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Safely Navigating the Accelerating Digital Transformation

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Introduction

I am delighted to be part of this conference once again, though this time in a virtual setting. The fact that we are meeting remotely illustrates my theme for today: how the pandemic has accelerated the use of digital tools across the economy, and what this means for the financial sector.

Society's digital response to the Covid-19 crisis has been remarkable. Those of us with office jobs now have a style of work unrecognisable from just twelve months ago. This time last year, I was wondering whether it would be practical for ESMA to host our board meetings as a video-conference. Chairing the meetings of 27 heads of EU national regulators – plus official observers and support staff – requires discipline, as we always have a busy agenda.

I confess to being sceptical that we could make video-based meetings a success. The technology seemed an unwelcome distraction. Moreover, our ability to communicate remotely was untested and seemed unnatural. But once circumstances changed, we all adapted. The new pattern of working was rapidly embraced in businesses across the economy. Even many social and family events now take place online.

Once the danger of the pandemic passes, we will want to get back to meeting in person. But we will also find that sometimes, we want to use the additional flexibility of online working. Some people may find they can improve their work-life balance while maintaining or even improving their productivity. And from a social perspective, families and friends living far apart may become better at keeping in touch.

In other words, some of the radical changes in our daily lives bring opportunities. But there are challenges too. Digital interactions are not always a proper substitute for face-to-face interactions. We know this all too well from recent experience.

My remarks today will focus on the accelerated shift to online finance. I will start by describing the long-standing phenomenon of digitalisation in the financial sector and how the Covid-19 crisis has acted as a catalyst. In this context, I will highlight some serious risks. Finally, I will suggest how we can address the risks while embracing opportunities. In short, how can we safely navigate this period of accelerated digital transformation?

Digitalisation: risks and opportunities

Digitalisation is far from a new phenomenon in finance. The promise of efficiency gains has for decades led firms to digitalise their operations. From back office functions to customer-facing activities, financial services have steadily moved first to digital format, then online and in the cloud.

In recent years, advanced technologies have proliferated. Consumers can manage their portfolios or bank accounts via smartphone apps. Financial firms are using data analytics and machine learning for a wide range of purposes, including risk management, fraud detection, customer research and devising new investment strategies.

Other technologies play a linking role. Behind the scenes, digital infrastructures are connecting different business services together. For example, APIs enable the interoperable use of data. In so doing, they promote the use of technology for regulatory purposes in the form of RegTech. This newfound interoperability is supported by regulatory frameworks and common standards, which ESMA does much to promote. The cloud is now a vital infrastructure in many sectors and plays an increasing role in the financial world.

Distributed Ledger Technology – DLT for short – also continues to hold promise. Estonia has introduced a DLT-based public digital identity system alongside extensive online provision of state services. Initiatives of this kind reduce paperwork, save citizens time and make records more accurate. We are yet to see a ‘killer app’ for DLT in finance, but given the growing civic and economic applications, it remains a realistic prospect.

The opportunities from digitalisation are clear. It has the potential to bring faster, cheaper, more transparent and more efficient financial services to consumers. Digital platforms can provide consumers with ready access to detailed information presented in new, intuitive ways. For people comfortable with digital technology, it may promote financial inclusion, even if others less inclined to use digital technology may lose out.

But there are risks, too. Despite new modes of presentation, technology may at times reduce transparency. For instance, it can be hard to explain an algorithm-based investment or lending decision to a consumer.

Zooming out, we can see an emerging economic trend towards technology-powered business models that operate across economic sectors. This profound change in market structure, despite potential benefits, raises concerns around privacy and data rights. Furthermore, it may raise concentration risk.[1] An operational incident that originates in one platform service could have a large impact on other lines of business, including financial services.

Accelerating trends

The Covid-19 crisis has brought existing trends, risks and opportunities into focus. The cloud is a good example. Global revenues for public cloud services in general continued an existing upward trend in 2020, at around 25% annual growth. And some key technologies built on cloud platforms have boomed during the crisis. In the first few months of 2020, major video conferencing platforms saw user numbers increase many times to facilitate radical changes to how we work. Daily meeting minutes on one major platform more than doubled between February and April 2020.[2]

Overall, the technology sector has been resilient. In the US, the market cap of established technology firms grew over 40% during 2020, versus single-digit growth elsewhere. The crisis has made us more reliant not only on certain technologies, but also on the firms that provide them. Even before the crisis at the start of 2020, the largest five BigTechs represented 18% of the market cap of the S&P 500. By the end of the year the figure was 23%.

BigTechs are now starting to enter finance. China-based firms offer the widest range of services, but there is potential for BigTech financial

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1 Bank of International Settlements (2019), *BigTech and the Changing Structure of Financial Intermediation*, BIS Working Papers no. 779

2 Source: Statista. The measure of global cloud revenues includes Infrastructure-as-a-Service, Platform-as-a-Service, Hosted Private Cloud, Enterprise, Software-as-a-Service, Data Center Hardware and Software, Public Cloud and Data Center Colocation & Construction. The meeting minutes figure is for Cisco Webex.

services to grow in Europe and the US, including through partnerships with incumbents. For example, Apple and Goldman Sachs have together launched a credit card. Another example is the Diem project from Facebook, which aims to provide an alternative global payment system using DLT. Its scope now appears more limited than originally planned, but it remains high profile.

We can expect these huge firms to win market share in the financial sector. Not only have they been bolstered by the crisis, but they enjoy competitive advantages such as vast customer networks and access to cheap funding. While they have different core services, they use the same key raw material – Big Data. Like smaller FinTech firms, they are able to ride on the wave of digitalisation. They enjoy ‘digital proximity’ to clients as people connect to financial services from their screens, reducing the advantage of established branch networks.

The tailored services that BigTechs offer, based on their customer data, can improve quality for clients. Integrating services across platforms may be convenient for many of us. But it brings risks, such as around competition. Even if the entry of BigTechs into certain financial services promotes competition at first, they may grow dominant. Eventually, customers may be reluctant to switch from a firm that provides them with many other online services.

In summary, the growing role of technology on the supply side, boosted by the crisis, has major consequences for the financial sector. Let me now turn to changes in demand since the pandemic hit us.

The necessary public health measures in many countries have prompted changes in behaviour and accelerated key consumer trends. According to Deloitte, 35% of consumers have increased their digital banking usage during the pandemic. Visa reports that over 13 million customers in Latin America made their first-ever online transaction in the first quarter of 2020, as the pandemic took hold.

An important consumer development is the use of online investment tools. Huge bouts of market volatility have spurred online transactions by retail investors, able to trade securities via their smartphones. To learn about this, several of ESMA's competent authorities are analysing new regulatory data available at national level. A striking early example was the study published last April by the French *Autorité des Marchés Financiers*. Retail client purchases of blue-chip equities in France increased fourfold in March 2020, while overall volumes tripled. New client money accounted for up to a fifth of total retail investments. Other competent authorities have similar findings. Data from the Belgian Financial Services and Markets Authority suggest that the growth in investing was concentrated among young investors.

How we evaluate the surge in retail trading depends on what is driving it. Although many households have suffered financially during the pandemic, the overall savings rate has shot up. To the extent that new participation in capital markets is channelling long-term savings, it is welcome. But other possibilities are more concerning. There is a risk that much of the new activity is speculative, as retail investors try to profit from market volatility. Equally concerning, they may have turned to day trading to fill in their time during lockdowns. Even worse, as seen in recent headlines, some speculation is fed by online message boards. This can result in mass retail investor trades that create bubble risk.

What is the scale of the risk here for investors? What are the potential abusive practices involved? Together with national competent authorities we are closely monitoring these new developments and are assessing whether any further supervisory action is needed.

A related development of clear concern is the large price bubble that formed in Bitcoin and other crypto-assets during the second half of 2020. Although it is hard to establish cause and effect, increased speculation in this area may be linked to increased retail trading of traditional financial instruments. Certainly, it has never been easier to gain exposure to Bitcoin. Some popular apps used for more standard financial purposes now also offer crypto-asset trading. ESMA and the other ESAs issued warnings around crypto-assets in recent years and we remain vigilant in monitoring developments.[3]

I would like to highlight one more risk, and it is a serious one. During the pandemic we have seen an increase in cybersecurity incidents. A recent report by the Bank of International Settlements highlights how hackers have especially targeted the financial sector during the crisis.[4] These cybersecurity incidents highlight a long-term trend. Cyber risks pose a growing threat in terms of their prevalence and sophistication. The potential operational impact on financial services grows with the increasing use of online digital platforms.

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[3] See (i) ESAs Warning on Virtual Currencies, 12 February 2018, ESMA50-164-1284; (ii) ESAs Statement to Firms, 13 November 2017, ESMA50-164-828; (iii) ESAs Statement to Investors, 13 November 2017, ESMA50-157-829

[4] Aldasoro, Frost, Gambacorta and Whyte (2021), BIS Bulletin No 37

Safe navigation

The title of my speech today refers to safe navigation, alluding to a voyage by sea. It is a well-worn metaphor, but I think it fits the present context. Our objectives for the financial sector – such as market integrity, financial stability and consumer protection – set our desired compass direction. But we face currents in the water, which can drag us off course. Conditions have recently been stormy, and we need to move intelligently in this new environment.

The existing regulatory framework could not anticipate all the recent technological developments. This creates challenges for firms and regulators. First, it may be unclear whether and exactly how the existing rules apply to innovative business models and processes. Different interpretations among firms and supervisors may create inconsistencies and fragmentation in the EU. Second, some adaptations may be needed to allow the existing rules to be applied effectively, such as when new technologies make certain operating processes redundant, or to address risks introduced by new technologies. Third, firms and authorities face challenges in building the knowledge and expertise they need to address the risks of technology and harness its benefits.

The accelerating move to digital finance therefore poses serious questions for policymakers. As new technologies are typically global, we increasingly need to cooperate closely at European level and internationally. One way we meet this challenge is through the European Forum for Innovation Facilitators. The Forum was launched by the ESAs and the European Commission in 2019. We are now working together to strengthen it in line with the Digital Finance Strategy the Commission published last September.

A coordinated approach to monitoring markets helps us spot important developments early on, so that we can take timely action. We maintain regular contacts with authorities internationally to share information and ideas about innovation and financial market trends.

At European level, we are increasingly making use of the regulatory data we have available to monitor risks to markets and investors. I observed just now that national competent authorities have been able to study national-level MiFIR transaction data to reveal a surge in retail trades in response to the crisis. ESMA's role is to enable the authorities to share not only the underlying data but also exchange analyses and to find ways to harmonise their approaches. More generally, we continue to develop our own indicators and analysis in our six-monthly report on Trends, Risks and Vulnerabilities. To complement this work, we have launched several Annual Statistical Reports covering a range of important topics in our remit.[5]

As well as using data for monitoring, ESMA continues to improve the quality and availability of data in financial markets. By helping to develop and promote common reporting formats, standards and identifiers, our work supports the interoperability of digital tools and is a key enabler of RegTech and SupTech solutions. Interoperability further is supported by mature but evolving regulatory frameworks.

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[5] ESMA publishes Annual Statistical Reports on the following topics: (i) Performance and Costs of Retail Investment Products in the EU; (ii) Alternative Investment Funds; (iii) EU derivatives markets; (iv) EU securities markets.

In the crypto-asset area, building on the 2019 ESMA Advice, the European Commission has set out two legislative proposals for a Regulation on Markets in Crypto-Assets (MiCA) and a Regulation for a pilot regime for DLT market infrastructures. The two proposals form a comprehensive framework for the regulation of crypto-assets. The MiCA proposal intends to address the important risks that unregulated crypto-assets pose to investor protection and financial stability. It is particularly timely and relevant considering the current speculation around Bitcoin and recent developments around so-called stablecoins. The DLT pilot regime is especially innovative to the extent that it provides a safe space for market participants and supervisors in the EU to experiment and build expertise around the technology.

As I have observed, financial sector firms are increasingly outsourcing certain operations to the cloud. At the individual level, it is vital that market participants carry out proper risk management in a proportionate manner. For this reason, ESMA recently published guidelines for outsourcing to cloud service providers. In addition, we regulators need to be alert to the associated risks at the system-wide level.

Finally, I noted that cyber threats continue to increase against the backdrop of the crisis. The Commission has published a legislative proposal for a Digital Operational Resilience Act – or DORA for short – which will impose strict standards on entities across the financial sector. DORA is a vitally important initiative. Building on Joint Advice to the Commission from the ESAs in 2019, DORA aims to streamline and strengthen the existing patchwork of relevant provisions across the body of EU financial services legislation. I warmly welcome its aims and fully echo the call for enhanced collaboration among authorities, both within the EU and internationally.

A key part of DORA is to propose new oversight powers for the ESAs regarding third parties providing critical services to financial sector firms. The oversight framework is a difficult balancing act in various respects. A fundamental challenge is that many critical third parties will have, in contrast to the sectoral roles of the ESAs, a cross-sectoral business model with the majority of activities outside the financial sector. Indeed, there is a case that in an ideal world, oversight would be best carried out by a dedicated, fully-resourced and cross-sectoral EU authority, assessing impacts across the financial sector and beyond. But I fully understand that ideal solutions are not necessarily feasible.

Just as we gave detailed advice to the Commission on the early stages of DORA, ESMA will actively support the EU institutions as they refine the proposal. We will continue to contribute ideas on how to make DORA as effective as possible.

Conclusion

To conclude, the pandemic and the ensuing public health measures have accelerated the trend towards digital finance. Now more than ever, consumers are managing their finances online and investing online. Firms have rapidly adapted their working practices and business models in response to the crisis and the associated shifts in consumer demand. Businesses must continue to reinvent themselves, and authorities will need to coordinate their policy response. To remain steadily on course towards our objectives, we must renew our focus on digital finance.