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EU Retail Financial Regulation in the Digital Age

Short course, Bologna, 26 November 2021

Prof. dr. Olha O. Cherednychenko

Overview

› **Regulation of retail financial services**

- Why regulate?
- How to regulate?
  - the main building blocks of financial regulation: prudential and conduct of business regulation
  - the degree of legal paternalism
- Conduct of business regulation:
  - the case of simple consumer credit in the EU
  - the case of retail investment services in the EU
- FinTech and sustainable development

WHY REGULATE RETAIL FINANCIAL SERVICES?

What are retail financial services?

- Services provided by financial institutions to consumers and other non-professional parties (such as SMEs)):
- payment
- credit
  - simple (non-mortgage) credit
  - mortgage credit
- investment
- insurance

The origins of the global financial crisis (i)

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The origins of the global financial crisis (ii)

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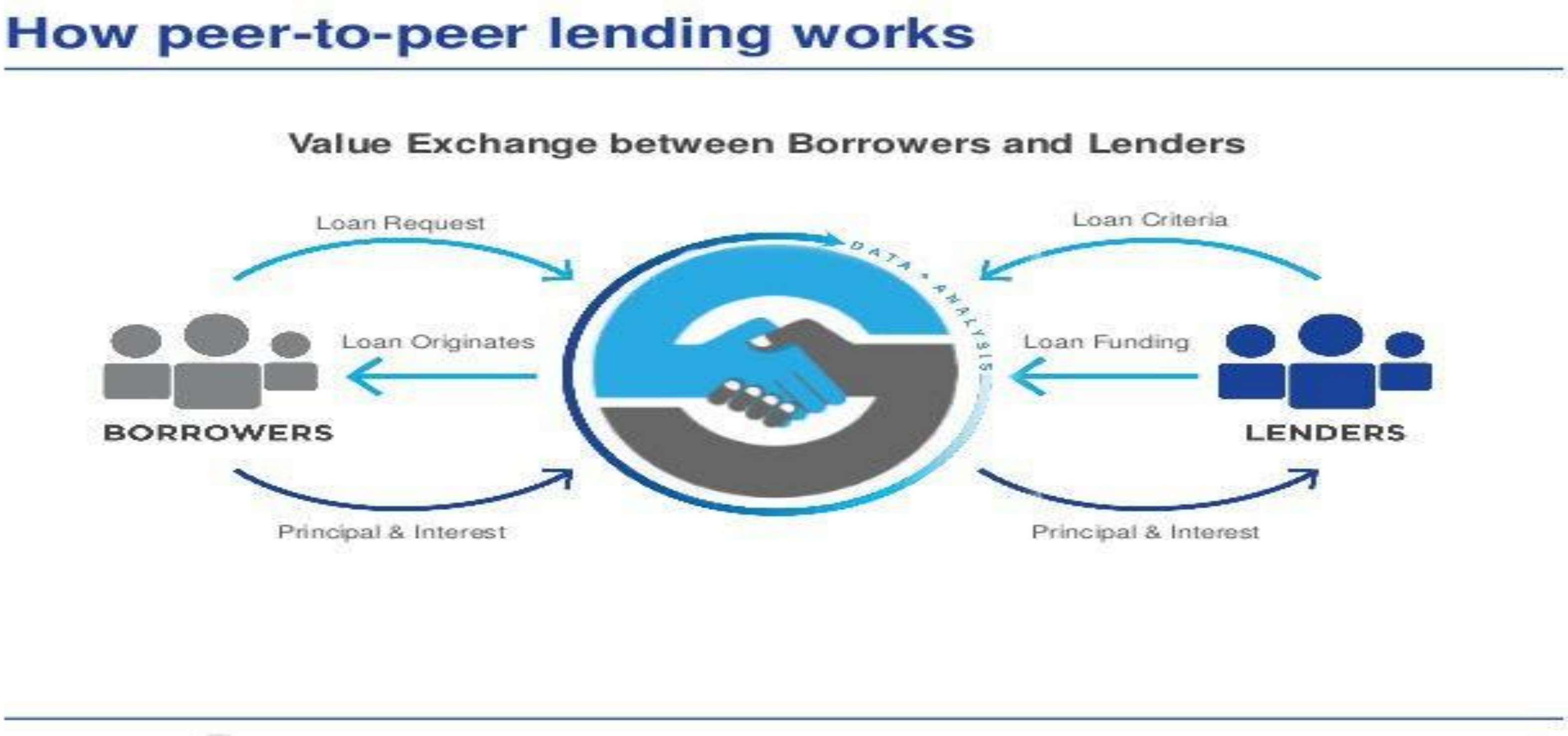
- And many new challenges ahead in the age of financial technology (FinTech) …

Consumer credit: Quick and easy access for consumers?

Crowdfunding – A brave new world of alternative consumer finance?



What is the future of Bitcoin?

Julia Kollewe
Tue 9 Nov 2021 08.22 GMT

Bitcoin price surges to record high of more than $68,000

Other cryptocurrencies such as ethereum also reach records as investors hedge against inflation

The bitcoin price has reached a new record high, breaking through $68,000 (£50,000), and analysts predict that the world’s best-known cryptocurrency will rise further in the coming weeks.

This beats the previous record high set in late October, when bitcoin reached nearly $67,700 before falling back again when investors discovered a new cryptocurrency, shiba inu. Other cryptocurrencies have also risen to record highs, such as ethereum, which soared to $4,837.

What is FinTech?

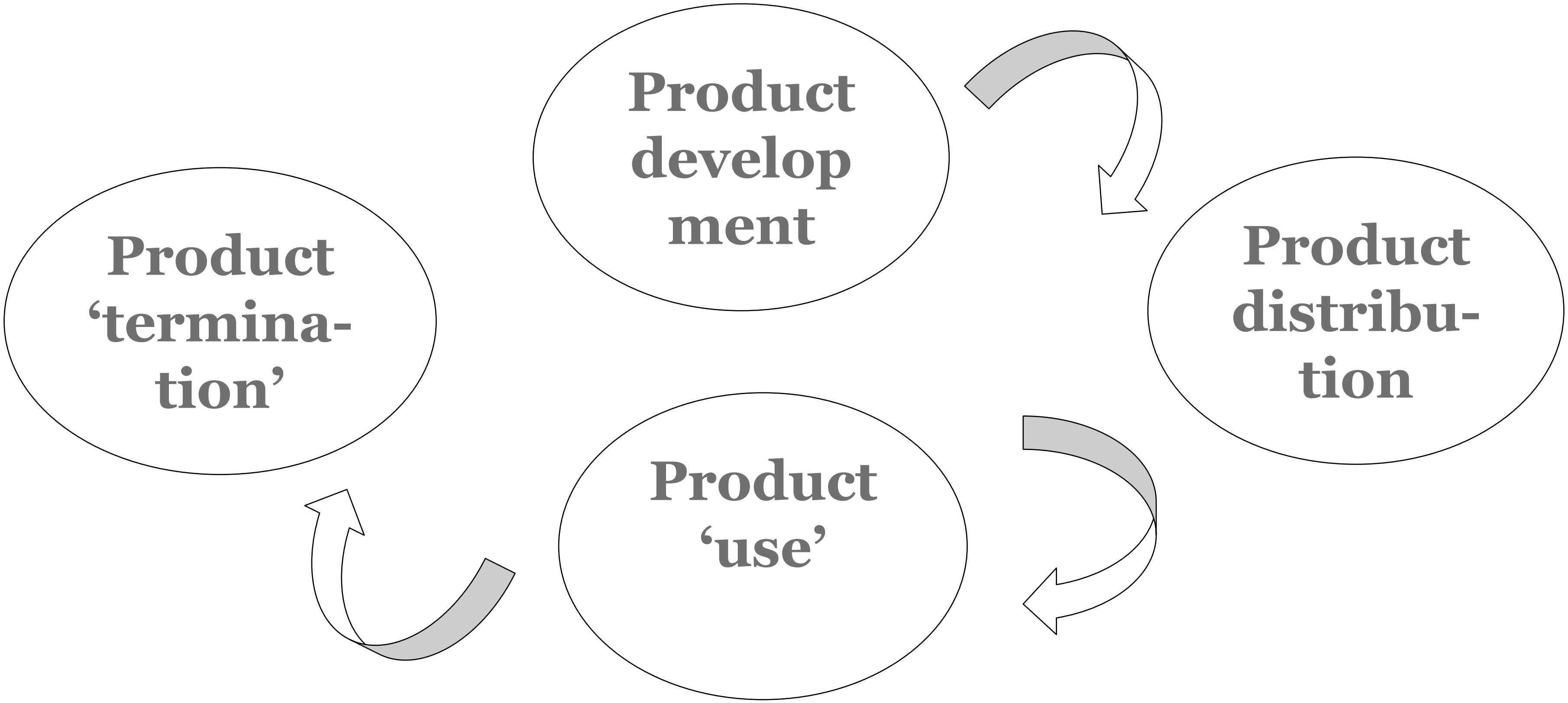
- Technology-enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services

(Financial Stability Board 2017)

- E.g. online platforms, artificial intelligence (AI), big data analytics, machine learning, distributed ledger technology (DLT)

Financial product lifecycle

› **Financial product is a contract!**



Types of financial institutions: e.g.

- Credit institutions (e.g. banks)
- Credit intermediaries
- Investment firms
- Insurance companies

Different roles of financial institutions: e.g.

- Financial product manufacturers
- Financial intermediaries = financial product distributors = financial service providers
- Trading platforms (e.g. stock exchanges)

Financial consumers / Retail investors

› Financial consumers:

- ‘ ‘consumer’ means a natural person who … is acting for purposes which are outside his trade, business or profession’ *(Consumer Credit Directive, art. 3 (a))*

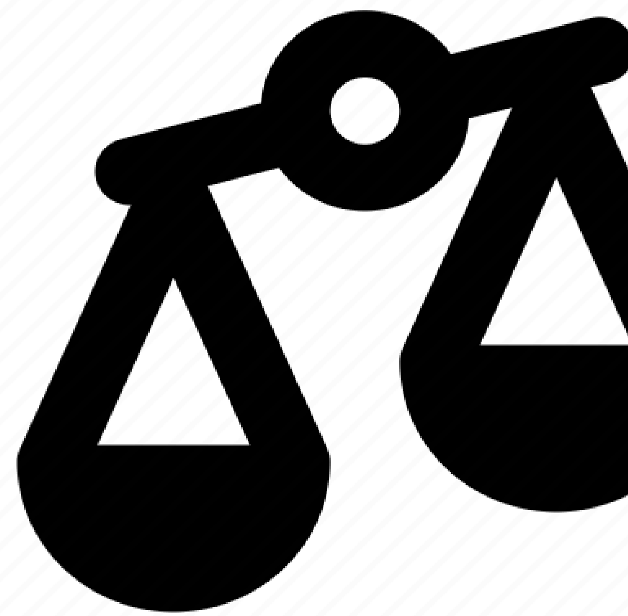
› Retail investors:

- ‘ ‘retail client’ mean a client who is not a professional client’ *(Markets in Financial Instruments Directive II, art. 4 (11))*

- a broad definition which includes not only consumers but also SMEs

Relations between financial institutions and consumers/retail investors

- Information asymmetries/ imbalance of bargaining power
- Consumer behavioural biases in financial decision-making (e.g. overoptimism, myopia)
- Negative third party effects of individual transactions (externalities)



Regulatory goals (1)

- European market integration:
  - a level playing field for financial institutions through (minimum or maximum) harmonisation of national laws
- Financial stability:
  - a state in which the financial system is capable of withstanding shocks
- Orderly functioning and integrity of financial markets:
  - markets operate in a fair, transparent and efficient way

Regulatory goals (2)

- Financial consumer/retail investor protection:
  - to correct a market failure resulting from information asymmetries between financial institutions and consumers/retail investors *(the 'economic version' of public interest theory)*
  - to ensure interpersonal justice between the parties as an intrinsic value?
- Sustainable development:
  - sustainable finance as a prerequisite

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HOW TO REGULATE FINANCIAL SERVICES?

The major challenge for retail financial regulation

- How to empower and protect financial consumers / retail investors at the same time?

- given characteristics of financial markets (J. Black, *MLR* 2012):

  - complexity
  - uncertainty
  - fragmentation
  - ungovernability
  - dynamism

- Need for public regulation undisputed but many questions about the appropriate regulatory design

The main building blocks of retail financial regulation

Prudential regulation

- concerned with the safety and soundness of individual financial institutions (i.e. micro-prudential regulation) and with systemic risks to the financial system as a whole (i.e. macro-prudential regulation)
- micro- and macro-prudential regulation complement each other in ensuring financial stability
- tools: e.g. requirements on authorization, capital and management bodies

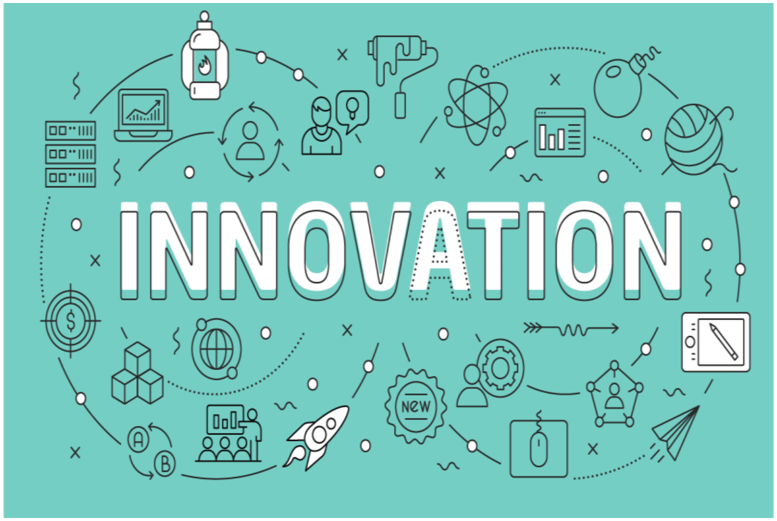
Conduct of business regulation

- concerned with the orderly functioning of financial markets and consumer/retail investor protection
- increasingly covers not only product distribution but also product development
- tools: e.g. product regulation, information requirements, duties of care and loyalty

Legal paternalism to what degree?

- ‘Hard’ (‘strong’) paternalism:
  - the law forces individuals to avoid certain risks
  - individuals are deprived of choice
- ‘Soft’ (‘weak’) paternalism:
  - the law, without coercion, nudges individuals away from certain risks towards what is generally considered to be a preferable course of conduct
  - freedom of choice is preserved

Regulatory dilemma



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Three main building blocks of conduct of business regulation on the continuum between ‘soft’ and ‘hard’ paternalism

Disclosure regulation

Distribution regulation

Product regulation

‘Soft’ paternalism

‘Hard’ paternalism

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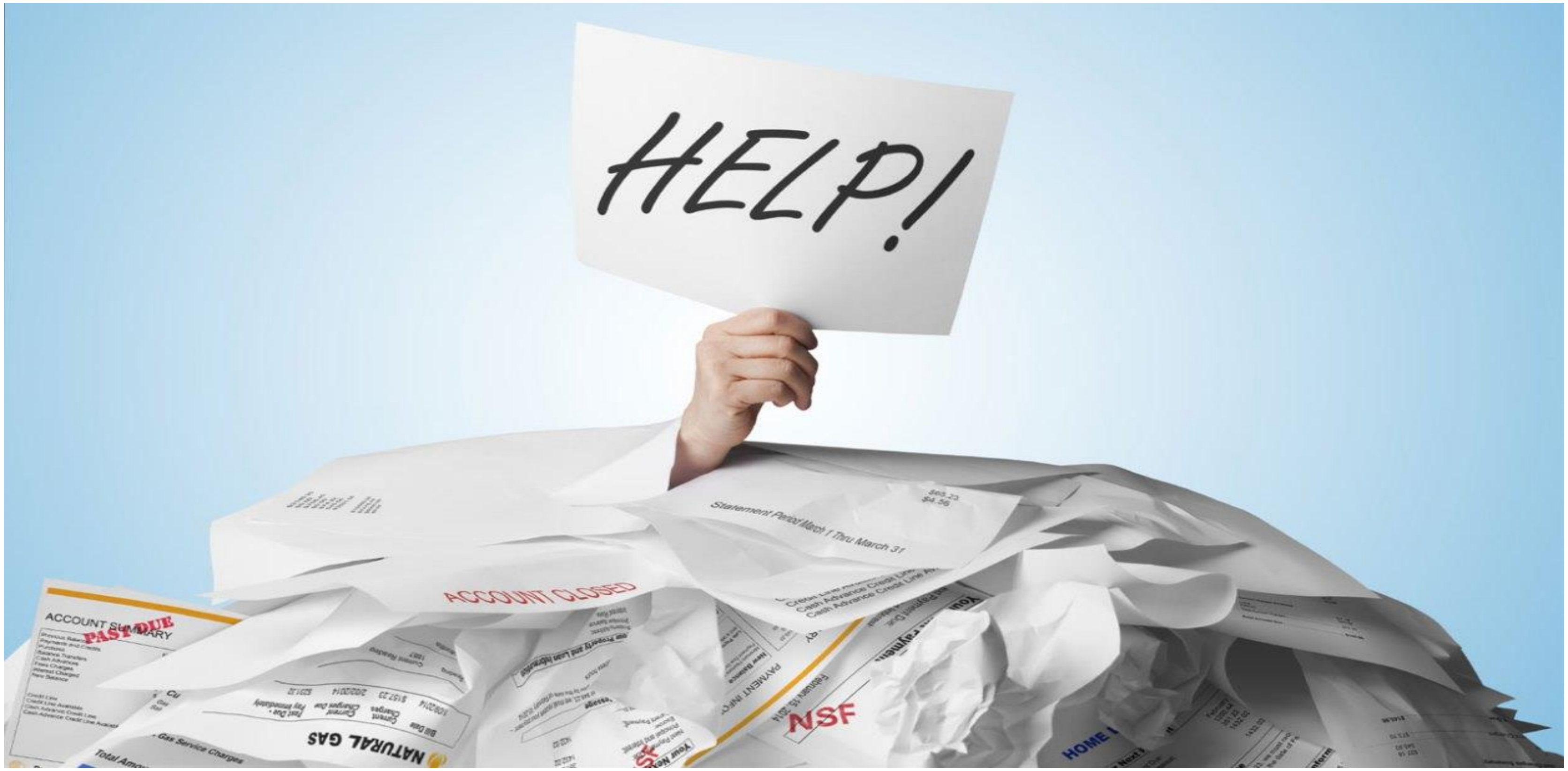
CONDUCT OF BUSINESS REGULATION: THE CASE OF SIMPLE CONSUMER CREDIT IN THE EU

Consumer credit: lubricant or a potentially dangerous financial product?



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Key regulatory tools currently used by the EU (i)

General:

› Prohibition of unfair commercial practices *(Unfair Commercial Practices Directive)*

› Contract terms control *(Unfair Contract Terms Directive)*

› Data protection *(General Data Protection Regulation (GDPR))*

› Prohibition of discrimination (e.g. Directive 2000/43/EC and Directive 2004/113/EC)

Key regulatory tools currently used by the EU (ii)

Specific:

- Right of withdrawal for consumers
- Information requirements for lenders
- The lenders' duty to assess consumer creditworthiness
  - but only a modest version ('soft' paternalism): no duty to refuse granting credit in case of the negative result (Member States may impose such a duty)
  - the duty is typically further specified by the codes of conduct adopted by professional associations of lenders (e.g. Dutch Banking Association)

(Consumer Credit Directive 2008)

Access to credit vs. consumer protection: Payday loans

- Small instalment loan to be repaid over a short term (until ‘payday)
- Quick and easy access to credit on smart phone apps or online
- But excessive interest rates, high additional costs after a missed payment, often multiple rollovers
- Consumer vulnerability in a dehumanised environment
- Is the Consumer Credit 2008 fit for its purpose? (O.O. Cheredny-chenko& J.M. Meindertsma, *JCP* 2019)

Potential regulatory tools: e.g.

- Stricter lenders' duty to assess consumer credit-worthiness:
  - incl. a duty to deny credit in case of the negative result?
- Interest rate caps?
- Product regulation:
  - prohibition of potentially dangerous credit products?

(See Proposal for a New Consumer Credit Directive, COM/2021/347 final)

Access to credit vs. consumer protection: Peer-to-peer lending

- Should the rules for traditional lenders also apply to peer-to-peer lending platforms and, if so, to what extent?

(See Proposal for a New Consumer Credit Directive, COM/2021/347 final)

CONDUCT OF BUSINESS REGULATION: THE CASE OF RETAIL INVESTMENT SERVICES IN THE EU

Capital markets

› Primary market:
- investors buy directly from the issuing company (e.g. an initial public offering (IPO))

› Secondary market:
- securities are traded after the company has sold its offering on the primary market
- investors trade securities among themselves (e.g. New York Stock Exchange (NYSE), London Stock Exchange (LSEG), European New Exchange Technology (Euronext))

Types of investment products: e.g.

- Shares
- Bonds
- Derivatives (e.g. options, futures)
- Packaged retail investment products (e.g. investment funds, investment insurance)
- Crypto-assets (e.g. Bitcoin)

Three main types of investment services

- Execution-only
- Investment advice
- Portfolio management

Mis-selling of investment products (i)

(Markets in Financial Instruments Directive II)

Mis-selling of investment products (ii)

HSBC fined £10.5m for selling five-year bonds to over 80s

Bank's subsidiary advised 2,485 people to invest in bonds to pay for their long-term care costs

HSBC has been fined for mis-selling bonds to elderly people.

Jill Treanor

Mon 5 Dec 2011 12.29 GMT

•HSBC, Britain's largest bank, has been hit with a record £10.5m fine for selling unsuitable products to almost 2,500 elderly customers.

Mis-selling of investment products (iii)

Independent review of Interest Rate Hedging Products

First published: 14/08/2019 Last updated: 27/09/2021

An independent review into the FSA's – and subsequently the FCA's – approach to, implementation and oversight of the Interest Rate Hedging Products Redress Scheme.

Background to the IRHP review

In March 2012, the Financial Services Authority (predecessor regulator to the FCA) identified significant issues with the sale of Interest Rate Hedging Products (IRHPs) to UK Small and Medium Enterprises (SMEs). The FSA intervened and secured voluntary agreements with the banks to provide redress.

ESAS WARN CONSUMERS OF RISKS IN BUYING VIRTUAL CURRENCIES

12 February 2018

JOINT COMMITTEE
MIFID - INVESTOR PROTECTION

The European Supervisory Authorities (ESAs) for securities (ESMA), banking (EBA), and insurance and pensions (EIOPA) have today issued a pan-EU warning to consumers regarding the risks of buying Virtual Currencies (VCs).

The ESAs are concerned that an increasing number of consumers are buying VCs unaware of the risks involved. VCs such as Bitcoin, are subject to extreme price volatility and have shown clear signs of a pricing bubble and consumers buying VCs should be aware that there is a high risk that they will lose a large amount, or even all, of the money invested.

Non-regulated products and exchanges

Additionally, VCs and exchanges where consumers can trade are not regulated under EU law, which means that consumers buying VCs do not benefit from any protection associated with regulated financial services. For example, if a VC exchange goes out of business or consumers have their money stolen because their VC account is subject to a cyber-attack; there is no EU law that would cover their losses.

Key regulatory tools currently used by the EU (i)

General:

- Prohibition of unfair commercial practices *(Unfair Commercial Practices Directive)*
- Contract terms control *(Unfair Contract Terms Directive)*
- Data protection *(General Data Protection Regulation (GDPR))*
- Prohibition of discrimination (e.g. Directive 2000/43/EC and Directive 2004/113/EC)

Key regulatory tools currently used by the EU (ii)

› Specific:

1) Product disclosure regulation
2) Distribution regulation
3) Product regulation

1) PRODUCT DISCLOSURE REGULATION

Regulatory tools

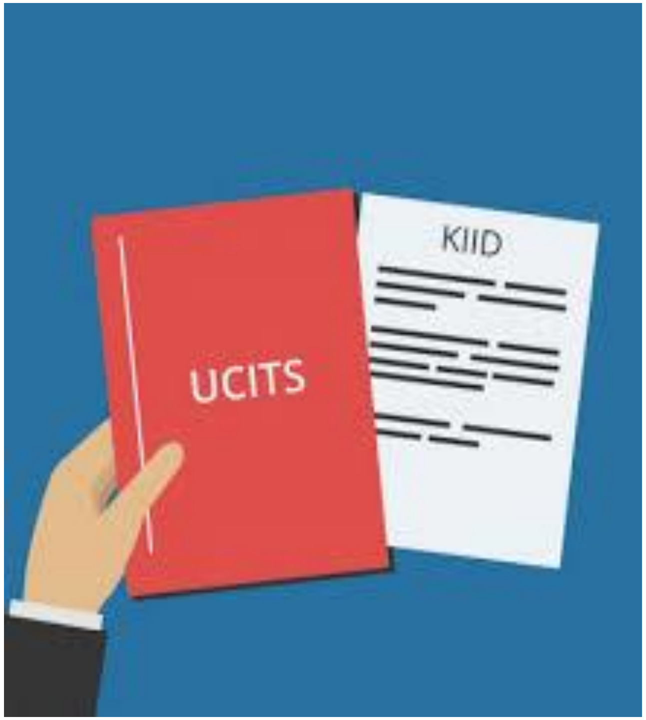
- **Information requirements:**

  - form
  - content
  - provision

Example

Key investor information document:

[CESR's template for the Key Investor Information document]



(Packaged Retail and Insurance-based Investment Products Regulation)

2) DISTRIBUTION REGULATION

Regulatory tools (i)

- **a general duty of loyalty**: e.g.

'When providing investment services or, where appropriate, ancillary services to clients, an investment firm should act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in this Article and in Article 25.'

(Markets in Financial Instruments Directive II, art. 24(1))

Regulatory tools (ii)

› **Information requirements**:

- form
- content
- provision

E.g.

- All information, including marketing communications, addressed by the investment firm to (potential) clients should be fair, clear and not mis-leading
- Appropriate information should be provided in good time to (potential) clients with regard to the investment firm and its services, the financial instruments and proposed investment strategies, execution venues and all costs and related charges

(Markets in Financial Instruments Directive II)

Regulatory tools (iii)

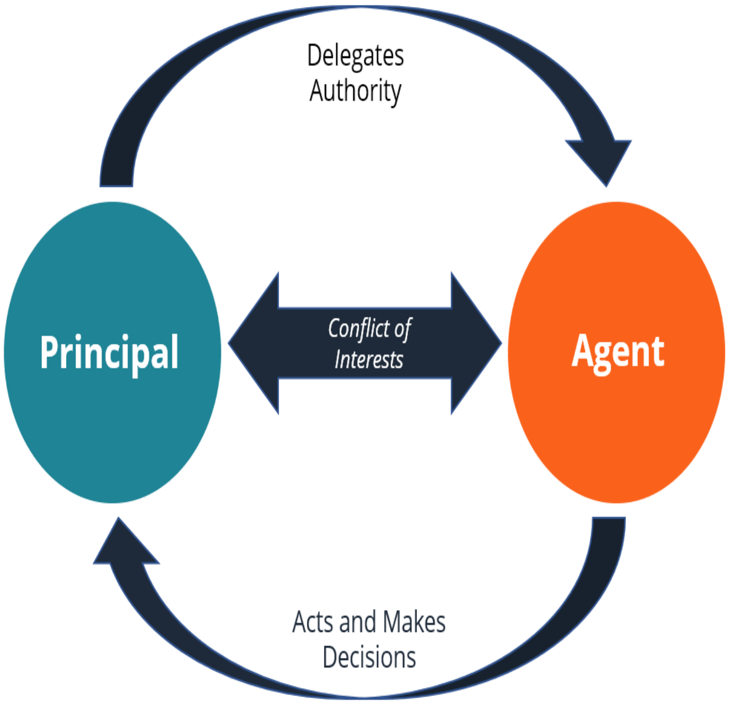
› **Know your customer rules**: e.g.

'When providing investment advice or portfolio management the investment firm should obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and his investment objectives including his risk tolerance so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance and ability to bear losses.'

(Markets in Financial Instruments Directive II), art. 25(2))

Regulatory tools (iv)

- **Third-party commission ban:**
  - When providing independent advice or portfolio management 'the investment firm may not retain fees, commissions or any monetary or non-monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients.'



(Markets in Financial Instruments Directive II, arts 24(7)(b) and 24(8))

3) PRODUCT REGULATION

Regulatory tools: An overview

- *Ex ante* product authorization
- **Product governance**:
  - oversight of product development processes
- ***Ex post* product intervention**: e.g.
  - a ban on the marketing of certain products to retail investors
  - a total product ban

(Cf. EU product safety regime for tangible goods)

Product governance (i)

- An investment firm which manufactures financial instruments for sale to clients should maintain, operate and review a process for the approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients
- The product approval process should:
  - specify an identified target market of end clients within the relevant category of clients for each financial instrument
  - ensure that all relevant risks to such identified target market are assessed
  - the intended distribution strategy is consistent with the identified target market

(Markets in Financial Instruments Directive II)

Product governance (ii)

- An investment firm should regularly review financial instruments it offers or markets
- An investment firm should provide distributors with all appropriate information on the financial instrument and the product approval process (incl. the identified target market)

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Product intervention

- NCAs may <u>permanently prohibit or restrict</u> the marketing, distribution or sale of financial instruments or a type of financial activity or practice
- European Securities and Markets Authority (ESMA) may adopt <u>temporary product intervention measures</u>

ESMA AGREES TO PROHIBIT BINARY OPTIONS AND RESTRICT CFDS TO PROTECT RETAIL INVESTORS

27 March 2018

MIFID - INVESTOR PROTECTION
PRESS RELEASES

The European Securities and Markets Authority (ESMA) has agreed on measures on the provision of contracts for differences (CFDs) and binary options to retail investors in the European Union (EU).

The agreed measures include:

1. **Binary Options** - a prohibition on the marketing, distribution or sale of binary options to retail investors; and

2. **Contracts for Differences** - a restriction on the marketing, distribution or sale of CFDs to retail investors. This restriction consists of: leverage limits on opening positions; a margin close out rule on a per account basis; a negative balance protection on a per account basis; preventing the use of incentives by a CFD provider; and a firm specific risk warning delivered in a standardised way.

FINTECH AND SUSTAINABLE DEVELOPMENT

What is FinTech? (revisited)

- Technology-enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services

(Financial Stability Board 2017)

- E.g. online platforms, artificial intelligence (AI), big data analytics, machine learning, distributed ledger technology (DLT)

What is sustainable finance?

- Process of taking <u>due account of environmental, social and governance (ESG) considerations when making investment decisions in the financial sector</u>, leading to increased longer-term investments into sustainable economic activities and projects
- ESG: e.g. climate change mitigation, pollution prevention, circular economy, human rights issues, management structures

?

Retail investment	+	FinTech	=	Sustainable finance

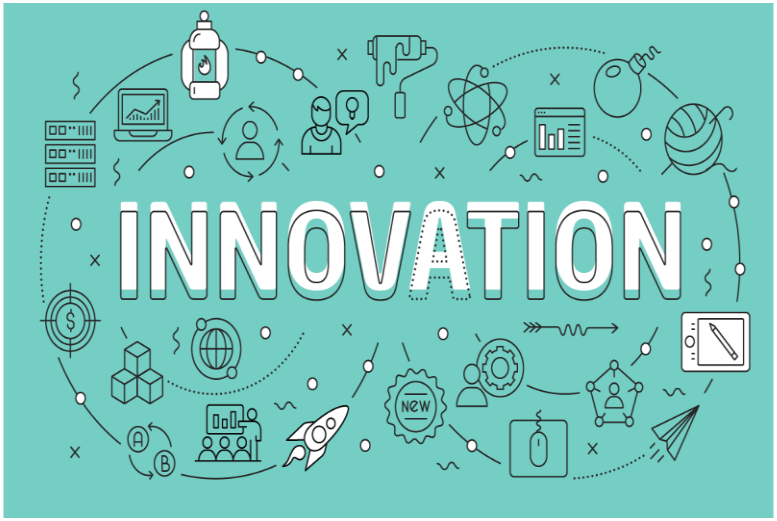
FinTech opportunities

- Ensure efficient supply of accurate ESG data from firms (i.e. ESG reporting) and their translation into standardized and comparable data
- Increase access to sustainable financial products and services for retail investors (e.g. through ‘green’ crowdfunding platforms)

FinTech risks

- Retail investor protection:
  - information asymmetries/ imbalance of bargaining power
  - lack of sufficient data protection
  - price discrimination
  - financial exclusion

Regulatory dilemma (revisited)



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(Potential) regulatory tools for promoting sustainable finance within:

- Product disclosure regulation?
- Distribution regulation?
- Product regulation?

THANK YOU FOR YOUR ATTENTION!