DIGITAL TRANSFORMATION IN THE FINANCIAL SECTOR AND POLICY IMPLICATIONS

1. Digitalisation trends, drivers and opportunities

1.1 Main trends and drivers of digitalisation in the financial sector

An industry representative stated that digitalisation and technology have been a crucial part of the financial services industry for decades, but some new developments need to be considered. In addition to financial customer data, there is now the possibility and the need to make use of data across industries in order to develop innovative financial service offerings. Today, partnerships are a prerequisite for innovation. For example partnering with cloud service providers (CSPs) on infrastructure and platform allows financial institutions to develop more scalable, robust and stable service offerings for customers.

Another industry representative stated that customer needs and expectations are a major driver of innovation in the financial sector. A recent McKinsey report suggests that banks are being disrupted more by their customers' expectations, than by fintech. Online banking has been widely used for a number of years but a new approach, with new services and capabilities is needed at present to move at the speed that customers are expecting in terms of digitalisation. All major financial institutions have large legacy systems with which it is difficult for them to achieve a proper level of operational resilience and to effectively protect against cyber-risks. Moving to the cloud allows them to respond more effectively to the expectations of their customers, while offering enhanced security, risk management, scalability, availability and resilience. The cloud also enables progressive scaling up to address novel requirements without needing to predict the full extent of future developments. The ability to build out dev-test environments moreover facilitates the creation of new business models, which allows a faster response to customer requirements. Working with financial institutions so that they can achieve their business goals is a key focus of the speaker's firm, a major CSP, however the regulatory environment can be an obstacle in certain cases. The industry representative finally noted that COVID has accelerated the movement to cloud services and that financial institutions that had been using cloud services for some time were able to adapt more easily to the changing remote working environment due to COVID and could more easily scale up their online activities.

A policymaker agreed that although an adjustment in business models would likely have happened anyway, the pandemic played a role in accelerating transformations both on the demand and supply sides.

A third industry representative concurred with previous speakers that developments in digitalisation and awareness about the importance of data in finance are not new, but they are accelerating. Technology and finance are converging and the scale of technology use is increasing in line with increased demand.

An official agreed that the digitalisation of the financial sector is driven by demand and supply factors such as customer requirements, particularly those of digital-native consumers, competition from newcomers such as fintechs or big techs going into new fields of business and the efficiency gains that the technology enables.

A fourth industry representative stated that evolving needs of clients are inevitably driving improvements in financial products and services, the benefits of which can be seen across the financial sector with the progressive integration of new technologies such as blockchain and artificial intelligence (AI). The pace and embrace of digitalisation however differs greatly across jurisdictions. According to a recent study by the Cambridge University Centre for Alternative Finance, the World Bank and the World Economic Forum, growth in the EU's broad fintech and digital-finance sector is lagging significantly behind the US and China, alongside digital payments, lending and capital raising sector growth. EU policymakers should prioritise reversing this trend by cultivating and supporting a proportionate regulatory and supervisory ecosystem that may allow financial firms to make the most of digitalisation.

1.2 Opportunities associated with further digitalisation

An industry representative outlined examples of new opportunities offered by the use of technology and data analytics in the financial sector. At a moment when manufacturing industries are starting to transform their business models offering products such as machinery or cars as a service, it is essential that financial services institutions are able to incorporate their services into these new business models. Instead of selling a product once, there is a permanent cash stream around which financial services can be proposed, as customers pay whenever they use the product. This also reduces balance sheet size and capital outlays for customers and avoids incurring depreciation expense. Customer data can also provide vital information if appropriately processed. In March/April 2020, a great deal of companies were seeking liquidity and additional credit lines. Three or four months later, many treasurers realised liquidity needs were lower than originally thought. State-of-the-art AI, machine learning and data analytics would have provided these customers with more precise insights for adjusting their liquidity needs. A further area where technology can support innovation in the financial sector is central bank digital currencies. These should allow the achievement of efficiency gains particularly in peer-to-peer payments in the inter-banking-payment area, as these cross-border payments could be massively accelerated, reducing inefficiencies and improving the cost-income ratio of financial institutions.

A second industry representative considered that new digital currencies will need to be assimilated into

the current financial infrastructure and use cases. It is not yet clear how current protocols will need to be adapted to leverage these new technologies, but progress is needed in that area, in part because the existing financial system is relatively fragmented. Digitalisation offers many new opportunities in terms of efficiency and synergy gains within the EU and more internationally that need to be taken advantage of. A policymaker emphasised the previous point on fragmentation. Digitalisation can help to reduce fragmentation in the financial single market and globally with the progressive emergence of an ecosystem leveraging the capabilities of financial institutions and fintechs.

A third industry representative commented that digitalisation provides 'a myriad of opportunities' in the asset management value chain in particular. There are two clear priorities for the sector: open finance, which is the extension of open banking principles to a broader range of financial products and services, and the tokenisation of assets, including investment funds, enabled by distributed-ledger technology (DLT). Open finance can give European consumers more control over a wider range of their financial data, provide consumers with an aggregate view of all their financial information, liabilities as well as assets, in a consolidated manner, and significantly improve the financial planning and investment opportunities of customers, particularly those who are underserved and underinvested. As for tokenisation, it can improve client onboarding, particularly through the use of digital IDs or security profiles, and reduce costs and frictions associated with client servicing such as subscriptions and redemptions.

The industry representative added that open finance and tokenisation taken together could help to make a step change in terms of financial planning and investment and contribute to unlock historic levels of uninvested cash in the European market to the profit of the European economy. The European Central Bank (ECB) estimates that euro-area citizens have accumulated an additional €540 billion of excess savings over the course of the pandemic while investment rates remain at a record low level. With the EU's post-recovery plan still to be funded, the EU must find ways to make investing easier, safer, cheaper and more efficient and digitalisation and the digital finance strategy have a key role to play in this regard.

2. Main regulatory challenges associated with digitalisation in the financial sector

An official explained that different regulatory issues need to be tackled for accelerating digitalisation. The increased pace and scale of digitalisation require more flexibility and speed on the regulatory side, as well as new competencies. It is important indeed that the regulatory side is able to fully understand and anticipate technological developments that may affect the financial sector, in order to avoid lagging behind evolutions in the business. However it is difficult for regulators to rival with the private sector for the hiring of the proper profiles.

The Commission should also be in a leading position in terms of policy-making in this area, because digitalisation provides opportunities to move towards a more unified financial market. For example fundamental reforms in areas such as e-identity, are needed.

A public representative noted that, at the beginning of the pandemic, the use of digital financial applications increased by more than 70% in Europe in only 10 days. This can be alarming from an customer protection perspective, because it shows that the market tends to move very fast and that regulators might be outpaced by such evolutions. Many digital developments in the financial sector however also have positive implications in terms of customer protection. Outsourcing to cloud service providers (CSPs) for example provides more efficiency for the financial industry and also allows better protection from cyber or operational risks. Blockchain technology is a second example. Often associated with cryptocurrency, it can also play a key role in the improvement of KYC solutions or real-time payment processing.

The public representative also emphasised customer protection issues associated with digitalisation that also need considering. The use of AI for financial services can boost innovation but it is important that its social and ethical aspects are well understood by regulators, which requires a constant monitoring of transactions using AI and of customer behaviours. Finding the right balance between fostering innovation and not invading the personal data of every customer is also currently an active topic in the European Parliament. AI might also lead to changes in the labour market. A further source of innovation that needs to be considered from a customer perspective is the digital euro project that the ECB has launched in July 2021 for a trial period. Regulators can attempt to act quickly to address these different changes, but this requires a great deal of monitoring. A key aim in this perspective is the creation of futureproof legislation. The Digital Operational Resilience Act (DORA) is a good example of this, where Europe is in a leading position. Europe is good at exporting standards and norms and it is hoped that this will also be possible in the data and operational resilience space.

An official added that there is a need for financial regulators to master the new risks created by increasing digitalisation concerning data privacy, data protection and data uses, as well as increasing cybersecurity threats in this context because there is no effective market response to these increasing risks. Although cyber insurance can help, it is first essential to diminish risks and the consequences of potential cyber-attacks. DORA is an important step forward in this perspective and it is hoped that a general agreement can be achieved on this legislative proposal by year end.

3. Regulatory priorities associated with digitalisation

3.1 Ensuring consumer protection and risk mitigation

An official considered that the main role of regulators is to identify the actions required to ensure financial stability and consumer protection, without trying to master all the aspects of technologies, because that is out of reach for them. Legislative processes

should also be reconsidered in the light of increasing digitalisation because they are too lengthy at present. By the time Level 1 discussions are completed, which may take 2 years or more, underlying technologies or their use might have evolved. More flexibility should therefore be introduced in the regulatory process particularly when the changes needed are limited, for example through no action letters being given to the Commission or European supervisors.

A public representative stated that the main focus of the European Parliament in the area of digitalisation is to ensure that consumers' interests are taken into account and to guarantee consumer protection. Two key aspects of digital transformation are being considered in this perspective in terms of regulation: cybersecurity and digital identities. Concerning cybersecurity, there is active work underway on DORA in the Parliament to ensure that all actors operating in the financial sector are covered by the legislation, taking into account the increasing trend of services outsourcing. The fact that DORA notably includes an oversight framework for some critical ICT providers, including major CSPs is essential from a customer protection perspective. The Network and Information Security (NIS) directive, the European cybersecurity directive, is also being updated, with new sectors being added. The new regulation will apply in the same to companies of all sizes, which may be challenging for the industry but offers more protection with a higher general level of oversight. Massive cyberattacks on important institutions and entities all over the world are taking place on a daily basis, so updating the directive in that direction is crucial. Efforts on cyber-security should not be restricted to Europe however, because cyber-risks have a worldwide impact.

3.2 Reducing fragmentation in the EU digital finance market

An industry representative stressed that their organisation, a major CSP, is in favour of an increased harmonisation of regulations. Their customers operate in many different jurisdictions and there is now a worrisome trend towards fragmentation of the regulations concerning new technologies and data in particular at the international level, which is increasing the burden for financial institutions. Progress within the Financial Stability Board (FSB), in terms of exploring a coherent, cross-border regulatory framework, is encouraging however. DORA, which proposes a unified way of examining and supervising significant technology providers in the financial services industry is also a step in the right direction. It is important that players of different sizes can prove that they can work within the risk tolerances, capabilities and requirements for stability, security and resilience. However standards should be aligned at the international level so that regulatory processes are not duplicated. Such a level of regulatory consistency has been achieved in the derivatives market after the 2008 financial crisis, therefore it should be feasible in the digital space.

A second industry representative considered that the EU Digital Finance Package is a timely response to the opportunities and challenges created by digitalisation, however there is a sometimes restrictive interpretation of sovereignty, introducing challenges in certain proposals, such as DORA, that need addressing. Some stakeholders indeed suggest that measures need to be taken in the regulatory requirements to retain European digital sovereignty and sometimes even retain Member State sovereignty on these issues. That would lead to more obstacles being put in front of technological developments for European companies, which are already lagging behind those in the US and China. Instead of a narrow interpretation of digital sovereignty, that would require building separate EU infrastructures from scratch, the sovereignty debate and digital regulation more broadly should also take into account the opportunities offered by the single market and the broader global market. In Europe, a consistent, innovation-friendly regulatory framework that overcomes country-specific regulations should be the way forward.

The industry representative suggested a number of policy priorities that would support further digitalisation across the EU in this perspective. First, is a KYC process leveraging electronic identification and verified data. After a customer has gone through the process of identification, one company could bequeath that certificate to others. Secondly, the creation of a single European rulebook focused on outcomes rather than individual technologies would encourage innovation by providing companies with more flexibility. Thirdly, Europe could encourage a holistic B2B2C approach regarding secure data management across industries, allowing trusted collaboration between companies, while ensuring that General Data Protection Regulation (GDPR) requirements are respected for consumers.

A public representative agreed that efforts should be made to overcome market fragmentation in Europe. Digital identity solutions are one of the key steps to remove fragmentation in the financial services market across member states while also protecting consumers. This should be facilitated by the electronic Identification, Authentication and Trust Services (eIDAS) regulation, which is under discussion and will support cross-border ID services. A new proposal for a regulation on digital identity is also being developed at the European level, aiming to improve security on a cross-border level with an extended scope. An industry representative agreed that initiatives to establish a true European digital ID are essential for supporting the digitalisation of the European financial sector. An industry representative stressed the importance of improving the cross-border coherence of regulation. Technology and finance are becoming truly global and as a result more difficult to supervise, because at present there is no global regulator or supervisor. This highlights the importance of pursuing convergence across national or regional supervisory groups in Europe and also with the US and Asia.

3.3. Ensuring a level playing field across entities operating in the financial sector

An industry representative suggested that the appropriate way to regulate tech entities operating in the financial sector still needs to be defined considering the features and impacts of entity-based prudential regulation and activity based regulation. Banks are regulated as holistic entities with prudential

requirements applying to all their activities, whereas tech companies are regulated in an activity-based way, which may create level playing field and also financial stability issues. Technological advancement should also be reconciled with some of the regulatory priorities in the EU, such as the Capital Markets Union (CMU), so that digital companies develop in a way that can support on-going objectives in the European financial sector.

An official agreed that the regulation of tech entities is challenging, in a context where an increasing number of newcomers, both fintechs and bigtech entities, are focusing on certain activities of the financial value chain. There needs to be a level playing field between entities covering a wide range of business, such as banks which are subject to prudential requirements for all their activities and tech entities focusing on specific activities. Level playing field issues also need to be tackled concerning data. More data can help to provide clients with better services, but there needs to be sufficient reciprocity between different data sources. The Payment Services Directive (PSD2) in particular creates an unbalance between banks and fintechs to the benefit of the latter. It would be preferable to regulate the use that is being made of the data. The European financial data space project represents an opportunity for considering this.

3.4. Supporting developments in the area of tokenisation and open finance

An industry representative stated that their organisation is strongly supportive of the European Commission's Digital Financial Strategy, which has the capacity to deliver new opportunities for European consumers and help to encourage more investment to the benefit of the post-COVID economic recovery. The Commission's proposal to create a pilot regime for market infrastructures based on DLT is welcomed in particular and should include UCITS, as proposed by the European Parliament. Policymakers should however go further in two areas, the industry speaker believed. The first area is the tokenisation of assets, including investment funds, for which an efficient and robust ecosystem needs to be established. Co-legislators are encouraged to consider the benefits of including exchange-traded products and alternative investment funds within the scope of the DLT pilot regime in order to take advantage of the potential of tokenisation in the asset management space. Secondly, the industry representative acknowledged that the regulatory agenda on open finance is moving, since the European Commission announced its intention to come forward with a legislative proposal by mid-2022, but considered that this is too slow. In addition care must be taken to appropriately consider the needs of the industry in the course of this legislative process.