DIGITAL FINANCE STRATEGY: IS THE EU PROPOSAL UP TO THE CHALLENGES?

1. Opportunities and challenges of digitalisation in the financial sector

1.1 Digitalisation trends and opportunities in the EU financial sector

The Chair introduced the session by emphasizing the transformational effects of digitalisation on societies and economies, including the financial sector and the acceleration of this trend during the pandemic. An industry representative stated that at their firm – a leading European bank - the number of digital customers has been steadily growing in the last five years and that Covid doubled the pace of this growth in 2020. Digitalisation is an irreversible trend and is now fundamental to financial services. More than 55% of their active customers are digital, which corresponds to about 50 million digital users of their systems, platforms and channels daily across a number of countries. Going forward, their objective is to continue providing customers with digital solutions that anticipate and fulfil their changing needs in a simple, personal and fair way.

An industry representative concurred that digitalisation is a key driver of the evolution and integration of the EU financial industry. New technologies have changed the ways that customers interact with market infrastructures in particular. Tech developments in relation to data analytics, cloud computing, machine learning, artificial intelligence (AI) and blockchain are all opening up new possibilities. The COVID-19 pandemic has accelerated digitalisation. For instance, exchanges operated remotely during the pandemic and performed extremely well despite the uncertain and volatile market conditions.

Tomorrow's markets will increasingly thrive in a digital economy, the industry representative believed. In today's markets, every exchange system is on premise for the most part. The rest of the ecosystem sits within the data centre as well, and connectivity operates in a hub & spoke model. There is an opportunity to lift all of these bespoke environments into the cloud and look at the industry on a broader basis in terms of having a universal platform for transactions. As the economy becomes increasingly digital the cloud will enable companies around the globe to connect in new ways through the formation of a mesh-style network that leverages modern APIs and actors will be able to scale communications more easily and quickly thanks to this.

1.2 Questions and challenges raised by digitalisation for the EU financial sector

An official noted that with digital finance it is sometimes difficult to distinguish the hype from real progress. Many of the issues now on the table were already discussed 20 years ago about the internet. Finance is an area that lends itself very well to digitalisation because almost all services can be delivered digitally, but other aspects such as trust are also important. The brick-and-mortar model has persisted particularly for banks, because meeting advisors physically still contributes to building this trust.

New technologies including big data, AI, the blockchain and the development of apps that provide a great deal of convenience offer new opportunities, but the current digital strategy of traditional banks is often not very advanced, the official believed. In many cases it boils down to enhancing payment and transaction services. The way traditional banks react to the development of new payment service providers challenging one of their few remaining segments is usually by creating their own payment service provider or optimizing their in-house solutions but it is not much more advanced than that. More fundamental evolutions as to how financial services can fit into the new digital ecosystems are being discussed but good answers have so far not been found in Europe. One idea would be that financial service provisions could be an add-on to a wider digital platform offering a variety of services ranging from booking holidays to buying music. With a payment function integrated into the platform the provider would have access to much more data than a traditional financial institution. Combining the data from the platform with financial data would allow the development of a range of models for evaluating credit risk or consumer preferences and would help to develop and offer services in a much more effective and profitable way than at present. The question of what that type of evolution means for traditional banking and the European financial system is still open however. That model exists in China, for example, but has not arrived in Europe yet, because there are regulatory implications that need considering such as GDPR and technology-neutrality. Attempts to create new currencies have also triggered strong reactions in Europe in particular, justified by the systemic questions they raise.

An industry representative observed that digitalisation is both an opportunity and a challenge for the traditional financial sector. Beyond facilitating the access of customers and businesses to financial services, digital transformation plays a critical role for European banks in adjusting economically to the new low interest rate environment. At the same time huge investments are needed to accelerate these innovations and new digital entrants are competing for banks' customers and businesses and their existing profit pools, including in payments. Digitalisation also entails huge challenges for financial institutions in terms of potential cyber security and data protection risks. Another industry representative observed that while new technologies may increase the risk of cyber-criminal activities, they also support the development of more effective tools for fighting financial crime.

An official noted that digitalisation also raises new questions in terms of supervision. Supervisory bodies are mainly populated with financial experts. They also have some IT experts but do not always have all of the competencies required to assess the operational risks associated with new technologies and tend to outsource these assessments to independent experts. At present there are rarely enough people within the financial regulatory and supervisory authorities who can really understand for example how IT operational cloud risk or digital risk interconnect with traditional financial risks or the specific risks that sophisticated algorithms may create.

2. Expected impacts of the Digital Financial Strategy (DFS) on the acceleration of digitalisation in the financial sector

The Chair stated that the European Union is supporting the digital transition as a priority, and is encouraging in particular the financial sector to embrace these trends and seize the opportunities brought by the digital revolution. The European Commission aims to make the benefits of digital finance widely available to European consumers and businesses, based on European values and the sound regulation of risks. To do so, the Commission published the Digital Finance Strategy (DFS) last September 2020.

In this strategy the Commission set out four priorities. First is tackling fragmentation in the digital single market for financial services in order to help consumers access cross-border services and help European financial firms scale up their digital operations. The second objective is to ensure that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency. Then there is creating a European financial data space to promote data-driven innovation. Finally, there is the objective of addressing new challenges and risks associated with the digital transformation. The DFS is accompanied by two legislative proposals, one on crypto-assets, the Markets in Crypto-assets (MiCA) regulation, and one on digital operational resilience, the Digital Operational Resilience Act (DORA), as well as a strategy for retail payments, which is an area where the pace of innovation is particularly fast.

The panellists welcomed the proposals of the DFS, considering that they identify the right priorities for accelerating digitalisation in the financial sector, and highlighted certain priorities among the different proposals of the Digital Financial Package.

An official suggested that, when considering what is happening in other regions of the world, the European financial data space is probably the most crucial element, because what is needed to promote digitalisation is making better use of the vast size of the single market in terms of data. The European financial data space should provide an opportunity to really make use of that scale for financial innovation. That is probably the one area where other countries like China are performing better than Europe at the moment. In China this comes at the expense of other aspects such as data privacy, but Europe should be able to do this in a more trustful way.

An official considered that the main drivers that the DFS identifies for accelerating the digitalisation of the EU financial sector are quite relevant. Removing fragmentation in the digital single market is essential, as well as adapting the EU regulatory framework to facilitate digital innovation and fostering data-driven finance. At the same time the challenges and risks with digital transformation need to be tackled, particularly cyber-risk which could be the next biggest financial stability risk. There are some risks associated with digitalisation, but there is also the need to move forward and what the Commission has proposed is definitely the right direction.

The proposals placed on the agenda by the Commission as short-term priorities for 2021 also seem particularly relevant for facilitating digital innovation in the current context, the official added. On MiCA, work is progressing quickly in a context where cryptoassets are gaining attention. One challenge is finding the right balance between protection and not hindering innovation in this area. In addition there is an upcoming debate on the prospects of central bank digital currency which may affect the core of financial services and thus have significant consequences. On cyber resilience DORA is a major step forward because more investment is needed in cyber resilience. It was not an easy task, but there is now a significant consensus on this proposal that was very well designed. Finally the strategy on payments is heading in the right direction, the official considered. Pan-European instant payment solutions need to be improved and in this regard the European Payment Initiative[1] is of major importance because it proves that incumbents can support the improvement of cross-border payments. It is indeed important to be able to rely on both incumbents and newcomers for achieving this objective and to keep an ability to master the whole value chain in this regard, avoiding excessive fragmentation.

An industry representative agreed that the DFS and its strategic objective to embrace digital finance for consumers and businesses is very welcome and identifies the key critical areas. One of these is data and access to digital platforms. Everyone agrees that data is a core asset in the digital economy, and the benefits of the recent sharing of data on payments as part of the revised Payments Services Directive (PSD2) have been seen. There is no reason why non-financial data should not follow the same path. There needs to be work towards enhancing data sharing and openness across and within other sectors, always in compliance with data protection and competition rules. That openness will bring huge benefits. Large digital platforms should be required to give access to third-party providers under fair, transparent and objective conditions, with financial authorities ensuring that these conditions are respected within the financial ecosystem.

A second critical area is the direct supervision of critical third-party technology providers, in particular for cloud services, which have become essential for banks due to the flexibility and the time to market benefits that they offer. The Commission's DORA proposal which introduces a new framework for the direct supervision of critical third-party providers is welcome in this regard. In the absence of a cross-sectoral digital authority, the financial authorities will be better positioned with DORA to oversee the cloud service providers critical for the financial sector. This oversight can improve the

1. The "European Payments Initiative" is an initiative launched by 31 European banks/credit institutions and 2 third-party acquirers to create a new pan-European payment solution leveraging Instant Payments and cards. This solution aims to become a new standard in payments for European consumers and merchants.

overall resilience of the financial sector and ensure that financial services in Europe have access to the best technology available.

The third aspect that the industry speaker highlighted is the importance of ensuring a regulatory level playing field between non-financial players that are becoming an intrinsic part of the financial ecosystem, specialising in specific areas of the value chain, and more traditional financial institutions. Rules should be the same for the same activities and same risks. That principle is necessary to ensure a fair, competitive and safe landscape. It is important that the European supervisory agencies should assess whether to apply a more proportionate approach across the financial ecosystem activities in order to ensure consumer protection, fair competition and market integrity, and also safeguard the stability and security of the financial ecosystem. It is also important to ensure that traditional players should not have undue constraints from these new rules related to digitalisation.

Another industry representative stated that their organisation – a major stock exchange - welcomes the digital financial package published by the European Commission last year, which is moving in the right direction. It is indeed important that the EU financial services rules should be fit for the digital age, in particular allowing the uptake of new technologies such as cloud services, AI, distributed ledger technology (DLT) and crypto-assets. Allowing the testing of new technologies as with the DLT pilot regime is also important. The rules relating to these new technologies need to be well-designed and strike the right balance between safety, customer protection and innovative possibilities, as was highlighted in recent draft reports published by the European Parliament on these proposals. The speaker also concurred with the importance of ensuring a level playing field between traditional market players and technology companies and enforcing the 'same activity, same risk and same rules' principle in rule-making.

An official noted that the DFS is pointing to very important systemic elements, such as interoperability, and provides an appropriate focus on the digital transformation of the EU financial system, which is very relevant for this sector, where digitalisation is largely underway.

Answering a question from the audience about how digitalisation may help to tackle new requirements such as anti-money laundering (AML) or ESG, an official replied that legislators should endeavour to integrate digitalisation as much as possible in the way regulation is being designed. It would be useful to include in the review of the non-financial reporting directive (NFRD) for example, the idea of how such data should be gathered and with which access. This is also true for other financial requirements such as those concerning reporting, where there are many unnecessary or unwanted overlaps that may be reduced by digitalisation.

3. Expected impact of the DFS on the integration of the EU financial market

An official considered that the DFS should support the integration of the EU digital financial market to a certain extent, first, with the focus put on on interoperability aspects, specifically of data, while respecting data protection rules. A second important element is the emphasis on underlying fragmentation factors such as the barriers created by AML privacy protection and cross-border IBAN issues.

Another aspect is whether the DFS proposals can have an impact on the integration of the European financial market in general. Concerning the achievement of the Capital Markets Union (CMU), the DFS will contribute to this objective for example by helping existing EU capital market legislations such as MiFID and CSDR to adapt to the digital age or by supporting the CMU objectives such as the implementation of a European Single Access Point (ESAP) and the sharing of corporate data. Effective progress in the integration of EU capital markets measured by the effective reduction of cross-border costs however cannot be achieved solely by digitalisation, because the reasons behind this fragmentation are much deeper.

On the retail side, i.e. the capacity for consumers to access cross-border financial services, overcoming the current fragmentation and increasing the use of digital services requires increasing trust in digital financial services and institutions, the official believed. Cyber-security is an important factor here for a large number of customers and is rightly included in the DFS action plan. Interoperability is also important for integrating tools and processes that support the services provided for retail investors and allow a reduction of costs. The objective of developing financial literacy, which is another important element, is not included in the DFS but is part of the CMU.

An industry representative explained that their company is aiming to become the world's best open financial services platform with a strategy hinging notably on the development of a digital native retail consumer business and the launch of a disruptive payment company. At the core of this strategy is the ability to grow the business in a cost-effective way and improve customer experience, which require using automation and AI, while leveraging scale in a sustainable way. There are two very important areas in the DFS that will help to create synergies and economies of scale: the interoperability of digital identities and the principle of passporting across Europe, and one-stop-shop licensing. Those actions will simplify the cross-border operations and enable banks to provide better customer experiences for a larger number of customers, and at the same time create the size and economies of scale needed for growing the business. This will allow the leveraging of what technology and digital disruption bring for achieving a wider scale and size in the current environment.