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Fintech Disruption: The changing role of regulators

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Regulators are some of the main backers of the use of new financial technology

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Trapped by still functioning legacy systems and industry infrastructure institutions, the legacy mindset embedded in financial institutions may be providing the opportunity for Fintech companies to sweep past them. Regulators are becoming enablers.

The 'industry' has long informed regulators as to how to improve markets by invoking the principle of 'best practices'. At the same time regulators have gone along with these best practices by accepting the principle of an industry's 'consensus' approval. The two principles, best practices and consensus approval has long been the way regulators obtained input from the industry and made decisions as to what regulations to implement. Incremental change was thought to be the best way forward. Then the financial crisis came along and regulators were forced to step out of their comfortable 'go along with the industry' mode. In fact the industry, bounded in the past by sovereign regulation, was now forced to consider itself as the unbounded 'global financial industry'. This change was most apparent and traumatic in the over-the-counter derivatives space where the CFTC, the minor regulator in the US back then, led the charge to regulate the previously unregulated industry, and to do it at the global level.

The then CFTC commissioners and Chairman, swept up in the fury of a disenchanted political class interested in appeasing their constituents, forced through legislation that has manifest itself in dysfunctional regulations. Subsequently the CFTC leaders were exchanged for a new, better informed group, better informed by realizing that hastily implemented regulations were not working.

The most enlightening observation to inform the ensuing discussions was the notion that while regulation was local, the financial system was global. The industry, born in silos of understanding, had no understanding of their own global institutions let alone the interconnectedness of each to the other in the global financial system. Regulators, likewise, born in silos of sovereign regulation had no understanding of what constitutes global financial regulations. Directives promulgated globally still had to be approved and implemented locally. A new label for these global institutions was born, Systemically Important Financial Institutions – SIFIs, and new regulations put in place to oversee them.

OTC derivatives was to be the first globally regulated market, with the promise of implementing it in unprecedented ways using the technology of the digital age. Somewhere along the way, probably because of the long standing advocacy by the listed futures industry and the willingness of the CFTC to embrace its methods for the OTC derivatives world, regulators tried to squeeze the square peg of OTC derivatives markets into the round hold of the listed derivatives markets. It did not quite fit! This resulted in 'unintended consequences' that we are still trying to dig ourselves out from.

Furthermore the financial crisis awakened us all to a global financial industry that was severely handicapped by its legacy infrastructure, an infrastructure built to support separately regulated sovereign markets. It was and still is burdened by a lack of data standards and yesterday's technology. Older technology supports the after-the-trade middle and back-office processes while the front-end of the business is whizzing away in real-time at millions of transactions a second.

With the understanding that regulators' understanding of the industry comes from the industry's understanding of itself, regulators have issued consultation documents and received comments from industry members, academics, consultants and others. Regulators continue to follow this outreach approach by inviting such industry 'experts' to participate on panels and advisory groups to inform their previously ill-informed decisions about regulations.

However, as logical as this approach seems, this only serves to embed the expertise learned from the processing and operational models of what is still deemed best practices even though those practices had in the main failed the industry. Even as of this writing, the new digital era envisioned by regulators and supported by industry experts envisions a new set of infrastructure intermediaries, SEFs (Swaps Execution Facilities), CCPs (Central Counterparties), SDRs (Swaps Data Repositories), LOUs (Local Operating Units), collateral depots, et al piled on top of existing financial market trading venues, processing utilities, securities depositories, clearing entities, and data vendors. Industry members must interface, integrate and interoperate in the same inefficient manner with this new infrastructure piled on top of old, inefficient, expensive, and risk prone existing infrastructure.

In fact, it is still not over, regulators creating more infrastructure entities even as new entities created to satisfy earlier regulations proliferate. Industry panels of experts in coordination with regulators are contemplating additional infrastructure entities to aggregate data by first harmonizing data after passing through existing and newly formed entities at the end of the data transformation process. The failure to get it right from the start, when new data standards and common data elements were to be defined and then coordinated globally from order placement through to systemic risk aggregation, has been replaced by incremental regulations causing incremental implementations.

Unless industry asks for and regulators agree to a restart, a next set of infrastructure intermediaries, to aggregate SDR, SEF, CCP and LOU data will again be placed atop existing infrastructure. Yet to come is how to aggregate these transactions for systemic risk analysis. This evolving ecosystem will continue to look even more precarious, like a Rube Goldberg or Heath Robinson contraption, those ridiculously complicated machine depictions of springs, pulleys, and ratcheted wheels put together incrementally to accomplish a simple objective, rather than anything well thought through around good systems design.

There is an immediate need to let new and innovative ideas into the current industry/regulator dialogue. Such voices are usually drowned out by industry admonitions of dire consequences should regulators advocate for untested ideas. However, this legacy mindset stymies innovation and does not let disrupters, who are not encumbered by previously failed best practices or the need for consensus approval, to advance their ideas.

This is changing though. Fintech companies are finding regulators opening the door to disruptive thinking leading to 'leap forward' strategies. The CFTC, led by Commissioner Giancarlo, is advocating for letting the disruptors in. Some strategies are relatively new; distributed ledgers, smart contracts, wholesale infrastructure replacement. Some have been long sought after; global identification standards, common data definitions of transaction elements, standard reference data, straight-through-processing. Some transcend conventional legacy thinking; infrastructure utility replacement, direct customer to customer trading, and replacement of central bank currencies with digital surrogates.

So far, these disrupters are finding a myriad of partnering opportunities with financial institutions and infrastructure facilities operators. The question is will Fintech companies accept the marginal improvements that financial institutions will be willing to experiment with and pay for. Or will regulators demand more innovation should the technologies become viable? It may well be that Fintech disruptors will see a clearer path to riches by becoming a digital financial institution rather than serving simply as technology providers.