also observing that, rather than switching providers, consumers are multi-homing, i.e. opening several accounts with different providers, to test the market and build up trust. A key element for this

* This executive summary does not necessarily represent the consensus view of the Competition Committee. It does, however, identify key points from the discussion at the Digital Disruption in Financial Markets, including the views of a panel of experts, the delegates' oral and written contributions and the background note prepared by Professor Xavier Vives.

development is the EU's General Data Protection Regulation (GDPR)[1] and similar rules in other jurisdictions related to data privacy, as well as regulatory encouragement such as the Open Banking initiative in the United Kingdom. Overall, the outlook for consumer services is favourable.

In the short run, there is still scope for increased competition in these markets where previously there was not much competition. In the longer run, there are several risk factors that may hamper competition. These relate to access to infrastructure, to data, and to software; all of which will need to remain open.

2. Incumbents have adapted a number of strategies, trying either to co-operate with or to fight against the new entrants. Strategies include pre-emptive mergers, the launch of their own mobile banks, or joint branding.

Incumbents have responded to this challenge in a number of ways. In some cases, they have co-operated; entered into partnerships with the new entrants to continue to receive fees or keep customers. In other cases, they have fought back, either by pre-emptive actions such as merging payment services, launching their own mobile banks or degrading access to the infrastructure. In this regard, incumbents benefit from better regulatory navigation skills and, in several cases, from superior trust from customers and data security.

FinTechs, on the other hand, benefit from state-of-the-art technologies with no rigid legacy systems, and this allows a fast and flexible response to changing consumer preferences, almost in real time. In this regard, FinTech technology is a driver for efficiency as it allows for a better screening of potential borrowers via big-data and increases financial inclusion by opening the door to financial services for less developed countries and other parts of the population and firms underserved by banks. Notwithstanding, many FinTechs have settled for forming partnerships with incumbents when faced with difficulties in increasing scale and customer numbers.

The perceived threat from Big Techs is however more preoccupying for incumbent banks, as they seem to have all the advantages of FinTech with none of the drawbacks. Big Techs are now entering the market for financial services with superior customer data, better distribution and lower cost of capital. There was some debate about what shape competition from the Big Techs will take; whether they will fully enter the market for lending and deposits (which is regulated with strict prudential regulation); or continue as payment service intermediaries and operate as platforms, horizontally, rather than the vertical integration which is typical of a bank. In this regard, Big Techs have a wider choice of strategies and have the potential to become fully-fledged intermediaries, without having to develop their own services, but benefiting from superior customer knowledge.

3. Regulation is essential to promote a level playing field to guarantee fair competition but has the potential to discourage innovation. Therefore, regulation should be carefully targeted to balance the *trade-off* between financial stability and innovation.

There is a tension between extending the perimeter of bank regulation to all financial service providers, which can constrain financial innovation, and keeping the new entrants out of the perimeter completely and tilting the playing field in their favour. A balance is needed to allow the regulatory perimeter to cover all activities that have systemic risk potential, while being more lenient otherwise.

[1] The General Data Protection Regulation 2016/679 is a regulation in EU law on data protection and privacy in the European Union and the European Economic Area. https://gdpr-info.eu/

The challenges posed by FinTech require a move from traditional regulation to new forms of monitoring and regulation. While the former is focused on consumer protection, prudential regulation and financial stability, by contrast, the latter is moving towards data privacy, algorithms, sandboxes and financial networks. The main competition aspect between the two is the following: traditionally, the need to obtain a licence was a barrier to entry for competitor banks. In the new financial markets, the main barriers to entry for newcomers will take the form of the proficiency of algorithms, AI and deep learning they can bring to the market.

That said, at present, many neo- or challenger banks do in fact have full banking licences. Either because they were launched prior to current regulatory inventions such as sandboxes, or because of the nature of the services they offer: any bank that proposes to take deposits or to extend credit needs a banking licence, regardless of whether it is entirely mobile or has a network of branches. Regarding FinTechs, some of which operate in the periphery of banking services, offering infrastructure or technical solutions, currently, the tendency is to regulate new FinTech services by offering a regulatory sandbox. This gives firms the opportunity to experiment without the regulatory burden that the traditional banking sector is faced with and, at the same time gives regulators the chance to look for the most effective ways to safeguard stability while encouraging innovation. At the same time, to ensure that financial markets remain competitive, in some jurisdictions financial regulators have been given a competition mandate, such as the UK Financial Conduct Authority. As part of its duties, it must support innovation and competition. The sandbox approach, such as practiced in the UK, has the advantage of nurturing start-up banks and allowing them to try out innovative services, without being subject to costly regulatory requirements. However, neobanks that succeed face differing regulatory requirements as they expand into new markets.

Challenges for neobanks include regulatory entry barriers across jurisdictions which create de facto entry barriers and prevent a faster uptake of mobile banking services, in particular in Europe. While most bank, in particular incumbent brick-and-mortar banks, all for regulation that favours a so-called level playing field, the actual form that such regulation would take is less clear-cut. There is likely to be a trade-off between regulating by activity, which should foster a level playing field for services, while guaranteeing financial stability would focus more on protecting against systemic risk of failed entities. Nonetheless, market actors tend to favour regulating the activity rather than the firm, which is perceived as promoting a level playing field for all market players.

Regulation for the financial services sector, whether FinTechs or traditional banks, should continue to be technology neutral, transparent, principles based and non-discriminatory and should include equal access to data, to infrastructure and fair taxation for all companies operating in the same market. To achieve this, a further strengthening of international and interdisciplinary co-operation is needed to reduce regulatory arbitrage. As such, current regulatory principles underlying FinTech regulation should not change. In addition, to fight money laundering, regulation of safe transmissions is also needed. Two European initiatives favour obtaining data on behalf of consumers, to help switching. These are Open Banking initiative and the EU Payment Services Directive 2 (PSD2). Nonetheless, none of those focus on the data requirements needed if Big Techs were to enter the market for financial services, and where additional provisions may be needed to enforce a level playing field, such as issues of reciprocity in data exchanges, and access to infrastructure requirements.

To help regulators conceive of a more suitable regulatory environment, the way regulation is designed may also have to evolve. In particular, whether to regulate the action (e.g. lending), as opposed to the agent (the bank), and a more granular approach. This would contribute to establishing a level playing field, while still regulating new and old, entrants and incumbents, in a manner that does not skew the market towards the one or the other, and with a similar regulatory burden. In terms of the content of the regulation and the mandate of the regulator, a number of aspects should be taken into consideration: (1) how to handle new entrants (new regulation *versus* old framework); (2) determine at what level should one regulate (regulate the firm *versus* regulate the network); and (3) what should be the main focus of the regulator's mandate (consumer protection *versus* financial stability *versus* prudential regulation *versus* competition). Regulators are likely to have to think along this axis to determine the appropriate level, scope and intensity of regulation.

4. So far, competition agencies have not yet been very active in enforcement (as there have not been many cases owing to the novelty of the phenomenon). However, agencies have been highly active in advocacy.

As far as enforcement is concerned, there has been little activity by competition authorities to date within the FinTech sector, as the market is still relatively new. The European Commission, Norway, Lithuania and Brazil were some of the few jurisdictions to present cases. Mainly in the form of pre-emptive mergers and exclusionary action by incumbents.

With few cases to get involved in, agencies have however been very active with advocacy, with several examples of active and often successful advocacy efforts, either in the form of market studies or issues papers that had contributed to changing legislation, for instance in Mexico or in the UK. More active advocacy will be needed to ensure that domestic markets allow new entry, as in Portugal, or fully integrate the regulatory changes needed to account for FinTechs. As an example, the Portuguese Competition Authority recommended that credit institutions should not create unnecessary barriers to client-account data access through technological factors that could somehow jeopardise system interoperability. Additionally, banks should provide the necessary and sufficient information to third party providers (for instance, in terms of the type and granularity) without charges, as that would undermine the objectives of PSD2.

The discussion clearly showed that the agencies agreed that we need a fair, open, and safe competition environment to provide choices for consumers. Fair access to data, for example, may allow for user control and the assurance of safe transmissions including improved anti-money laundering rules. Finally, a key theme that emerged was the fact that regulation should be identical across markets.