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Swiss Financial Market Supervisory Authority FINMA

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Fintech and Blockchain:
More than hype? A regulator‘s perspective

Ladies and Gentleman

I would like to thank you for the opportunity to speak at today's event on the topic of innovation in the financial sector.

Innovation is nothing new. Thomas Nashe, the English Renaissance author, wrote in 1594 that "those furnaces of falsehood… must be dissolved and broken… or else I fear me the false glittering glass of innovation will be better esteemed than… ancient gold." In fact, he was talking not about bitcoins, but about post-reformation religious innovation, puritanism to be precise. That argument between the establishment and the religious innovators in England led some fifty years later to full-scale civil war.

I do not think the battle of ideas between crypto-fans and the monetary establishment will go that far – but there is at least a whiff of religious mania hanging around the blockchain world. That is a heady atmosphere for a financial regulator, but history has repeatedly proven that financial markets can and do occasionally turn manic. So is today's glittering glass of innovation a glass half-empty, or a glass half-full?

At FINMA, we have long advocated the removal of barriers to entry in order to release the potential of technological innovation in finance.

The financial industry is in need of that innovation. Paul Volcker famously noted that the ATM was the only useful innovation in banking in the 20 years prior to the financial crisis. Low interest rates, changing consumer behavior and low profitability make innovation an existential question for the financial industry.

Our goal as regulators should be to create an environment where innovation can happen. Regulators naturally have a conservative bias. They, we, tend to be innately suspicious of new approaches. Regulation is also generally written to address negative experiences of the past, and designed for the business models of today. Us regulators tend to have the largest players of today in our ears not the as yet unproven next generation.

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So the system is to some extent stacked against innovation, maybe to the comfort of the incumbents. That means that we need to be consciously self-critical and maybe even a little provocative to somewhat redress the balance.

That is why, for example, FINMA has pioneered online- and video client identification and why we have cleared the way for legitimate blockchain innovation. That is why Switzerland's regulatory sandbox and dedicated fintech licence were ideas that emanated from us as regulators. We have forced ourselves outside our own comfort zone. Because comfort zones are the antithesis of innovation.

Innovation-friendliness, however, does not mean carelessness. We are as passionately anti-crime as we are pro-innovation. And innovative environments are prone to abuse and even criminal behavior. The world of the gold-diggers was exciting, occasionally profitable, and lawless. And the miners of cryptocoins could be seen as the gold-diggers of today. It is our duty as a regulator to fight misuse of the financial system and protect investors.

As an integrated supervisory authority with responsibility for all market participants, their stability and their conduct, we at FINMA are in a unique position to address investor protection, money laundering risks and banking and payment issues out of one hand.

Fintech – the new world order?

So where does fintech fit in? Undoubtedly, it holds great promise. A myriad of interesting new products and business models are emerging. Mobile banking is broadening access to financial services. Robo-advising looks to reap the benefits of artificial intelligence and machine learning at very low cost. Crowdfunding is opening up new channels to finance economic activity – something desperately needed in bank-credit heavy Europe.

Then, there is the blockchain. Many financial institutions are testing use cases and it is conceivable that parts of the financial infrastructure will shift to this new technology and render existing processes and even players obsolete. And then there are the blockchain's most famous applications: cryptocurrencies and ICOs – more on them later.

So far, disruption has only timidly knocked on the door of existing financial institutions. It has not yet taken place on a noticeable scale, at least not in the developed world. A recent study from the Bank of International Settlements concluded that finance is an industry with excessive rents and poor overall efficiency. Finance has benefited more than other industries from improvements in information technologies. However these improvements have not been passed on as lower costs to the end users of financial services. And they have not halted the decline in the industry's profitability.

To paraphrase the nobel laureate Robert Solow: fintech can be seen everywhere, except in the productivity statistics.

What role for the regulator?

In the face of these developments, what should our regulatory strategy be?

As I said earlier, we should strive to eliminate unnecessary barriers to entry and rid the system of anti-innovation bias. In Switzerland, we have undertaken a thorough review of all the technical standards in our circulars and eliminated any discrimination against digital processes, for example unnecessary requirements for physical paper, presence or signatures. We have opened up client identification and onboarding via digital channels. Given the technological improvements, there is no justification for favoring physical identification, which itself is not foolproof.

We are strongly committed to continuing on this path. However, for a regulator, fintech cannot only be about opportunity. A supervisor is after all a risk manager. So what sort of risks do we have in mind?

Some risks are more philosophical or societal such as the question of autonomy in an ever more algorithm-based world or the quest for an adequate protection of privacy. When it comes to fintech and financial institutions, we are most concerned with the appropriate level of security against cyber threats, and risks related to outsourcing. ICOs and cryptocurrencies add risks related to investor protection and financial crime.

The most obvious risk is cyber-attacks. The financial sector is the single most attractive target. Statistics from Melani, the Swiss Reporting and Analysis Centre for Information Assurance, show that 62 out of 94 incidents reported to them targeting critical infrastructure in 2017 occurred in the financial sector – and those bigger attacks are only the tip of the iceberg, On the one hand, there is classic robbery. Bank heists in our era no longer happen on Royal Mail trains but in the virtual world. In addition, data is an ever-more valuable commodity. Banks and insurance companies are under threat. But not only individual institutions are vulnerable. The financial market infrastructure is vital for the functioning of developed economies. It does not take a lot of imagination to come up with a crisis scenario.

A second important potential risk is the extent of outsourcing. As traditional value chains are broken up, the risks migrate. Nowadays we see banks outsourcing their entire back-offices, for instance. Increasingly across borders. The economic rationale for outsourcing is compelling. However, it should not come at the cost of stability. Data needs to be instantly accessible during a crisis, and confidentiality protected. Equally important is the stability of third party service providers who are mostly non-financial institutions.

Cryptocurrencies and ICO – more than hype?

Then of course, there is market risk – or market opportunity.

Bitcoin's price rose over 17 times in 2017 and 64 times in the last three years and has risen faster than that of the Dutch Tulip bulbs in the 1630s. Some observers see the biggest bubble in financial history. For others, this is merely a short stop on the march to an anonymous and free financial system.

History will judge. It is not for me to hazard a prediction. I would say this, however. In my view, an anarchic, parallel monetary world is unlikely to fly beyond a certain size. The world simply does not work that way. Hippie communes may be tolerated, but not when they get too big. Therefore, the best way to exploit the potential of blockchain technology is to get out of the ghetto, and accept that innovation-friendly regulation and supervision is the best deal there will be.

ICOs exploded onto the scene last year, going from a relatively unknown fundraising method used in the blockchain community, to raising over USD 6 billion in 2017 through almost 900 projects. In addition, the individual sums grow ever larger: Ethereum raised 18 million USD in 2015, the DAO 150 million USD in 2016 and Tezos 240 million USD in 2017. Switzerland has become a hub for ICOs, 4 of the 6 largest ICOs in 2017 taking place in Switzerland.

Cryptomania is everywhere. We were flooded last year with enquiries about the applicability of our regulation to ICOs. We had three basic choices: anarchy, prohibition or something more reasonable. No prizes for guessing which route we chose.

Our third way is actually quite simple: In assessing ICOs, we look at the economic function and purpose of the tokens that are issued. In other words, if it looks like a duck, swims like a duck, and quacks like a duck, then FINMA will treat it like a duck.

We categorise tokens into three types: Payment tokens are synonymous with cryptocurrencies and have no further functions or links to other development projects. Utility tokens are tokens which are fully functioning ways of providing digital access to an application or service. And asset tokens are tokens that are issued in fundraising processes and are functionally analogous to equities, bonds or derivatives.

Our analysis indicates that money laundering and securities regulation are the most relevant regulatory aspects for ICOs. Money laundering risks are especially high given the decentralised blockchain-based systems, in which assets can be transferred anonymously without any intermediaries. One USP of bitcoin and other cryptocurrencies is opacity, after all. Securities regulation is intended to ensure that market participants can base their decisions about investments on a reliable minimum set of information. Moreover, trading should be fair, reliable and offer efficient price formation.

So using the duck test: Payment tokens like bitcoin or their newer cousins look like means of payment and are therefore subject to AML requirements. And asset tokens look like securities and therefore fall under securities law.

Seize the opportunity being mindful of risks

I am convinced that with this balanced approach we can kill two birds with one stone: We give ICOs a chance to establish themselves as a trustworthy blockchain-based fundraising mechanism while at the same time reducing the risk of illicit financial activity.

ICOs can have many benefits. They are an easy way of raising funds without the need to pass through expensive intermediaries. They can allow start-ups to tap funds quickly at an early stage of the business development. And the liquidity of tradeable tokens is potentially much higher compared to venture capital financing.

But just because this innovation is blockchain-based, doesn't mean that it can simply bypass proven regulations to protect investors and fight financial crime. We have a heady mixture of innovators, copycats, regulatory arbitrageurs and fraudsters in the cryptoworld. It's our job together with our partner authorities to try and make sure that the innovators have the chance to thrive if their idea is worth it, that the arbitrageurs have nothing to gain, and that the fraudsters end up where all fraudsters should.

That's no easy job, but a job worth doing and therefore a job worth doing well.

Thank you very much for you attention.