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Doubling Down on Digital:
EU Sets Course for Digital Finance and Payments

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The European Commission has proposed a comprehensive new digital finance and retail payments strategy. This is a blueprint for the future of digital finance in the EU, and an unprecedented expansion of financial services regulation over technology. FTI Consulting Brussels explains how it could affect Europe's global role in digital finance.

The European Commission's Digital Finance Package comprises far-reaching strategies for retail payments and Digital Finance. It also includes an additional three proposals on operational resilience, crypto-assets, and the use of distributed ledger technology (DLT) in capital markets.

At a time when digital lies at the heart of the European Union agenda, the Commission's proposals bring financial services firmly within that ambition. What has been presented is an outline of the future of Digital Finance in the EU, and a blueprint that could be exported globally – yet another illustration of the 'Brussels Effect'.

The package covers all aspects of Digital Finance:

— **Data and infrastructure:** review of rules for instant payments, open finance, and cross-border digital identity.

— **Operations and risk:** comprehensive cybersecurity requirements for all types of financial service players and their providers, and a move towards automated regulatory reporting.

— **New technologies:** an EU 'sandbox' for the use of blockchain in market infrastructure.

— **New markets:** all crypto tokens covered by legislation and certifying RegTech solutions.

With its Digital Finance Strategy, the Commission wants to harmonise the cross-border offering of all digital financial services in the EU and ensure that legislation is fit for purpose.

The Commission doesn't want to hang around: the EU institutions (European Parliament and Council) are due to kick off negotiations shortly.

While the aspiration might be for rapid agreement, it may not all be smooth sailing. These are highly political issues which also reverberate globally. Digital Financial Services is not only a priority due to its impact on economies, digital inclusion and access to the EU market by new, non-EU players, but it touches wider EU conversations such as the green agenda, and crucially the debate on digital sovereignty in Europe. As our colleagues recently wrote, connectivity itself is (geo)politicised.

Another element of controversy is that of supervision. EU-level regulatory oversight has been a highly political and difficult conversation in recent years, and this will raise its head again given that the Commission has suggested that the European Supervisory Authorities (ESAs) are given supervisory powers in relation to larger tech players. If agreed, technology providers in future will have to work with a new set of stakeholders and regulators and enter the highly regulated world of financial services.

For both the tech and financial services communities, there will be a steep learning curve of getting to know each other's language, concerns and business.

Payments Strategy

For a long time, payments policy was an EU 'backwater' and rarely in the limelight. That's no longer the case. Payments issues are now at the forefront of the EU's strategic autonomy agenda, and so it comes as no surprise that a key element of the Commission plan for Digital Finance focuses on payments with a standalone Payments Strategy.

The strategy aims to encourage pan-European payments solutions and sets out the EC's future policy agenda.

Instant payments are singled out as a key driver for success with several policy measures put forward. These include examining the number of payment services providers (PSPs) and accounts able to send and receive instant payments, and potentially mandate the adherence to the pan-European instant payments scheme by 2021. The EC will also consider how to improve acceptance of digital payments and the availability of cash.

Finally, a review of the Payments Services Directive (PSD2) is planned for the end of 2021. This could lead to a change in the rules on authentication of payments, contactless payments and risks stemming from unregulated services within the payments space.

Digital Finance Strategy

The strategy aims to enable the development of digital finance products which can easily be sold across the EU. It also aims to ensure that new types of actors in financial services do not create new risks.

The steps announced by the Commission include the development of a pan-European digital identity in 2021, and a broader open-finance framework (that is, unlocking access to customer data held by all financial services players) by mid-2022 – which will align with the timing for the PSD2 review.

By 2024, the EC wants the principle of 'one-stop shop licensing' to apply to all areas of Digital Finance. It already has plans for passporting to be extended to crowdfunding, possibly other forms of non-bank lending, and tech solutions used for more efficient compliance, i.e. RegTech, through a certification scheme.

The strategy sets out that EU prudential and conduct supervision must be future-proof, as it predicts that more technology firms will enter the financial services area, fragmentation of traditional value chains, and the need for the prudential rules to be broad enough to capture risks arising from platforms and large technology companies.

Finally, a new framework for AI across financial services sectors will be published in 2021.

Digital Operational Resilience Regulation Proposal (DORA)

DORA is the most comprehensive framework on digital operational resilience for EU financial entities do date; it extends over cloud and other critical third-party providers.

In financial services, DORA enhances ICT risk management and harmonises reporting of ICT-related incidents. It allows financial entities to exchange cyber threat information and intelligence without the risk of being seen as anti-competitive. It further considers creating a single EU hub for major ICT-related incident reporting.

DORA also targets so-called critical third-party providers in the first large-scale attempt to include ICT services providers under financial supervision. Cloud services providers would now be directly supervised by the ESAs when servicing the financial services sector. Any failure to comply with the rules might result in a periodic (daily) penalty payment of 1% of average daily worldwide turnover.

DORA is another illustration of the EU's keenness to strengthen its sovereignty around the cloud ecosystem. France and Germany are already leading a push for data sovereignty within the framework of their Gaia-X project.

Markets in Crypto Assets Proposed Regulation (MiCA)

MiCA is the proposed new regulatory regime for all crypto assets, ranging from bitcoin to tokens representing fractions of gold bullion, and beyond. In this case, the EU is going beyond the approach of most other jurisdictions: by proposing to regulate the currently non-regulated parts of the crypto space, including issuers of utility tokens[1], all types of service providers, and stablecoins[2]. MiCA could become a global template.

Striking the right balance between embracing distributed finance and levelling the playing field with traditional financial actors could make or break this nascent market which has huge potential. Stablecoins alone could have systemic significance if they start behaving like money flowing through a sufficiently large non-bank platform.

To illustrate this: e-money tokens (stablecoins pegged against currency) should be redeemable at any moment and at par value. This may not be aligned with direction taken by several projects to date, and industry will have to pivot to fit the regulatory mould. Nevertheless, it will give consumers a new instrument which behaves like digital cash, and custodian banks a new type of client.

In a bold move, supervision of large stablecoins will go to the European Banking Authority, and a college of supervisors. Outside banking, only central clearing counterparties are supervised at that level. Industry may find it helpful to have a harmonised EU approach, but it may come with a very stringent framework for supervision and strong political restrictions.

This cautious approach comes amid calls from EU Member States to restrict stablecoins "until legal, regulatory and oversight challenges have been addressed", and warnings from the ECB of the risks posed by stablecoins. Indeed, the question has also been raised by some whether the move of financial service provision from traditional finance to platforms is desirable. A key question will be to assess whether the current proposal does enough to alleviate the concerns of Member States and Members of the European Parliament.

Additional requirements include issuers of utility tokens being required to set up as a legal entity and produce a 'white paper' (an investor information document following standardised requirements). This may be new and uncomfortable to an industry where products are currently set up as decentralised projects without a governing body. While the new rules do not apply to already issued tokens, such new projects will face the simple choice of launching or not in the EU.

Finally, service providers will be subject to a comprehensive set of operational, governance, capital, disclosure and client asset segregation rules. Given that these build on the existing capital markets regulation, which in the EU are mostly outlined in the Markets in Financial Instruments Directive (MIFID), they will not be a total surprise. They should not be unsurmountable either – particularly for the more mature market participants. In fact, a harmonised EU approach and a regulated status across all Member States could make it easier for this part of the industry to grow.

Pilot Regime for Market Infrastructure Based on Distributed Ledger Technology (DLT)

As one of the 'next big things' for the equities and debt market, security tokens[3] and their service providers have of all the crypto assets attracted most institutional interest and investment.

In a step towards creating this market, the EC proposes a pan-EU regulatory sandbox for providers of multilateral trading facilities (MTF) or securities settlement systems (CSDs), if they are developing a DLT-based product. As with most regulatory sandboxes, the play and innovation under the exemption from impediment of certain rules comes with limits. Here, it is the types of securities and the business volumes.

The rules on exiting a sandbox are even more important than the rules on entry, as they determine how the participating company can scale up when the training wheels are off. Here, the exemptions will last up to six years, after a decision to be made by the EC on whether to continue the sandbox or change the EU legislation.

1. A type of crypto asset which is intended to provide digital access to a good or service, available on DLT, and is only accepted by the issuer of that token
2. Tokens whose price is pegged to a currency, and asset, or a basket of each
3. Crypto assets which give investors security-like rights and therefore are regulated like securities

Global Implications

The Digital Finance Package will affect both existing operations and new business lines. But it should not be seen in isolation from global trends.

Firstly, this is the EU's bid in the race to be a leading FinTech hub. The promise of a harmonised pan-European market for digital financial services makes that bid a lot more convincing. So does the promise of reduced regulatory risk as unregulated spaces are brought into the regulatory framework. The EU's legislation process might be lengthy, but it is comparatively predictable, and once policy is set, it is unlikely to change in the short to medium term.

Secondly, other jurisdictions will be following the developments closely. In the short term, the negotiations on the concrete proposals will show the EU's willingness to progress on legislation in politically sensitive areas. In the longer term, the EU can influence the global debate. Leadership in regulatory thought can be, and has been, a powerful EU export. EU decision makers will want to remain in the lead and set the international agenda.

Whether sitting in a Board Room or in the shoes of an entrepreneur, the policy and regulatory outlook can determine market entry strategy and the flow of investment. After all, Digital Finance is highly mobile.

Engaging with the Digital Finance Agenda

The elements of the Digital Finance Package are at different stages of their EU lifecycle.

Some, like MiCA and DORA, are now embarking on a negotiation journey between the EU institutions. They will be the law of the land within a few years, and between now and then, those with strong views and industry insight could inform the conversation between Members of the European Parliaments (MEPs) and representatives of EU Member States in the Council.

Others, like the review of PSD 2 are still in the making, which means that over the next year and a half, the EC will be consulting and forming a view on the changes it needs to put forward.

In the meantime, global policy developments will not stand still as FinTech hubs compete to attract investment.

There is a pressing need for key industry participants and policymakers to join together in a constructive cross-border conversation to regulate digital finance effectively and strike a balance between innovation and regulatory clarity.

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