Minutes of the November 16, 2018, Financial Advisory Roundtable Meeting

Present:

FAR Members: Hayley Boesky, Laurie Goodman, Robin Greenwood, Bradford Hu, Ralph Koijen, Andrew Lo, Lynn Paquette, Stephen Ryan. Special guest: Thomas Philippon (NYU Stern).

FRBNY: Gara Afonso, Beth Caviness, Nicola Cetorelli, Gerard Dages, Dianne Dobbeck, Thomas Eisenbach, Michael Held, Beverly Hirtle, Michael Holscher, Anna Kovner, Sandra Lee, Jim Mahoney, Meg McConnell, Asani Sarkar, Or Shachar, Joe Sommer, Kevin Stiroh, Michael Strine, Desi Volker, John Williams.

Summary

The ongoing technological change in financial services ("FinTech"), particularly related to information technology — and its implications for the stability and efficiency of the financial system — was the main topic of discussion at the Financial Advisory Roundtable ("FAR") meeting. The meeting included two presentations: (1) Thomas Philippon discussed the costs of financial services over time and the opportunities and challenges that FinTech poses in transforming the industry. (2) Bradford Hu presented his perspective on the impact of FinTech on the financial sector. These presentations were followed by an open discussion on the topics listed on the meeting agenda.

Financial Services and FinTech: Opportunities and Challenges

FAR members discussed the potential impact of FinTech on the financial sector. Evidence was discussed that financial services remain expensive, and real unit costs of financial intermediation have only marginally declined since the crisis. This might capture the effect that FinTech has on competition, limited due to barriers to entry coming from high upfront costs and consolidation of market power. FAR members pointed out that market power can be used to first drive out competitors and later raise prices, with the resulting increase in concentration raising potential systemic risk concerns.

FinTech presents both an opportunity to improve the productivity of financial services and regulatory challenges insofar as it pertains to potential risks to financial stability. Defining FinTech is non-trivial and the discussion evolved around all technology-enabled business model innovations in the financial sector broadly defined, including: blockchain and cryptocurrencies, artificial intelligence and machine learning, peer-to-peer lending and crowdfunding, mobile payment systems, and digital advisory systems.

FAR members discussed the opportunities presented by FinTech along three main dimensions: (1) cost, (2) equality and (3) stability. First, the potential to lower the cost of financial intermediation services was discussed. Second, members noted the potential distributional effects of FinTech by "democratizing" access to financial services. A caveat was raised that the broader access might come at the cost of price discrimination, such as against individuals with lower credit ratings. In addition, FAR members voiced concerns about how well less financially sophisticated individuals understand the complex products they have been now given access to. Third, FAR members saw the potential for FinTech to reduce the overall risk of the financial services sector by relying less on leverage. Some FAR members noted that an additional aspect to consider is the quality of the services provided in face of the inherent complexity of the systems in place: while the unit cost of the services might not have decreased substantially in the last two decades, the quality and complexity of the services could have improved, rendering comparisons over time more complicated. FAR members noted that FinTech offers agile and easily adaptable service, with a friendly interface and positive customer experience, in contrast to the more traditional financial intermediaries that rely on less flexible infrastructure and might struggle to integrate and link different sources of data at reasonable costs. FinTech's effectiveness was mainly attributed to its new, purpose-built infrastructures and its greater ability to make use of customer data.

The discussion pointed out a range of challenges and concerns that FinTech presents both for regulators and for the industry. FAR members found it difficult to assess the actual value of the innovation and to distinguish between regulatory arbitrage and valuable innovation. In addition, data plays a central role in Fintech, and it is challenging to determine who owns the data, who is responsible for its protection and how to ensure privacy rights. FAR members noted that the complexity and importance of these issues might not have been completely internalized and appreciated by FinTech firms. Some FAR members noted that FinTech firms seem to enjoy an advantageous position because they do not provide the same level of protection as traditional financial institutions which are bound by fiduciary responsibilities. A concern raised is that investors might not be fully aware of FinTech tail risks, since they have not been observed yet. FAR members pointed out that customers have been willing to grant their trust in exchange for convenience; however, trust might vanish during a FinTech-specific system failure or during a market downturn more generally. Furthermore, while operational risks pertaining to FinTech might be idiosyncratic, certain risks — such as data breaches — can be systematic, posing an additional threat to financial stability. The discussion stressed the relevance of these concerns given that lack of reinsurance market for losses arising from data breaches.

In discussing the future of FinTech, FAR members distinguished between narrow, specialized FinTech firms and "BigTech" firms and their impact on the financial sector. Some BigTech firms provide a range of financial services that are integrated with other parts of their platforms, e.g. social media. Another topic of discussion concerned the areas within the FinTech space with more potential for changes and new entrants, with FAR members noting user interface, payments systems, consumer lending services and loan origination services. Another promising area that has moved at a slow pace is insurance technology ("InsurTech").