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More documents related to this discussion can be found at:

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Canada

1. The Competition Bureau's FinTech Market Study

1. Financial technology (FinTech) has the potential to dramatically change the way financial products and services are accessed and used by Canadians. The innovative technologies being introduced by new entrants into the financial services sector promise to increase choice, improve convenience and lower prices for consumers and businesses alike.
2. Despite the attention that FinTech is generating, Canada lags behind its international peers when it comes to FinTech adoption. The Competition Bureau (Bureau) launched its market study into the financial services sector to understand why this is the case.
3. The findings of the study are based on a review of publicly available information as well as submissions from FinTech start-ups, incumbent financial institutions, industry experts, regulators and industry/consumer associations. The Bureau also conducted 130 stakeholder interviews and 10 information sessions, participated in 13 outreach events and hosted a FinTech workshop that brought together market players, regulatory authorities and policymakers. The Bureau used the collected information to assess the impact of FinTech innovation on the competitive landscape, identify the barriers to entry and expansion of FinTech in Canada, and determine whether regulatory changes may be needed to promote greater competition and innovation in the financial services sector.
4. To ensure its relevance for Canadians, the study focuses on three broad service categories:
 - retail payments and the retail payments system
 - lending and equity crowdfunding
 - investment dealing and advice
5. The draft report was released for public comment on November 6, 2017¹.

2. Retail Payments and the Retail Payments System

6. Canadian consumers and businesses rely on retail payments to purchase goods and services, make financial investments, pay wages and send money to one another. Whether in the form of cheques, electronic point-of-sale (POS) debit transactions, electronic funds transfers or credit card transactions, payments are critical to Canada's economic activity. While a strong regulatory framework is needed to ensure payments are made and received in a safe, secure and expedient way, regulatory constructs can sometimes have unintended consequences that slow innovation and reduce competition.
7. Influenced by the mobile and online experiences available in other sectors, today's financial services consumers are demanding seamless, instant, around-the-clock

¹ The draft report can be found on the Bureau's website at: <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/04315.html>

payment options. A number of new payment service providers (PSPs) have entered the market, using technology and innovative business models to meet that demand. Mobile wallets, for example, allow consumers to make retail payments with their phones, reducing or eliminating the physical limitations on the number of cards they can carry and use at any given time. Low-cost POS terminals and mobile credit card processing solutions have made it possible for merchants to accept a wider range of forms of payment, greatly improving convenience for consumers. Other entrants have launched entirely new closed-loop systems for initiating payments and transferring funds that are making the financial institutions involved invisible to end users.

8. Still, there are many barriers to entry and growth facing new and incumbent firms alike. These include regulatory gaps between regulated PSPs and new, potentially unregulated, firms attempting to enter the space, lower public confidence and trust in alternative payment products and services, and insufficient incentives for consumers and merchants to switch to other payment methods. Some new entrants also lack easily available access to the core banking services and payments infrastructure required to underpin a FinTech product or service. Some barriers will need to be overcome by the FinTech firms on their own; others may require regulatory intervention.

9. The Department of Finance Canada is developing a new regulatory oversight framework that should help promote innovation and competition in the financial services sector. In the meantime, current regulations focus only on incumbent and traditional PSPs, meaning non-traditional PSPs are not yet subject to any specific requirements related to operational, financial and market-conduct risks. This regulatory uncertainty adds to the costs and risks faced by “non-bank” firms attempting to enter this market, particularly smaller firms with limited resources.

10. Moving in a positive direction, Payments Canada (the organization responsible for operating and overseeing Canada’s national payment systems) has announced plans to develop a modernized, real-time retail payments system. If interoperability between payment platforms is built into this system, it will spur competition and innovation. However, because a system with high interoperability requires significant collaboration, a strong governance framework is needed to prevent incumbent members and early entrants from strategically developing rules that exclude others from entering the market in the future.

3. Lending and Equity Crowdfunding

11. The availability and provision of financial credit is a key driver of economic activity in Canada. Small and medium-sized enterprises (SMEs) use financial credit to bridge cash flow gaps and make investments—but since the 2008 financial crisis, increasing risk aversion from financial institutions has led to a tightening of credit markets, particularly for SMEs. Many smaller and newer businesses have difficulty accessing financing from formal sources such as retail banks because they lack the credit history or collateral needed to secure a loan. As a result, nearly half of Canadian SMEs rely on informal sources such as personal financing, loans from friends and family, retained earnings and personal savings—and almost one-third have turned to credit cards as a means of financing.

12. In response, FinTech firms offering new financing methods have entered the market to provide new forms of financing, with two main business models emerging:

peer-to-peer (P2P) lending, which brings together lenders (institutional and retail investors) and borrowers (consumer and business) in an online platform to fund loans; and equity crowdfunding, which allows SMEs to raise capital from a large pool of investors through an online platform (in other words, they no longer need to build their own networks of contacts to find potential investors).

13. These new forms of SME financing have the potential to relieve some of the frictions faced by SMEs in obtaining financing, while at the same time allowing investors to access new products typically out of reach in traditional markets. Yet the providers of these platforms face significant barriers that may be inhibiting their market entry and growth.

14. For example, because Canada's regulated banking system is so strong—our financial institutions did not fail during the global financial crisis—Canadian SMEs may lack the desire or will to venture outside of that system and try new forms of financing. Consumer confidence is another major barrier to overcome: because there is a lack of clear regulation governing P2P lending, for example, it is not clear what happens to investors and borrowers in the event a platform fails.

15. There are also regulatory barriers. Due to the confederated nature of Canadian laws, subtle variations in laws exist from one province to the next. As a result, it can be difficult for FinTech-based financing platforms to navigate the various federal and provincial laws that might apply to their business models. At the same time, technology-driven financing platforms are subject to the same regulations as their bricks-and-mortar counterparts, despite potentially different risks associated with their business models. Finally, while some FinTech firms in this marketplace have partnered with incumbent financial institutions, these arrangements are subject to regulations governing outsourcing by federally regulated financial institutions, which have processes and policies that are difficult for many FinTech companies to follow.

4. Investment Dealing and Advice

16. Retail investors have many options in terms of the products available and number of firms offering investment services. While investment advice has traditionally been supplied in person by investment professionals, shifting customer demand and the advent of the mobile Internet have led to a new wave of tools for investors. FinTech entrepreneurs have entered the market using technology to appeal to consumers with entirely different preferences for advice services: some want just basic advice or a “set-and-forget” portfolio, for instance, while others do not have the time or resources to meet with a financial advisor in person.

17. Leveraging less-expensive exchange-traded funds and operating predominantly on a fee-only basis (rather than earning a commission from each fund), online advisors (also called “robo-advisors”) have established themselves as low-cost alternatives to traditional advisors. Using model portfolios based on model investor profiles, they can reduce the time and cost of meeting with clients. Without the need to support a branch network of advisors, they can operate at a substantially lower cost, putting pressure on traditional advisors to lower their fees so they can remain competitive.

18. While a handful of robo-advisors have been successful, there are still many barriers to their growth. In any industry, consumers will consider switching to a competitive offering if they can easily understand the cost benefits. This can be difficult

in the investment dealing and advice industry, where fees are commonly embedded in the management expense ratio. Compounding this challenge, these fees are often not discussed or understood by investors. There are also tangible costs that may discourage switching, such as the time and expense of setting up new accounts and transferring assets. In addition, robo-advisors may not be able to deliver the true online experience consumers might expect, particularly given that electronic forms and signatures are not yet accepted throughout the industry.

19. Certain regulatory requirements also inhibit the growth and competitive influence of robo-advisors. For example, investment dealers must ensure any investments offered are suitable for a client's risk tolerance and investment objectives. Holding a "meaningful discussion" to obtain the necessary information (as required by securities law) can be difficult in an online setting. Robo-advisors must also hire registered advising representatives to be involved in portfolio decision-making, increasing costs and impeding the development of automated solutions.

20. Similarly, robo-advisors must have an agent-for-service (i.e., someone present to accept legal documents should the corporation be sued) in each province where they provide services. Robo-advisors looking to keep costs low by operating from a single location (or even from the cloud) may find that even small hurdles like the agent-for-service requirement can contribute to increased operating costs.

5. Global Reactions to FinTech Innovation

21. Many FinTech entrants told the Bureau that other jurisdictions have more welcoming and innovation-conducive regulatory environments than Canada. The United Kingdom, the United States, Singapore, Germany, Australia and Hong Kong have all been identified as leading FinTech hubs based on talent, funding availability, government policy and demand for FinTech. Unlike Canada, these countries have a unified financial sector regulatory framework. As such, many have been able to take a national, unified approach to encourage FinTech development.

22. Most of these countries are encouraging experimentation in a controlled environment and, at the same time, creating flexible regulatory frameworks proportional to the risks presented by FinTech innovation. For example, these other countries are increasingly establishing fora for regulatory experimentation and engagement between the private sector and regulators. Regulatory sandboxes, accelerators and innovation hubs can promote innovation and improve competition by reducing regulatory uncertainty as well as the sunk costs associated with navigating the regulatory framework, and by giving firms that would otherwise have abandoned entry in the early stages the ability to test their services and their ability to meet regulatory requirements. Numerous jurisdictions have also developed specialized regulatory frameworks or licensing regimes to reduce regulatory uncertainty and clarify how rules will be applied in the digital arena.

23. While some Canadian authorities have introduced similar initiatives—several Canadian securities regulators have launched regulatory sandboxes—there remains potential for more. For example, Canada lacks a clear and unified policy lead on FinTech. Such a body could combine federal, provincial and territorial expertise to facilitate FinTech development, and improve the scope and applicability of existing initiatives.

24. "Open banking" is another concept currently being explored around the world. Regulators in the United Kingdom and Europe have been examining how access to data

and banking infrastructure can help spur FinTech development, with the European Union's revised *Payment Service Directive* (PSD2) allowing third parties, including FinTech firms, to access customer bank account data to develop more innovative services and make it easier for consumers to shop around for financial services. The Bureau encourages policymakers to continue to examine the experience of other jurisdictions and adopt best practices as they balance the potential risks with the competitive benefits.

6. Recommendations for Regulators and Policymakers

25. Financial sector regulators and policymakers have made significant progress in adapting Canada's regulatory environment to support innovation in the financial services sector. While regulation is needed to achieve important policy objectives, such as consumer protection and a stable financial system, regulations should be modernized to promote greater competition and innovation for Canadians.

26. Based on the findings of its market study, the Bureau developed 11 broad recommendations for financial sector regulatory authorities and policymakers to ensure future regulatory change creates space for innovation in this important sector of the Canadian economy.

27. In brief, the recommendations are as follows:

1. **Regulation should be technology-neutral and device-agnostic.** Rules that can accommodate and encourage new and yet-to-be developed technologies open the door to more innovative offers today and down the road.
2. **To the extent possible, regulation should be principles-based.** Instead of prescribing exactly *how* a service must be carried out, a principles-based approach will allow regulators to be more flexible in their approach to enforcement as technology changes.
3. **Regulation should be based on the function an entity carries out.** This will ensure that all entities that perform the same function carry the same regulatory burden and consumers have the same protections when dealing with competing service providers.
4. **Regulation should be proportional to risk.** This requires a tiered approach: functions whose failure poses lower risks to the financial system should not necessarily face the same strict oversight as those whose failure poses higher risks. This will give smaller players a level playing field to innovate.
5. **Regulators should continue their efforts to harmonize regulation across geographic boundaries.** Differences in regulations across provinces can lead to increased compliance burden. Consistency, on the other hand, can facilitate entry and expansion of FinTech across Canada and abroad.
6. **Policymakers should encourage collaboration throughout the sector.** Mechanisms for doing so include the use of regulatory sandboxes and innovation hubs. Greater collaboration will enable a clear and unified approach to risk, innovation and competition.
7. **Policymakers should identify a FinTech policy lead for Canada to facilitate FinTech development.** This would give FinTech firms a one-stop resource for information and encourage greater investment in innovative businesses.
8. **Regulators should promote greater access to core infrastructure and services.** This includes access to the payments system (under the appropriate risk-

management framework) and banking services to facilitate the development of innovative new FinTech services.

9. **Policymakers should embrace broader "open" access to systems and data through application programming interfaces.** With better access to consumer data (obtained through informed consent), FinTech can help Canadians overcome their inability or unwillingness to shop around and switch between service providers.
10. **Industry participants and regulators should explore the potential of digital identification verification.** This would reduce customer-acquisition costs for service providers, ultimately reducing the costs of switching for consumers and facilitating regulatory compliance where identity verification is needed.
11. **Policymakers should continue to review their regulatory frameworks frequently.** Doing so will ensure that these frameworks remain relevant in the context of future innovation and can achieve their objectives in a way that does not unnecessarily inhibit competition.