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FINANCIAL SERVICES IN THE 2020s: TECTONIC SHIFTS AND NEW LANDSCAPES

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FINANCIAL SERVICES IN THE 2020s: TECTONIC SHIFTS AND NEW LANDSCAPES

JUNE 23 TO 25, 2019

Session 621

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FINANCIAL SERVICES IN THE 2020s: TECTONIC SHIFTS AND NEW LANDSCAPES

The geopolitical landscape and the global economy are going through tectonic shifts with the pace of global growth becoming less vigorous and balanced. Growing polarization and protectionist tendencies give rise to continuous economic, political and financial fragmentation. The increasing importance of environmental threats as a result of climate change and their potential impact on the long-term economic and financial stability lead to a growing relevance of sustainable finance and extensive and consistent environmental, social and governance (ESG)-related disclosure.

Additionally, the rise of new technologies, the increased maturity of players like fintechs, and the entrance of large, established technology companies into financial services are transforming the financial system from a centralized framework into an open architecture. Emerging platforms and fundamental changes in the distribution mechanism of financial services result in a range of activities being offered outside of the core jurisdiction of banking regulators and create new regulatory challenges regarding contextual finance, privacy, and data protection.

The ninth session of the **Salzburg Global Finance**

Forum – *Financial Services in the 2020s: Tectonic Shifts and New Landscapes* – brought together stakeholders from different financial institutions, regulators, and policymakers around the world to discuss how new global trends and emerging risks are both impacting and challenging society and financial markets, and what consequences they imply for policy, regulation, and practitioners.

The following report is an executive summary of the discussions from the two-day session (June 23-25, 2019) at Schloss Leopoldskron in Salzburg, concluding with a list of all participants in attendance.



EXECUTIVE SUMMARY

SOCIAL AND TECHNOLOGICAL DEVELOPMENTS ARE KEY DRIVERS OF GLOBAL CHANGE AND EMERGING RISKS

Geopolitical risks and social as well as technological developments have become more complex in recent years, affecting economic structures and producing a higher degree of uncertainty under which regulators and market participants have to operate. Ten years after the financial crisis, its legacy is still being felt, as it has become one of the catalysts of backlash against liberal democracy and globalization, amplified by an increasing income inequality.¹

Growing polarization and protectionist tendencies on a global level are an indication that the benefits of international integration and coordination have not been shared by all social strata and all countries. Trade tensions between major economies and populist movements in a number of countries reflect a growing discontentment with existing global cooperation frameworks and the associated institutions, giving rise to continuous economic and political fragmentation. Trust in governments and political institutions is eroding also, putting the financial system at an increasing risk of fragmentation.

Additionally, in many emerging countries, financial inclusion is still limited with significant portions of the population lacking proper access to finance and financial advice. While technological developments and mobile penetration provide a variety of opportunities to participate in the economic value creation, growing automation and digitization will pose severe societal challenges, especially in countries with a high labor participation in manufacturing in the long run.

The financial system has become more resilient from a regulatory standpoint, however, concerns arise

especially regarding risks shifting to non-bank finance. The proliferation of alternative finance as well as non-bank providers of financial services is partly driven by the enabling role of technological development, but can also be attributed to an increasingly pronounced disillusionment with and an erosion of confidence in conventional finance after the financial crisis. This deterioration of trust is not only evident between citizens and traditional financial service providers, but also between regulators and financial service providers and is affecting communication and interaction between the involved parties.

This decline in cross-party communication and interaction also raises challenges regarding the capability of regulators and market participants to efficiently respond to market shocks. Global debt has risen significantly over the past ten years, while at the same time low interest rates have formed a number of asset bubbles. As banks are currently able to play only a limited role as shock absorbers regarding liquidity and the pricing of market risk, the consequences of a new crisis could be even more severe than that of a decade ago.

With the continuously rising power of Asian economies – especially China – new challenges arise and exacerbate current tensions. On a political and societal level, fundamentally different stances become evident regarding privacy and data protection, which become pivotal in an increasingly digitalized world with a growing influence of automation and artificial intelligence (AI). Demographic developments, especially in aging economies, require stable and well-developed financial markets, which are still not of an adequate size and depth in a number of affected countries.

The astounding penetration of technology in financial services in China also poses challenges for the financial community and regulators alike. With predominately US and Chinese platforms currently combining content, retail, and financial offers, the financial services industry is beginning to become more and more contextual, resulting in a range of activities seemingly being offered outside of the jurisdiction of bank regulators. Another fundamental risk is fueled by the growing economic activity in Asian countries: The potential severe and adverse consequences of climate change that will affect Asian economies strongly due to the sheer size of their population. The threat of climate change also needs to be approached and managed more actively in these regions due to the enormous impact these economies may have on mitigating the ensuing risks.

¹ Especially in the US, income inequality has been rising more than in most other large countries based on GINI coefficient analysis.

DISCLAIMER

The executive summary reflects the author's view of the overall discussion during the program and should not be attributed to individual participants.

ESG ASPECTS HAVE INCREASING IMPORTANCE FOR THE ENTIRE FINANCIAL SYSTEM

Undoubtedly, environmental, social, and governance (ESG) aspects are becoming critical considerations for investment decisions and the redirection of capital flows. While estimates of the size of the sustainable finance market vary significantly – according to J.P. Morgan², investments where ESG factors are systematically and actively incorporated are estimated at US\$2.5 trillion, compared to the US\$30.7 trillion in global sustainable investment assets reported by the Global Sustainable Investment Alliance (GSIA)³ – interest the market is growing. The increasing importance of

environmental threats due to climate change is particularly evident, as shown in the 2019 Global Risks Report by the World Economic Forum (WEF)⁴.

Climate-related risks threaten the larger private sector as well as financial systems. First, the potentially disastrous consequences of climate change are highly correlated on a global scale and hence by nature difficult to hedge. Extreme weather conditions often lead to physical risks such as damage to infrastructure and disruptions of production and supply chains, which in turn translate into negative shocks to productivity. Second, transition risks such as regulatory changes affecting resource prices and taxation, changes in dominant technology, or even changing customer preferences and behavior can have a structural impact on the private sector and financial system in turn.

Due to its significance, sustainable finance will become a key element in ensuring the long-term stability

² Elders, G. (2019). J.P. Morgan Perspectives: ESG Investing 2019: Climate changes everything (Rep.). J.P.Morgan.

³ Arai, M., Lanz, D., O'Connor, S., Oulton, W., & Woll, L. (2018). Global Sustainable Investment Review 2018 (Rep.). Global Sustainable Investment Alliance.

⁴ Collins, A. (2019). The Global Risks Report 2019 (Rep.). Geneva, Switzerland: World Economic Forum.





and competitiveness of the global economy. While its importance has been recognized by the financial sector as well as regulators, the high number of different ratings and standards, and the resulting lack of common definitions, still impede the investability in appropriate financial

instruments. To foster sustainable investments more dynamic and up-to-date data is necessary, including a better taxonomy as to which economic activities contribute to the transition to a greener economy and which, on the other hand, increase exposure to environmental risks.

PROGRESS ON TRANSPARENCY

Progress toward transparency has been made on different levels by a multitude of institutions:

- Regarding principles, the Task Force on Climate-related Financial Disclosures (TCFD) established by the Financial Stability Board (FSB) developed principles and associated recommendations for climate-related disclosures with the aim of supporting “informed, efficient capital-allocation decisions”¹ and decrease the financial system’s exposure to climate-related risks.
- Similar work has been pursued by the Climate Disclosure Standards Board (CDSB) which aligned its framework for reporting environmental information with the recommendations of the TCFD.
- Work on clarification of industry-specific standards, sustainability topics and their associated metrics across a wide range of industries has been promoted by the

Sustainability Accounting Standards Board (SASB), taking into account that effective standards and metrics ideally need to directly relate to balance sheet items or cash flows.

- Understanding the long-term consequences of climate change on financial stability, the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), developed a report containing six best-practice-based recommendations for central banks, supervisors, policymakers and financial institutions “to enhance their role in the greening of the financial system and the managing of environment and climate-related risks.”² These include for example the integration of climate-related risks into financial stability monitoring, increased international data and knowledge sharing, as well as striving for internationally consistent environment-related disclosure.

¹ The Task Force on Climate-related Financial Disclosures: 2019 Status Report (Rep.). (2019). Washington, DC: Financial Stability Board.

² Network of Central Banks and Supervisors for Greening the Financial System. (2019). A call for action Climate change as a source of financial risk (Rep.). NGFS Secretariat/Banque de France.

Financial firms and policymakers are expected to play an enabling role in accelerating the awareness of climate-related financial risks and scaling up green financing. Measures include: fostering sustainable finance to redirect capital flows; increasing the awareness of the impact of corporate actions on climate change; and improving financial education of market participants and investors.

The most important progress, however, has to be made at the levels of both individual corporations and national governments. Extensive and consistent disclosure is a prerequisite, but it will not be sufficient to achieve the necessary level of change. Only with societal agreement on the key aspects, globally-consistent solutions, and positive as well as negative incentives for corporations and investors, will sustainable finance scale up sufficiently and environmental risks be appropriately managed.

TECHNOLOGY AND DIGITALIZATION GIVE RISE TO NEW BUSINESS MODELS

The rise of new technologies, the increased maturity of new players like fintechs, and the entrance of large, established technology companies into financial services are transforming the financial system from a centralized framework into an open architecture. Collaboration between banks and fintechs in general can often be mutually

beneficial due to their complementary capabilities: the agility and technology expertise of fintechs combined with the broad customer base, product range and regulatory expertise of incumbent banks. Similarly, the entrance of big tech firms, such as Alibaba, Amazon, Facebook, Google and Tencent, may significantly increase customer convenience due to their customer-centricity and aptitude for advanced data analytics.

On the other hand, the growing presence of fintechs, as well as big tech in this space, increases the diversity and competitive pressure within the financial system. This is driving significant changes due to the different cultural dynamics in the technology industry, as well as their way of delivering services and thinking about risks, compared to the financial services and banking industries. As a result, this changing technological and competitive landscape is leading to a fundamental transformation in the distribution mechanism by changing how, by whom and at what speed financial services and products are delivered.⁵

⁵ With approximately 8.6 billion global mobile devices and connections in 2017, consumers also have immediate access to a wider range of products, services and information. See: Cisco. (2019, February 27). Cisco Visual Networking Index: Forecast and Trends, 2017–2022 White Paper. Retrieved from <https://www.cisco.com/c/en/us/solutions/collateral/service-provider/visual-networking-index-vni/white-paper-c11-741490.html>



Due to these trends, emerging platforms are changing the dynamics and collaboration between different players in the financial industry. This leads to the disintermediation of traditional banks, intermediaries and gatekeepers, in addition to a fundamental transformation of their operations and value chains. At the same time, scalability becomes increasingly important as network effects lead to a “winner-takes-all” phenomenon. The increased speed of change and technological developments due to increased computing power and its diminishing cost, as well as the ensuing ability to use data much more comprehensively and efficiently, leads to a more rapid development, iteration, and testing of business models and their subsequent instantaneous adoption via the internet.

As a consequence, small start-ups, which initially may lack regulatory and compliance expertise, can quickly scale up their operations and presence globally. This goes hand-in-hand with a trend toward convergence. Due to the internet and mobile infrastructure lowering barriers to

entry to the financial sector, more players from different sectors are competing with comparable offerings for the same customers.

Additionally, consumer expectations and behaviors are changing, resulting in an increased irrelevance of *who* is delivering certain services and instead a greater focus on *how*, based on convenience, reliability, accessibility, and personalization. Financial services become progressively contextual especially with retail banking services such as payments, lending, and asset management being offered as part of the customer journey of retailers, comparison websites, social media, and lifestyle apps.

Emerging banking platforms blur boundaries between sectors, resulting in a range of activities being offered outside of the core jurisdiction of bank regulators. This also raises questions and challenges about the perceived and real accountability regarding the protection of personal as well as financial data on an individual, organizational, and societal level.



IN THE FACE OF OPEN BANKING, DATA PROTECTION AND PRIVACY BECOME PIVOTAL

Open Banking initiatives around the world are leading application programming interface (API)-based access to accounts and banking infrastructures, as well as customer and transaction-related data for non-financial third party providers.

Generally, combining data from different sectors could significantly enhance offers, tailor user experiences, increase efficiency, and ameliorate insights and decisions by all participants. However, this data is currently mainly unstructured without agreed standards and formats, and even databases within organizations are often not adequately connected. New technologies such as cloud computing and the use of distributed ledgers allow users to aggregate data into interoperable and standardized formats, to move, analyze, and use it more efficiently, transparently and at lower cost, and subsequently to facilitate its automation in the context of smart contracts.

Players like Alibaba and Tencent in particular benefit from a substantially different attitude towards data sharing and privacy in China, allowing them to interlink insights on consumer behavior across a wide range of activities with financial data, and consequently offer a broad array of potentially value-adding comprehensive services on their platforms. This mindset towards data ownership and usage, combined with the resulting network effects and all-encompassing services offered by these large platforms, leads to overwhelming adoption of their services within China. This is reflected by an almost 54% market share in the mobile payments market for Ant Financial's Alipay and an almost 40% market share for Tencent's WeChat Pay and QQ Wallet.

Nevertheless, not all elements of these business models will be transferable to other geographical parts of the world mainly due to a diverging stance on privacy and data protection, particularly highlighted by the EU's General Data Protection Regulation (GDPR) and comparable laws in the US and Asia.

The general deterioration of trust that consumers have in banks as a long-term consequence of the financial crisis remains an issue. Additionally, the current situation lacks reciprocity and creates an asymmetry. The Payment Service Directive (PSD) II is allowing standardized and real-time access to payments data to non-financial third parties, but yet, financial institutions are being denied access to tech companies' data on customers and their behavior.

These differing approaches to data usage, protection and privacy and the resultant concerns may, however, present banks with an opportunity to act as the trusted custodian of clients' financial data and digital identity. They can thus regain and retain clients' trust in a world where personal data is unwittingly used to pay for increased convenience and seemingly "free" amenities. Feedback circles between trust and data may lead to a virtuous circle with those players who earn the consumers' trust also becoming their data's guardian. Clear ethics regarding the use of financial data will be paramount for data- and privacy-based business models to grow, as well as to ensure accountability by all parties involved, and to safeguard the obligation to protect the users' privacy.

OPEN ARCHITECTURE REQUIRES MOVE TOWARD MORE ACTIVITY-BASED REGULATION

New challenges for regulators stem mainly from the speed and extent of technological developments, the structural impact of the entrance of new players, and the emergence of new business models such as robo-advisory, credit scoring by retailers or crypto-assets, and other Distributed Ledger Technology (DLT)-based services. Due to the disintermediation of financial services, a range of banking activities are increasingly offered by players that are not in the traditional core regulatory realm, making the assignation to existing entity-based regulatory regimes difficult if not impossible.

Regulators therefore have to either integrate these players and their activities into existing regulations, or redefine the perimeters of their regulatory scope to avoid risks to consumer protection and imbalances in the playing fields between regulated banks and new entrants (who otherwise provide part of the financial service value chain without being regulated). To accommodate these new business models and delivery mechanisms, regulation needs to become more activity-based instead of preserving the traditional entity-based approach. Applying the same rules and regulations to the same risks, activities, and business models also helps regulators to stay responsive in the face of an increasingly open architecture and the blurring of boundaries across sectors and industries.

The extent of these challenge becomes evident in the case of the Libra cryptocurrency introduced by Facebook: While bank payments have to undergo a range of checks regarding the consistency of payments with the client's

overall profile and the legitimacy of the origin of funds and recipients, questions arise about the level of safeguards for payments outside of the regulatory environment. This potentially raises security concerns regarding anti-money laundering (AML) and counter-terrorist financing (CTF) standards.

The accelerating dynamics of technology and changing market structures also require regulators and supervisors to become more agile, to expand their mindsets beyond sectoral and national borders, and to acquire and build new capabilities regarding their technological literacy and proficiency. Regarding the interaction with new players as well as striking the right balance between facilitating innovation on one side and consumer and investor protection on the other, some regulators have set up “sandboxes” such as the Regulatory Sandbox of the FCA (Financial Conduct Authority) in the UK and the FinTech Regulatory Sandbox of the MAS (Monetary Authority of Singapore). The FCA’s sandbox “allows businesses to test innovative propositions in the market, with real consumers.”⁶ Such initiatives foster innovation in a responsible way as they allow regulators to expand their understanding of new business models, products, and technologies early on while at the same time internalizing data and technology to make their own regulation more effective and efficient.

Regulatory challenges will also extend to the “explainability” of complex algorithms based on advances in machine learning, visual recognition, and language processing. Such processes allow a more efficient analysis of less structured data and are increasingly used to boost efficiency in back and middle office processes, improve credit decisions, and enhance risk management in general. While reliance on third-party service providers such as cloud storage by financial institutions is still low, an increased shift towards external partners such as Amazon Web Services (AWS), coupled with a high degree of concentration among these providers, also heightens the importance of issues around cyber security and accountability of digital providers.

The trade-off between data and privacy protection and the use and sharing of data is also reflected in the regulatory context: The opposing views on the importance of data protection in the context of big tech versus the regulatory goal of maximal information sharing to contain financial risk and deal with misconduct in financial markets result in

conflicting and overlapping policy objectives between bank and data regulators. This also creates challenges for banks that have to reconcile the need for central data repositories in the context of a single-client approach with data localization requirements preventing them from sharing information across jurisdictions or different legal entities.

Data sharing and connectivity agreements across countries, such as the International Organization of Securities Commissions (IOSCO) “Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information” (the MMoU), are a good basis, but the long-term goal should be global data standardization in a cross-border data repository with harmonized and real-time information. Data protection rights need to be able to be suspended if compliance would compromise market abuse investigations. Promising examples are the respective provisions in the new United States-Mexico-Canada Agreement (USMCA), which prohibits data localization and allows regulators to access relevant data while requiring robust privacy, as well as the recent work on legal entity identifiers (LEI) and uniform global unique transaction identifiers (UTI) in the context of over-the-counter (OTC) derivatives markets.

STRONGER PRINCIPLES FOR GLOBAL FINANCIAL GOVERNANCE ARE NEEDED

One approach discussed at the Salzburg Global Finance Forum to cope with rapid technological evolution and new business models is a partial reinstitution of principles-based regulation.

Principle-based and rules-based regulations do not have to be mutually exclusive. They can coexist in an aligned fashion with broader-based principles on top of their respective international levels, backed up by detailed guidelines and rules about how these principles should be applied in practice. This would address the challenge of rule-based systems lacking the flexibility to adapt to the increasing pace of change. A combined principle/rules-based approach also provides the necessary degree of consistency and clarity needed by market participants regarding the practical implementation, since a purely principle-based regime runs the risk of lacking a level playing field for banks across different jurisdictions and for banks in turn lacking certainty regarding their level of compliance.

The goal is to ensure consistent outcomes across different countries and jurisdictions, and to avoid diverging interpretations of principles and their practical realizations

⁶ Financial Conduct Authority. (2019, April 29). Regulatory Sandbox. Retrieved from <https://www.fca.org.uk/firms/regulatory-sandbox>



both within supervisory organizations as well as across different regulators and supervisors. This is especially relevant as the internet – and hence digital business models – cut across legal and territorial boundaries. Immediate measures that are already being undertaken among others, by the FSB are a recalibration and evaluation of existing rules to ensure that the current framework and international standards are at the appropriate level of generality to provide the necessary flexibility to address emerging risks and meet the desired results without having unintended economic consequences.

To ensure that the international financial architecture and the surrounding governance will remain able to cope with the many and expansive emerging risks – spanning environmental, social and cyber issues – more coordination and cooperation at European and international levels are urgently needed. Strengthening the assertiveness of multilateral institutions and securing their credibility and legitimacy in the face of the fragmented political and economic environment is becoming pivotal. Giving international financial institutions more power will ultimately lead to greater benefit for the entire system.

A crucial first step is to build a general consensus between policymakers and regulators around common policies and approaches, as well as around the importance of emerging topics such as creating a level playing field with big tech and facilitating sustainable finance. Additionally, more detailed agreements on international recommendations as well as a stronger ex ante coordination prior to their legalization

including agreement on definitions and processes will make international standards and recommendations more equivalent, acceptable and enforceable. Ideally this should be accompanied by stronger monitoring and mechanisms for dispute settlement, as well as a higher degree of enforceability, for example through sanctions.

A higher degree of inclusion of various players and experts from emerging countries is also crucial in the face of the increasing border- and jurisdiction-encompassing emerging risks and the growing power of Asian economies as the international financial governance is still predominately bank-centric and Western-oriented.

To address risks that have not yet had immediate impact on the financial system and financial stability but very likely will do so in the future, such as climate change, appropriate expertise outside of the financial realm should be incorporated in a more intensively and institutionalized way. To better understand and assess the potential impact of these risks, analysis has to become more scenario-based besides the customary surveillance of current and often cyclical data.

Given the increased pace of change, institutions must become even more forward-looking, and systematically build up competencies in the areas of new technologies such as cyber, crypto assets and DLT, as well as in emerging issues such as climate-related risks and data protection at the crossroads between financial service providers, fintechs, and big tech.

CONCLUSION AND NEXT STEPS

Growing geopolitical risks, economic and political fragmentation, challenging societal and technological developments, and a deterioration of trust characterize the complex environment in which market participants, regulators and supervisors have to operate today.

The ethics and values surrounding privacy and data in an increasingly digital world are becoming pivotal to avoid a fundamental crisis of confidence and to hopefully restore the trust of the public in financial service providers. Retail financial services like payments, lending, and asset management are becoming more and more contextual due to fundamental changes in underlying business models, dominant technologies, and delivery mechanisms. As a consequence, market participants have to rethink their role, competitive position, and collaboration models.

Regulators and supervisors also have to adapt to the wider variety of players offering financial services sometimes outside of their traditional core regulatory regimes. Increased international coordination and integration, as well as strengthening multilateral systems, are important aspects in overcoming these challenges on a global scale.

Additionally, in the face of long-term climate-related risks, fostering green and sustainable finance needs to become a greater priority for all involved participants with banks and regulators acting as facilitators.

The deliberations of the 2019 program of the **Salzburg Global Finance Forum** demonstrate that a new economic and financial system is emerging – one that is driven by technology, demographics, social and political pressures, climate change risks, and the environment. New challenges ahead require new finance, which will be more greatly rooted in society, more inclusive, more responsive to the new needs of the real economy, households and entrepreneurs, and better able to support the transition to sustainable development, as well as to serve emerging digital needs. All this must be achieved while still retaining trust and maintaining resilience.

As the world of finance continues to change, the Forum's future programs will tackle this new role of finance and explore the new implications and redefining possibilities in the banking and financial markets industry, which in turn could help enable a more sustainable and resilient economy.





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(June 2019)

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