LIETUVOS BANKAS
EUROSISTEMA

Renewed European perspective on digital finance and payments

Bank of Lithuania policy considerations

No 1 / 2020

ISSN 2669-204X (online)

Edited by
Mindaugas Liutvinskas
Dovilė Arlauskaitė

Authors
Simonas Algirdas Spurga
Audrius Šilgalis
Rūta Merkevičiūtė
Tomas Karpavičius
Ramūnas Baravykas
Martynas Pilkis
Kristina Sačilkienė
Jurga Kamienė

Supervisory, regulatory and technological convergence is needed to establish a culture of trust, level the playing field and deliver a stronger single market

Gedimino pr. 6, LT-01103 Vilnius
www.lb.lt

To date, EU-level initiatives have played an instrumental role in the ongoing digitalisation of the European financial sector. The Digital Single Market Strategy (2015), the package of cybersecurity measures introduced in 2017, the Consumer Financial Services Action Plan (2017), as well as sectoral initiatives, such as the revised Payment Services Directive (2015), have promoted the uptake of new technologies by the financial industry. The FinTech Action Plan (2018) set out further specific steps to facilitate financial technologies in the EU, including the legislative proposal for a regulation on crowdfunding service providers, on which a provisional agreement was reached by the European Parliament and the Council in end-2019.

Going forward, President von der Leyen's political guidelines emphasise the need to ensure Europe is fit for the digital age. In this vein, we highly welcome the Commission's Work Programme (2020), which foresees a proposal for a new Digital Finance Strategy, as well as a Strategy on an integrated EU Payments Market. In this context, the Commission has launched or has already completed consultations to gather stakeholders' views, including more recently, on digital finance, retail payments, and crypto-assets. These initiatives demonstrate the EU's overarching commitment to support technological innovation in the financial sector.

Despite the significant progress made over the recent years, further and decisive European action is indeed warranted on the digital finance front to address inefficiencies in the EU's financial system and its regulatory framework. These include Europe's overbanking problem and, in some jurisdictions, a large market concentration; inefficiency in cross-border payments and the withdrawal of correspondent banking relationships; fragmentation along national borders in the provision of an array of financial services; and the lack of opportunities for SME financing. The supervisors and the public sector at large can and should play a strong catalytic role in resolving these issues through innovation and digitalisation.

Box 1. Bank of Lithuania's considerations for a new EU agenda on digital finance and payments

1. Accelerate supervisory and regulatory convergence through EU regulations rather than directives;
2. Increase cross-border supply of fintech and crypto asset solutions by updating current frameworks and delivering tailored EU-level regulation;
3. Standardise and digitalise regulatory practices, paving the way for a stronger European dimension to the supervision of digital finance;
4. Facilitate cooperation between financial and non-financial supervisors, including through novel models of partnership;
5. Develop pan-European instant payment solutions in the area of retail payments.

Moreover, the importance of digital finance has only been amplified in the context of the pandemic. COVID-19 has prompted a renewed sense of urgency to ensure innovation for the benefit of consumers, businesses, and indeed the entire economy. We strongly believe that the crisis at hand provides a window of opportunity for further digitalisation of the financial sector – and in particular financial services – rather than an excuse to delay action.

A coordinated European action would both expedite innovation and allow for better risk management, ensuring a well-balanced approach to digitalisation of finance. Digitalisation tends to cross national borders, and a single jurisdiction can hardly be isolated from the related risks. An EU-level approach is best suited to pool knowledge and upscale the best regulatory and supervisory practices. Stronger cooperation would enable public authorities to keep up with, or even to lead market developments, rather than trail behind them.

Therefore, with the European Commission developing new EU-level digital finance, payments, and crypto agenda, we put forward the considerations listed in Box 1 above, which in our view would:

- Help create a level playing field for novel market players;
- Open the doors for scaling up financial technology products and services across the single market;
- Unify the regulatory perimeter and help avoid regulatory arbitrage, neutralising the related risks;
- Help avoid a regulatory race to the bottom;
- Help supervisors achieve efficiency gains and enhanced supervisory outcomes;
- Facilitate smooth circulation of knowledge and ideas between regulators from different sectors.

From a broader perspective, a truly joint European action in digital finance and payments can contribute to the broader EU agenda and reinforce the sovereignty of Europe. A renewed European push in the area of digitalisation of finance can deepen the single market – the vehicle of growth in Europe – and contribute to reducing its fragmentation in services. Digital finance can also help build the banking union and the capital markets union, essential pillars to the smooth functioning of our Economic and Monetary Union. Moreover, financial innovation may facilitate the delivery of the Green Deal and the sustainable finance agenda. Finally, it can strengthen the international role of the euro – and, by extension, Europe's economic autonomy.

Below is an overview of the considerations set out in the paper for a renewed European perspective on digital finance and payments:

1. Accelerate supervisory and regulatory convergence through EU regulations rather than directives

Transitioning from directives to a more extensive use of EU regulations should be considered in order to ensure a more consistent application of EU rules pertinent to the digitalisation of finance. Current differences in the national transposition of EU directives can create barriers for scaling innovative financial technology solutions across the continent. The application of the AMLD is a case in point, as differences in its national transposition call for further work in terms of harmonisation of AML/CTF requirements for client CDD/KYC processes, as well as requirements for remote client onboarding. Better-harmonised AML rules should also take into account and find an appropriate balance with other areas of regulation, such as GDPR.

2. Increase cross-border supply of fintech and crypto asset solutions by updating current frameworks and delivering tailored EU regulation

Where our frameworks do not keep up with the developments in the market, novel emerging market segments require updated – or, in some cases, entirely novel – EU-wide regulation that is targeted and up-to-date. An operational EU-level framework for emerging innovative market segments could help make sure that novel solutions are subject to the same regulation and supervision across the EU; that regulation of innovative business models is proportionate to the associated risks; and that these new entities consistently fall under the regulatory perimeter. Moreover, targeted and up-to-date regulation can also render the regulatory framework more technologically neutral – without assuming usage of a predefined technology.

One particular segment that warrants a more tailored approach is the emerging P2P insurance sector (see Box 2 below), which so far has not been regulated consistently across the EU. The sector may require a similar EU-level framework on par with the proposed regulation on European crowdfunding services providers.

Similarly, a clear classification of crypto assets – harmonised across the EU – would address their divergent treatment across jurisdictions and help apply the appropriate regulation in a technologically neutral way. Crypto assets, which represent a financial claim on, or a liability of, any identifiable entity, are tokenised representations of traditional securities, investment funds or e-money – and should therefore be treated as such across the EU. In this vein, we should review existing regulation in order to allow broader application of distributed ledger technology, rendering the current framework more technologically neutral and ensuring consistent supervision. At the same time, where necessary, the EU should look to create new standards regarding those crypto assets to which the prevailing regulatory framework is not directly applicable. For instance, the sale of utility tokens can indeed stimulate the growth of the EU's capital markets and provide an innovative and inclusive way of financing SMEs – but a consistent regulatory approach is needed in this segment to ensure a level playing field and appropriate consumer protection.

Box 2. Current issues with P2P insurance regulation

Currently across the EU, the legal framework for insurers or insurance intermediaries is usually applied in relation to P2P insurance entities. However, the P2P business model differs from both the insurance company's model (whereby the company assumes insurance risk and guarantees loss compensation), as well as the model of an insurance intermediary. Arguably, requirements applied with regard to the traditional insurance business model are not best suited to capture the specific risks arising from the P2P insurance activities, which are geared towards building risk sharing networks. At the same time, these requirements may also prove to be disproportionate to the risks posed by the P2P insurance.

Moreover, applying different requirements to P2P insurance activities depending on the type of the provider (for example, the insurance company or the insurance intermediary) does not bode well with the principles of activity-based regulation. These inconsistencies also give rise to divergence in the requirements applied towards the sector across the EU, with P2P insurance requiring different licenses in different Member States. As a result, the development of this innovative sector across borders has been constrained.

3. Standardise and digitalise regulatory practices, paving the way for a stronger European dimension to the supervision of digital finance

Standardisation and digitalisation of regulatory practices – upgrading the everyday work of the NCAs in a harmonised way – could contribute to a culture of trust across borders, deliver a more unified supervision of digital finance, and facilitate the spread of innovative solutions in the Single Market. Standardisation and a common digital toolkit could also help reap tangible efficiency gains for the supervisors. Therefore, we put forward the following considerations:

- **The EU should lead the way on unifying and standardising protocols for data reporting.** We note that there are good practice examples to reduce the reporting burden for financial institutions in certain jurisdictions. These country-specific initiatives may have the potential for broader use. However, the uptake should be harmonised across the EU, as it is paramount that NCAs move towards a set of unified standards. This could reduce the reporting burden for financial institutions, facilitate the upscaling of innovative business models, and enhance trust among the NCAs themselves. Moreover, data and standardised protocols would induce the uptake of novel technological solutions, including RegTech and SupTech instruments.

- **We propose considering the establishment of a platform listing certified RegTech providers, linking financial institutions with RegTech entities across the EU.** In this vein, EU-level action is warranted to provide registration or certification requirements for RegTech instruments that may operate across borders and be applicable in different jurisdictions. For instance, mandates of European institutions could be extended to supervise regulatory compliance solutions.
- **We see a need to arrive at a common European concept of a regulatory sandbox and the tools national regulators can use when testing novel solutions.** This would in turn facilitate cross-border testing and contribute to more equal treatment of innovation across the EU. At the same time, a common European approach would reduce the risk of regulatory arbitrage.

4. Facilitate cooperation between financial and non-financial supervisors, including through novel models of partnership

The EU should actively promote cooperation between financial sector supervisory authorities and authorities from various non-financial sectors, particularly data protection and AML supervisors, but also consumer protection, competition, transport, health authorities, and others.

In this vein, we propose the establishment of cross-sectoral EU-level regulatory sandboxes. Innovative technologies raise questions that are not strictly limited to financial market regulation only. European cross-sectoral sandboxes could be multi-disciplinary environments, providing a platform for knowledge sharing and allowing for input from GDPR, AML or consumer protection supervisory authorities. This initiative may well fall under the umbrella of the European Forum for Innovation Facilitators.

5. Develop pan-European instant payment solutions in the area of retail payments

A push for better integrated, faster, and more efficient retail payments would spur competition, catalyse innovation and advance digitalisation across the EU. In this vein, we put forward the following considerations:

- **In our view, the provision of instant payments should become mandatory for credit transfer service providers.** Such a requirement would necessitate that market participants are provided an appropriate amount of time to prepare, while exemptions may be applied to smaller entities.
- **Accordingly, the EU should support the deployment of instant payments and their pan-European reachability, including through linkages between instant payment systems.** It is likely that in high-volume currency corridors the links between instant payment systems could positively contribute to the reduction of costs. Moreover, payment data entry methods (e.g. NFC, BLE, QR-code) for an instant payment transaction should be standardised across the EU.
- **Development of a pan-European solution for payments at the point-of-interaction (POI) is warranted.** Adoption of such a solution should be initiated in all EU countries within an as-short-as-possible time frame. Acceptance of a pan-European solution for payments at POI at a global level would decrease dependencies on existing non-EU payment schemes.
- **EU-level initiatives are needed to ensure objective and non-discriminatory access of non-bank payment service providers to the payments infrastructure.** Should constituencies adopt instant payment infrastructures and enable the eligible non-bank entities to participate in these infrastructures directly, without the intermediation of banks, this could *inter alia* bring substantial progress in the area of international remittances. Overall, wider access would reinforce competition and help develop a more innovative market for payments.