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Afore Consulting 7th Annual FinTech and Regulation Conference

Afore Consulting held its 7th Annual FinTech and Regulation Conference on the 7th and 8th February 2023. The Conference brought together more than 1 000 participants from the European regulatory and supervisory community, industry, academia and civil society. We would like to take this opportunity to thank once more the speakers, sponsors and participants and all who helped make this conference the success it has become.

This year, the discussions focused on the transformation of the payments sector, including through the significant growth of crypto-assets and the emergence of central bank digital currencies, the upsurge of the data economy and data aggregation, the importance of greater resilience in the digital space and the importance of trust, European values and transparency in the financial services sector.

High Level Observations

- Digital transformation is fundamentally changing the financial sector and the way businesses interact with their customer base. This transformation can help **deliver better products and services**, that bring value and respond to consumers' preferences, but it is pivotal to ensure that the **regulatory frameworks remain fit-for-purpose.**
- **Trust, sound governance and transparency** are three of the most important values in financial services. They are at the core of the data economy, artificial intelligence developments, payments and the evolving crypto-asset markets.
- The **mindset** towards technology in financial services is also changing. The attitudes towards technology are more positive and there is an openness to innovation in the sector. This is reflected in **greater collaboration** between banks and FinTechs.
- There is now a trend to move beyond the 'platformization' discussions to *embedded finance* and its benefits.
- The **data economy** continues to thrive and is becoming a critical part of the financial sector. New data-based business models continue to evolve, from information service providers to data aggregators.
- Data use is also **transversal** across financial services. It will be at the core of upcoming initiatives such as Open Finance, to extend the benefits of Open Banking beyond payments, and the ESG framework. It can also improve the European Capital Markets, informing investors decisions and registering market developments. The benefits will however be dependent on the **quality and reliability** of the data.

- The dependency on big data requires more regulation and supervision. The challenge is to balance the **incentives** for innovation while safeguarding **competitive markets** and ensuring high levels of **data security**.
- **Artificial intelligence** is also in the spotlight for regulators for the upcoming months. The priority is to ensure proper algorithms and rules for the development and deployment of AI.
- Private means of payments continue to evolve with the advent of crypto-assets. Despite the 2022 events, **crypto-assets are likely to stay** and therefore sufficient safeguards, focused on consumer protection and market integrity need to be in place. The use of crypto-assets is also leading to a broader understanding of digital assets that can have applications at the corporate level.
- As a response, several jurisdictions are also moving forward with **public alternatives to digital money**. In the EU, this is taking the form of the Digital Euro. The Digital Euro will need a strong democratic basis and will be designed around high levels of privacy and security.
- As the economy becomes increasingly digitalized, **cybersecurity** and **operational resilience** continue to dominate the discussions. Reliance on IT infrastructures which are vulnerable to attacks, requires companies to have in place strong counter-measures. Supervisors must promote high-standards in this regard.
- Technological evolution is also being increasingly incorporated into supervisory practices. SupTech is improving market monitoring processes and facilitating ongoing 'live' supervision.
- In light of the fast technological changes, maintaining a **proper and open dialogue** between all stakeholders is imperative. This dialogue cannot be limited to financial authorities and market participants, but must also involve other supervisors in the data privacy and cybersecurity space. This will ensure proportionate rules that tackle the risks while safeguarding those incentives needed for innovation to flourish.
- Digitalization also requires **enhanced international cooperation.** Cyberattacks are conducted on a global scale; crypto-assets transpose borders and pose risks to global financial stability; and payment systems are globally interconnected. International collaboration based on commonly shared principles is increasingly important.

Opening Keynote speech by Mairead McGuinness, Commissioner for Financial Services, Financial Stability and Capital Markeys Union

Digital technology is **transforming** the financial system. While there are many benefits to derive from this, it is crucial to ensure that the changes occur in the right away. Infrastructure needs to be resilient, consumers safe and the European economy must remain competitive.

The European Commission's approach in the past few years was to guarantee that there is **trust** in the financial system as it undergoes significant changes. This includes the proposals on Digital Operational Resilience (DORA), Markets in Crypto-Assets (MiCA) and the DLT Pilot Regime as part of the 2020 Digital Finance Package.

To follow digital transformation and the advent of private means of payment, the European Union is also working towards a Digital Euro. The Digital Euro would be a **complementary public money solution** with an open interface for both senders and receivers. It would also enable to have a pan-European payment system, support financial inclusion and enhance the European open strategic autonomy.

In the private side of payments, the European Commission will also work this year towards a revised PSD2 that would enable the framework to **remain fit-for-purpose**. The key themes for the Commission's work are centred around fraud prevention, implementation, maintain a level playing field and open banking. The work on the PSD2 will also set the foundation for Open Finance, which aims at **leveraging the data economy**. Open Finance will enable more services based on data with the guarantee that customers retain control over their data.

All these proposals are expected to come **late in the first half of 2023.**

Thematic Overview

Payments

Disruptive technologies have a strong impact on the payments industry, with the potential impact to improve financial inclusion and make transactions safer and faster. The sector evolved considerably in the last years, with the expansion of mobile payments, contactless and wallets, and with many new players entering this space since the application of the Payment Services Directive (PSD2). Safeguarding competition in the payments space and a consumer-centric approach to innovation is therefore crucial.

To this end, the European Commission is working on putting forward a legislative proposal in the second quarter of 2023 **revising the PSD2 to ensure it remains fit-for-purpose**. The review, in line with the remaining payments agenda for the European Union, aims at leveraging new technological developments to improve services and consumer experience whilst mitigating the risks. There are four areas which the European Commission is prioritising in this exercise:

- Improve **fraud prevention**;
- Enhance **implementation** and **enforcement** of the rules;
- Maintain a **level playing field** between the banks and other payment service providers; and
- Revamp **open banking** rules.

The revision of the PSD2 is welcomed by the industry, specifically the improvement of the fraud prevention rules. The implementation of Strong Customer Authentication (SCA) requirements has been a painful experience for companies, who support a more outcome-based approach to the rules.

The experience with open banking, in combination with the data economy, is also creating the need to look into broader data sharing arrangements in the financial sector. This is taking the form of "open finance", which extends the learning from **open banking beyond payments**. Together with the proposal revising the PSD2, the European Commission is also working on an Open Finance proposal. The work is currently being centred around four fundamental questions:

- Which data should be in **scope** of the proposal?
- How can data be **standardised**?
- How will the involved parties be **compensated** for the data availability and treatment?; and
- How to retain a **level playing field**?

Open Finance, at the European level, also sits between other cross-sector regulations dealing with data, data-sharing and data governance. Ensuring consistency amongst these horizontal discussions is essential to ensure a **well-integrated framework**, that promotes safe data transfers and consumer trust.

There is general agreement that regulatory actions can act as enablers for data-sharing and data-driven business models, however there is also an important role for private sector initiatives. While the benefits of open finance are overall consensual, the views on potential risks and impact on disintermediation diverge. While some stakeholders believe that open finance can bring greater collaboration between traditional finance players and FinTech companies, others argue that open finance can further push for disintermediated business models and expand the decentralized finance (DeFi) space.

Alongside legislators and the private sector, Central Banks also have an important role to play in the payments space. Payment infrastructure falls under the remit of Central Banks and they give value to the applicable rules. New forms of **cooperation** between all the actors in the payment's ecosystem are therefore necessary. As observed by Hanzo van Beusekom, Member of the Executive Board, Dutch Authority for Financial Markets, digitalization will continue to move fast and new market practices will continue to increase. It is therefore crucial for regulators and supervisors to ensure a continued dialogue with the private sector.

Crypto-Assets & Central Bank Digital Currencies

In the crypto-assets market, the events of last year with the FTX collapse have diminished consumer's trust. European supervisors also believe that it has materialized the risks that crypto-assets can pose to market integrity at large, as well as demonstrating the weak corporate arrangements in the market. The EU Rulebook on crypto-assets (MiCA) is generally viewed as a step to **boost consumer protection and transparency** in the crypto market, however there is also a recognition that it is not a silver bullet and needs further improvement.

One area in particular where deficiencies are identified concerns the **international** aspects of MiCA. Harmonisation of the rules across jurisdictions is crucial to decrease regulatory arbitrage. To this end, the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) are working towards **international standards** and **global consistency** in this space. Jean-Paul Servais, Chair of IOSCO, stressed the close cooperation taking place at the global level to ensure complementarity between financial stability on the one hand and consumer protection on the other.

While these international bodies recognize that the spill-over effects from crypto-assets space into the traditional market are still limited, these markets can evolve quickly and therefore *doing nothing* is not an option. Other industries such as the funds industry are already drawing-up lessons from crypto-assets.

Following the political agreement on the Rulebook, 2023 will also be an important year for MiCA and crypto-asset players with the development of Level 2 measures, regulatory technical standards and Guidelines for the industry. The EBA and ESMA are currently working on these measures and collaborating to ensure a consistent approach.

Crypto-assets and the development of private currencies have also reinforced the discussions of European **sovereignty** in the area of payments. Globally, this is being translated into a Central Bank Digital Currency (CBDC) "space race", with the EU leading the work on the Digital Euro. As Burkhard Balz, Member of the Executive Board of the Deutsche Bundesbank, explained, the Digital Euro is expected to take the form of a retail CBDC, complementing the current payment system and adapting to consumers' preferences for digital means of payment.

The European Central Bank (ECB) is conducting its investigation into the introduction of such a project. The key challenge for the ECB will be to achieve the right balance between a successful product that responds to the needs of European citizens and a product that is "too successful" leading to a crowding-out effect of the private sector. Mitigation techniques are being explored, targeting specifically disintermediation of deposits. Concerning competition with the payments space, the ECB argues that the EU payments market is large enough to accommodate all the players, including the possible Digital Euro. A wholesale usage of the Digital Euro is a different area, less known to the public, but also with great potential for the Eurosystem.

Cybersecurity and Operational Resilience

Financial institutions' **reliance** on IT infrastructure continues to increase. An emerging trend of **interconnectedness** between financial institutions is also developing. This, alongside **concentration risks**, leads to an aggravation of security threats due to digital dependency, including on specialized third-party providers. Sarah Pritchard, Executive Director for Markets from the Financial Conduct Authority, and Phil Venables, Chief Information Security Officer and Vice President at Google Cloud, reflected on these issues and how to deliver the digital transformation.

In the European Union, a political agreement was reached last year on the Digital Operation Resilience Act (DORA). DORA will apply from 2025 and includes the rules for operational resilience to be put in place by in-scope entities as well as a new oversight framework for critical third parties. The ESAs are coordinating to ensure a coherent approach. Specifically on incident reporting, Steven Maijoor, Executive Director, De Nederlandsche Bank, pointed out that there is a recognition that the right balance needs to be reached between avoiding a "data overload" and ensuring that no information gaps exist. Against this background, the ESAs note that the level of information will probably change over time, depending on practical experiences from cyber-attacks, which will be possible to recalibrate through Level 2 measures.

Cybersecurity and digital resilience are also at the top of the agenda in the US and the UK. The UK in particular is progressing on its **three-year strategy** which is focused on three main areas:

- Reduce and prevent serious harm;
- Setting and testing higher standards; and
- Promoting competition and "positive change".

Similar to the EU, the UK is also working towards introducing a new regime for critical third-parties providers. This new framework is still being developed but will take into account the identification, mapping, testing and the sharing of information with regulators.

Data and Markets

The data economy is changing financial services. This is an extremely complex space but crucial for the lifecycle of financial services and products. There is an **emergence of "data aggregation" as a service**, which can be summarized in three layers: (1) data collection from different sources; (2) processing of data; and (3) dissemination of said data. The concept of data aggregation is convoluted, with entities – including Central Banks – being both providers and consumers of data aggregation services.

Several challenges still persist around data aggregation. The most prominent one concerns the **quality and reliability of the data**. However, other considerations such as the trade-off between data quality and timely availability, the cost of treating and sharing data, interoperability and the skills gap still need to be addressed. Policy-makers recognize that these challenges need to be properly addressed and that data aggregation markets need to remain competitive in order to take full advantage of the data economy.

As demand for data management continues to grow, third-party data aggregators and intermediaries can have an important role to play given their **scalability** advantages. Data gathering comes from very different sources and areas (e.g., ML/TF, sustainability, credit risk) while data is also being produced at the same time, which creates difficulties in being too prescriptive in this space.

Data is also at the core of different EU initiatives to make the Single Market more effective. The 2020 Capital Markets Union (CMU) action plan, focusing on the need for an EU level playing field and reducing regulatory arbitrage, can benefit greatly technological developments in the data space. The European Single Access Point (ESAP) in particular can play an important role since it is meant to collect all available information that can be processed to make **investment decisions**, extended to ESG data. For the success of ESAP – and all other data initiatives – users' confidence is key and needs to be a central element from the very beginning. Data aggregators will therefore play a critical role in storing the information, assessing its quality and providing timely data to ESAP.

Artificial Intelligence is also leveraging the data economy to improve financial services and products. AI will be a core focus for the European Supervisor Authorities in 2023, in parallel with the ongoing discussions on the AI Act. There are risks of market concentration with the increased use of AI in financial services, which can be tackled by the adoption of proper governance measures to ensure responsibility and accountability. Moreover, as highlighted by Verena Ross, Chair of the European Securities and Market Authority, AI techniques are also useful for regulators and supervisors to boost efficiency in their work.

Supervision and Oversight

Digitalization in the financial sector is also changing the context in which regulators and supervisors co-exist with innovative firms. Understanding how to keep up with innovation is identified as a key challenge for regulators. **Proper dialogue and understanding** of the developing industries are imperative to safeguard appropriate and proportionate rules that tackle the risks while safeguarding incentives for innovation to flourish.

In Europe, **culture, communication and conduct** are guiding principles to enable responsible innovation. José Manuel Campa, European Banking Authority, explored these three principles, noting that:

- **Culture** is reflected in the financial institutions' role in encouraging positive attitudes towards the application of innovative technologies with a risk-mitigation approach;
- **Conduct** is focused on a proactive approach towards "compliance by design"; and finally
- **Communication** which is based on effective and open dialogue between industry participants and supervisors.

These concepts go hand in hand with the requirements for **"same risk, same rules",** as noted by Petra Hielkema, Chair of the European Insurance and Occupational Pensions Authority**.** From a supervisory perspective, a technologically neutral approach needs to be maintained, despite technological evolution. A key challenge will be how to look across an increasingly fragmented market while coming together to create new propositions for services owned by only one institution. Against this background, clear liability across the value chain needs to be ensured.

Space for innovation and technological development is also important at the supervisory and regulatory level. One area where this is most prominent is on the framework against money-laundering and counter terrorism financing (AML/CTF). Rapid innovations are improving customer identification and onboarding processes that can prevent fraud and ML/TF. The regulatory framework needs to be **future-proof** by having open clauses that can easily be adapted to technological development. This also includes rules for outsourcing, as highly innovative technologies tend to come from third-parties.

A risk-based approach in the AML/CTF might be a difficult balance to achieve, but it is possible. The Financial Action Task Force (FATF) for example is acting as a promoter of a risk-based approach to standard-setting as a global project for harmonisation. The EU could maintain a similar approach to its regulatory and oversight framework.

International cooperation

The emergence of common challenges, such as Russia's invasion of Ukraine, the social and economic recovery from the pandemic and global climate change, is deepening the need for international cooperation. The need for such cooperation is important in financial services as it is interlinked globally.

Jay Shambaugh, Undersecretary of the US Treasury for International Affairs, pointed out three main areas where cooperation is particularly relevant:

- **Digital assets**, to address global financial stability, decrease regulatory arbitrage and protect consumers and investors;
- **Payment systems**, with the decline of traditional financial infrastructures and the emergence of digital currencies; and
- **Cybersecurity and operational resilience.**

Alexandra Jour-Schroeder, Deputy Director General for DG FISMA at the European Commission, also highlighted the power of cooperation. The EU is dedicated to a joint approached based on commonly shared international principles. It's starting line is based on a few key principles that govern its regulatory approach to new technologies and their impact on financial services: no product should be unregulated; supervisors must guarantee an effective exchange of information and retail investors and consumers must be protected at all costs.

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