SESSION SUMMARY - BERLIN SEPTEMBER 2020

How to support effective digitalisation of EU finance

1. Main impacts of digitalisation in the financial sector

1.1 Benefits of digitalisation

An industry representative explained that digitalisation has radically changed the cost structure of retail banking. Fully digital banks operate a cost structure that is a tenth of a traditional bank and thus are able to provide retail banking products at a much lower price point, offering their customers better value for money and increasing competition in the market. The lower fees charged by digital banks also increase returns on investments for retail customers. Technology moreover facilitates the access of customers to banking and investment services with convenient apps, allowing a wider proportion of the population to create future wealth.

Another industry representative stated that the banking business of the future will be technology driven. Technology can improve the profitability and cost-income ratio of all types of financial institutions, increase their flexibility and also facilitate the fulfilment of regulatory obligations such as anti-money laundering and know-your-customer rules (AML and KYC). With digitalisation, financial institutions can also provide customers with better value for money and develop their activities more easily on a cross-border basis.

A third industry representative emphasized that technology can 'democratise' the access to the financial market and allow smaller financial institutions to compete with the larger ones. There is however the need for a level playing field in the market for all types of institutions to be able to compete.

An official suggested that demand factors also need considering. Digitalisation is changing behaviours and needs in the whole of society. The demand of customers is evolving and the way financial services are provided also needs to change as a result.

Another official added that technology helps to improve customer service and also the agility of the sector, with the development of fintech companies. There are also huge opportunities for digital inclusion and financial literacy that need to be considered, because more vulnerable sectors of the population should not be ignored in digitalisation efforts.

1.2 Technology as a driver of innovation and performance

An industry representative explained that the cloud is a major driver of digitalisation in the financial sector. Their company, a digital bank, has run its activity entirely on the cloud since its outset and this has enabled it to scale up. More generally technology has moved from being a cost factor to a key success factor for the financial industry. In 10 years' time, the banks with the best technology will win. Traditional banks are aware of this but have not yet fully implemented technology-based solutions because they still have many traditional customers and legacy systems.

Another industry representative agreed that, with the evolution of technology and financial institutions becoming more familiar with technology and cloud services in particular, the focus concerning the use of IT in the financial sector has moved from cost optimisation to leveraging technology for innovating and increasing resilience. Moving their activities to the cloud allows financial institutions to re-think their operating model, implement cost-saving measures and increase security. This enhances their ability to innovate, improve end-user experience and adapt to market changes. Cloud services also help traditional financial institutions to address the challenges raised by their legacy systems, which prevent them from using effectively machine learning (ML) and artificial intelligence (AI) technology and obtaining appropriate insights from data. Implementing these new technologies can lead to significant improvements in the end-customer experience and to differentiation with competitors, which is why they may be so transformational for the financial sector. These developments are however still at an early stage.

1.3 The prospects of future technological developments

An official asked if there is a new technology still in development that might bring a significant change to the world of finance and banking in the near future. An industry representative suggested that quantum computing could be a possibility, but it is still in the early stages of development. Quantum computing could notably improve performance agility and allow ML and AI to be used in a faster and more cost-effective way. Blockchain is another technology with strong potential, but it is already in use.

Another industry representative felt that finding the new technology with the most potential is not the issue. Although quantum computing might accelerate analyses even more in the future, high-performing technology is already available. The question to address is rather whether currently available technologies are appropriately used in retail banking and how to do so effectively in the present regulatory environment. The industry should not wait for the great technology likely to radically transform retail banking or financial services. Companies need to work with the technologies they have at their disposal and regulators should develop the frameworks that may support the use of these technologies. Many pending issues can potentially be addressed with existing technologies. This includes AML and KYC for which video and photo solutions have been available for a long time. Card fraud is another major topic in Europe for which there are solutions. Through knowing the geolocation of a smartphone and the location of a transaction, a multitude of frauds can be avoided. The industry needs to provide regulators with more data and information on these systems, which are not really high tech, in order to demonstrate their effectiveness, the industry representative suggested.

2. Digitalisation partnerships

An industry representative stated that financial institutions need to establish partnerships with technology providers

and platforms, as other industries have been doing for some time. This is the condition for enhancing and accelerating the digitalisation of the sector and implementing effectively AI and ML solutions in particular. The Covid crisis also shows that the trend from ownership to consumption is due to accelerate. This is a challenge for financial institutions, which are used to managing their own developments, and also for their regulators. However financial institutions have demonstrated their capacity to react quickly and adapt to other challenges, such as low interest rates or the situation created by the pandemic. In addition, banks should focus on their core financial activities, serving their customers and helping companies to implement their future business models rather than on developing new technologies.

An official agreed that partnerships and importing technologies will be essential for the successful digitalisation of the financial sector. Building everything in-house is indeed impossible and innovation is happening now in the technological sector rather than in banks. As a result financial business models will need to evolve towards more openness, and financial regulation will need to be adapted. This may also put some pressure on the revenues and profits of the financial sector. The increasing role of third-parties may also create new risks that need to be clarified and carefully monitored. This issue is being addressed by the Commission in the Digital Operational Resilience Framework for financial services currently being prepared.

The industry representative suggested that some resources could be shared across industries and countries for supporting digitalisation. For example, a cross-industry and cross-country digital identity system leveraging technology could be developed. All industries, including the financial sector, are indeed faced with frauds such as attempts to hide identities or execute fake payments that require AML, KYC and CFT (combatting the financing of terrorism) verifications. These could be shared through the use of a common utility and shared identity verification system, which could cover both individuals and corporations and reduce duplicate investments by multiple organisations in these capabilities.

3. Policy priorities put forward in the new Digital Finance Strategy for the EU

A policy-maker stated that digital technologies are a key driver for rebuilding the European economies and ensuring a transition to more sustainable growth. A policy paper on how to shape Europe's digital future[1] was issued earlier in the year by the Commission, covering all sectors of the economy. Additional targeted initiatives are being prepared for implementing this overarching strategy in different industry sectors. Concerning financial services, a Digital Finance Strategy[2] will be issued by the end of September proposing measures for supporting the digitalisation of the sector in 4 different areas. In doing so, the Commission will pay particular attention to the provision of new opportunities for consumers and to their protection and also to the international consistency of the standards developed.

- **Tackling the fragmentation of the Digital Single Market for financial services:** The objective is to make it easier for European financial firms to operate cross-border and scale up their digital operations and for European consumers to access cross-border services digitally. This will require a harmonisation effort building on previous initiatives conducted notably in the banking sector for harmonising prudential requirements or centralising supervision. Further work is needed on AML in particular. Differences in consumer protection approaches across member states remain a challenging area and are unlikely to be addressed in the short term, but should be considered for the future.
- **Ensuring that the EU regulatory framework facilitates digital innovation in the interest of consumers and market efficiency:** EU financial services legislation and supervisory practices must be regularly examined to ensure that they remain relevant with rapid digital innovation. Additional rules are also needed in certain new areas. One is crypto-assets that qualify as financial instruments, for which interpretative guidance on the application of existing rules will be provided. A pilot regime will be designed to support the uptake of financial applications based on DLT (digital ledger technology). The use of other technologies such as AI in the financial sector will also be considered. The general policy framework proposed for AI[3] earlier in 2020 will serve as the basis for more targeted rules in the financial sector.
- **Creating a European financial data space to promote data-driven innovation:** This action will build on the cross-sectoral European data strategy[4] proposed at the beginning of 2020, with measures for enhancing the access to and sharing of data within the financial sector. Progress has been made in the payments area, where the EU has led the way in opening up data sharing, but the objective is to go further and foster more data-driven innovation in the financial sector. The aim is to facilitate real-time digital access to all regulated financial information and to encourage business-to-business data sharing, as well as the implementation of innovative IT tools for facilitating reporting and supervision.
- **Addressing new challenges and risks associated with the digital transformation:** This area focuses on the measures needed for mitigating potential risks associated with digitalisation, notably cybersecurity and data protection. A new legislative proposal on operational resilience is being prepared. Adaptations that may be needed to existing financial legislations in order to take into account the impacts of digitalisation are also being examined. Particular attention will be paid to the principle of 'same business, same risk, same rules' in order to safeguard the level playing field between existing financial institutions and new market entrants.

4. Views expressed on the policy priorities for supporting digitalisation in the financial sector

Several speakers suggested that the actions of the EU authorities concerning digitalisation should focus mainly for

[1] https://ec.europa.eu/info/publications/communication-shaping-europes-digital-future_en

[2] https://ec.europa.eu/info/publications/200924-digital-finance-proposals_en

[3] https://ec.europa.eu/info/sites/info/files/commission-white-paper-artificial-intelligence-feb2020_en.pdf

[4] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020DC0066&from=EN

the time being on the gaps left in regulation and on addressing regulatory fragmentation.

4.1 Addressing regulatory fragmentation across the EU

An industry representative stated that EU banking regulations allow digital banks, such as theirs, to operate throughout Europe, but they still face many domestic obstacles, which impact their competitiveness. Harmonisation efforts are being made in the EU, but differences subsist across domestic requirements and the way they are executed because supervisors tend to consider that their market is specific. One example of this is KYC requirements that differ significantly across EU member states. Another example is IBANs. The intention of the IBAN system is for EU citizens to be able to use the same IBAN for payments and transfers throughout Europe, but at present German IBANs are not accepted in France for instance by large mobile phone companies or cannot be used for receiving a salary. This means that it is very difficult to scale up a company to being a large tech player in the EU, unlike the US, where fintechs can more easily market their products across the whole country and leverage economies of scale, even though regulation also differs to a certain extent across US States. The problem is that at present there are a limited number of institutions operating cross-border in the retail space, therefore domestic regulators do not see the need for changing their rules. In addition financial regulations are based on detailed rules that apply to financial activities or entities and each country has a different way of approaching these. More flexibility would need to be built into the regulation, e.g. with a stronger focus on targeted outputs or principles, and more consideration should be given to the opportunities associated with the development of cross-border financial services across the EU.

Another industry representative agreed that there is a need for further harmonisation of European regulation and that regulation should be as much as possible principles-based in order to allow more flexibility and innovation. The delay of regulatory approval is another issue that needs to be considered because time is of the essence when launching new products or services. It is hoped that initiatives such as the Capital Markets Union (CMU) can reduce market fragmentation and support the diversification of financing in the EU. Digitalisation can also play a role in supporting these integration efforts.

4.2 Ensuring security in the context of digitalisation

An official noted that security is also an important consideration in the context of digitalisation. Cyber-security initiatives are in development in the EU but there is less discussion about the potential systemic risks related to the development of technology. Regulation and supervision are very sector oriented, but the financial sector is interlinked with telecommunications and energy networks for example. Cross-sector aspects should be further considered in legislation, as well as in crisis management arrangements and non legislative actions such as joint testing and scenarios. The Digital Operational Resilience framework for Financial Services proposed by the Commission is also extremely important in this perspective. Cooperation and information exchange between all levels of authorities should be included in this approach. Financial infrastructures should also be considered as critical infrastructures in EU frameworks, which is not always the case at present. It is also important to reflect crisis management arrangements in the Digital Finance Strategy now being prepared.

Another official asked if there is a need to respect national specificities in this context, given that by nature digital risks are borderless. The first official replied that although incidents can happen in many places at the same time it is difficult to have a 'one* size fits all approach', because there will be local consequences as well, so local authorities should be involved in the preparations and they also need to consider their own national security issues related e.g. to their geographical location. However, these national considerations should not be used to hinder cross-border business or competition. A balance between national and EU-level issues should therefore be sought in this regard.

A third official stated that the approach to risks such as the potential misuse of data and cybersecurity has to be flexible because they interact with many social norms and other legislative areas that may differ across the EU. The policy framework should also retain appropriate protections for consumers.

4.3 Balancing risk mitigation and innovation objectives

An official emphasized that the pace of development and innovation is very fast in the digital space within and outside the financial sector and that it is very difficult to predict how digitalisation will develop in the financial sector. The aim is to provide a sound regulatory framework that is able to evolve over time. In setting out priority issues for the coming years, the Commission has recognised that it is an evolutionary process. Whether the appropriate legislative and regulatory frameworks are in place should be constantly questioned. Another important point is that an appropriate balance should be sought in regulation between risk mitigation and customer protection objectives and the encouragement of innovation. Innovation must not be stifled indeed, because the most agile companies with the latest developments in technologies are essential for providing a fast response to adverse changes in the economy such as the one experienced with the COVID crisis. Engagement between the public sector and industry are particularly important in this perspective and tools such as the innovation hubs that have been introduced by several member states can help. Supervisory architecture should also ensure a level playing field across the member states and across different sectors of the financial industry.

An industry representative agreed that the innovation cycle is accelerating. Putting in place the appropriate policies for supporting this development is essential, as well as ensuring their consistent implementation throughout the member states. Exchanges of views between the digital industry and regulators are important in this context and should be further developed. ■