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Emerging Topics in Financial Regulation

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Lima, January 2020

The views presented in this document are personal, and do not represent those of the CMF.

Topics

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- The CMF
- Three topics that are relevant from supervisory perspective…and in need of research
  - Regulating and supervising FINTECH
  - Environmental and social concerns in financial markets
  - Financial consumer protection

Financial Market Commission

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2017 Changes in governance and mandate of securities and insurance regulator (SVS)

- Governance:
  - board => continuity
  - greater independence
  - accountability: annual reports, consultation process
- Expectations of greater flexibility in laws
- Mandate:
  - Micro: prudential and market conduct (consumer protection)
  - Macro: financial stability and market development

Financial Market Commission

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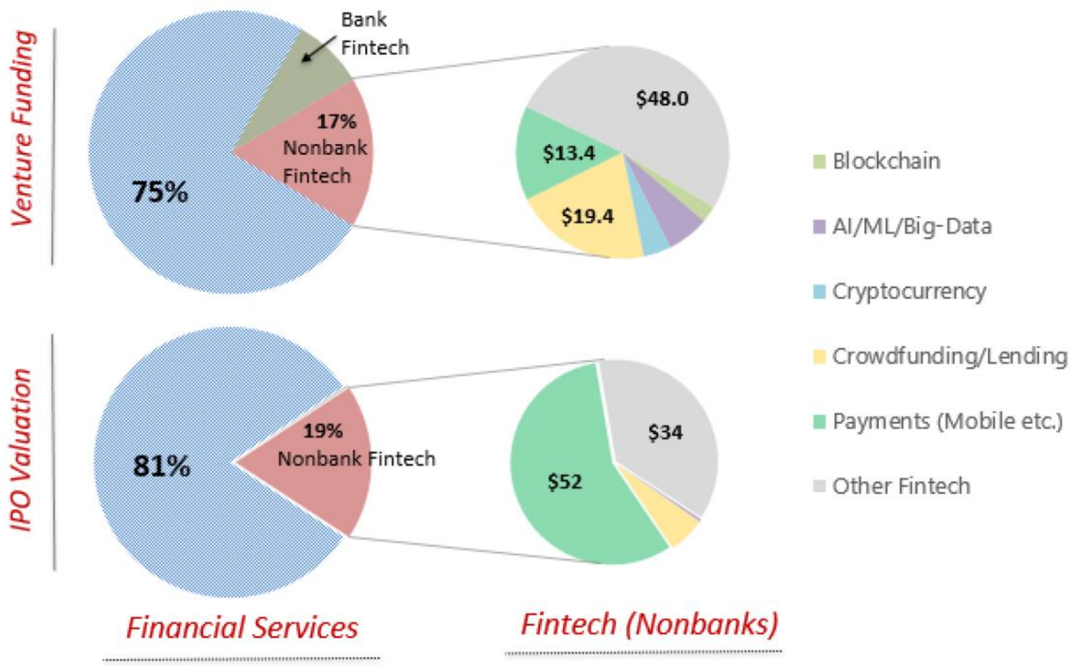
2019 CMF integrates with bank supervisor (SBIF) and general banking law approved

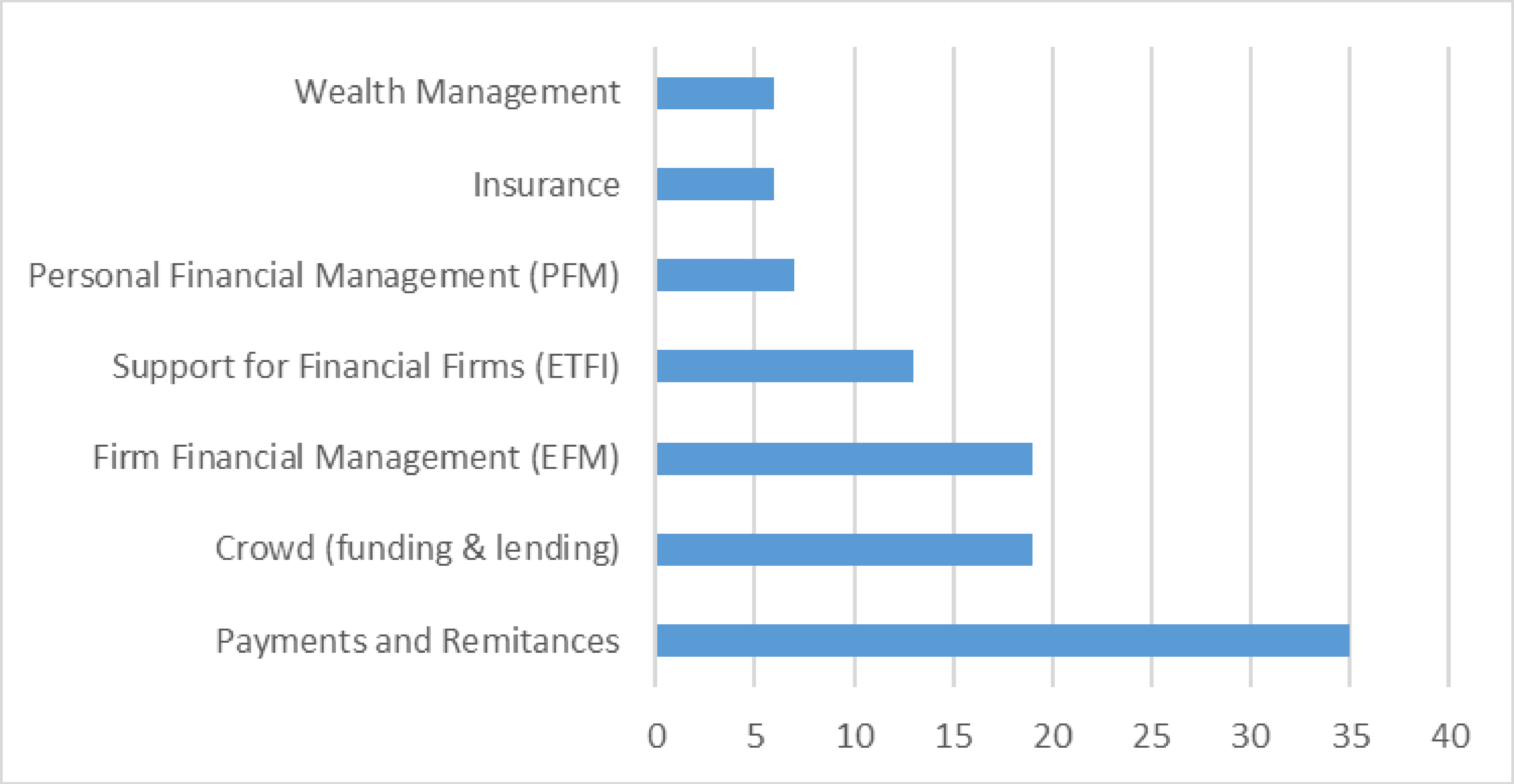
- Part of global trend away from silo supervision
- Increasing regulatory and supervisory consistency
- Improving supervision of conglomerates
- Facilitating a systemic view of market developments and risks

FINTECH

- Technological change and finance go hand in hand…but recent years have seen an acceleration in innovations in communication, data storage and processing and automation.
- Substantial innovation in "traditional" firms and FINTECH startups…that have received 25% of venture and startup financing



Chilean FINTECH map

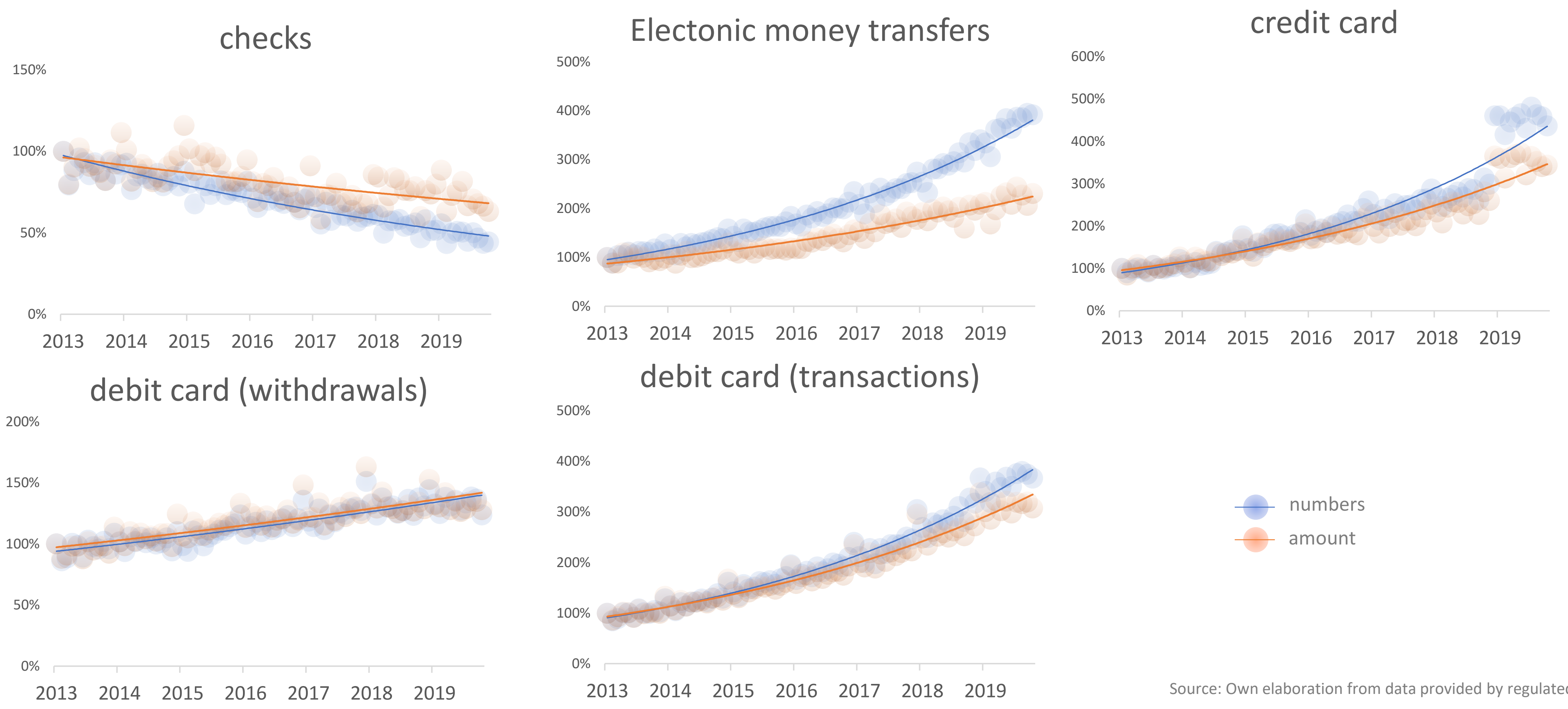


Compete or complement traditional providers

Source: Finnovista (2019)

Electronic bank payments rising…non bank starting

(Index: Jan 2013=100)



Source: Own elaboration from data provided by regulated institutions.

Still relatively small…but growing fast

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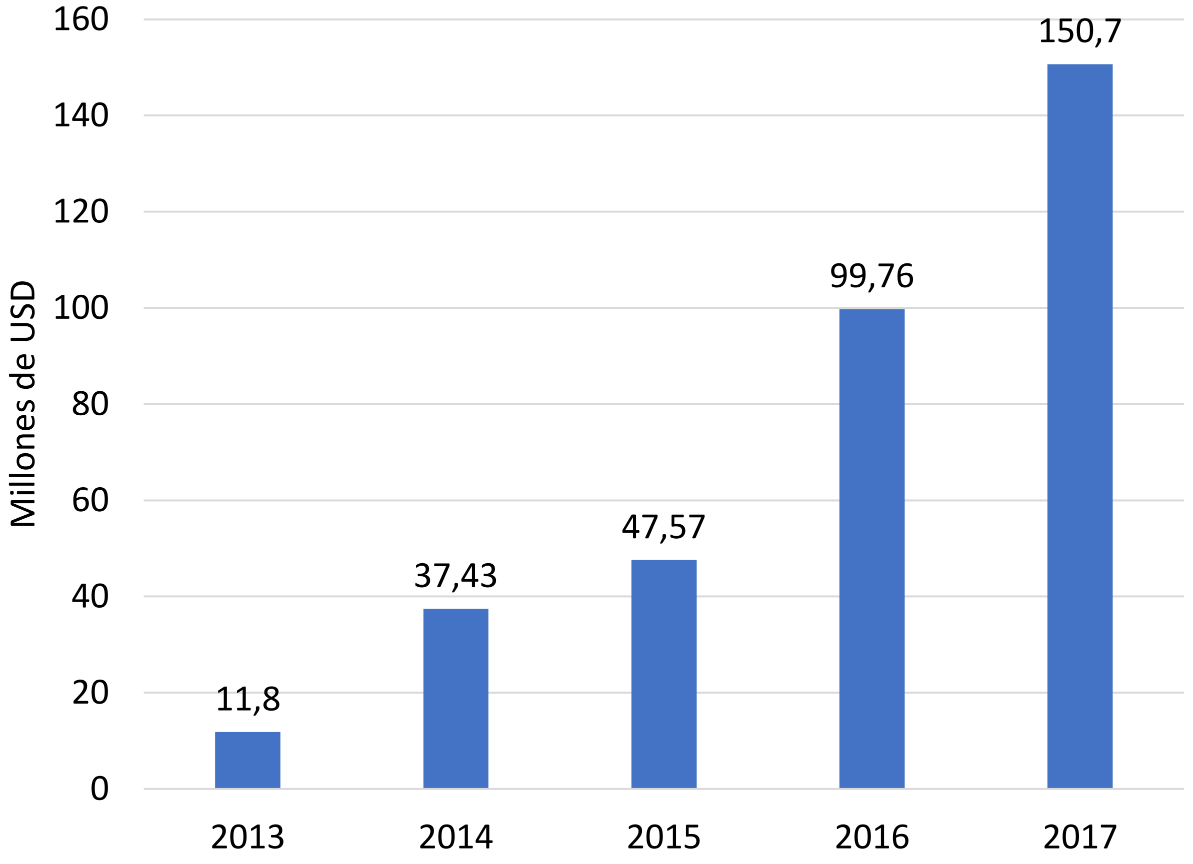
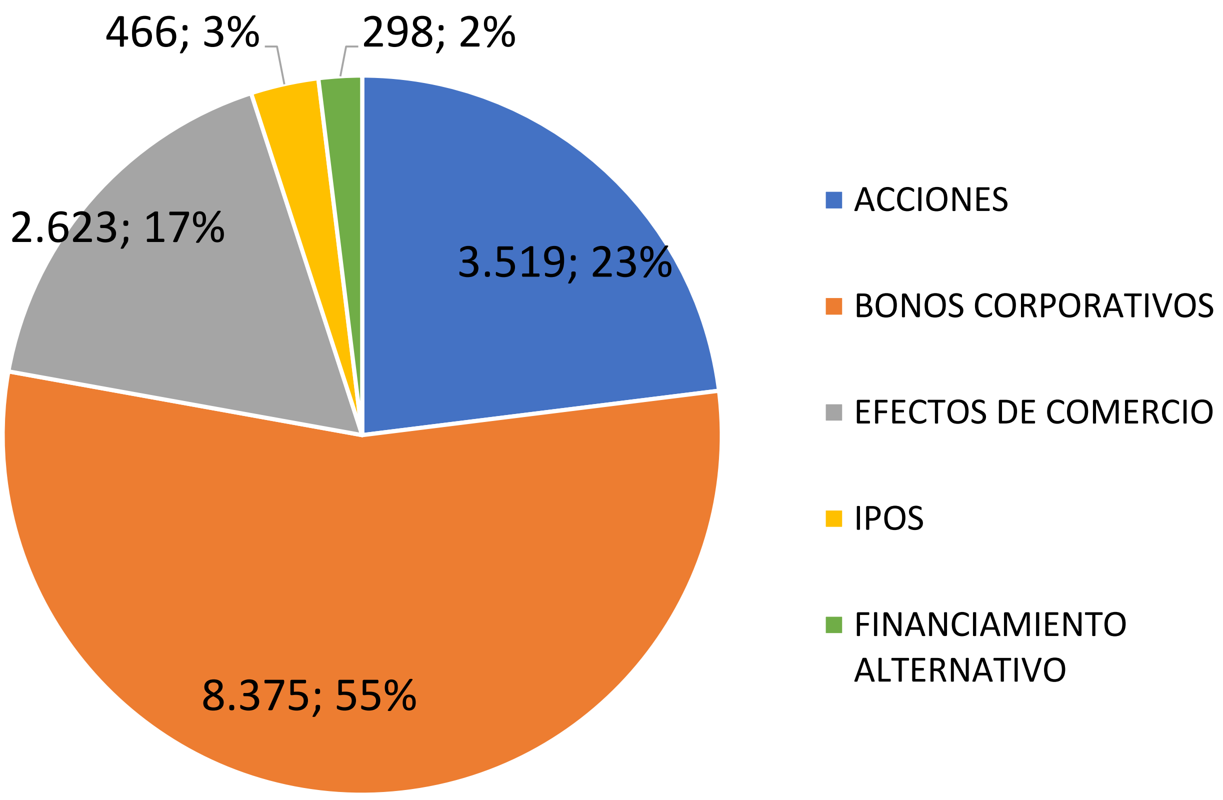
Alternative Finance



Market Based Finance

(2015-17MM USD; %)



Source: *Cambridge Centre for Alternative Finance* (2018) y CMF.

Some common FINTECH characteristics…

- Segmentation of financial products
  - Example: *Destácame*
  - Lower fixed costs (less relevance of economies of scale and scope)…
  - …or quicker scaling up
- High automation
- Rapid overseas expansion
  - Example: Cumplo (Chile => Mexico => Peru?)
- Potentially beneficial
  - Reduced fees from greater efficiency + higher competition
  - Better services
  - Financial inclusion: survey data => 33% of firms in Mexico and Chile believe only source of financing

FINTECHs and regulation…

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- Market failures persist…
- …and some risks more relevant (cybersecurity and ALM)
- => many FINTECH firms dealing with end user should be regulated
- Getting regulation right:
  - Multi year process in Chile
  - 2016 non bank payment law
  - 2019 discussion of FINTECH law for financial market activities…
    - Many outside the perimeter
    - Those inside the perimeter no adequate
- Key tradeoff: not to stifle innovation by recognizing the particularities of FINTECH business models while at the same time adequately protecting clients of the FINTECH firms.

Principles for regulation…

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- Proportionality
  - What is the minimum standard? (aircraft)
  - Reputation risks of lower standards within the perimeter
- Modular
- Level playing field between “tech” and traditional
  - Ideally introduce proportionality for all intermediaries
- Technologically neutral
  - Consumers have same protection independent of channels
- Flexible
  - Test and adjust
  - Where to draw the perimeter…financial stability issues?
- Prioritize operational risk (cyber) and data protection

Multiple challenges for supervision

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- Understanding a dynamic sector…skills and know how
- Minimize deadweight costs of supervision
  - Reg Tech
  - Sup Tech
- Supervising automated processes
  - E.g. suitability of an algorithm
  - Fall back on neutrality idea.. transparent, understood by firms and explainable
- Cross border coordination
  - Move fast…or not?
  - Principles

Enabling conditions…open data

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- Importance of open data initiatives
  - Key feedback in consultation process
  - Capacity for individuals to exchange comprehensive and verifiable information on their financial situation is key for the efficient functioning of the financial sector
  - Large cache of data in banks and insurance companies…
  - Possibly offset concerns regarding Big Tech
- How to do it
  - Comprehensive (avoid cherry picking) and broad (as in Mexico FINTECH law)
  - Mandatory but with informed consumer authorization
  - Standardization in protocols and centralized authorization makes sense
  - Robust requirements for data protection (regulation and supervision)

Key research questions…

- Evaluating the outcomes of FINTECH
  - On fees and services provided to end users
  - On financial inclusion
  - Crowdfunding: robustness of credit scoring to the cycle, gaming alternative scoring
  - Robo-advising: performance of algorithms
  - DLT as a desirable substitute to centralized ledgers

- Impact of regulation as FINTECHs are brought into the perimeter

=> evidence based calibration

WEF Risk Report 2020

Climate Risk and Financial Markets

- Risks driven (or aggravated) by climate change have moved to the forefront of recent discussion in financial markets
- Example: WEF 2020 global risk report 2020
- Relevant discussion in Chile: high vulnerability to climate change (variables listed in UN Framework Convention)
- For banks and insurance companies potential impact on credit risk and market risk of asset portfolio
    - Physical risk
    - Transition risk
- For insurance companies potential impact on underwriting of risk and potential role in risk sharing
    - Estimates by the Insurance Council of Australia estimate that bushfire catastrophe losses are close to 700 million USD

Role of insurance limited by coverage gaps

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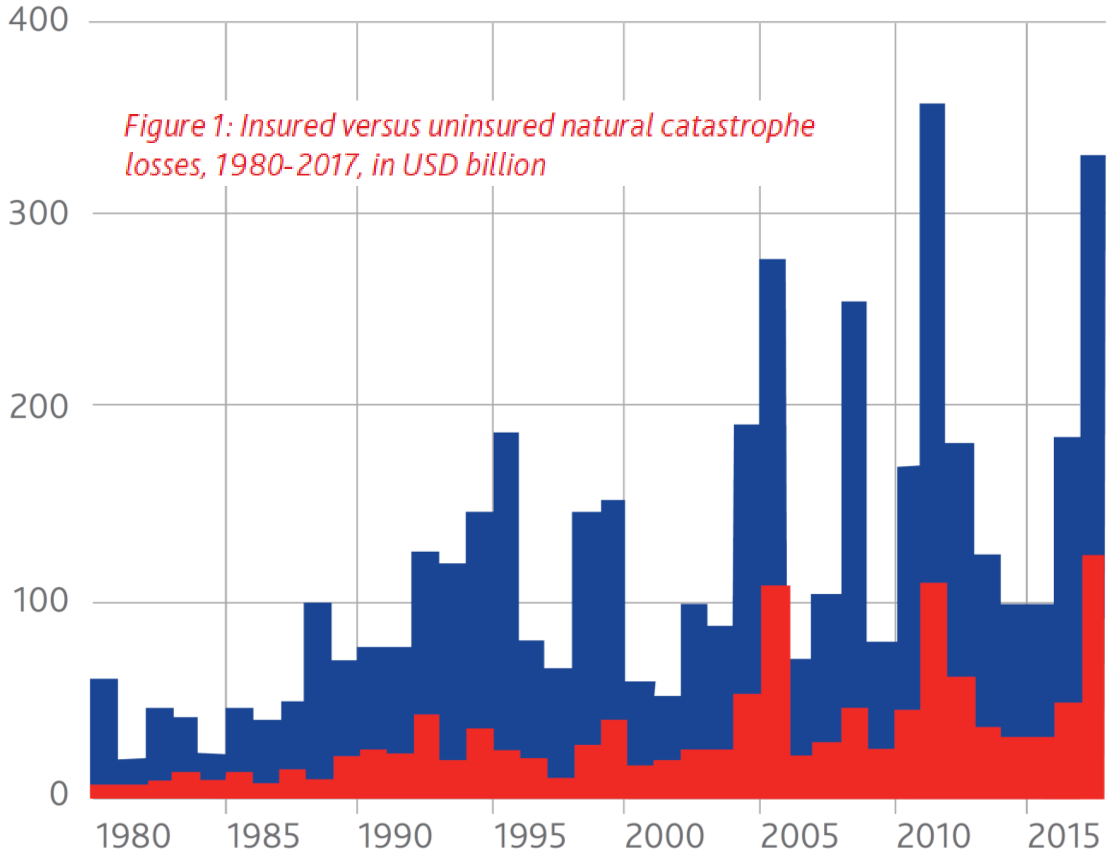
- Coverage gaps larger in EMEs
- Chile coverage of close to 25%
- 50% for high income countries and 9% for upper middle income countries.



Source:. Munich RE

Insurance Penetration by Income Quintile

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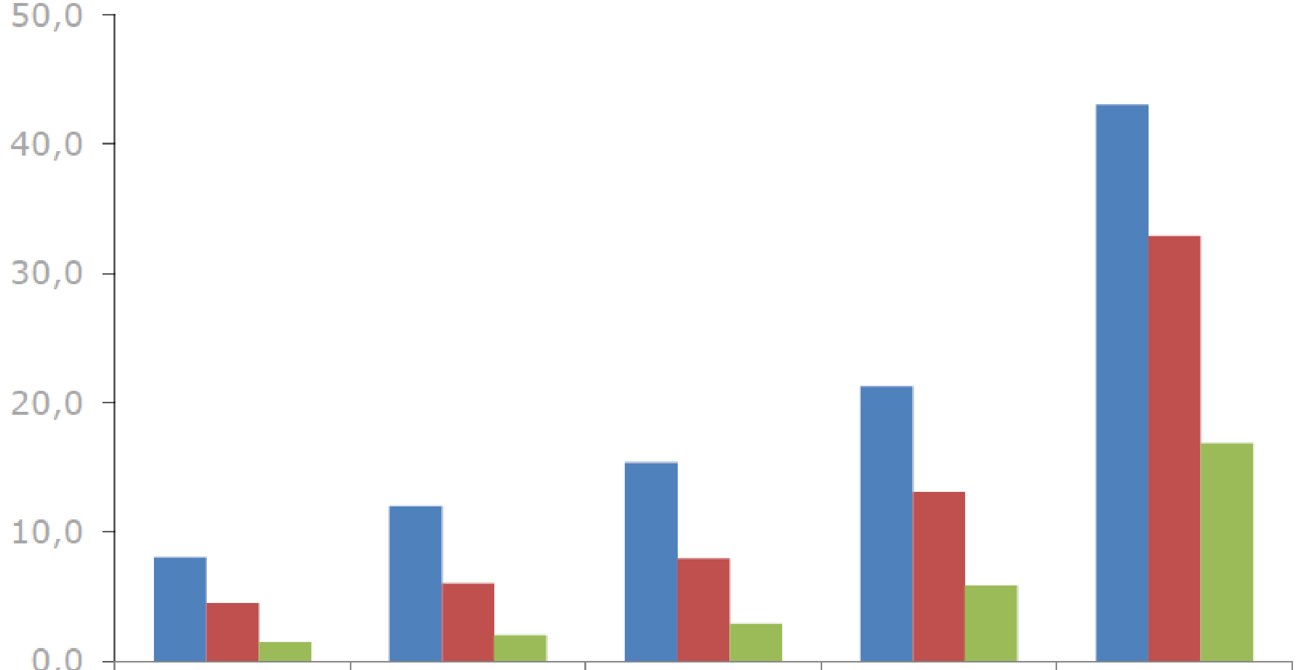
HOGARES PROPIETARIOS DE VIVIENDA¹ QUE DISPONEN DE SEGURO 2011, POR TIPO DE SEGURO, SEGÚN QUINTIL DE INGRESO AUTÓNOMO

(Porcentaje)



	I	II	III	IV	V
Seguro de Incendios	8,0	12,0	15,4	21,3	43,1
Seguro de Terremoto	4,5	6,1	8,0	13,1	32,9
Seguro contra Robos 2	1,5	2,0	2,9	5,9	16,9

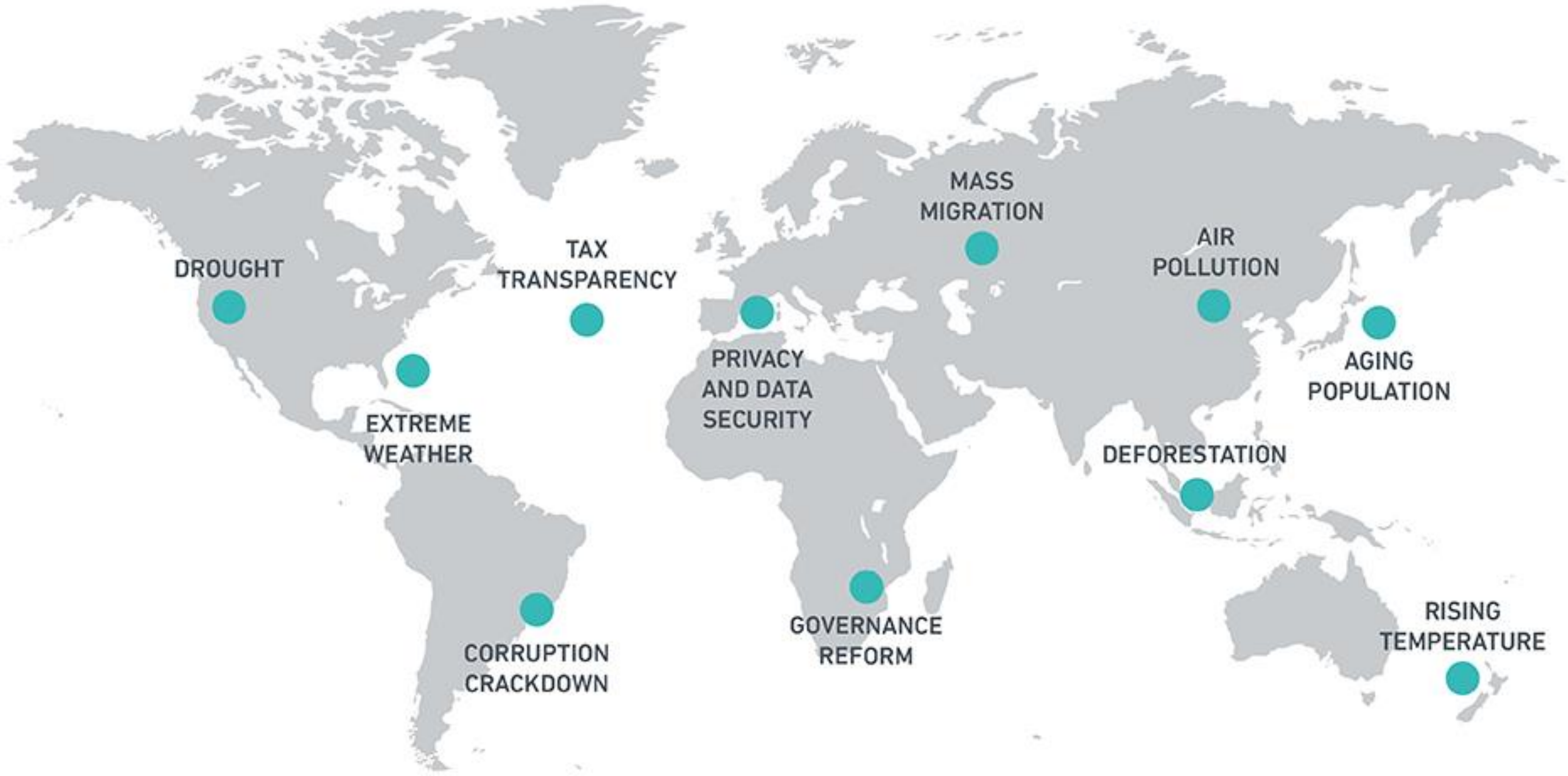
Source: CASEN Survey

Fuente: Encuesta CASEN 2011.

Closing the coverage gap

- Potential role of “insuretech” (reducing costs and improving risk modelling)
- Inclusive insurance products (Peru and Colombia as examples)
- Parametric (index based) insurance
  - High impact / low probability events
  - Lower costs of settlement
  - Used in sovereign insurance (CAT Bonds)
  - Basis risk is a concern from consumer perspective

Concerns go beyond climate risks



Environmental and Social Factors

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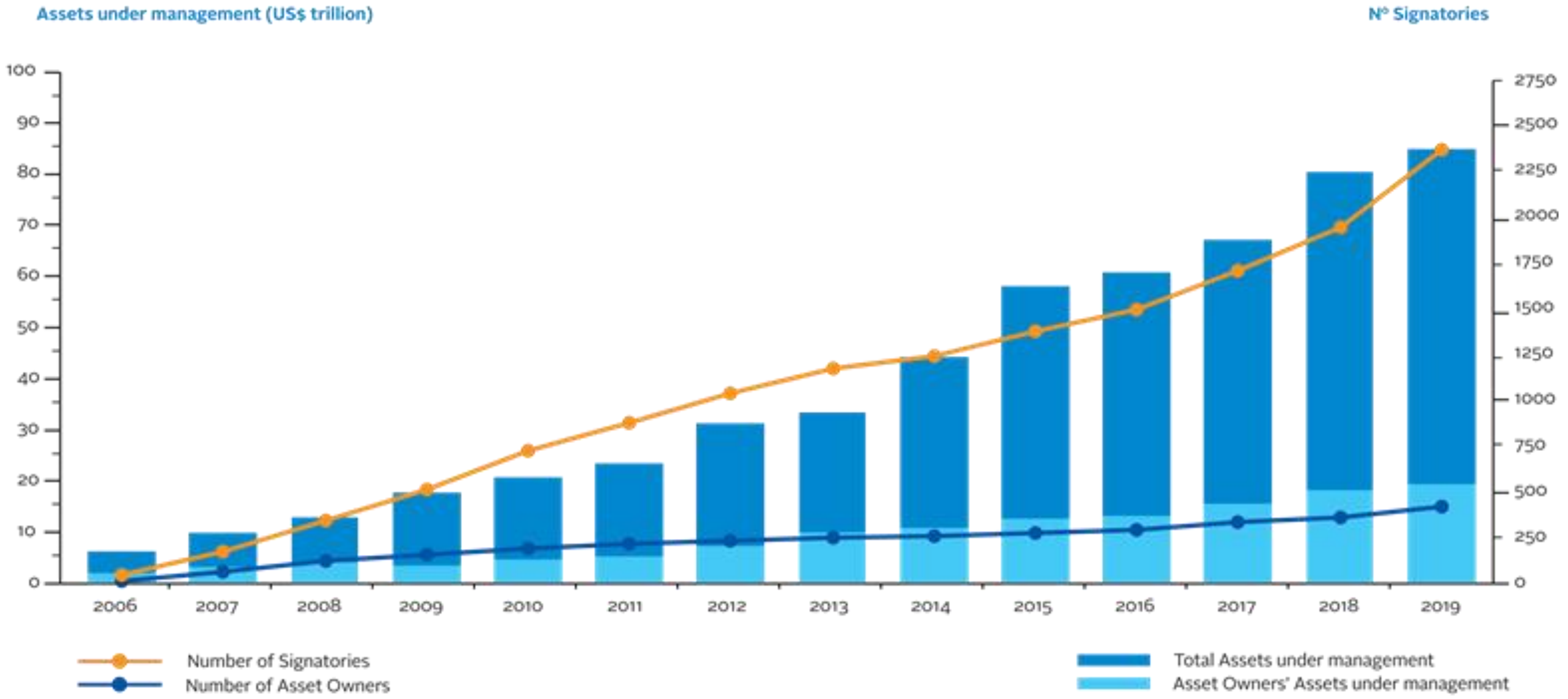
- In securities markets climate change is part of the broader discussion of ESG variables
- Key regulatory role in capital markets => information disclosure
- Increased demand of information disclosure from investors:
  - Disclosure of exposure to E&S risks (e.g. TCFD)
  - Disclosure of impact on E&S variables (e.g. GRI)
- Growing number of asset managers subscribing to Principles For Responsible Investment (PRI) and specialized demand for "Green Instruments"

Asset Managers Subscribing to PRI



Environmental and Social Factors

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Regulation should play a role: comparability and completeness

In Chile, two phase approach:

- Phase 1: Requirement of impact of firms on E&S
  - Based on subset of GRI
  - Report metrics and policies/targets (if they have them).
    - Environmental: Waste management, carbon footprint, water usage
    - Social: employment conditions (training, gender…), supplier treatment, anticorruption and competition policies…

- Phase 2: Reporting of E&S risks
  - key input for banks and insurance

Relevant research questions…

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- Quantifying scenarios for impact of climate change on credit and market risk on portfolio of banks and insurance companies
- Actuarial analysis of impact of CC on insurance
- Importance of public- private initiatives that promote cooperation around information gathering and sharing
- ESG reporting: getting the information requirements right
  - investor information vs listing costs
  - materiality vs comparability
- Coverage gaps in insurance
  - demand or supply driven
  - Potential role of regulation in inhibiting supply

Consumer financial protection

- Broad consensus that information disclosure is a necessary, but not sufficient condition for optimal consumer decisions => behavioral aspects in consumer choice
- OECD/G20 “G20 Principles on Financial Consumer Protection”
- Enhancing regulation and supervision of consumer financial protection is a key priority of CMF
- What we are doing
  - Principle based regulation for financial service providers
  - Reviewing specific requirements on product design and fees, information (how to present, how much)…
  - Financial education

Research questions

- Continue to expand knowledge of biases leading consumers to make mistakes of judgement and to identify the products/services causing the main problems
- What works in terms of information to support consumer choice
  - Framing
  - Nudging and default options
  - Examples: SCOMP system
- Self protection (education) vs responsibility of providers to sell appropriate products
- Unintended consequences
  - Example: interest rate ceilings and fee transparency
- How to avoid impacting inclusion via cost of regulatory burden

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