The road ahead for digital finance

Looking forward at regulatory developments and market 2020 predictions for digital assets

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In brief...

The regulatory agenda for FinTech in the EU is moving forward at pace. Late in 2019, a broadly sourced European expert group (ROFIEG) published a lengthy report containing no less than 30 recommendations to the European Commission on how to create a more accommodating environment for technology-enabled provision of financial services (FinTech) in the EU. Shortly afterwards the European Commission published a consultation document on an EU framework for regulating markets in cryptoassets. These initiatives have common ground as part of the development of a Digital Finance Strategy for the EU, stemming from the March 2018 European Commission Fintech Action Plan.

The FinTech action plan included the following statements, clearly laying the groundwork for the initiatives which are now emerging:

- The European Commission will set up an expert group to assess…whether there are unjustified regulatory obstacles to financial innovation in the financial services regulatory framework; and
- The European Commission will continue monitoring the developments of cryptoassets and Initial Coin Offerings… and…based on the assessment of risks, opportunities and the suitability of the applicable regulatory framework, the Commission will assess whether regulatory action at EU level is required.

Digital finance strategy and regulation at the EU level are highly complex issues because advances in technology are bringing what were historically fragmented, separately regulated, services, processes and systems onto single source platforms. On the service-delivery side, this offers abundant potential for service improvement, efficiency, accessibility, flexibility and future adaptation. However, the technology has outrun the comparatively neolithic regulatory framework, exposing gaps and inconsistencies which are likely to further damage the competitiveness of the EU in this area if not resolved effectively and soon.

In this article, we look at a few overarching themes that are likely to be at the fore in FinTech strategy during 2020, followed by some of the opportunities, challenges and features in the market that we predict will shape behaviour from a European perspective.

Themes

Competitiveness is a very important driver – the ROFIEG report, before getting to recommendations, calls broadly for greater pro-active leadership in the region. This is needed to recalibrate effective regulation around celebrated “European” values such as data protection and fair competition, whilst avoiding undue barriers to innovation in financial services. With the advancement of Asian and US markets in both digital financial services provision and digital assets clearly on their radar, big market players in the EU see the existing regulatory stage in the region as a major barrier.

In many ways, this is more significant than it has ever been before, because these services are truly global, users are considerably more agnostic to the jurisdiction of source and combined with the prospect of a *global currency*, the threat of overwhelming international competition is becoming ever more acute.

Conflict is the next obvious challenge – financial services is a traditionally highly regulated sector. Even more so in the post – financial crisis era where echoes of “contagion”, “too big to fail”, “systemic risk” and all the other lessons and warnings that arose in 2008 still reverberate today. Regulatory sensitivity remains high – whilst on the one hand the financial crisis contributed to the fertile conditions for major disruption in the sector, it also generated the type of regulatory reaction that is bound to result in barriers to entry and an inability to transform at an appropriate pace.

The idea of integrating flashy new technology into large bureaucratic institutions, many of whose traditional processes are arguably self-serving and institutionally protected, is clearly one that is full of contradictions. No more keenly have these been felt than on the front line of “fintech collaboration” which itself has given rise to new business lines in trying to smooth the path to change. Creating mutual understanding and proper interoperability is a very long journey which institutional players argue is currently hampered by unfit regulatory frameworks and compliance requirements.

Bigger Ethical Picture – whilst it is clear that the EU is focused on the detail of FinTech, and offering better integrated regulation with a positive practical impact, there are also opportunities and consequently some challenges in the bigger ethical picture around ownership and protection of data, for example, and financial inclusion. Developing measures which will promote the right behaviour and outcomes, in a consistent way on these bigger ethical questions, certainly needs to be part of the strategy. However, the details remain very unclear – how, for instance, will it be possible to bring together digital identity, with the right mix of public information and personal data ownership, across diverse topics such as FinTech, social media and communications, healthcare and insurance? Within FinTech itself, the fruits of financial inclusion appear to be there for the taking, but in the bigger picture a number of questions remain about whether these “advancements” will ultimately serve to broaden the gap between tech-enabled users and those at risk of being left behind. The elderly are often mentioned in this context, as well as others for whom continuously evolving choice is actually limiting, as they are unable to keep up and therefore end up transacting on less favourable terms. The EU’s FinTech strategy, and any regulation which will be forthcoming, needs to strike a balance on these difficult “bigger picture” points.

Market predictions

Whilst these political and regulatory themes are important in shaping the 2020 and beyond road map, the markets themselves also clearly have a vital role to play. It is clear that the digital assets sector will continue to grow and develop through 2020, and it should ultimately be assisted by the regulatory developments we have touched on. So in this section, we look at the shape which the digital assets sector is expected to take and we have set out some key predictions for what we think will be the biggest growth and focus areas for 2020.

Regulated exchanges

We will see regulated exchanges in key jurisdictions allowing market participants to trade digital securities. We have seen a shift in attitude from regulators, previously being able to regulate exchanges in an e-money (or equivalent) context, but little else. They were much more reluctant to consider application for fully regulated securities exchanges. Indeed there have been very few instances of fully regulated exchanges which are able to trade digital securities (security tokens) and certainly not in Europe. At the time of writing, Singapore regulator (MAS) is one of the few key jurisdictions in this sector which has granted recognised market operator licenses to digital securities exchanges, although these are primarily private exchange trade services.

However, the market in Europe is bringing pressure to bear – across the region, there are many exchanges leading the way hoping to become the leading regulated digital securities exchange both in private sector and also from such leading jurisdictions such as the Swiss SIX Digital Exchange (SDX), Gibraltar Stock Exchange, Malta Stock Exchange and others. We note that in the US, tZero in conjunction with Boston Stock Exchange (BSTX) is looking to be the first fully compliant security token exchange and as highlighted in the themes – competitiveness is key in this sector. The timing here is crucial, which is why we see this moving forward in the coming year.

There is a clear need for such regulated securities exchange to bring liquidity and maturity to this sector so we think this is simply a case of when and 2020 looks to be a promising year where the regulators and the service providers will be aligned.

Central Bank Digital Currency (CBDC)

One of the leading world economies will issue its own Central Bank Digital Currency (CBDC). China has been very vocal about its plan to unveil its CBDC. If it does that soon, it will become the first to do so, however, there are other jurisdictions hot on its heels. It is understood the digital currency would be fully backed by central bank deposits from commercial and institutional banks. There may be surprise front runners or at least near competitors from Switzerland whose national bank is said to be working closely with SDX to launch digital tokens backed by central bank currency in 2020, and Sweden whose e-Krona is already undergoing preliminary tests to name a few. Drawing in the themes, and why this will be important in Europe, some of the ideas behind CBDCs pull together in the bigger ethical picture with arguments, for example, that fully digitalised currencies will lead to increased financial inclusion. For a full discussion on CBDCs and why they will be the currency of the future, see ConsenSys' whitepaper ' Everything You Need to Know About Central Bank Digital Currencies' published earlier this year.

UK v EU Regulation – Equivalence, divergence and the Brexit impact

As the UK prepares for Brexit to come into effect following the official departure from the European Union on 31 January, regulators and government will be looking to highlight and showcase the strength of the UK economy in its own right. FinTech is a natural focus, with London being a hub for this sector.

The Financial Conduct Authority (FCA) will look to continue to drive forward its innovation agenda which is largely seen as start-up friendly, in large part due to its innovative Sandbox which has now been replicated across various other jurisdictions. The FCA launched its own cryptoassets consultation in 2019 and provided guidance to market participants, largely delineating the digital assets which sit within the regulatory perimeter and those which fall outside the FCA 'net'. The EC cryptoassets consultation, discussed in the introduction above, is likely to bear fruit in terms of regulatory initiative towards the end of 2020, just when the UK will be leaving the block. This is clearly a sensitive topic with discussions already highlighting the political importance of equivalence in standards, but given the timing and the fact that London is a FinTech powerhouse in its own right, we expect UK local initiatives to develop further as we head into 2021.

Digital identity

In July 2019, the UK Government Department for Digital, Culture, Media & Sport launched a call for evidence on how the government could support development and secure use of digital identifies fit for the UK's growing digital economy. It recognised that, despite various technological advances and use of 'digital identities' by various service providers, there is still no clear and consistent application of its use in a manner which satisfies the need of consumers to have their personal information adequately protected. The call for evidence closed in September 2019 and the department is current analysing the feedback received. It is anticipated that a full report of findings will be published in 2020.

This coincides with both one of the overarching themes, the importance of digital identity and data ownership in the bigger ethical picture, and also with the market trend towards development of regulated exchanges, which will need to rely on digital identity services for effective execution of online transactions. This will be a key focus in the coming year.

On other topics, we also expect 2020 to be a year of increased investment activity in FinTech – both by way of increased investment quantum in later stage companies and through FinTech M&A activity which has already seen a big upward trend through the first quarter. We expect that the regulatory position of the stablecoin product will become much clearer in the European market, it is likely to ultimately come in for direct EU regulation as perceived gaps in the existing rules are plugged (whether the UK will follow a similar route here remains to be seen). Finally, we expect decentralised finance (de-fi) to remain on the agenda in the coming months, alongside the theme of market integrity. In particular, as cryptocurrency trading continues to mature alongside the development of more regulated exchanges, the role of de-fi in generating trading opportunities and liquidity will increase, alongside the growth in importance of maintaining ethical trading practices and integrity in the markets.

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