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Joint Committee Report on the results of the monitoring exercise on 'automation in financial advice'

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List of acronyms

ACPR	Autorité de Contrôle Prudentiel et de Résolution
AMF	Autorité des Marchés Financiers
AML	Anti-Money Laundering
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
BdE	Banco de España
CBI	Central Bank of Ireland
CFD	Contract For Difference
CFT	Combatting Financial Terrorism
CSSF	Commission de Surveillance du Secteur Financier
DP	Discussion Paper
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Funds
FCA	Financial Conduct Authority
FMA	Finanzmarktaufsicht
FSMA	Financial Services and Markets Authority
GDPR	General Data Protection Regulation
IDD	Insurance Distribution Directive
JC	Joint Committee
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MNB	Magyar Nemzeti Bank
NCA	National Competent Authority
PRIIPs	Packaged retail and insurance-based investment products

Management summary

1. Following the publication of the 2015 JC Discussion Paper (DP) on Automation in Financial Advice and the 2016 Report on the same topic, a new analysis has now been done, through a survey with national competent authorities (NCAs), on the evolution of 'automation in financial advice' in the securities, banking and insurance sectors over the past two years.

2. The analysis shows that while the phenomenon of automation in financial advice seems to be slowly growing, the overall number of firms and customers involved still seems to be quite limited.

3. The risks and benefits of this phenomenon, which had originally been identified by the ESAs in the development of the DP and related Report, have largely been confirmed by NCAs and seem to be still valid.

4. In terms of emerging business models, it appears that these kind of automated services are being offered, through partnerships, by established financial intermediaries, rather than by pure FinTech firms and while some new trends seem to emerge (such as the use of Big Data, chatbots and extension to a broader range of products) there seems to have been no substantial change to the overall market since the publication of the ESA Report in 2016.

5. Considering the results of the analysis, in terms of limited growth of the phenomenon and lack of materialisation of the identified risks, no immediate ESAs action appears to be necessary. A new monitoring exercise will be done if and when the development of the market and market risks warrant this work.

Background

1. On 4 December 2015, the three European Supervisory Authorities (EBA, ESMA and EIOPA) published a Discussion Paper (DP) on Automation in Financial Advice (JC 2015 080), which described the phenomenon whereby advice is provided to consumers without, or with little, human intervention and providers rely instead on computer-based algorithms and/or decision trees.

2. The DP was aimed at assessing what, if any, regulatory and/or supervisory action is required in response to this phenomenon. To that end, the DP presented the risks and potential benefits of this innovation to consumers and financial institutions, sketched the potential evolution of this innovation, and asked stakeholders for their views on the accuracy of this preliminary assessment.

3. The ESAs received 68 submissions in response to the DP from a wide variety of stakeholders, including trade associations, individual firms, consumer associations, and other interested parties.

4. A Report was published on 16 December 2016 (2016 Report) presenting the conclusions of the assessment on automation in financial advice.

5. In the DP, the ESAs identified benefits of automated advice to consumers and financial institutions in respect of:

    - reduced costs for both customers and financial institutions;
    - easy access to more products and services to a wider range of consumers and wider client base for financial institutions; and
    - improved quality of the service provided.

    Having assessed the referred responses to the DP, the 2016 Report concluded that the benefits of automated advice that had been identified in the DP were accurate but might not yet be fully realized or be subject to additional caveats, due to the early stage of the development of the phenomenon.

6. In the DP, the ESAs identified risks of automated advice to consumers and financial institutions in respect of:

    - consumers having limited access to information and/or limited ability to process that information;
    - flaws in the functioning of the tool due to errors, hacking or manipulation of the algorithm;

- legal disputes arising due to unclear allocation of liability; and
- the widespread use of automated tools.

The 2016 Report concluded that the identified risks were also accurate, but the likelihood and impact of the materialisation of these risks can vary substantially.

7. The 2016 Report also concluded that the proliferation of automated advice, often referred to as robo-advice, was still at an early stage and the phenomenon was not equally present across the insurance, banking and investment sectors, having – at the time – a greater prominence in the investment sector.

8. Finally, the 2016 Report noted that several EU laws and regulations already apply to automated advice and can address the risks identified and that no cross-sectoral regulatory or supervisory actions were needed.

9. When finalising the 2016 Report, the ESAs agreed to monitor this phenomenon given its growth potential. In line with this decision an analysis was conducted on the evolution of 'automation in financial advice' in the three sectors since the publication of the 2016 Report. This monitoring exercise also included a separate section on the automation of the service of 'portfolio management' that was not covered in the original work.[1]

10. This Report presents the results of the monitoring activity and is structured as follows:

- Section A – sets out a brief summary of the recent sectoral work carried out by the ESAs in the area of automation in financial advice.
- Section B – sets out the main results of the monitoring exercise on the evolution of the market in automation in financial advice and related regulatory/supervisory activities in the different Member States/sectors.

[1] 'Portfolio management' according to Article 4(1)(8) of MIFID II means "managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments".

Section A - Summary of the recent sectoral work carried out by the ESAs in the area of automation in financial advice

ESMA

11. In July 2017, ESMA published a Consultation Paper with proposed draft guidelines which confirm and broaden the existing ESMA MiFID I guidelines on suitability, issued in 2012. The new guidelines consider - amongst other things - technological developments of the advisory market and notably the increasing use of automated or semi-automated systems for the provision of investment advice or portfolio management. When developing the guidelines, three main areas where specific needs of protection may occur have been identified:

    - The information that should be provided to clients on the investment advice and portfolio management services when these services are provided through an automated tool (this concerns both what information should be provided and how information should be illustrated to clients);
    - The assessment of the suitability (with particular attention to the use of online questionnaire with limited or without human interaction);
    - The organisational arrangements that firms should implement when providing robo-advice.

12. The Final Report with the finalised guidelines has been approved by the ESMA Board of Supervisors and has been published on the ESMA website on 28 May 2018[2].

EBA

13. On 15 March 2018, the EBA published its Roadmap on FinTech, setting priority areas of work for 2018 and 2019[3]. The Roadmap was preceded by a Discussion Paper that the EBA published on 4 August on its approach to FinTech where respondents expressed their views that the EBA should engage on the topic of automation in advice. The Roadmap identified as priority areas of work the following 6: (i) authorisations and regulatory perimeter issues; (ii) regulatory sandboxes and innovation hubs; (iii) impact on business models, prudential risks and opportunities; (iv) cybersecurity; (v) consumer and conduct issues; and (vi) AML/CFT.

14. Based on the roadmap, the EBA is currently conducting work, amongst others, on the analysis of prudential risks and opportunities arising from FinTech for Credit Institutions, Payment Institutions and E-money Institutions that supervisors need to take into account when

[2] See ESMA35-43-748.

[3] https://www.eba.europa.eu/-/eba-publishes-its-roadmap-on-fintech

conducting their supervisory work. The work is being carried out by selecting and analysing seven use cases, one of which is automation in advice. A publication of a Report is foreseen by summer 2018.

EIOPA

15. There are two EIOPA deliverables to date and one upcoming thematic review that can be seen as related to automation in financial advice.

Firstly, EIOPA Opinion on sales via the Internet of insurance and pension products[4] where EIOPA recommended that NCAs take the necessary and proportionate supervisory actions to ensure that online distributors comply with a duty of advice, if such a duty exists in national law or when sales are so promoted. NCAs should also make sure that customers are provided with appropriate information on the selling process of the online distributor with a view to avoiding unsolicited, or mistakenly concluded, contracts.

Secondly, EIOPA's Report on Good Practices on Comparison Websites[5] which outlines good practices concerning online comparisons of insurance products. The report outlines good practices for websites that compare insurance products. The Report gives guidance on the following topics: information about the comparison site itself, the market coverage of the site, how the site deals with conflicts of interest, the criteria used to make the ranking of providers and products, and the presentation and the frequency of updating the information. EIOPA considers it, for example, good practice for a comparison website to

- give clear and easy-to-find information about who to contact with complaints about the products purchased via the website;
- disclose those providers with whom a comparison website has a commercial, contractual or ownership relationship;
- present clearly and in detail main features and characteristics of products, insurance cover and limitations;
- not use price as the sole criterion for comparison and provide the user with the final premium and details of all fees and charges;
- communicate in a clear and simple language, avoiding jargon and unnecessary technical terms.

This year EIOPA is planning to carry out a thematic review on Big Data, seeking to gather empirical evidence on the use of Big Data in areas such as pricing, underwriting, claims management, sales and/or marketing. The thematic review will analyse the benefits and potential risks to fair treatment of consumers, including assessing the boundaries of potential

[4] See EIOPA-BoS-14/198.
[5] See EIOPA-CCPFI-13/100.

ethical and privacy issues arising from enhanced consumer profiling techniques and more granular risk assessments. It will also assess the impact of Big Data on the availability and affordability of insurance for consumers.

Section B - Results of the monitoring exercise

16. A follow-up survey on the evolution of "automation in financial advice"[6] in the securities, banking and insurance sectors was done in March 2018 with NCAs. The main findings of the survey are summarised below:

Evolution of the market of automated financial advice tools

Changes incurred in the scale of the market

17. The responses from NCAs showed that the European market in 'automation in financial advice' seems to be growing, although not very rapidly. Precise figures are not available for all Member States, but the overall **scale of the market** appears to be still quite limited. However, there is some variation in the development of the sector across different Member States.

18. In terms of the development of automation in financial advice, while it appears that the phenomenon is still prevalently focused in the securities sector, some NCAs have however noted that insurance and banking products are being distributed through automated tools in their jurisdiction. In particular, with regard to the products offered:

    - Securities – Several NCAs noted that intermediaries are mainly offering ETFs and mutual funds, AIFs, and for a few firms signal-following in CFDs
    - Insurance products – Some NCAs noted that intermediaries are offering life insurance products; non-life insurance; travel insurance, foreign health insurance, car insurance, personal liability insurance, supplementary dental insurance, occupational disability insurance, pension products.
    - Banking products – Few NCAs noted that intermediaries are offering mortgages and private loans.

19. The **level of concentration** of the market appears to be relatively high, although only limited data is available.

Changes in the use of these tools by consumers

[6] For the purpose of the monitoring exercise, the survey covered tools which (i) are used directly by the consumer (client-facing tools including 'hybrid' business models, under which the use of automated advice tools is combined with an element of human advice); (ii) Include an algorithm that uses information provided by the consumer to produce an output; and (iii) the output of the tool is, or is perceived to be, financial advice.

24. Very few NCAs were able to provide figures about the **number of clients** of automated financial advice or information concerning the **types of clients** using automated financial advice. From the results of the survey, it is therefore challenging to state if any significant changes have occurred in the use of automated advice tools by clients.

20. Information available on consumer complaints shows low figures relating to these services.

New business models that have emerged in the area of automated advice

21. With regard to **new business models** which are emerging in the different jurisdictions/sectors, some NCAs reported that:

- partnerships are increasing between traditional financial intermediaries and FinTech firms as it is easier to attract clients for these services and to fulfil regulatory requirements;
- some firms are using chatbots for customer service;
- self-learning automated advice based on technologies which use artificial intelligence is being developed by some firms.

Identified barriers preventing the development of automation in financial advice

22. The main barriers identified by NCAs are:

a) **Cultural/psychological barriers** – In particular some NCAs noted that lack of digital (financial) literacy of consumers may be considered one barrier to the development of 'robo-advice'. Consumers with low levels of (or without) digital (financial) literacy are less confident in the use of this tool (preferring face-to-face interaction) and the potential lack of trust of consumers may discourage financial institutions' investment on 'robo-advice'.

b) **Regulatory barriers** such as the complexity of existing applicable regulation, such as MiFID II/MiFIR, IDD, GDPR, PRIIPs (especially for smaller firms); the lack of "digital identity" and European harmonization between digital procedures for identity identification; the lack of a consistent legal definition of "advice" across the three sectors.

23. Furthermore, while it has not been identified as specific to the development of the phenomenon, it has been noted that (i) firms still find it challenging to correctly profile clients and understand their objectives when there is no face-to-face interaction; and (ii) in an online environment it can be a challenge to ensure that the customer understands both the advice and the features (such as the costs) of the product.

Evolution of the national legislative framework and/or supervisory approach

Recent NCA supervisory activities with firms offering automated advice tools

24. Several NCAs noted that supervisory work has been carried out at national level in relation to automated advice, including: meetings, questionnaires, off-site analysis or on-site inspections and thematic reviews.

25. It is important however to note that other NCAs have stated that the supervision of these firms is carried out under the principle of technological neutrality and proportionality, within the common framework applied to all entities. These NCAs have not therefore reported specific activities performed in this area (although automated advice models are discussed as part of ordinary inspections, together with any other business model applied).

New domestic regulatory legislation covering automated advice tools

26. No NCA has reported new domestic legislation covering automated advice. NCAs emphasized that under the "technology neutrality principle", consumers using automated advice tools should be equally informed and protected as when advised by a human adviser.

Information on other national initiatives taken on the topic of 'automation in financial advice'

27. Relevant initiatives mentioned by NCAs include the following:

- In Austria, the FMA is currently carrying out a project focusing on financial market's digital strategy, capabilities and degree of digitalisation. The FMA will also launch a survey concerning digitalisation including automated advice in the insurance sector.

- In France, ACPR and AMF work closely together to supervise robo-advisors and to provide the market with feedback about increasing automation practices. Indeed, robo-advisors fall usually into the remit of the two supervisory authorities, when they deal with life insurance products (ACPR's remit) and with financial instrument (AMF's remit). Firstly, both authorities have each set up a Fintech Innovation Hub in 2016: new players can call upon these teams to get views on the regulation of robo-advice. This single point of entry enables new players to incorporate regulatory requirements sooner. It also supports supervisory authorities to anticipate better market developments. Indeed, the majority of active new robo-advisors in France have been in contact with the ACPR or AMF Fintech Innovation Hubs. Secondly, ACPR and AMF supervisory teams coordinate their works on robo-advice through the "Coordination Committee" (set up in 2010)[7]. As result of on-site

[7] Based on this common assessment, AMF and ACPR have issued guidelines on customer information gathering in a digital world (ACPR 2013-R-01, AMF 2013-02), on the selling of complex life insurance products (ACPR 2016-R-04) and on forward-looking performance simulator (AMF 2017-07).

inspections and of a joint working group on selling practices in a digital world, ACPR and AMF have observed that fully automated robo-advice was still very scarce. Most of misselling practices were actually observed for channels where both internet and phone were used. Thirdly, ACPR conducts a new Industry Task Force on artificial intelligence so as to address regulatory issues related to AI-algorithms. That type of algorithms like Machine-Learning algorithms could also be used for providing investment advice to customers in the future.

- In Germany, BaFin published in 2017 an article in its regulatory journal ("BaFin Journal"), where the guidelines of differentiation between automated "investment advice" (in the sense of MiFID II and German legislation respectively) and other automated investment services were explained[8]. BaFin has also established a dedicated section on its website for FinTechs; furthermore there are dedicated supervisors who focus on the supervision of certain firms, such as robo-advisors. Additionally, BaFin organises FinTech conferences which bring together representatives of the industry and its associations, the German Federal Ministry of Finance and BaFin. Finally, there are several information articles for consumers available on BaFin's website, which describe the risks and structures of automated financial services.

- In Hungary, the MNB has set up a special unit responsible for Fintech.

- In Ireland, the CBI issued a survey to regulated firms seeking information on the new and innovative products and services that have been offered or are in development in the Irish market for consumers in the digital financial services context. This survey was undertaken in order to inform the content of the Central Bank's Discussion Paper (DP7) on the Consumer Protection Code and the Digitalisation of Financial Services.

- In the Netherlands, the AFM published their View on Robo Advice in March 2018. With this report the AFM is clarifying the expectations it has regarding the further development of automated financial services, in particular concerning the quality of the services and the duty of care. The report is available in English.[9]

- In Luxembourg, the CSSF issued a communication on "Robo-advice" on 27 March 2018.[10] Moreover, the CSSF noted that a dedicated control plan for suitability assessment (when automated investment services are provided by firms) is currently under development in the On Site Department of the CSSF.

[8] The article *"Robo-advice - Automated investment advice in supervisory practice"* was also published in English on BaFin's webpage: https://www.bafin.de/dok/9968210.

[9] https://www.afm.nl/en/nieuws/2018/mrt/doorontwikkeling-roboadvies

[10] http://www.cssf.lu/fileadmin/files/PSF/Robo_advice_270318.pdf

- In Spain, BdE has recently created a new Associate Directorate General Financial Innovation and Market Infrastructures with the aim of monitoring and analysing financial market innovations.

- In Sweden, at the end of 2016, Finansinspektionen published a paper on automated investment advice (FI Dnr 16-19268). In the paper, Finansinspektionen took a positive stance to the developments that were occurring, but also emphasised that the interests of the client must remain at the centre of the development. The report followed a FI Forum with 350 participants, where Finansinspektionen communicated important issues and discussed automated investment advice with participants from the market.

- In the UK, the FCA launched "The Advice Unit" in 2016. The Advice Unit provides regulatory feedback to firms developing automated models to deliver lower cost advice and guidance to consumers. Furthermore, the UK - FCA published some guidance for firms seeking to develop automated or partly-automated advice services. This guidance is intended to help firms develop compliant new models and to remind them that the regulator expects firms using automation to meet the same regulatory standards as traditional advice channels (FG17/8).[11] In addition, in May 2018 the FCA published findings from a supervisory review of a sample of firms offering automated online discretionary investment management and retail investment advice exclusively through automated channels.

Risks and benefits of automation in financial advice

Analysis whether risks and benefits identified in the 2016 ESA Report are still valid

28. Most NCAs confirmed that risks and benefits identified in the 2016 ESA report are still valid. It is interesting to note that one NCA stated that some robo-advisors are currently losing money, facing economic difficulties. This NCA noted that this may lead to the development of more aggressive business and marketing strategies to attract customers implying a higher risk for them.

Evolution of the market of automated financial advice

29. One NCA noted that some of the automated services provided have similarities to licensed services. This implies that firms providing automated services must carefully assess the applicability of relevant laws and regulations to the services they are providing.

Portfolio management

Evolution of the market of automation in the service of portfolio management

[11] https://www.fca.org.uk/publication/finalised-guidance/fg-17-08.pdf

30. NCAs do not generally observe a significant evolution of the market of automation in the service of portfolio management, while there seems to be a growing trend for this market. NCAs noted that most of the conclusions set out in the other sections of this report also apply to portfolio management.

National legislative framework and/or supervisory approach to automation in the service of portfolio management

31. NCAs do not report any significant change of the national legislative framework. However, one NCA issued communications and/or guidance in this area specifically[12].

32. It is interesting to note that, in the course of supervisory activities, one NCA identified significant issues related to the algorithms supporting the partially automated portfolio management activities. This NCA observed that the client risk-profiling algorithm was inadequately designed and implemented, which resulted in clients being misclassified and assigned an excessively high risk profile.

Conclusions

33. Considering that results of the analysis show limited growth of the phenomenon of 'automation in financial advice', no significant change in the previously-identified risks, and any substantial changes to the phenomenon since the publication of the 2016 Report, no immediate further ESA action appears to be necessary.

34. However, considering the overall importance of the topic, and the emergence of some ongoing changes to business models, a new monitoring exercise will be done if and when the development of the market and market risks warrant this work.

[12] https://www.afm.nl/en/nieuws/2018/mrt/doorontwikkeling-roboadvies