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Digital finance: Time for a paradigm shift in our approach to regulation and supervision?

I am delighted to join you for this year's conference on FinTech and digital innovation, the timing of which could not be more fitting. Yesterday, the European Banking Authority (EBA), together with the other European Supervisory Authorities (ESAs), published our response[1] to the European Commission's Call for Advice on Digital Finance.[2] I would like to use this opportunity to reflect on some of the broad themes underpinning the report and other parts of our work on digital finance.

First a few words by way of background and some information on market developments.

The Call for Advice

As many of you will be aware, the European Commission requested the ESAs provide technical advice on:

- more fragmented or non-integrated value chains,

[1] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1026595/ESA%202022%2001%20ESA%20Final%20Report%20on%20Digital%20Finance.pdf

[2] https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/210202-call-advice-esas-digital-finance_en.pdf

- digital platforms and bundling various financial services, and
- new mixed activity groups, namely groups providing both financial and non-financial services.

The EBA was also requested to examine to what extent lending provided by financial intermediaries outside the pan-European financial services regulatory perimeter exists and how it may evolve. Our findings in this regard, including on the need for any regulatory changes, will be published next month.

The wide scope of the Commission's Call for Advice highlights the broadening of our collective assessment of the impact of technology-enabled changes in the EU financial sector. These changes arise in many dimensions that can be grouped in three broad categories: new financial products and services, new ways of delivering those services by incumbents and newcomers, and deeper and larger interdependencies among players within and beyond the financial industry.

Emerging products and services require us to closely monitor and adapt our regulatory and supervisory frameworks where appropriate. Of course, we continue to monitor the way in which technology is being leveraged to transform delivery mechanisms whether those be customer-facing or back office. We have seen, for instance, an acceleration in experimentation and rollout of RegTech solutions and issued a report last year on the benefits, challenges and risks, and set out steps to ensure the sound adoption and scaling of RegTech solutions in the EU banking sector.[3] Recently, we have also issued a discussion paper and have open a public consultation on the implications that the use of machine learning techniques have in the context of internal ratings-based (IRB) models to calculate regulatory capital for credit risk.[4]

Technology is also impacting the structure of the EU financial sector through the emergence of new business models and new entrants. Clearly payments has been an area of faster development. Following the opening up of payment accounts data as a result of the PSD2 and with that the growth in the use of APIs to support information sharing, we have seen large innovations and players actively transforming the business.

But business models transformation is affecting all areas of banking. Bundling, and the cross-selling of financial and non-financial products by new players will likely rise.

Finally, this transformation of business models also brings new inter-dependencies within the financial sector. The value chain of many financial products is being disrupted, broken. Who does what in the provision of a financial service is rapidly changing. By now, we are aware of the increase in cyber-related risks or some of the implications of financial institution dependencies on large technology companies, including the BigTechs, for data analytics, cloud, platform and advertising services. But new and more complex interdependencies will continue to arise.

[3] https://www.eba.europa.eu/eba-assesses-benefits-challenges-and-risks-regtech-use-eu-and-puts-forward-steps-be-taken-support

[4] https://www.eba.europa.eu/regulation-and-policy/model-validation/discussion-paper-machine-learning-irb-models

Looking across these three dimensions, I think the first – the emergence of new products and services – is, in relative terms, the most straightforward to deal with through targeted perimeter extensions.

But the second and third dimensions – new delivery mechanisms by new players and deeper structural interdependence – represent on the one hand more transformational potential and opportunity and, on the other, more complex challenges for us as regulators and supervisors.

Indeed, do we need a paradigm shift in our approach to regulation and supervision? And are we equipped sufficiently, in both regulatory and supervisory terms, to mitigate effectively the risks whilst leveraging the opportunities offered?

Market developments

Before I address these questions, let me say a few words about market developments.

In the joint-ESA report we identify growing interactions between incumbent financial institutions, FinTechs and BigTechs through a variety of models, including partnerships, joint ventures, outsourcing and sub-outsourcing, mergers and acquisitions. These firms may also be partnering to co-innovate and provide new products or services leveraging complementary competencies and customer bases, for instance in the context of health insurance, health monitoring and health care.

As noted by the EBA in its recent report on the platformisation of the EU banking and payments sector,[5] by the Bank for International Settlements, Financial Stability Board and others,[6] there are growing interdependencies between the financial and non-financial sector via a rapid growth in the use of digital platforms to 'bridge' customers and financial institutions.

Value added chains are being redesigned. For example, technology companies, including the BigTechs, are offering mobile payment and digital wallet platform services which allow users to pay for products and services albeit the partnering financial institutions remain the relevant payment service providers.

We are also seeing new groups emerge which are active in the financial sector both through the provision to financial institutions of cloud, platform, Big Data analytics and advertising services, but also through the direct provision of financial services such as lending and payments, potentially leveraging their access to data and network effects.

These evolutions in value chains and the increasing platformisation of the financial sector offer potential benefits for both EU customers and financial institutions. However, new forms of financial, operational, and reputational interdependencies are emerging and give rise to complex issues about:

[5] https://www.eba.europa.eu/eba-sees-rapid-growth-use-digital-platforms-eu%E2%80%99s-banking-and-payments-sector-and-identifies-steps

[6] See, for example, BIS (2021), *Fintech and the digital transformation of financial services: implications for market structure and public policy*, BIS Papers No. 117, July and FSB (2020), *BigTech Firms in Finance in Emerging Market and Developing Economies; Market developments and potential financial stability implications*.

- the mitigation of risks: operational, concentration and step-in for instance;
- data access and privacy: who provides data access to who, and the empowerment of citizens to control how their data is being used and monetised; and
- adequacy of supervisory structures: supervisory knowledge, powers and adequacy of cooperation mechanisms.

So how should we respond to these issues?

The risk-based approach

As you will all be aware, in the EU we adopt a risk-based approach to regulation and supervision. We act where needed, and only to the extent needed, to achieve our objectives of consumer protection, prudential resilience, market integrity and ultimately financial stability.

Sometimes we direct requirements to the performance of a specific activity. This is the case, for example, in relation to payments and strong customer authentication or in AML/CFT requirements, where activities are subject to the same regulation and supervision notwithstanding the entity carrying out those activities or the technology leveraged.

Other times, for instance in terms of prudential requirements, we address rules to entities to ensure that combinations of activities and aggregate risks are appropriately regulated taking account of the impact of collective failure.

The object of regulation is not to favour one technology above another, nor to prefer or prejudice a particular business model or market player. As such this approach of 'technological neutrality' is about achieving the right balance between facilitating innovation, scalability and competition across the internal market whilst continuing to achieve our central regulatory objectives.

Lately, however, there has been something of a debate in policymaking settings about the way in which to respond to the market developments to which I referred earlier – do we need pivot towards activities or entities-based regulation and supervision?

From my perspective, this is not a dichotomy; they are alternative tools to be used in different circumstances and to achieve our objectives, both activities and entities-based regulation and supervision play a role in mitigating specific types of risk.

The proposal for MiCA illustrates this point very well. Regardless of the type of crypto-asset issued, issuers must prepare white papers to ensure that consumers have the information they need to make informed choices taking account of the key characteristics of the tokens (activities-based regulation). However, some issuers who issue crypto-assets that are classified as 'significant' will be subject to additional requirements, including governance and prudential requirements, in view of the scale of their activities and potential impact should things go wrong (entities-based regulation). If we just had a one-sized fits all approach this would be neither proportionate nor effective in mitigating risks that derive from the impact of failure.

The blend of activities and entities-based regulation can continue to serve us. But some work is required on the calibration of our regulatory requirements and supervisory structures to get the cumulative approach right in light of value chain evolutions, platformisation and new mixed activity groups active in the EU financial sector.

Key here is the need to ensure we mitigate risks of regulatory arbitrage, secure a level playing field, and address gaps in our regulatory or supervisory reach. And, of course, not all of this is for us as financial sector authorities to address but we need to work together on collective solutions. We need to enhance our cooperation with other regulatory bodies in the areas of data protection, technological security and competition.

Some initiatives are underway already with flagship legislative proposals such as the Digital Operational Resilience Act (DORA) which will expand the boundary of financial sector supervision to those entities that provide critical ICT services to financial entities.

The proposals for the Digital Markets Act (DMA) and Digital Services Act (DSA)[7] will also enhance our collective capacity to better protect consumers using online intermediaries and digital platforms within and beyond the financial sector and mitigate ex ante potential competition issues.

For example, online marketplaces, social networks, content-sharing platforms, app stores and online travel and accommodation platforms are proposed to be in scope and the DMA includes proposals for rules that would apply to 'gatekeeper platforms'.

Gatekeeper platforms are digital platforms with a systemic role in the internal market that function as bottlenecks between businesses and consumers for important digital services. Gatekeepers would be prohibited, for example, from treating services and products offered by the gatekeeper itself more favourably in ranking than similar services or products offered by third parties on the gatekeeper's platform.

The EBA welcomes these legislative proposals as an essential step toward ensuring a level playing field in the digital environment.

But in other areas work remains to be done, and here I will turn to some of our key horizontal findings.

First, closer cooperation between financial and relevant non-financial authorities to address these new challenges. It is clear from our work that the vast majority of financial sector authorities currently have a limited understanding of platform-based business models, and value chain evolutions, particularly in the context of interdependencies between financial institutions and technology companies outside the perimeter of competent authorities' direct supervision. Over time, this imperfect understanding of business models could impair the effective monitoring of specific risks, including those arising from financial, operational and reputational interdependencies.

As such, close cooperation between different types of authorities, including financial, data, cyber, consumer protection and competition authorities, is needed at the horizon-scanning and rule-

[7] https://digital-strategy.ec.europa.eu/en/policies/digital-services-act-package

making stage, and in the context of the supervision of large technology firms and mixed activity groups.

In this respect, the ESAs recommend the European Commission explore possible ways to foster an enhanced cooperation framework, with potential new approaches needed to structure cooperation that would promote information-sharing on market and policy developments in each authority's respective sector, and bring authorities together where coordinated policy or supervision action is needed.

Second, in light of the emergence of new mixed activity groups combining different types of financial services (and sometimes other services), the ESAs note that the existing perimeter of prudential consolidation and financial conglomerates rules may no longer ensure effective coverage of group-wide prudential risks and may give rise to level playing field issues (e.g. between bank and non-bank groups).

The ESAs recommend the European Commission to consider potential changes to the perimeter of consolidation rules, and potentially new consolidation and structured-supervision frameworks.

Third, although the proposal for DORA provides a framework for the mitigation of ICT risks, regular assessments should be carried out to determine whether financial institutions exhibit dependence on certain providers that may not be captured by DORA and represent a risk to financial stability.

Fourth, actions are needed to better protect consumers against this background of market change. There are two aspects to this: (i) supply-side measures, such as measures to ensure that disclosure requirements are fit for the digital age, and (ii) demand-side measures, to ensure consumers have the skills they need to help make informed choices. Here I point to a need to further clarify the proper use of customer data under the ultimate ownership and understanding of the consumer. To achieve this objective, we are working on further actions to promote a higher level of digital and financial literacy. Our joint-ESA High Level conference on Consumer Education and Financial Literacy last week provided some excellent inspiration for our work.

Overall I believe our recommendations are well targeted, ambitious and I hope they will help the Commission progress in addressing these challenges.

So what can you expect from the EBA in the year ahead?

I can assure you that digital finance remains one of the EBA's strategic priorities and will be taking forward an ambitious programme of work in 2022.

By way of follow-up to the EBA's September 2021 report on digital platforms, we will support competent authorities in:

- developing common questionnaires for regulated financial institutions on digital platform and enabler use;
- sharing information about financial institutions' reliance on digital platforms and enablers.

On digital operational resilience, the EBA will continue its preparatory activities for the implementation of DORA, which is expected to enter into force in 2023. These activities aim to ensure the EBA will be well-prepared to take up any new tasks under DORA. Moreover, the EBA will be enhancing its focus on cyber security through targeted monitoring of the cyber landscape across the finance sector. We will work along with the other ESAs towards addressing the recently published ESRB recommendation on a pan-European systemic cyber incident coordination framework.[8]

In relation to crypto-assets and DeFi, the EBA will develop in 2022 templates that competent authorities can use to facilitate a more convergent approach to the monitoring of crypto-asset activities at the domestic level. Additionally, the EBA will continue to contribute to ongoing EU and international work streams on crypto-assets, including so-called global stablecoins, and the prudential treatment of banks' exposures to crypto-assets on which a further BCBS consultation can be expected this year.

In the area of artificial intelligence, as mentioned before, the EBA will assess the public feedback received on the Discussion Paper on the use of Machine Learning for IRB models and will consider whether any additional measures should be taken in this regard. Moreover, the EBA will continue following the co-legislative procedure on the proposed AI Act[9] with a focus on its potential impact to finance sector.

Speaking of industry engagement, we will also be organising a series of RegTech-related events where we will invite financial institutions and RegTech providers to share their experience on the use of RegTech. In parallel, the EBA will continue to facilitate the sharing of best practices among competent authorities on how to use Supervisory Technology (SupTech) to enhance the effectiveness and efficiency of their work.

Finally, it goes without saying that the EBA is looking into the interfaces between technology, sustainability and product innovation, in order to contribute to the green and digital transformation of the EU financial sector and the real economy.

I will close by noting that by leveraging on our insights and expertise, we can achieve an EU regulatory and supervisory framework that is able to accommodate the benefits of innovation while properly monitoring and limiting the potential concerns on consumer protection and financial stability and ensuring proper risk management. I look forward to continuing to engage with you on these issues and draw your attention to the EBA's FinTech Knowledge Hub for our publications and information about upcoming events.

Thank you very much for your attention.

[8] https://www.esrb.europa.eu/mppa/recommendations/html/index.en.html

[9] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0206