

# Digitalisation trends and policy approach

---

## 1. Digitalisation trends and drivers

---

The Chair stated that digitalisation impacts all financial activities, steps in the financial value chain and players involved. In some cases it disrupts existing market structures and value chains, in others it is absorbed by the existing players. For regulators and supervisors, the challenge is striking the right balance between openness to innovation and mitigating the potential risks from digitalisation for customers and the overall financial system.

A regulator suggested that technological disruption supports three different developments. First is the emergence of new products associated with new business models such as decentralised finance (DeFi) and cryptoassets. Second is the emergence of new digital distribution channels and production processes for the delivery of traditional financial services. Third is the emergence of new players in the financial market, such as fintechs and bigtechs.

An industry representative remarked that customer needs and expectations are the main driver of digitalisation. Customer demands are evolving and digitalisation can help to better meet these expectations. Customers expect a wide range of channels to access financial services including digital channels, services that are easy to use, convenient and accessible anywhere at any time, as well as maximum security and safety. Regulation is a second important driver of digitalisation, as an enabler of data sharing. The upcoming open finance framework notably should facilitate data sharing with the implementation of new data sharing and API standards. Care must be taken however that regulatory requirements do not hamper innovation.

A second industry representative agreed that customer expectations are a key driver. Digital innovation is continuous within financial institutions because customer expectations are evolving and they need to respond to these evolutions. Technologies will also continue to evolve, providing financial institutions with new opportunities to respond to customer expectations. Quantum computing in particular should be a major driver of innovation in the near future.

A third industry representative stated that digitalisation has also helped market infrastructures such as CSDs (Central Securities Depositories) to innovate and seize new opportunities, while preserving operational resilience. For example the French securities market has been dematerialised for many years, which has improved efficiency. New technologies can also be used for addressing new challenges related to data. The collection of ESG-related data for example is going to be a significant challenge for the industry that can be supported by digital tools.

## 2. Benefits and challenges from digitalisation

---

### 2.1 Main benefits from digitalisation

An industry representative noted that technology, and cloud computing in particular, enables financial firms to enhance customer experience and customer interaction. The result is that now very few customers still regularly go to bank branches. Technology also allows financial firms to improve risk management, especially against fast-evolving cyber-threats such as distributed denial-of-service (DDoS), ransomware and state-sponsored attacks. Cloud computing also provides a higher level of cyber-resilience due to the level of security put in place by cloud service providers (CSPs). A third benefit of digitalisation, which partly relates to the second is a higher level of operational resilience and business continuity, as seen during the Covid crisis where technology supported remote processes.

A second industry representative emphasized that digitalisation helps financial services firms to achieve better outcomes for individual consumers and also SMEs and larger enterprises. Technology can for example support more effective and sustainable credit processes with new payment options and tools to allow customers to manage their finances responsibly, which contributes to driving down costs and better allocating capital across the economy. In this respect, two technologies – open banking and artificial intelligence (AI) – have the potential to bring significant customer value. Open banking allows for accounts to be verified and fraud to be tackled more effectively and supports more dynamic underwriting. Open banking also facilitates access to financial services for example with financial services embedded in e-commerce platforms, which saves customers' time and money. Artificial Intelligence (AI) should also be a key driver of innovation and improvement in the financial sector in the future, for example allowing financial institutions to proactively inform their customers of a reduction of interest rate or to better tailor products to customer needs.

### 2.2 Challenges and risks from digitalisation

A regulator noted that digitalisation will be beneficial to customers and the financial industry, as far as the related risks are appropriately managed. Four main types of risks from digitalisation can be identified. First is the risk of exclusion. Enhanced data-driven risk assessments e.g. for insurance or credit attribution might lead some riskier customer categories to be systematically excluded or charged excessive prices. While charging higher prices for higher risks is normal, this raises questions about the nature of insurance activities going forward, whether risk pooling will still exist and what the consequences of such

evolutions could be. Another type of exclusion is digital exclusion for customers who are not capable of using digital tools appropriately or who do not want to share data because of privacy concerns. Different access channels need to be maintained because the financial system needs to be inclusive.

A second risk is price optimisation and abusive sales practices. Price optimisation involves using AI technology for pricing on the basis of elements that are not relevant from a risk perspective. Data analytics can for example allow financial firms to assess the price sensitivity of different customer segments and raise prices for those who are less likely to leave if there is an increase. This can lead to significant price discrimination for similar services, which should be avoided. In addition, there can be quite aggressive sales practices in online environments with the role of social media and influencers in particular, which may lead to mis-selling.

A third risk is financial stability risk due to the possibility offered by technology to quickly scale-up a business, which can lead to concentrations of risk or to possible spill-over risks within diversified tech companies or multi-activity groups providing a range of different services. It is uncertain whether current regulation is sufficient to deal with such risks. This is currently being assessed by the European Supervisory Authorities (ESAs).

A final risk concerns supervision. The current approach which is technology-neutral and applies 'same activities, same risk, same regulation' principles is well suited for addressing digital evolutions in the financial sector. However digitalisation also leads to an increasing number of companies selling products and services remotely with no local branch on the basis of the freedom to provide services provisions. If there is a problem of mis-selling for example it is up to the home supervisor to act but if this is not done effectively or fast enough, there should be the possibility for a European supervisor to step in. The importance of this issue is due to increase as digitalisation develops.

An industry representative noted that some technologies such as distributed ledger technology (DLT) are also bringing new challenges. Their potential impact needs to be appropriately evaluated as well as the possible implications in terms of regulatory framework. The DLT pilot regime should allow to do this and to test in production what the technology can bring to the market.

### 3. Update on the European policy approach to digitalisation

A policy-maker stated that digitalisation is profoundly transforming the way the financial sector works and also the way consumers approach financial services. There are different opportunities, and also challenges and risks associated with these evolutions. Digitalisation may accelerate the fragmentation of the single market in certain areas. There are issues around how to foster digital innovation and deal with data sharing at the European level. The challenge is providing a regulatory framework that will support these evolutions

adequately. A Digital Finance Strategy was adopted in 2020 and was completed by horizontal measures concerning data and AML. Several additional legislative texts have been adopted since 2020 covering different areas of digital finance. The DLT pilot regime has been in application since March 2023 and provides a sandbox approach that allows securities firms to use DLT for trading and post-trading activities following specific rules. With MiCA (the Markets in Crypto-Assets regulation) a comprehensive framework has been provided for cryptoassets, stablecoins and the related service providers. The Digital Operational Resilience Act (DORA) will enter into application shortly. Proposals are also being prepared for the revision of Payment Services Directive 2 (PSD2) and open finance. Work is also being conducted on the digital euro. The legal framework for the digital euro will be proposed by the Commission, but the decision on whether to issue it will be taken by the ECB.

Three additional aspects are being closely considered by the Commission in the digital finance space, the policy-maker stated. The first is supervision, both at the domestic and at the cross-border levels, since many digital operators are active cross-border. The second is digital inclusion. Financial education will help, but there is a need to be mindful of citizens who are less digitally adept. Moreover, there is also the international dimension. There is supervisory and regulatory work taking place at the international level on many topics of digital finance such as cyber-resilience and crypto for which consistency is needed at the international level.

## 4. Issues to consider in further steps of the regulatory approach to digital finance

### 4.1 Conditions for a successful regulation of digital finance

The panellists highlighted a certain number of conditions that are important to meet for a successful regulation of digital finance notably in terms of focus on data, proportionality, collaboration between regulators and the financial industry.

An industry representative suggested that it is critical for digital finance regulation to be centred on data usage and data sharing. From that perspective, two important legislative proposals are expected in the coming months: the upcoming open finance framework and the review of the PSD2. The aim should be to enhance competition within the EU financial services sector while maintaining a level playing field among the different players concerned. The AI Act is also very important in this respect. The industry speaker moreover called for proportionality in the regulation applying to digital finance, as well as the promotion of mobility and choice among financial services and products.

A second industry representative emphasised the importance of collaboration between the authorities and the financial industry in the development of

regulatory frameworks and technical standards, with the objective of ensuring that the learnings of earlier regulation and the conditions for a successful implementation of the regulation are taken into account in the drafting of legislation. A second issue is the overlap of regulations, although this is not specific to digital finance measures. Matching DORA, AML and GDPR requirements at the same time is quite challenging for banks, which may need the support of supervisory activities to ensure the implementation of these different rules in an efficient way. The harmonisation of regulatory frameworks is a further aspect to consider the industry speaker suggested. A harmonised regulatory framework is needed for building an effective digital finance ecosystem, but the differences between different markets and countries in terms of digitalisation of financial activities or usage of cash also have to be factored in. Combining harmonisation and an understanding of the differences across markets is very important. Another important element for the success of future digital initiatives is the EU e-ID which needs to be appropriately developed.

The Chair observed that customer protection is another important dimension to consider. For example in the digital world, the reverse solicitation of retail customers should be banned because it is too risky.

#### 4.2 Speed of digital innovation

The Chair remarked that the speed of innovation is a challenge for the regulation of digital finance, because by the time the legislative process is finished, the world has already changed to a certain extent. A policy-maker noted that that is not unique to Europe or to digital finance. Regulators are always slightly regulating in retrospect, and that is inevitable because democratic legislative processes and Level 2 standard setting take time. What can be done is trying to have frameworks that are as flexible as possible, and anticipate the fact that there will be further evolutions in the market that may require a review of the legislation. For example, in MiCA there is a need to further consider decentralised finance (DeFi).

A public representative suggested that while there is a temptation to change the regulatory and supervisory approach with digitalisation, this should not be done in haste. The correct approach with continuous evolution is to keep a steady pace in the legislative making process. A regulatory framework that stays in place for some time provides predictability and stability for the industry and also for the public authorities who have to supervise the implementation. For example, many events happened in the crypto market over the last months, when MiCA was being finalised, including the failure of certain major cryptoassets and crypto service providers. Some were calling for these issues to be taken into account in the negotiations, but that is not the way to proceed. There should be a longer term view about the objectives of the regulation, its potential benefits for different stakeholders and how it can be effectively implemented. However if there are some systemic problems or threats of the scale of those that emerged during the 2008 financial crisis, then the regulatory framework has to be rearranged.

The public representative added that while it is unlikely that the European legislative process can be significantly accelerated, what could be considered is moving towards a more principle-based approach to regulation. That could help legislation to adapt more easily to changes in the market than the current prescriptive approach with rules addressing issues that happened in the past. Much more could be achieved that way with a more future-proof perspective.

An industry representative suggested that an outcome-based regulation can indeed be more effective because businesses then have the opportunity to find different ways to achieve the outcomes defined by regulation while focusing on common objectives.

#### 4.3 Adapting regulation to industry evolutions triggered by digitalisation

An official emphasized that many stakeholders convey a complacent view to regulatory changes, considering that issues raised by new products, players and production processes supported by digitalisation can be addressed with a slight adaptation of the current framework. That is a first step, but is not sufficient in all cases. For example, regarding new products, the AML/CFT standards were successfully adapted to incorporate the new crypto-related service providers. However, that is not enough for tackling these risks in a decentralised finance (DeFi) environment, in which accountability is difficult to determine. A new regulatory approach is needed in this case, that allows the identification of the people or entities in charge of those platforms or the focusing of certain regulatory actions on the actual users of those platforms.

When it comes to new production processes, there is an increasing challenge posed by the reliance of traditional financial institutions on the services provided by certain new entities, especially CSPs that operate on a global scale. The current rules for outsourcing and operational resilience are not fit for purpose to tackle the risks posed by those third party providers which have become critical to the financial sector. The concentration of this market and the dependencies created require that rules focus not only on the financial institutions outsourcing those services but also on the providers of those services. From that perspective, the DORA approach is relevant, but it does not provide a global response. The services provided by CSPs to European financial institutions are typically provided from outside of the European Union. That means there is a limit to what the EU DORA legislation can achieve by just regulating activities in the EU jurisdiction.

When it comes to new entities, the idea that activity-based regulation is not sufficient to address the risks posed by multi-activity groups such as big techs has been expressed at previous Eurofi events. Big techs provide regulated financial services and need to obtain a licence to do that. The issue is when they provide a mix of services including regulated financial services, non-regulated financial services and non-financial services. This combination of activities generates specific risks such as spill-over risks that require a specific regulatory response, which cannot be activity by activity. It has to incorporate an entity-based dimension.

Taking these issues together, an ambitious regulatory revamp is required, the official believed. It is not enough to just enlarge or adjust the existing regulatory framework to take these new evolutions into account. There is a need for new approaches in some areas. The European Union has been at the forefront of this so far and a similar approach is needed at the global level. Technological disruption also requires a rethink of supervisory approaches. There are two main channels through which technological disruption can eventually affect the safety and proper functioning of financial institutions. One is operational resilience, because financial institutions increasingly rely on ICT third party service providers and the second is business model sustainability, as traditional financial institutions have to face the competition of new players, threatening the viability of certain business models. Those two risks, which could eventually affect the solvency of financial institutions are recognised in the current prudential framework, but those risks cannot be addressed solely by increasing capital requirements. There is indeed no reasonable level of capital that could compensate for a bank failing to provide sensitive services to its clients on a continuous basis, or for a unsustainable business model. These risks posed by digitalisation require novel approaches. The official concluded that the supervisory approach has to pay more attention to fostering risk-preventing management actions. Quantitative capital and liquidity requirements should remain at the core of the prudential regime of banks, but in the future the supervisory regime should probably become more forward-looking and less capital-centric.

#### 4.4 Next steps of the DLT pilot regime

An industry representative highlighted the importance of the DLT pilot regime that was launched earlier in 2023, which will allow to assess the value that this technology can bring to the securities ecosystem. A certain number of successful experiments have already been conducted for the issuance of government bonds on DLT. One challenge with the pilot regime is that it is outside of the current regulatory framework. It is not known what the future regulatory framework will be, but this can influence the uptake of DLT-based solutions.

Following a remark by the chair that the DLT pilot regime is a regulatory experiment in itself, the industry representative acknowledged that the regime shows the willingness of European regulators to authorise a wider use of DLT in the securities market. It will be important to test the implementation of DLT using both the current regulatory environment and the pilot regime to identify the pros and cons of both regulatory environments and to have the right insights for drafting the future regulation.

## 5. Supervisory implications of digitalisation

A public representative emphasised the importance of the proper enforcement and application of regulations such as MiCA. Supervision can contribute to this but there is also the need for effective cooperation between

the industry and the regulatory and supervisory authorities to achieve an effective enforcement of regulations and to anticipate the need for future evolutions of the framework. In the new landscape of digital financial services, mutual learning and cooperation to improve the regulatory framework are essential. Improvements can be made thanks to supervision and an effective collection and use of data, but there are still a number of shortcomings in this regard, both at a national level and at the European level.

Answering a question from the Chair about whether digitalisation challenges the very idea of national supervision in the EU, the public representative suggested that with digitalisation, much more effort is required in terms of a harmonised and cooperative approach to supervision. That does not mean abandoning national-level supervision but adapting it to digital services that can more easily be provided on a cross-border basis. Technology can also help supervisors to overcome some of the issues. The public sector side also needs to embrace digitalisation in its own processes.

An industry representative added that for efficient supervision what matters is approaching issues and compliance with a 'same activities, same risk, same rules' perspective. It is not just about protecting customers or financial stability but about protecting trust in the financial industry. Trust is essential for banking activities in particular and effective supervision can help in this regard. There is also a need for supervisors to have the right digital skills, which means hiring new competences and training and retaining existing people.

Another industry speaker stressed that supervisors need to adapt their approach to the digital world. The objectives of supervisors have not changed with digitalisation, but they need to adapt their tools and practices to the new digital environment. One example concerns CSPs that operate multi-tenant environments, which means providing similar services to clients across industries such as financial services, healthcare providers, governments etc. The possible implications of supervisory requests for the rights to security and privacy of other customers need to be considered. In addition, CSPs operate on a global scale, which raises questions, from a supervisory perspective, with regards to the evolution of different frameworks impacting cloud services across jurisdictions. The shared responsibility model that is used for cloud services is a further issue that customers face in supervisory discussions. These two aspects – the multi-tenant environment of cloud and the shared responsibility model – will require an adaptation of supervisory approaches and tools, particularly when DORA comes into force in 2025..