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Technological change and innovation in the financial sector

Ladies and gentlemen

First of all, I'd like to thank you for inviting me to be the guest speaker here today at the Zurich Business Club. Looking around me at the wonderful 18th century décor, the topic I have chosen – technological change and innovation in the financial sector – may seem out of place. It might feel more natural in an "impact hub", an "innovation park" or even an "incubator", but not necessarily in a guildhall.

But there are good reasons for choosing it. Firstly, *financial technology* – or *FinTech* for short – is on everyone's lips. Secondly, everyone here is potentially affected by it, whether as a financial services provider or as a customer. And thirdly, one of FINMA's responsibilities as a supervisor is to stay abreast of technological change in the financial sector.

Clearly, an innovative and competitive Swiss financial marketplace is high on FINMA’s list of priorities. Innovation is crucial to the competitiveness of Switzerland's financial sector. In fact, much more energy should be invested in this area than in time-consuming rearguard actions defending outdated business models.

So how has technological change affected FINMA so far? The revised FINMA Anti-Money Laundering Ordinance, for instance, now includes explicit rules for digital business. Client authentication is now possible online. Where digital payment methods are concerned, we have defined specific limits below which no formal client identification is required. In fact, we are currently revising all our ordinances and circulars to ensure that they are neutral in terms of technologies and business models. What does that mean? Essentially, the idea is to create a level playing field for all market participants, whether they are established financial service providers or start-up companies.

New possibilities and opportunities always come with risks. FINMA's primary task is to protect creditors, investors and policyholders and ensure the stability of Switzerland’s financial markets. This is why we are also looking closely at new risks arising from technological change. We are keeping a close eye on two issues in particular: the threat posed by cyber-attacks, and the risks inherent in increased outsourcing.

I'll come back to them later, but first I'd like to give you a brief overview of various aspects of technological change. Then I’ll move on to look at the role of regulation and supervision and at FINMA's position.

Technological change

Well we are all familiar with "AAA" as a credit rating. But is there a chance that in ten years' time it will stand for the three biggest and most successful financial institutions? Apple, Alibaba und Amazon? I don't know. But when you see all the hype about FinTech and digitalisation, it's at least conceivable.

Hardly a day goes by but another established financial service provider announces the triumphant arrival of the digital era and signals its intention to jump on the bandwagon. Start-ups are busy organising podiums; competitions and prizes are springing up everywhere; innovation labs are being set up; and start-ups being launched by young entrepreneurs. There's almost a Gold Rush atmosphere, and at times you can almost imagine yourself somewhere in the American Midwest in the mid-1800s!

Clearly, technological innovation and the many ways in which technology impinges on our everyday lives have the potential to change the financial sector. It remains to be seen, however, whether Bill Gates was right when he said: “Banking is essential, banks are not”. It's still too early to proclaim the dawn of a fully digitalised financial sector.

Can anyone here remember Bank Vontobel's You bank, or Julius Baer Net, or UBS's e-services? All of these projects were planned to go live in the summer of 2001. But what actually happened – nothing. Instead of ground-breaking projects, these banks delivered nothing but red ink and damp squibs.

We've left the era of dotcom hype behind us and have entered a new era – of FinTech hype. Just as it was impossible in the early 2000s to predict which of the many up-and-coming internet companies would survive the dotcom mania, we still have no idea what types of business model will succeed now. Some digital models are actually in competition with existing business models. Individualised, algorithm-based investment strategies, for example, are particularly well regarded. The market leaders are American. One company, founded just three years ago, already has 2.5 billion dollars of assets under management. In Switzerland too, banks and start-ups are trying to tap into this market. Another new business segment is crowdfunding, which bypasses the banks entirely and recruits investors online. This is a particularly attractive option when access to traditional lending is restricted.

I myself strongly believe that market forces and client needs – not the regulatory framework – must determine the success or failure of these business models. In the end, clients will decide whether the expected bonanza becomes a reality. Governments should stand back – it's not their job to pick the winners and losers in a free market.

Regulation and supervision in the digital era

So when and to what extent should governments intervene in financial markets? There can be no doubt that they have a role to play. We all know about market failure and systemic risk, not to mention the all too frequent incidents of deliberate misconduct in recent times. Governments do have the right to intervene.

However, this does not mean that governments should have carte blanche. Governments too can provide false incentives and, in the worst case, trigger crises. This is why state intervention, in the form of regulation, must be intelligent. Admittedly, this is easier said than done.

Globally, there is a trend for governments to micro-manage. Some governments want to regulate everything down to the smallest detail; central banks dominate the financial markets; explicit and implicit state guarantees distort markets; and the motivation behind some regulation is clearly protectionist. I'm sure that very few of those present here today would wish it to be this way, but this is the world we live in.

And that's something I'd like to focus on today. There is always a risk that the regulatory environment will discourage innovation by sealing markets off and shielding current market actors from competition. Unsurprisingly, this tends to weaken innovation. Current market participants have an interest in regulation which makes it difficult for new actors to enter the market, and they wield their influence accordingly. Start-ups, on the other hand, find it hard to make themselves heard.

FINMA wants to see a successful and sustainable Swiss financial sector. That's why we focus not only on the success of today's dominant actors, but also on removing regulatory hurdles to create the space for innovation.

What should the regulatory framework look like?

In my opinion, regulation should be based on the following three principles:

Firstly, regulation must be neutral as regards technological change and should neither encourage nor hinder it. Instead, it should enable fair competition among all market players: analogue versus digital; existing ideas versus new business models; Swiss providers versus foreign competitors. Unjustified barriers to new providers and products should therefore be removed.

Secondly, it is worth remembering that the principles-based approach to regulation, as it currently exists in Switzerland, tends to provide a good basis for the development of the digital business sector. This type of regulation is much more flexible in terms of its actual application than rules-based regulation. It does not matter whether an analogue or a digital channel is chosen, as long as the actual principle of regulation is preserved. Principles-based regulation provides space for innovation, while a regulatory system which controls everything down to the last detail tends to smother it.

And finally, it is vital to prevent the emergence of technology-based regulatory gaps which threaten client protection and the system as a whole; and, where these gaps do emerge, they must be shut down. Where necessary, the rules must be adapted to protect investors and the system. In the digital world, as elsewhere, there is a legitimate need for protection.

I'm aware that these proposals are somewhat contradictory. However, it's absolutely clear that it's not just regulators who are challenged by digital innovation. There is a need for more general legislative change, including amendments to tax law and the basic rules on business transactions in the Swiss Code of Obligations, in order to accommodate digital business. It's easy to put the focus on regulation, but it's not sufficient.

Where does FINMA stand?

As a supervisory authority, our first priority is to apply the law as it stands. However, we have a vital interest in developing and adapting regulation to the needs of a digital world. And I reiterate: FINMA regards innovation as a key factor in the competitiveness of the Swiss financial centre.

To this extent, we have set ourselves the goal of supporting innovation. We can achieve this firstly by making our own regulations technology-neutral. And secondly, we are also considering changes to the overarching legislative framework.

As regards FINMA's own remit, in 2015 we revised the Anti-Money Laundering Ordinance to make it fit for purpose in the digital era. As I've already mentioned, we have introduced rules on online authentication, and we have also established a framework for online identification. We are in contact with providers whose products enable identification by video. This is another development that is on the way, but the conditions under which it will operate still need to be clarified.

We have also relaxed the due diligence requirements for payments of small amounts. For instance, retailers in Switzerland can offer cashless payment methods for goods and services up to CHF 5,000 a month or CHF 25,000 a year without the need for formal client identification. The main beneficiaries will be digital providers.

Our regulations should be neutral as regards technological developments and business models. We do not want to block or impede competition and innovation. To this end we have launched a project to modernise financial market regulation. We want to find out which rules inhibit innovation. As things stand today, we see potential for improvements in some areas, for instance, increased recognition of electronic identification and contracts. However, to make real progress in terms of technological innovation, there are many cases in which changes to the legislative framework will be required.

FINMA's remit is restricted to downstream regulation. It does not determine the legal framework in which it operates. However, there's no harm in thinking out loud.

FinTech companies operating in Switzerland are practically always subject to the Anti-Money Laundering Act or the Banking Act. As the Banking Ordinance states, any company which accepts deposits from more than 20 clients must have a banking licence. This applies not only to payment service providers, but also to crowdfunding platforms and digital currency providers. While I agree that the licensing requirements in the area of money laundering are right and appropriate for start-ups, a banking licence is too expensive for most of these companies during the start-up phase.

I am therefore in favour of giving serious consideration to a new licensing category with less stringent requirements than those currently set out in the Banking Act. However, there are two prerequisites for any relaxation in licensing requirements. Firstly, the volumes concerned must be relatively low. I'm aware of course that it's not easy to define these thresholds. Secondly, these companies must not be allowed to transform maturities – by which I mean they must not be allowed to offer long-term loans based on short-term deposits. This restriction would eliminate any liquidity or interest rate risks. The financial risks for clients would be considerably lower than with a traditional bank. In fact, without maturity transformation we're not really talking about a bank in the traditional sense. And logically, if one is not operating a bank, there is no need for the same level of protection that is required for a bank. Creating a new licensing category for these less complex institutions would eliminate a major hurdle for the digital financial centre.

New business, new risks

Technological change brings both opportunities and risks. As a supervisory authority, it is in FINMA's DNA to be risk-conscious, and I'd like to focus on two particular risks in this final section of my address.

The first one is the growing number of cyber-attacks. A study by Lloyds puts the annual cost of these attacks at 400 billion dollars. Every day there seems to be another sensational story, whether it's the theft of US tax data or the disruption of the German parliament’s IT system. The financial sector is a prime target for hackers, with three times as many cyber-attacks on financial institutions as on other companies.

Wasn’t it Barack Obama’s former security adviser who said: “The internet was built on trust, not on security”? And how right he was. The increased distribution of digital products exposes the financial sector to greater risks. Potentially the worst of these is the non-availability of systemically important functions due to cyber-attacks. If these are orchestrated by professionals, they have the potential to produce severe liquidity and solvency problems.

In view of these threats, FINMA has been looking at the problem of cyber risks for some time now. We now have an overview of the sections of the value chain which are particularly vulnerable. We are also working on ways of using external test attacks to assess whether the institutions which we supervise are adequately protected. We also ask them to carry out self-assessments of their own defensive capabilities. This year we have also carried out additional targeted inspections with a focus on IT security.

The second area in which new risks may arise is outsourcing. It is common practice nowadays for financial institutions to outsource a wide range of IT services to external providers. The value chain is broken down, and important functions are performed by third parties. Operationally, of course, this makes sense. However, the risk is that oversight systems become fragmented. How can access to outsourced services be guaranteed? What happens in a crisis? And does the failure of a critically important outsourcing provider represent a new form of systemic risk?

All these factors will be considered when we revise our circular on outsourcing, and we will look closer at controlling outsourcing risks more generally.

Conclusion

The Swiss financial centre can benefit enormously from technological progress. Regulation should encourage competition in ideas, not stand in its way. Governments should restrict themselves to providing a technology-neutral framework. The innovative ideas must come from private companies, which above all else need to have a pioneering spirit and the ability to think and act as entrepreneurs.

Governments should define the regulatory environment with the aim of making the financial centre stable, innovative and sustainable. For its part, the financial centre must behave ethically and accept social responsibility. We at FINMA are adapting our regulations to accommodate FinTech. We are also seeking to influence the legislative framework in a positive way. An innovative financial sector is in all our interests.

Thank you for your attention.