BANKING STAKEHOLDER GROUP

CONSULTATION OF THE ESA'S JOINT COMMITTEE JC/2015/080 ON "AUTOMATION IN FINANCIAL ADVICE"

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

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Foreword

The EBA Banking Stakeholder Group ("BSG") welcomes the opportunity to comment on the Discussion Paper JC//2015/080 on automation in financial advice. This response has been prepared on the basis of comments circulated and shared among the BSG members and members of the BSG's Technical Working Groups on Consumer Protection. The response outlines some general comments by the BSG, as well as our detailed answers to the questions indicated in the Consultation Paper.

General comments

The financial industry is one of the most IT-intensive industries, just behind media and ICT services. Therefore, the numerical transformation is at the heart of the present development for banks and financial institutions and has a central place both on the relationship with clients and on employment patterns. In less mature markets, in terms of banking services (excluding Poland and Turkey) the development of digital advice may even be quicker than in mature markets, comparable to the so-called leapfrog development, as seen in the development of the mobile phone services in the late 1990s.

The digital transformation touches all financial services, including front and back offices. If the back offices do not follow with adequate investments, digital front offices will not be able to deliver the services required in the long term[1]. Developing adequate **integrated** IT is one of the main challenges for the financial services industry.

Robot-advice may destroy some jobs but, on the other hand, create new jobs where different skills will be needed to handle the systems and offer related services. The IT revolution will therefore require an adequate development and training of human resources. Organising qualifications for this evolution is a core task for educational, professional and commercial organisations. According to the German Federal Institute for Vocational Education and Training, a training standard for IT, or more specifically for media competence, is needed. Being able to use smartphones to make calls, research or for gaming is certainly not enough. Knowledge about the functioning of an operating system and how to improve data protection will have to become a new standard. These are fundamental key skills in an increasingly digitalised economy and society[2]. A recent French government report on the impact of digitalisation on working life[3] also stresses the importance of adequate education (including lifelong education and vocational training) as a number one priority. Unfortunately, this aspect is totally missed out in the analysis, although the development of qualification is also a core aspect in the financial industry, which is a knowledge-intensive industry**.**

For comparison, the McKinsey Global Institute quotes a 2014 Linkedin analysis from member profiles in the US, which identifies the most important ICT skills for improving job prospects. These range from data mining and cloud computing to information security in the digital economy[4]. In the same report, McKinsey states that the digital economy and the US economy have become synonymous in terms of growth and innovation.

[1] PAC 2015 : La transformation numérique des banques

[2] Skilled crafts and economy 4.0; Interview with Prof. Dr. Friedrich Hubert Esser; Thursday 16 July 2015, (issue no. 13/14) on page 2 in the "Deutschen Handwerksblatt" (German Skilled Crafts Journal). www.bibb.de

[3] B. Mettling, Septembre 2015, Transformation numérique et vie au travail, Rapport pour la ministre du Travail, de l'Emploi, de la Formation Professionnelle et du Dialogue Social.

[4] McKinsey Global Institute, Digital America, Dec 2015, p. 24

1. **Do you agree with the assessment of the characteristics of automated financial advice tools presented in this Discussion Paper? If not, please explain why.**

Yes. However, some precisions could be added to make the description clearer. For example, does the robot-advisor use any "big data", which was not been directly provided by the consumer for the purpose of the envisaged transaction?

Comparison sites should be included in the study as they offer services and advice which enable customers to make a choice between different products. Some of the so-called robo-advisors can be put in this category, as well as a number of insurance comparators. In addition, many comparison websites[5] in particular in the insurance area are problematic and should be under the radar of financial supervisors:

- conflict of interests: many of them have been created by an insurance company or group of insurance companies (no information on the site on possible conflicts of interest); the site is paid for by companies or insurance intermediaries of which it makes offers;
- Partial coverage of the market (unspecified selection criteria);
- Ranking methodology: companies that offer temporary teasing premia are always well ranked, even if their offers are conditional (excess, deductibles, ceilings, exclusions), which is detrimental for companies that do not use such commercial practices and offer lower premia for all their range on a permanent basis.

It might be interesting to note that internet advice is often designed for a mass market of retail clients. When it comes to private banking, internet services are less considered and high profile clients rather prefer personal advice[6]. This can be detrimental to the less wealthy "retail" customer as he/she may in the future not have access to personalised advice. It also means that a certain number of skills (IT and financial literacy) are necessary for the customer in order to make an investment choice. This may disadvantage clients without these skills.

In the securities business, robo-advisors can offer different types of services ranging from advisory services (just helping to choose the right product which then has to be bought through a deposit bank), indexed portfolios according to the risk profile of the client, or all of this, including custodial services[7]. Some robo-advisors are branches of exisiting retail banks, but others may just be start-ups.

In the US, online alternatives to traditional advice are thriving. Even if very few European retail investors are using online advice services at present, the success of US firms demonstrates that there is potential for services offering more than execution only, but less

[5] BEUC position on comparison websites regardless of the sector: http://www.beuc.eu/publications/2012-00536-01-e.pdf

[6] PAC 2015 : La transformation numérique des banques, p. 15

[7] : http://www.finanztip.de/robo-advisor/#ixzz3vnOnFQ54

than full advice, at an appropriate cost. The question is whether these services are really able to offer a proper investment advice. In this respect, Which?, a UK consumer organisation, has tested three websites that make investment recommendations based on answers to pre-set questions[8].

In general, the range of FinTech is quite wide and also includes crowdfunding and other intermediary services. Thus, recent experience has shown marketing of possibilities for retail investors to have a robo-driven spread of investments in crowdlending.[9] This brings extra challenges to an area which, in many countries, is scarcely regulated and supervised.

2. Are there any other relevant characteristics of automated financial advice tools?

It might be interesting to describe the algorithms used for financial advice in a more detailed way. The main technological evolutions are based on artificial intelligence and cognitive IT, as well as connected objects or Internet of Things[10]. Cognitive IT has been used since the 1950s but has acquired additional power by the increase in IT capacity after the 1990s. An example is the IBM system of cognitive technology called "Watson". Cognitive technology has an advantage over the human brain because of its quasi-unlimited capacity for analysing data. Cognitive systems are potentially more objective than a human brain when it comes to formulating and testing a set of hypotheses, as humans are generally subject to cognitive biases depending on their experience, professional background and intuition[11].

As financial decisions are often based on subjective decisions, a new initiative by ING, a leading internet bank, is trying to explore the behaviour in everyday finance. Launched with the Institute for New Economic Thinking, the Think Forward Initiative[12] aims at a better understanding of human behaviour including behavioural biases and adapting the business strategy accordingly. However, the exploitation of such biases can lead to price distortion: prices are determined according to similar rules as in digital travel agencies which can result in different prices beig paid for the same product. This may depend on the sales channel or on a point in time.

3. Are you aware of examples of automated financial advice tools being used in the banking, insurance, and/or securities sectors? Please provide examples, giving details of their operating process.

Yes.

[8] Which? The final frontier: can on online service be an effective and cheaper substitute for face-to-face financial advice? Which.co.uk, February 2015

[9] For instance the relatively new 'Better Rates' platform : https://www.betterrates.dk/main/home.xhtml

[10] L'assurance vie à l'ère numérique : transformation radicale en perspective. SIGMA, Swiss Re N° 6/2015

[11] See Kanemann and Twersky on this.

[12] http://www.ing.com/Newsroom/All-news/Press-releases/PR/ING-Bank-Strategy-Update-Think-Forward-1.htm

For securities investments, there is often an "entrance test" designed to recommend potential assets to users through a series of questions concerning investment objectives, terms and risk appetite. Personal details (age, amounts available, investment preferences such as how much loss can be absorbed, investment horizon, percentage of money in fixed or variable income, etc.) are asked for. According to the risk profile a portfolio is proposed. The automated advisor will then provide a selection of customized asset allocations based on a pre-selected range of criteria such as rating, product costs and performance.

Depending on the tool, asset classes may include both actively and passively managed investment funds, bonds or shares, ETFs -exchange-traded funds, such as AnlageFinder by Deutsche Bank. Others offer passively managed funds only (ETFs and indexed investment, such as Ginmon). Every internet-advisor has its own investment strategy.

In the insurance sector, the set of questions is much more inquisitive and demands a whole range of personal data, even for a car insurance (date of birth, obtention of driving licence, domiciliation, marital status for a second driver, etc.). See below for disadvantages.

4. **Do you offer/are you considering offering automated financial advice tools as part of your business model? If so, please briefly describe: i) what type of entity you are, e.g., long established, start-up, a product provider, an intermediary; ii) the service you provide (e.g. to what extent do you integrate human interaction in the tool you provide?); iii) the nature of your clients; iv) your business model; v) who developed the automated tool (i.e. an external company or developed internally?); and vi) the size of your activity and/or forecast activity?**

   No. This response is done on behalf of the Banking Stakeholder Group. Certain members of the group are representatives of industry and their respective employers may offer these kinds of products. However, in this response the BSG answers as a consultant and not as a service provider.

5. **Do you consider there are barriers preventing you from offering/developing automated financial advice tools in the banking, insurance and securities sectors? If so, which barriers?**

   N.A. see question 4.-

6. **Do you consider the potential benefits to consumers to be accurately described? If not, please explain why.**

   Yes. Costs are certainly a benefit, as well as the access to a wider range of advice providers and the range of choice which is wider than in a traditional bank. The competition across borders and in the member states might hence be enhanced. However, investing in other jurisdictions can also present disadvantages if the products are different and different tax rules apply.

According to the study carried out by Which?, a UK consumer organisation, the charges look compelling when compared with those for traditional face-to-face advice. While annual fees are similar when stripping out funding costs, initial charges levied by independent financial advisors are high and can be avoided with an online service. Therefore, in the long run consumers do not necessarily pay less as is suggested. Low cost provision cannot be assumed and certainly not as a long-term benefit in an area where fees and charges are a mainstay of the industry.

Availability and choice: if the consumer has adequate IT skills, product choice can be convenient. However, in the securities sector it may be difficult to choose between the different robo-providers as a customer who invests in a robo-advisor needs to have **sufficient financial skills** to be able to decide on an investment strategy.

It is also not entirely clear how the regulatory requirements are observed as often regulatory requirements are based on questionnaires and knowledge of the customer (i.e. MiFID). For instance, how can a bank or a securities company be sure that the questionnaire has been answered correctly? In this respect, it might be interesting to distinguish between MiFID regulated products and the others. The legal requirements should be in accordance with the underlying product.

The point is made regarding 'well-developed' algorithms. This is key as there must be effectiveness and efficiency. An independent regulatory review/audit/oversight element or mechanism must therefore be considered for regular oversight to ensure the advice is current and fit for purpose. There again, it is important to ensure that the algorithm is kept confidential within the authority.

7. Are you aware of any additional benefits to consumers? If so, please describe them.

No comment

8. Do you see any differences in the potential benefits arising for consumers in each of the banking, insurance and securities sectors?

Buying an insurance generally requires a customer to provide more personal information than is the case with investment advice for financial products. This may then cause problems in terms of the administration and protection of the data provided. This reflects back to the oversight mechanism which will, of necessity, be required to be in place to provide consumers with guarantees also as to security. Trust is paramount to the success, acceptance and support for automated provision.

This is also the case when a customer is seeking to take out a credit over the internet, as a variety of information is requested.

9. Have you observed any of these potential benefits to consumers? If so, please provide examples and describe the kind of benefit that has accrued.

Likely one of the most prevalent and relevant benefits, with regard to health and property insurance, is the attached cooling-off period which provides for a return for clarification or cancellation.

A well-functioning system can provide assistance in quickly resolving disputes between consumers and providers through a robust recording system.

10. Do you consider the potential benefits to financial institutions to be accurately described? If not, please explain why.

Yes, the major items have been covered, such as cost, getting to clients who do not go to a branch in order to seek face-to-face advice and quality of service because of the objective manner of a machine, and also the possibility to maintain records of the financial advice processes – both generally and regarding the individually customer relations. In addition, a certain number of jobs can be replaced by machines: for example in Britain, the number of personal advisors has decreased between 2011 and 2014 from 26 000 to 24 000[13].

Developing automated advice is more of a necessity than an option with the galloping digitalisation of financial services, especially for generic advice. It seems that personal, face-to-face advice is used more in the segment of wealthier clients (private banking) than in traditional retail banking.

11. Are you aware of any additional benefits to financial institutions? If so, please describe them.

No comment

12. Do you see any differences in the potential benefits arising for financial institutions in each of the banking, insurance and securities sectors?

No comment

13. Have you observed any of these potential benefits to financial institutions? If so, please provide examples and describe the kind of benefit that has accrued.

No comment

14. Do you agree with the description of the potential risks to consumers identified? If not, explain why.

As already described, the utilisation of the tool may cause problems if all the devices are not correctly understood and to that can be added that customers quick acceptance of conditions could be emphasised further as it might result in advice not being fully understood by customers. The utilisation and transfer of data may be an element of caution, especially in the insurance sector, where a lot of personal data is required in order to receive an internet offer. Concerning life insurance (not the French context of

[13] Financial Advice Market Review, Call for input, October 2015, FCA, p. 15

"assurance vie" which is a packaged product for tax purposes) the protection of any further use of medical data is of paramount importance[14].

In addition, the reference to social engineering and its increased possibilities for a fraudulent use are explained but should be emphasised further. In any case, data protection becomes more and more difficult and the trade-off between the use of data for commercial purposes and the cost of protecting it or fighting against fraud should be carefully analysed.

Moreover, machines could analyse the market in a similar way and thus produce a pro-cyclical behaviour which, on a large scale, could be destabilising the economy.

15. Do you consider there to be any risks to consumers missing? If so, please explain.

The location of the robot-advice is not necessarily clear and a consumer could invest in a foreign country without being aware of him doing so. Again, we see how an independent regulatory oversight would help in assisting consumers' trust that ALL detail would be provided clearly and in understandable terms, as a standard requirement for any service.

In addition, advice can be more or less complex and a machine, despite being able to process huge amounts of data, is not necessarily able to check the degree of complexity needed by the consumer. In a Call for Input for the Financial Advice Market Review[15] the UK's Financial Conduct Authority has described the degrees of complexity which can arise from different types of financial issues, ranging from simple items (short term saving) to very complex issues (saving for a retirement income) and proposes a customer segmentation accordingly. It then shows the different reasons which might hinder customers in seeking advice (page 13: price, overconfidence, lack of trust or knowledge, lack of ability to use internet channels, the fact that they think that advice is not necessary etc.) It is also doubtful that a machine can distinguish the kind of complexity and direct a customer accordingly, especially if the customer is neither IT skilled nor has adequate financial knowledge. In this case, he/she may provide misleading information and therefore receive inadequate advice.

There is also a risk of segmentation of the market between those wealthier customers who get personalised advice, and the mass market of retail clients which may become problematic if those mass market clients do not have the necessary IT skills, such as older people.

The financial stability of intermediaries, especially start-up intermediaries, should also be mentioned. In this respect, it might be useful to recall the obligation to register as a financial intermediary. Under Article 10 (page 9) of the Discussion Paper, a certain number of directives or regulations are indicated, but it is not clear in the paper what the obligations resulting from these dispositions are. In France, for example, financial

[14] L'assurance vie à l'ère numérique : transformation radicale en perspective. SIGMA, Swiss Re N° 6/2015
[15] Financial Advice Market Review, Call for input, October 2015, FCA, p. 10 and 11

intermediaries have the obligation to register in the ORIAS database and provide a certain amount of information as to their competence and seriousness.

16. Do you see any differences in the potential risks arising for consumers in each of the banking, insurance and securities sectors?

The insurance sector is more exposed to the risk of disposing of personal data, especially in the medical field, which needs a special protection.

For the financial sector, when using start-ups, the financial stability should be mentioned.

Guidance to the consumer as to how to access current registration status of any provider offering will be important and especially in terms of the securities sector. However, it will be decidedly more important in the case of those purporting to be regulated agencies in the sectors.

17. Have you observed any of these risks causing detriment to consumers? If so, in what way?

In the majority of cases, consumers are potentially contracting in real time. The concern is how specific requirements affecting ultimate benefits – e.g. in terms of previous health issues, motor or property claim history etc. – have given rise to confusion resulting in loss of significant claims years after the instrument was put in place.

There remains an inherent challenge and risk that the absence of human interaction facilitates error of judgement on the part of a consumer and their clear understanding of what has been offered and advised.

The quality of the advice, and also its protection under data protection requirements, as well as technological security, cannot be understated.

18. Do you agree with the description of the potential risks to financial institutions identified? If not, explain why.

As mentioned in the analysis (63), if different tools are used to collect and treat information, and different institutions are concerned (for example a bank and a custodian), errors may occur because the IT tools do not comunicate correctly with each other. The process of digitalisation of advice has to be associated with the development of all tools, used for front, middle and back office services.

When taking out credits through a robo-tool, the bank may miss out some information: “Know your Customer” is also a safeguard for sound origination of credits. To the extent that digital granting of credits becomes more prominent, care should be taken that this does not result in an increase of bad loans.

19. Do you consider there to be any risks to financial institutions missing? If so, please explain.

The conservation of data is done more and more on the Cloud. This represents several risks, as professionals are concerned about the security of data on the cloud: they are at the mercy of the cloud's entity's cybersecurity skills, loose visibility and accessibility of their data and may have problems with government inspection of their data[16]. Of course, the problem of cybersecurity is not specific to cloud computing.

Technology barriers (connecting front, middle and back office technology) may also be an additional risk.[17]

There may also be regulatory risks, such as data protection issues or regulatory requirements to keep and store data which may be a risk for banks. For example, if the numerical transformation is more advanced at the front office than at the back office and the transfer of data does not function in a smooth way.

20. Do you see any differences in the potential risks arising for financial institutions in each of the banking, insurance and securities sectors?

No comment

21. Have you observed any of these risks causing detriment to financial institutions? If so, in what way?

No comment

22. Would you agree with the assessment of the potential evolution of automated advice? Please provide your reasoning.

Yes. The digitalisation of the economy is likely to increase. In addition, developments in the USA are often exported to Europe.

Concerning the differences of markets in Europe, it is likely that digital services develop fast and without intermediate stage in countries which are less mature in terms of banking services (Poland, Turkey)[18], similar to the development of mobile phone services in the late 1990s.

There will always be both a demand and a need for personally delivered advice in this most important of sectors. To consider that digitalisation will deliver all of the needs of either the consumer or of the financial institutions would be short-sighted.

Costs can be saved for both entities through smart and effective use of automation that is well considered selectively. A one-size-fits-all approach is not the primary solution here and should not be the goal.

[16] Defending Data: Turning cybersecurity inside out, Nuix, Ari Kaplan Advisors
[17] Sales or customer focused? Banks' evolution to customer-driven sales, Global research report by Misys and EFMA
[18] PAC 2015 : La transformation numérique des banques, p. 7

Also, a recent study[19] performed by the market research company Epinion for a mid-sized Danish bank showed some surprising results, i.e. concluding that 63 percent of the 18-29 year olds participating in the study preferred to have a physical branch of their bank nearby so as to be able to get face-to-face advice. An average of 54 percent of all respondents expressed the same preference.

23. How do you think that the market for automation in financial advice will evolve in the near future in the banking, insurance and investment sectors? Please also provide details of any relevant data or information to support your views, where available.

Yes, there will be a development of further automation in the financial sector.

24. Are there any other comments you would like to convey on the topic of automation in financial advice?

The increasing digitalisation of banking will necessitate the development of new skills. That is why it is of paramount importance to consider the development of IT skills, through initial training and through lifelong learning and professional training.

Submitted on behalf of the Banking Stakeholder Group,

David T Llewellyn

Chairperson

[19] http://politiken.dk/oekonomi/privatoekonomi/ECE2260705/unge-overrasker-de-vil-have-bankfilialer-taet-paa/