WHITE & CASE

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The Financial Regulatory Observer regularly sets spotlights on selected topics driving the regulatory and technological changes in the financial industry.

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Digitalization: Regulating the future of finance

As technology reshapes the banking industry, regulators are rising to the challenge, write **Carsten Lösing**, **Martin Weber** and **Reetu Vishwakarma**.

Digitalization is at the forefront of the challenges facing the banking industry as it undergoes a period of unprecedented upheaval.

Profit margins and returns are being squeezed as traditional banks face a perfect storm of negative interest rates, tight regulatory scrutiny and increased competition from new entrants, which range from small fintech upstarts to the giants of Big Tech.

These new market participants have captured the zeitgeist by catering to tech-savvy consumers who demand seamless online banking, instant information and high-quality services at lower costs. And regulatory authorities are increasingly interested in the new products and business models being adopted by these market participants.

The user experience is being tailored for mobile devices, and product features are adapting to the fast-changing consumer behaviors. Increased competition also comes from BigTech companies with large customer bases and major capabilities in the digital world: Google, Apple and Amazon are all scaling up their financial service capabilities and expanding into markets previously reserved for traditional banks. These companies continue to utilize the network effect to create platforms with plenty of users and the data that comes along with the users. More and more customers are offered various interactions in a single application as shown by the success of so-called "super-apps," such as WeChat offered by Tencent in China.

Payments are becoming increasingly integrated into other services and are less and less visible. The significance of cash is diminishing as well. Bricks-and-mortar branches are being replaced by chatbots programmed by natural language processing based on artificial intelligence (AI).

Market participants and regulators are discussing both the benefits digitalization brings and the challenges it poses. So far, where Big Tech has entered the market, it has sought to collaborate with global financial services firms. This approach has the advantage that tech firms can work with regulated entities. Google and Citigroup have recently announced a partnership for a personal checking account service, while when Apple had launched its credit card, it did so with the help of Goldman Sachs, which is the issuer.

But with the increasing influx of new technology players in banking, regulators are looking to prevent any loopholes in the supervisory scope and address new risks arising from such collaborations, through adequate prudential measures.

Fintech and the scope of regulation and supervision

Collaboration between banks and fintech companies brings clear benefits, such as catering to customer demand for quick solutions, as well as the facilitation of cross-border banking services. But as a result, new systemically important institutions may emerge from these developments that will inevitably use Big Data and artificial intelligence extensively while closely working with the banking sector.

As collaboration with traditional banks becomes more common, it raises the question of whether fintech companies should require a license to engage in banking business, whether directly or indirectly. Forcing fintech players that are partnering with banks within the purview of banking regulation and supervision to acquires a license would be premature as they do not extend financial services per se, but are only competing for small links of the value chain. However, it may be prudent to put a monitoring mechanism in place in order to facilitate quick supervisory adjustments in case of noticeable changes.

With the proliferation of payment services from the likes of Apple and Google, data misuse becomes a big area of concern, as tech companies will have access to the personal data of billions of users that can be sold or used for marketing purposes. This goes hand-in-hand with the risk of a

US$111.8 bn

Global investment in fintech companies in 2018

Source: KPMG, *"The Pulse of Fintech 2018"*

> **Regulatory authorities are increasingly interested in the new products and business models being adopted by market participants**

non-transparent credit scoring, which is leading to a so-called "black-box effect." Credit scoring models that are based on artificial intelligence (AI) may use that data without the knowledge of the customer.

As banks look to control costs and grapple with ever-more complex IT solutions, outsourcing is on the rise. But this outsourcing trend raises concerns over risk and market concentration.

Towards a systemic crisis?

If outsourcing leads to a situation where activities such as cloud computing end up being offered by just a handful of players, there could be severe operational risk implications for the whole banking sector. "If any of these players were to get into trouble, a huge number of banks might be affected, possibly unleashing a systemic crisis," said Andrea Enria, Chair of the Supervisory Board of the ECB in a speech in March 2019.

Cybercrime is another obvious risk, particularly given the new level of interconnectedness achieved by the "sliced and diced" banking value chain supported by various players including banks and fintech companies. This creates a complex network where any breach may have an impact on the entire value chain and could spark a systemic crisis.

The more business models become digital, the more important IT will be and the more complex technology will become as a result. Components of such complexity, such as AI, are prone to failures that are not easy to detect if small, or to more nuanced cyber-attacks planned by entities that thoroughly understand the financial system. The risks embedded in these complexities are not restricted to technical disturbance of operational processes. It may manifest into substantive aspects of supervision, for example, the black-box effect mentioned earlier. Such challenges are tougher to deal with given the accelerating pace of digitalization, thereby requiring adaptations and market assessments that are more frequent.

Regulators and supervisors are actively and openly engaging in the deliberations around digitalization. "We are neutral on technology. But one thing we are not neutral on is risk," said Enria.

"The new level of interconnectedness within the banking value chain creates a complex network where any breach may have an impact on the entire value chain and could spark a systemic crisis

3,583

Number of fintech startups in EMEA as of February 2019

Source: Statista

Supervisors recognize the challenge in dealing with innovation but ultimately wish to adhere to the core principal of "same risk, same rules, same supervision." This means that banks should be supervised proportionate to their individual risk regardless of whether they use innovative or traditional methods.

Different authorities have offered varied approaches to keep pace with technological advancements in the banking and finance industry. The UK's Financial Conduct Authority (FCA) in its early initiatives came up with the FCA "sandbox," which provided a space for fintech startups and even larger established financial services firms to prove that their business models work and are compatible with the regulatory framework. This has enjoyed considerable success with some fintech players who have benefited from the FCA's approach calling for a global sandbox network.

Meanwhile, the European Banking Authority has emphasized the increasing importance of new fintech providers in its new guidelines for outsourcing arrangements. While discussing the use of fintech solutions by traditional banks to achieve operational and cost efficiency, the EBA noted that "outsourcing is a way to get relatively easy access to new technologies and to achieve economies of scale."

Supervisors have stressed the need to ensure a high level of prudential safety as banks navigate various phases of technological change. Therefore, regulators and supervisors need to stay ahead of any new, emerging risks. A challenging aspect of dealing with the risks imposed by digitalization for banks is to ensure that they build up expertise and knowledge while establishing adequate governance structures and proper risk management practices. This also mandates simple measures such as regular training of employees and raising awareness of the problems with eliminating or attempting to diminish evident risks.

Harnessing technology for supervision

Supervisors have not just reflected on the challenges of digitalization and possible ways of dealing with it, but have embraced ways of using technology and innovation to support supervision and increase efficiency.

Supervisory technology—suptech—the use of innovative technology by supervisory agencies to support supervision, are evolving in areas such as data collection and data analytics.

As new digital business models lead to an ever-increasing amount of high-frequency data, AI and machine learning can help to manage and mine this data. Supervisors can use machine learning to identify patterns that may help to predict systemic risks, analyze credit risk taken by banks, and even play a role in detecting money laundering. Repetitive and periodic tasks can be digitized and therefore free up the workforce to engage in new supervisory challenges.

Digitalization can also make the supervisory process more efficient and less bureaucratic. However, supervisors emphasize that they should approach AI with caution due to potential risks and the need to make comprehensible decisions even when using suptech.

Another area where technology might alter supervision is the way data is shared between banks and supervisors. One option to address the uprising challenges of digitalization for regulatory authorities could be to establish "direct reporting" processes. Direct reporting models can increase efficiency and ease the burden of data collecting. Big Data and AI may thus help to overcome information asymmetries. Suptech represents a refreshing development in the approach to supervision in the financial sector.

What's next?

While supervisory agencies gear up for newer challenges offered by digitalization, market participants must also get ready for an oversight regime that strives to strike a balance between evolving consumer choices, technological innovation and the scope of banking regulation and supervision.

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ESG investing: The sharpening teeth of disclosure

By anticipating regulatory developments in ESG investing, financial firms have an opportunity to stay ahead of the curve, minimize future costs of compliance and feed the growing demand from investors for responsible products and services, write **Jonathan Rogers**, **Samantha Richardson** and **Paula Melendez**.

Environmental, social and governance (ESG) investing is accelerating into the mainstream, as awareness among investors intensifies and they increasingly exert pressure on companies and their boards to consider the environmental and social impact of their businesses.

According to Bloomberg, global sustainable investments grew by 44 percent to US$30.7 trillion over the past two years. Consumers can choose from a growing array of sustainable financial products, from green bonds to sustainability-linked loans and green mortgages, as well as ESG funds.

At the same time, regulators are developing adequate frameworks to ensure that companies—including regulated firms—have guidance to work towards, and to prevent consumers from being misled over an issuer's or products' green credentials and thereby prevent or reduce "greenwashing"—the practice of marketing financial products as "green" or "sustainable", when in fact they do not meet basic environmental standards.

Sustainability is relevant for all financial market participants—from issuers to financial services firms to consumers—and EU financial services regulatory authorities, as well as a number of national regulators including the UK Financial Conduct Authority (FCA), are keen to ensure that these market participants work together effectively and ensure that markets can be trusted and operate without harm to the sector or consumers.

The aim of regulators is to enhance the availability, reliability and consistency of issuers' information in relation to ESG risks and opportunities, so that regulated financial services firms can better integrate this information into the design and delivery of their products and services. In turn, consumers will have access to sustainable finance products and services and receive suitable information and advice to support their investment decisions.

> **"The aim of regulators is to enhance the availability, reliability and consistency of issuers' information in relation to ESG risks and opportunities**

US$ 30.7 tn

Value of global sustainable investment in 2019

Source: Bloomberg

EU regulatory initiatives

As part of their commitment to achieve the United Nation's 2030 Agenda and Sustainable Development Goals (UN SDGs) and to comply with various international agreements, such as the Paris Climate Agreement (COP 21), the European Commission has developed an Action Plan on Sustainable Finance (the EU Action Plan). The EU Action Plan, unveiled in March 2018, aims to provide a regulatory framework to support and promote sustainable investment in the EU in line with these global climate change commitments.

The EU Action Plan's aims include establishing an EU-wide classification system or "taxonomy" for sustainable finance and common labels for green financial products, clarifying sustainability-related duties for asset managers and institutional investors, and promoting transparent ESG policies and reporting. In order to implement the EU Action Plan, in May 2018 the Commission adopted several legislative proposals, which we examine in greater detail below.

Taxonomy Regulation

The proposed Taxonomy Regulation provides the framework for the establishment of an EU-wide scheme of classification to provide all stakeholders with a common language to help establish whether an economic activity is environmentally sustainable. In so doing, the stated aim of policy-makers is to reduce both greenwashing and fragmentation resulting from market-based initiatives and national practices.

The Regulation aims to embed the taxonomy in other EU laws in order to provide the basis for using a common classification system in different areas (e.g., standards, labels, sustainability benchmarks).

In practical terms, the taxonomy sets performance thresholds (referred to as "technical screening criteria") for economic activities which:

1. make a substantial contribution to at least one of the following environmental objectives (as set out in Article 5):
   - climate change mitigation
   - climate change adaptation
   - sustainable use and protection of water and marine resources
   - transition to a circular economy, waste prevention and recycling
   - pollution prevention and control
   - protection of healthy ecosystems
2. avoid significant harm to any of the other environmental objectives (further details of when this occurs are set out in Article 12) and

3. are carried out in compliance with a number of minimum social and governance safeguards (referenced in Article 13).

A report released by the Technical Expert Group (TEG), which was appointed by the Commission to develop the framework, sets out screening criteria for 67 activities across eight sectors that can make a substantial contribution to climate change mitigation, and provides guidance and case studies for investors preparing to use the taxonomy. Technical screening criteria for the other environmental objectives included in Article 3 are expected to be progressively established in delegated acts.

The Taxonomy Regulation continues to progress through the EU legislative process and came one step closer to being finalised on December 5, 2019 when EU negotiators reached a provisional agreement on the framework. The deal is subject to approval by the European Parliament and EU Council, which is expected before the end of 2019. Although the Taxonomy Regulation will come into force 20 days after it is published in the *Official Journal of the EU*, it will not apply until after the adoption of the delegated acts establishing the technical screening criteria for each environmental objective.

There will be staggered application dates for the different environmental objectives ensuring that market participants have sufficient time to prepare.

67

activities across eight sectors that can make a substantial contribution to climate change mitigation already have corresponding technical screening criteria

Disclosure Regulation and Low Carbon Benchmarks Regulation

On November 27, 2019, the European Parliament and the European Council adopted the following regulation as part of the EU Action Plan to facilitate investments in sustainable projects and assets across the EU:

- Regulation on disclosures relating to sustainable investments and sustainability risks in the financial services sector, or so-called Disclosure Regulation; and
- Regulation amending the Benchmarks Regulation as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks—the so-called Low Carbon Benchmarks Regulation.

The Disclosure Regulation details how financial market participants and financial advisors should incorporate ESG risks and opportunities in their processes, procedures and policies. The regulation sets out new responsibilities, which include:

- *Information on websites (Articles 3, 6 and 8):* In-scope entities will be required to publish policies on their website that describe the extent to which the organization integrates sustainability risks into the investment decision-making process. Additionally, for financial products that have sustainable investments as their target, prescribed information, such as a description and the sustainability assessment and monitoring methodologies, must be published on the website.
- *Pre-contractual information (Articles 4 and 5):* For all financial products, pre-contractual information should be provided that discloses how sustainability risks are integrated into the investment decision-making process and how those risks are expected to have an impact on the return of the product.
- *Reporting (Article 7):* On a periodic basis, reports will be required to be produced for financial products with sustainable investment objectives. These reports should evaluate the extent to which the sustainable investment objectives of the product have been attained and should detail the product's sustainability-related impact.

The Low Carbon Benchmarks Regulation amends Regulation (EU) 2016/1011 by introducing new categories of "low carbon" or "positive carbon impact" benchmarks.

To help investors compare the carbon footprint of investments, benchmark administrators will be required to disclose how their methodology takes into account ESG factors for each benchmark or family of benchmarks that is promoted as pursuing ESG objectives. That information should also be disclosed in their benchmark statement, along with the methodology used for the calculation, taking into account how the underlying assets were selected and weighted and which assets were excluded and for what reason. The index provider MSCI has announced that it has created provisional indices meeting the minimum standards of the Regulation and that these are being evaluated and tested by clients in anticipation of the final text being released.

The texts of both regulations were published in the *Official Journal of the EU* on December, 9 2019 and the Disclosure Regulation will take effect from early 2021, whilst the Low Carbon Benchmarks Regulation will take effect from early 2020.

Other anticipated EU legislative initiatives include amendments to Level 2 rules, including the Markets in Financial Instruments Directive (MiFID) and the Insurance Distribution Directive (IDD). These changes will be relevant to institutional investors, asset managers, investment advisors and other intermediaries, requiring them to consider sustainability risks in their activities.

UK and national regulatory initiatives

A number of national supervisory authorities have also pushed through initiatives aimed at improving ESG disclosure and preventing "greenwashing". France's Autorité des Marchés Financiers (AMF) recently announced the creation of a new Climate and Sustainable Finance Commission to tighten the supervision regime of ESG practices

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> ESG and climate risk remain high on the agenda of both the public and private sectors, and there is an obvious need for policies to guide and regulate the growth of ESG investing

under its 2016 energy transition law, which requires asset owners to report their management of climate-related risks and the integration of ESG into investment policies.

In the UK, both the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) are ramping up the development of supervisory guidance and requirements consistent with the UK government's commitment to transition to a net zero emissions economy by 2050.

FCA FS19/6 – Climate change and green finance

On October 16, 2019, the FCA published "Feedback Statement 19/6: Climate change and green finance", which summarizes responses received by the FCA to its October 2018 Discussion Paper (18/8). In FS19/6, the FCA identifies a number of priority actions, including:

- publishing a consultation paper in early 2020, in which the FCA will propose new mandatory disclosure rules for certain listed issuers and clarify existing obligations.
- finalizing rule changes requiring independent governance committees to oversee and report on regulated financial services firms' ESG and stewardship policies.
- challenging regulated firms where potential greenwashing is identified and taking appropriate action to prevent consumers from being misled, and
- contributing to several important collaborative initiatives, including the Climate Financial Risk Forum, the Fair and Effective Markets Review working group, the government-led Cross-Regulator Taskforce on Disclosures and the European Commission's Sustainable Finance Action Plan.

If the proposed disclosure rules noted above are adopted, the FCA will go further and faster than the UK government's plan to require securities issuers and large asset owners to start disclosing their climate-related risks by 2022. The FCA disclosure requirements would be in line with the recommendations made by the Task-Force on Climate-related Financial Disclosure (TCFD), a global organization formed by the Financial Stability Board to coordinate disclosures among companies impacted by climate change. Although mandatory, the proposed rules are currently expected to be on a "comply or explain" basis. In time, the FCA may consider disclosure requirements on other sustainability factors, beyond climate change, as appropriate frameworks emerge.

PRA SS3/19 – Supervisory statement on enhancing banks' and insurers' approaches to managing the financial risks from climate change

In April 2019, The PRA issued a supervisory statement addressing all UK insurance and re-insurance firms, as well as banks, building societies and PRA-designated investment firms. Building on its reviews of current practices in the banking and insurance sectors, the PRA highlights that while firms are enhancing their approaches to managing the financial risks from climate change, few are taking a strategic approach that considers how actions today affect future financial risks. In particular, the PRA has identified that financial risks from climate change arise through two primary risk factors—physical and transition—and additionally, liability risk, which applies to the insurance sector.

The Stewardship Code 2020 will take effect

On the basis of these financial risks, the PRA sets out clear guidelines for banks and insurers to follow in governance, risk management, scenario analysis and disclosure.

Regarding governance, and building on the Senior Managers Regime, banks and insurers must have in place updated senior management function forms addressing financial risks from climate change.

On the disclosure front, banks and insurers are being asked to consider disclosing how climate-related financial risks are integrated into governance and risk management processes, including the process by which a firm has assessed whether these risks are considered material or principal risks. These are in addition to their disclosure obligations arising from the Capital Requirements Regulation, Solvency II and the UK Companies Act.

The PRA also expects firms to improve their disclosures to reflect their evolving understanding of climate risks, to recognize that disclosure is likely to be mandated in more jurisdictions and to prepare accordingly.

Finally, and in line with the FCA's expectations outlined above, the PRA wants firms to engage with wider initiatives on climate-related financial disclosures, including the TCFD's policy recommendations and framework.

Other initiatives being heralded in the UK include the Financial Reporting Council's (FRC) recently revised Stewardship Code, which will take effect from January 1, 2020. This so-called 2020 Code includes a set of "apply and explain" principles for asset managers, asset owners and service providers who will be expected to report certain information in order to remain signatories.

In particular, signatories will be expected to take account of material ESG factors when fulfilling their stewardship responsibilities. The 2020 Code therefore presents an opportunity for listed companies to review their approach to ESG reporting and ensure that it is fit for the purpose. Although adherence to the 2020 Code is voluntary, the FRC can make annual assessments as to whether an existing signatory can maintain its status and take action where a signatory is not complying.

Risks and opportunities ahead

As ESG and climate risk remain high on the agenda of both the public and private sectors, there is an obvious need for the development of policies to guide and regulate the growth of ESG investing. Enhanced disclosure not only protects consumers against "greenwashing" but also ensures that risk management remains as transparent as possible, and that future performance data is valid. In fact, disclosure is likely to form the basis of future ESG regulation mandating specified levels of, for example, green holdings, and limiting the amount of non-green holdings.

Further, while ESG as a framework is already being applied by a large number of financial actors, substantive regulation appears to have mainly covered environmental factors thus far. This may be largely explained by the quantitative nature of environmental considerations, which makes it easier, in contrast to social and governance factors, to distill common metrics and generate comparable information. Initiatives on standards for social and governance factors do exist and may see further developments in the near future.

Enhanced disclosure protects consumers against "greenwashing" and ensures that risk management remains transparent

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Eight priorities for the new EU financial services chief

Valdis Dombrovskis has a full in-tray that includes securing the EU banking and capital markets union as he begins his term at the European Commission, writes **Willem Van de Wiele**.

The new President of the European Commission Ursula von der Leyen, has laid out the priorities she wants Valdis Dombrovskis, the EU's new financial services regulator, to pursue over his five-year tenure. In her mission letter published on September 10, von der Leyen called upon Dombrovskis, one of the new commission's three executive vice presidents, to preserve and improve financial stability, protect savers and investors, and ensure the flow of capital to where it is needed. Specifically, she called upon Dombrovskis to tackle eight main priorities.

1. Banking union

Dombrovskis must focus on the completion of the EU Banking Union, notably by finalizing the common backstop to the Single Resolution Fund and agreeing on a European Deposit Insurance Scheme. These two elements are politically sensitive obstacles to the Banking Union that the previous commission was unable to tackle.

2. Capital markets union

The mission letter also calls on Dombrovskis to speed up work towards a capital markets union (CMU) and "to diversify sources of finance for companies and tackle the barriers to the flow of capital". In particular, the new commissioner must explore ways to make cross-border investments easier, to improve the supervisory system and to better harmonize insolvency and tax proceedings.

To achieve its goal of finalizing the creation of CMU, the Commission has launched a High-Level Forum on Capital Markets, comprising experts from industry and civil society chaired by Thomas Wieser, former Chair of the European Financial

"Innovation and the digitalization of financial services are a priority, given the huge potential that new technologies bring to the sector

Ursula von der Leyen, the new President of European Commission, published her mission letter

Committee. Dombrovskis has asked the forum to submit a set of policy recommendations by May 2020 in order to "take CMU to the next level."

3. Green financing strategy

The mission letter also hands Dombrovskis the job of "developing a green financing strategy to ensure that we can direct investment and financing to the transition to a climate-neutral economy". In this respect, the vice president should work with the EU's partners to lead global efforts to scale up sustainable financing.

In a speech delivered in the Guildhall in London on November 15, Dombrovskis indicated that the Commission is moving quickly with negotiations for an EU classification system, or taxonomy, to define which economic activities are sustainable. In addition, he said that the Commission will soon start preparing another set of green finance initiatives, including the following:

- Incentivizing tools like green mortgage loans, and expanding the EU ecolabel to financial products
- Work on EU green bond standards, which could support local and regional authorities—and SMEs—to issue bonds to assist in setting up sustainable projects
- On the reporting side, proposing measures in the EU's Non-Financial Reporting Directive, and asking companies to give sufficient and reliable information on their sustainability risks and opportunities and
- Supporting those most affected by the green transformation through a new Just Transition Fund

4. Fintech strategy

The EU financial services chief must also "put forward a fintech strategy to support new digital technologies in our financial system", according to von der Leyen. However, the mission letter does not give further details regarding the proposed content of the fintech strategy.

In a speech delivered to the European Parliament plenary on November 27, von der Leyen said that financial innovation and the digitalization of financial services are a priority, given the huge potential that new technologies bring to the financial sector—for example, by giving consumers better and faster access to finance. She promised to "present a new strategy for Europe to get the best out of fintech and compete globally, as we remove regulatory barriers between countries. Of course, we will make sure to address risks related to consumer protection, money laundering and terrorist financing, and data protection, to give just some examples".

With respect to the new fintech strategy, it will be very interesting to see how this strategy will evolve against the broader background of the development of policy on technology, e.g., new developments in competition policy with respect to big technology companies, developments in data protection and artificial intelligence.

The EC President added that

The interaction between the regulation of cryptocurrencies and anti-money laundering supervision will continue to evolve

"with the General Data Protection Regulation we set the pattern for the world. We have to do the same with artificial intelligence. Because in Europe we start with the human being. It is not about damming up the flow of data. It is about making rules that define how to handle data responsibly. For us, the protection of a person's digital identity is the overriding priority." These declarations echo the recent recommendations from the High-Level Expert Group on Artificial Intelligence (AI HLEG). These recommendations put forward a human-centric approach to AI and list seven key requirements that AI systems should meet in order to be trustworthy. These requirements will go through a piloting process expected to conclude with the presentation of a revised document in early 2020.

5. SME strategy

Von der Leyen also called upon Dombrovskis to develop a new public-private fund specializing in initial public offerings for small and medium-sized enterprises (SMEs) as part of an overall SME strategy. She noted that "all too often, SMEs move abroad to scale up because they find it difficult to get market-based financing in Europe."

6. Anti-money laundering

The mission letter says that the new EU financial services chief must put forward "a new, comprehensive approach to fighting money laundering and the financing of terrorist activities". This should focus on "better enforcement of legislation, better supervision, adapting to risks linked to new technologies and a stronger role in setting international standards."

Vice president Dombrovskis said in a recent speech that he would see a lot of merit from handing specific anti-money laundering supervisory tasks and their coordination to an EU body. The debate about a central European agency dealing with anti-money laundering supervisory tasks had already started prior to the installation of the new Commission following a number of high-profile cases in certain Member States. It will be interesting to see whether the new Commission will usher such a new agency into existence, and what other initiatives it will pursue in this area.

AML5 already brought cryptocurrency exchanges and custodian wallet providers within the scope of anti-money laundering regulations. With respect to the risks related to new technologies, it will be interesting to see how the interaction between the regulation of cryptocurrencies and anti-money laundering will continue to evolve.

7. Cryptocurrencies

The mission letter also states that Dombrovskis "should ensure a common approach with Member States on cryptocurrencies to ensure we understand how to make the most of the opportunities they create and address the new risks they may pose."

Cryptocurrencies have already come under an increased scrutiny by policy makers and regulators in the EU (as well as in other jurisdictions). The debate around private companies launching blockchain digital currencies provides a clear illustration of this increased scrutiny. The French and German governments recently issued a joint statement stating that "no private entity can claim monetary power, which is inherent to the sovereignty of nations".

The mission letter does not solely focus on risks and restrictive measures with respect to cryptocurrencies but also calls upon the new vice president to look at the opportunities they might present.

May 2020

Deadline for submissions for CMU policy recommendations

For example, in Germany proposals exist that would enable banks to facilitate the sale and storage of cryptocurrencies.

8. Economic sovereignty

Dombrovskis must also "support our economic sovereignty, developing proposals to ensure Europe is more resilient to extraterritorial sanctions by third countries" and also ensure that the sanctions imposed by the EU are properly enforced, "notably throughout its financial system."

In addition to the priorities mentioned above, a number of other important topics will likely appear on the agenda of the new Commission, such as the MiFID and MiFIR review. It promises to be a crucial and potentially transformational tenure.

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Lifting the lid on MAR

The latest consultation paper from ESMA raises some important questions about the market abuse regulation (MAR) but lacks detail in some crucial areas, **Stuart Willey** explains.

On October 3, 2019, the European Securities and Markets Authority (ESMA) published a consultation paper that raised questions about the scope and operation of the Market Abuse Regulation—Regulation 596/2014 of the European Parliament and of the Council.

The background on the paper is Article 38 of MAR, which requires the European Commission to submit a report to the European Parliament and to the Council on the application of MAR together with amending legislative proposals. The focus is therefore on the Level 1 text of MAR and on identifying potential fixes to any problems in that text. To facilitate this, the Commission issued a formal request to ESMA to provide technical advice on a range of points, some of which are contemplated by Article 38 and other additional non-mandatory elements. The Commission issued its mandate to ESMA in March 2019 and asks for ESMA's advice by December 31, 2019. ESMA invited comments on its paper by November 29, 2019.

Spot FX contracts

Possibly the most significant point in the paper is the suggestion that the scope of MAR should be widened to include spot FX contracts. The impetus for this lies in the historic cases of misconduct that occurred in the G10 spot FX market and the resulting public fines imposed on market participants both in Europe and in the US. Some of those improper behaviors involved, for example, the actual or attempted manipulation of FX benchmarks and, as the paper says, such misconduct would in theory be capable of being assimilated into the MAR regime.

The paper reaches no clear conclusion or recommendation but notes a number of factors that would argue against extending the MAR regime to include spot FX contracts:

> **“One of the most significant points in ESMA's paper is the suggestion that the scope of MAR should be widened to include spot FX contracts**

- The spot FX market is predominantly an over-the-counter (OTC) market and does not have the characteristics that would enable it easily to fit within the MAR framework
- The concept of "issuer," which is central to many MAR requirements is not present and hence would not fit the spot FX market
- It is not clear that extending MAR to include "spot" FX contracts in the same way as spot commodity contracts would be practicable, for example, expanding the prohibition of market manipulation to cases where a spot FX transaction has an effect on the price or value of a financial instrument. One constraint is that the impact of FX price changes could be very widespread and distinguishing price movements that result from manipulative FX contracts would be very difficult
- The sheer volume of FX spot contracts could make regulatory monitoring an impossible task and
- A significant proportion of the market from 16 countries has already signed up to the FX Global Code of Conduct and it may be desirable to see how compliance with the Code is helping to prevent misconduct

On balance, it would appear that ESMA's current approach is leaning against the inclusion of spot FX contracts, but this is clearly a possibility that needs monitoring given its huge potential significance.

ESMA published a consultation paper on the scope and operation of MAR

Definition of "inside information"

Inside information

According to the definition of MAR, all inside information must be of a precise nature, not be public and, if it were made public, likely to have a significant effect on the prices of relevant financial instruments.

ESMA raises some very general and high-level comments and questions about the adequacy of the definition of inside information in Article 7 of MAR. One such question is whether market participants have encountered difficulties in identifying what constitutes inside information for the purposes of MAR.

ESMA does not specify what those difficulties might be, but for market participants they would include when information is deemed sufficiently "precise" and what is meant by it having a "significant effect" on the prices of relevant financial instruments.

Given the paper's very high-level treatment of and lack of transparency about these important questions, market participants may be reluctant to offer any specific recommendations for changing the basic building blocks of the regime.

Commodity derivatives

In relation to commodity derivatives, MAR says that as well as being precise and sufficiently price sensitive, "inside information" must also be reasonably expected to be disclosed or required to be disclosed in accordance with "legal or regulatory provisions at an EU or national level, market rules, contract, custom or practice on the relevant commodity derivatives markets."

One example of such information is the Joint Organisations Database Initiative for oil & gas. ESMA says that the additional criterion attaching to the definition of inside information in the case of commodity derivatives is anomalous because a listed commodity producer may be prohibited from disclosing trading information to others (because of the potential impact of the use of the information on, say, the price of the producer's listed securities) whereas a non-listed commodity producer would not be so constrained.

It would appear that any change in the definition of inside information in relation to commodity derivatives and spot commodities would nevertheless need to somehow respect the ability of commodity producers to trade on the basis of knowledge of their own trading intentions and strategies as currently contemplated by Recital 30 of MAR.

Pre-hedging

The paper asks some questions about pre-hedging practices: What market abuse or conduct risks arise from pre-hedging? What benefits flow to firms, client and the market generally?

ESMA appears to have a concern that pre-hedging by brokers following a request to quote may go beyond protecting the broker's legitimate interests and may be used to position a market price against the client and in favor of the broker.

ESMA says clients should be made aware of a broker's ability to pre-hedge a transaction. The paper acknowledges that there is a clear cross-over with other obligations imposed on brokers under MiFID II concerning the management of conflicts, handling client orders and the duty to act in the client's best interests.

Given the very open and high-level nature of ESMA's questions, it is unclear how far it will go in recommending changes to MAR that would clarify in what circumstances pre-hedging amounts to market abuse.

Insider lists

According to MAR, insider lists serve different purposes: they contribute to protect market integrity by allowing NCAs to identify who has access to inside information and by stating the specific date and time on which a piece of information became inside information, and also the date and time when the relevant persons gained access to it. Additionally, insider lists should be helpful for issuers to manage the flows and confidentiality of inside information.

ESMA is concerned that insider lists have suffered "inflation," as issuers and their external service providers have included individuals who in theory might access inside information but who in practice do not do so. They are similarly concerned that lists of permanent insiders extend beyond individuals who have access to all inside information at all times.

The maintenance of insider lists is already administratively onerous, and proposals that might add to the burden placed on issuers need to be weighed alongside the benefit to national competent authorities (NCAs) of, for instance, permanent insider lists being restricted to a few individuals who can be said to have access to all information at all times.

ESMA is also considering whether the obligation in MAR to draw up and maintain an insider list should be extended beyond the issuer and persons acting on their behalf or on their account to include persons performing tasks through which they have gained access to an issuer's inside information. Examples of such other persons include auditors and notaries, but the drafting of any changes to MAR could capture categories of persons such as law firms that are mandated in a transaction to represent banks (but not the issuer).

Competent authorities, market surveillance and cooperation

The paper refers to so-called dividend arbitrage strategies and highlights schemes that involve transactions aimed at creating circumstances that allow persons to obtain refunds on dividend tax that was not paid and that may involve fraud.

ESMA's investigations revealed that such schemes may not involve any violations of MAR, and national competent authorities may have no powers to investigate. ESMA suggests that such tax evasion schemes or improper tax reclaim schemes resulting from trading securities may impact "market integrity" and hence recommends that MAR should be amended to require that NCAs have powers that would enable them to investigate and take action in respect of unfair behaviors that—while not amounting to market abuse—could potentially impact the integrity of the market.

ESMA also recommends that all NCAs in Europe should be given the power to share information with tax authorities, if necessary on a cross-border basis.

Such changes would represent a significant and open-ended extension of investigative and sanctioning powers for regulators. Giving all financial regulators the express power to share information with tax authorities represents a potentially important development.

ESMA's advice to the EC on the implementation of MAR is due by December 31, 2019

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How to challenge the ECB: Lessons from the first EU court cases on the SSM

The European Courts have handed down first judgments on supervisory measures taken by the European Central Bank. These decisions shed light on important questions regarding the application of supervisory law and provide insight into how to challenge supervisory acts successfully, writes **Henning Berger**.

The Single Supervisory Mechanism (SSM) refers to the system of banking supervision in Europe that comprises the European Central Bank (ECB) and the national supervisory authorities of the participating countries. The ECB became the lead supervisor of the SSM in 2014 and currently directly supervises 116 "significant" banks accounting for 82 percent of banking assets in the euro area.

The European Courts have now published their first decisions on supervisory measures taken by the European Central Bank. Four of the judgments are first instance decisions by the European Court (EC) and one is an appeal decision by the European Court of Justice (ECJ). There are several important take-aways here that highlight the role of national law, the scope of judicial review, the principle of proportionality and limits to judicial control over discretionary decisions.

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The number of "significant" banks under the ECB's supervsion

Application and interpretation of national law

A central question in the SSM is the role of national law, as the ECB is an EU institution. Since the ECB also applies national law transposing EU law within the SSM under Article 4 (3) of the SSM Regulation, this "necessarily requires the Court to assess the legality of the contested decisions in the light of [EU law] and [national law transposing it]" (T-133/16, para 49).

When doing so, "the scope of national laws, regulations or administrative provisions must be assessed in light of the interpretation given to them by national courts." In the absence of decisions by competent national courts, it is however for the EC to rule on the scope of those provisions (T-52/16, para 131) and, therefore, to interpret the national law by itself.

Scope of judicial review

In general, the EC's examination of the merits is restricted to the arguments brought forward by the applicant. This holds true for most reasons possibly rendering an EU act invalid, e.g., error of law and disproportionality. To be heard by the EC, the applicant will always have to make an explicit plea of illegality of the underlying provision (T-122/15, para 38; T-52/16, paras 80, 151). Where a plea of illegality is raised within the meaning of Art. 277 TFEU, it is for the court alone to review its consistency with the provisions of the EU primary and secondary law (T-733/16, para 35).

Principle of proportionality

The principle of proportionality plays an important role when challenging a supervisory measure as it obliges both the legislators and the supervisors and is a requirement for the legality of a legislative act as well as for a supervisory measure based on it.

Proportionality means that the content and form of an EU legal act is not to exceed what is necessary to attain the objectives of EU law. Both the *L-Bank* and the *Crédit Mutuel Arkéa* cases addressed the proportionality principle.

In the *L-Bank* case, the EC stated that the principle of proportionality had already been taken into account by the legislator and, therefore, could not additionally be applied in the individual case. To support this view, the EC also put forward the allocation of responsibilities between the supervisory authorities, enshrined in the SSM Regulation.

In the *Crédit Mutuel Arkéa* case, the EC defined proportionality in the supervisory context. It stated that acts adopted by EU institutions must be appropriate for attaining the legitimate objectives pursued by the legislation at issue and must not exceed the limits of what is necessary in order to achieve those objectives. Where there is a choice between several appropriate measures, recourse must be granted to the least onerous, and the disadvantages caused must not be disproportionate to the aims pursued (T-52/16, para 200).

Review of discretionary ECB decisions

Many prudential rules under EU law provide for supervisory discretion, e.g., by referring technical and risk-related assessments or offering a choice of actions to the supervisors. Under general EU procedural principles, the Union courts have limited power to review discretionary decisions. This has now been confirmed by the EC with regard to discretionary decisions by the ECB. This is important for claimants from national jurisdictions, such as Germany, where the courts traditionally exercise a stronger scrutiny of administrative decisions. The EU courts limit their scope of judicial control to reviewing whether a discretionary decision:

- Is based on materially incorrect facts (including whether the evidence relied upon is factually accurate, reliable and consistent)
- Is vitiated by an error of law
- Is vitiated by a manifest error of assessment or
- Is vitiated by misuse of powers

First judgments explained

L-Bank Judgment (T-122/15, C-450/17): Claim dismissed

Landeskreditbank Baden-Württemberg (L-Bank), an investment and development bank of the German State of Baden-Württemberg, qualified as a "significant institution" under Article 6(4) of the SSM Regulation, which means that it is subject to the direct supervision by the ECB.

However, the applicant wanted to be exempted from the ECB's supervision because of "particular circumstances" according to Article 6(4) of the SSM Regulation and Article 70 SSM Framework Regulation.

The EC ruled that the exemption clause applies only when supervision by the national competent authorities (NCAs) would better serve the goals of the SSM than supervision by the ECB. The ECJ confirmed this ruling. Therefore, the applicant's claim was dismissed.

The L-Bank judgment was the first decision on the SSM by the EC and the first decision on appeal to the ECJ.

Crédit Mutuel Arkéa Judgment (T-52/16): Claim rejected

Crédit Mutuel is a French banking group made up of a network of local credit unions with the status of cooperatives. Each local mutual credit union must be affiliated with a regional federation and each federation must be affiliated with the Confédération Nationale du Crédit Mutuel (CNCM), the central body of the network.

In 2015, the ECB took over supervision of CNCM and required the entire Crédit Mutuel Group to comply with a Tier 1 capital ratio (CET 1 capital) of 11 percent.

Crédit Mutuel challenged the ECB's status as its lead supervisor on the grounds that it is not a credit institution. The main legal issue of the case concerned the interpretation of the term "supervised group" under Article 2(21)(c) of the SSM Framework Regulation and the requirements for a waiver under Article 10 of the Capital Requirements Regulation (CRR).

The EC rejected the claim on the grounds that consolidated supervision does not require the central body of the group to be a credit institution.

Crédit Agricole Judgment (T-133/16): Challenge dismissed

Crédit Agricole, a French non-centralized banking group with regional credit union branches, is classified as a "significant supervised group" under the SSM Regulation. Four of its branches sought approval from France's Autorité de contrôle prudentiel et de résolution (Authority for Prudential Supervision and Resolution) to appoint the same person as "effective director" and chairman of the board of directors.

The ECB approved the appointment of the persons concerned as chairmen of the board of directors but objected to them carrying out at the same time the function of "effective director" —a ruling that the French bank challenged.

The claim challenged the ECB's interpretation of the term "effective director" under Article 13, 88(1)(e) of the Capital Requirements Directive (CRD IV) and its transposition into the French Code Monétaire et Financier.

The EC ruled that the expression "two persons who effectively direct the business of the (…) institution" refers to the members of the management body who are also part of the senior management of the credit institution. It therefore upheld the ECB's interpretation and applied Article 88(1)(e) of CRD IV to prevent the appointment of the chairman of the board of directors in his/her supervisory function as an "effective director".

Banque Postale Judgment (T-733/16): ECB decision annulled

La Banque Postale is a joint stock company governed by French law and a significant credit institution under direct ECB supervision.

The bank challenged the decision by the ECB to reject its request for authorization to exclude the exposure of public sector entities from the calculation of the leverage ratio under Article 429 (14) of the Capital Requirements Regulation (CRR).

The claimant argued that the relevant exposure was made up of sums associated with regulated products it was required to transfer to the Caisse des Dépots et Consignations, a French public institution.

The EC found the ECB exercised its discretion incorrectly, thereby vitiating its decision by an error of law. The Court held with regard to the principle of effet utile that the ECB cannot rely on grounds that would make the application of Article 429(14) practically impossible.

This judgment was the first instance where the General Court has annulled a decision of the ECB since it became the lead supervisor of the SSM.

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Securitization set to come of age in NPL resolution quest

Refinements to the regulatory framework are needed before banks can make widespread use of securitization by European banks, according to **Dennis Heuer, Carsten Lösing and Reetu Vishwakarma**.

Volumes of non-performing loans (NPLs) European banks have halved since 2015, driven by an increase in NPL sales and securitizations, according to the European Banking Authority's (EBA) report on NPLs published in November 2019.

The fall is due to increased supervisory attention, political determination and efforts by banks to enhance their NPL management capabilities, according to the EBA report on NPLs, "*Progress Made and Challenges Ahead*".

An analysis of this report and the July 2016 EBA report, "*Dynamics And Drivers of Non-Performing Exposures in the EU Banking Sector*", reveal the progress that has been made over the past three years towards providing the EU with a secondary market for NPLs and sharing of NPL risk with the private sector.

€587bn

The volume of NPLs held by significant institutions in the EU by the end of March 2019

Source: European Central Bank

In a press release of August 2019, the European Central Bank (ECB) also reported that the volumes of NPLs held by significant institutions have fallen by almost 50 percent since November 2014. The volumes stood at €587 billion by the end of March 2019, from approximately a trillion euros reported in November 2014.

Although reductions are reported across the EU, the distribution of NPLs remains uneven (ranging from 36 percent in Greece to less than 1 percent in Sweden). Lending segments such as SMEs, CREs and consumer credit remain riskiest, although they have reportedly shown great improvements. Recent IFRS 9 data has also indicated better asset quality for both on-balance-sheet and off-balance-sheet items.

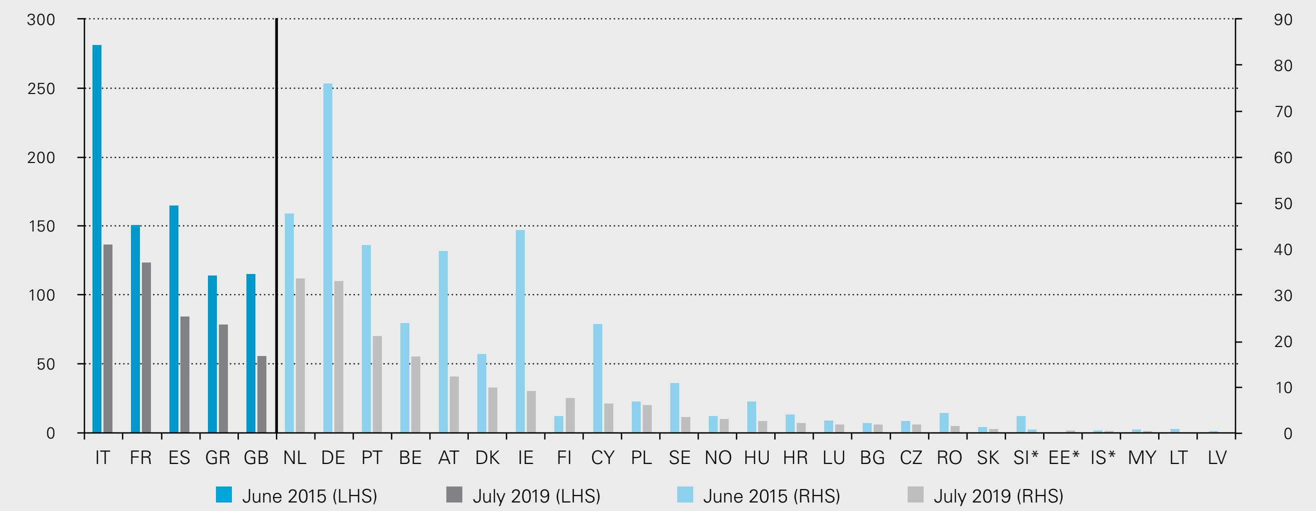
Regulatory activity

Regulatory activities can be divided into two phases: developments that have already helped reduce the stocks of NPLs in the EU, and the work that is currently underway to equip the market with stronger resolution tools and resilience.

The legislators and the regulatory authorities are still working towards a more sustainable and resilient banking sector despite the progress made in the aftermath of the 2008 financial crisis.

In recent years, the European Commission, European Council and European Parliament have finalized the Backstop Regulation (Regulation (EU) 2019/630 of the European Parliament and of the Council, 17 April 2019 amending Regulation (EU) No 575/2013 as regards Minimum Loss Coverage for Non-Performing

NPL volumes by country, June 2015 to June 2019, € billion



Sources: EBA report "*Progress Made and Challenges Ahead*" November 8, 2019

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Jurisdiction-specific constraints like inefficient legal frameworks for recovery procedures and the lack of a market for NPLs continue

Exposures), as well as the proposal for a Directive of the European Parliament and of the Council on Credit Servicers, Credit Purchasers and the Recovery of Collateral, to facilitate NPL resolution by banks. Meanwhile, the ECB has issued specific guidelines for NPL management.

In July 2017, the Council of the EU announced an "action plan" to deal with NPLs in Europe. The plan outlined policy actions and invited the various European institutions to take appropriate measures to specifically address the high stock of NPLs in the EU and restrict their emergence in the future.

On the one hand, the ECB has prescribed higher provisions for NPLs, making it more expensive for banks to hold them, and, on the other, a framework is being developed to incentivize banks to offload NPLs.

Some European countries are already working with systemic solutions. In 2016, the Italian government introduced the Garanzia sulla Cartolarizzazione delle Sofferenze (GACS) scheme, which facilitated the secondary market for NPLs held by Italian banks, by offering a public guarantee to the senior, low-risk notes, and thereby increased the creditworthiness of the senior tranches. The scheme has incentivized banks to sell NPLs in the Italian market and, reportedly, with sales in gross book value of approximately €123 billion, Italy has been the most active market for NPLs in Europe.

Greece has also been the subject of scrutiny from European regulators and stakeholders alike. While the decrease of NPL ratios in Greece is not impressive, NPL volumes of Greek banks have fallen by €35 billion or 30 percent.

Greece has shown considerable improvement in the past two years, with increased reliance on securitization as a tool for NPL resolution. Securitization has proved to be efficient in markets with high levels of NPLs because it provides legal certainty, adequate investor protection and a lower cost of funding. With further developments such as the GACS-like asset protection scheme "Hercules" and further regulatory reforms in the pipeline at the Union level, Greece is attracting investor interest as its banks tidy up their balance sheets.

One of the key impediments to NPL resolution is information asymmetry. The EBA is looking to address this by proposing standardised data templates for secondary market transactions in NPLs. This will not only impart more transparency to the markets with comparable and standardized data but also instill investor confidence in NPL securitization as a stable product.

The EBA has recently published an opinion paper for the European Commission's consideration on the regulatory treatment of non-performing exposures: the EBA Opinion on the Regulatory Treatment of NPE Securitizations dated 23 October 2019 (EBA-Op-2019-13). In addition to the policy issues already under consideration at the Union level, most pertinent roadblocks in further resolution of NPLs are member state-specific, like an inefficient legal framework and the lack of a market for NPLs.

Impediments in the regulatory framework and restorative recommendations

The EBA opinion paper:

- Highlights the shortcomings in the current regulatory framework that are developed primarily with performing assets in mind. Thus, the current framework inadvertently restricts a more effective utilization of the securitization regime as a tool to reduce NPLs in the EU
- Recognizes the potential of securitization in increasing the market's capacity to absorb NPLs from the European banking balance sheet and allocates the risk to a more diverse investor pool
- Emphasizes the inherent peculiarities of NPLs from the other assets that back securitization structures and recommends that the regulatory framework should take these peculiarities into account
- Highlights how leaving out the non-refundable purchase price discounts (NRPPD) from the calculation of expected losses and exposure values of the portfolio entails the disproportionately large capital charges under the current capital requirement regime

In response to feedback received from the relevant market players, the EBA also proposes that investor institutions be allowed to apply a 100 percent risk weight cap for securitizations where the originator

The EBA opinion recommendations

When a cap for securitization under 267-268 of CRR applies:

1. "Expected losses" and "exposure value" calculation to be net of NRPPD (and SCRAs)
2. Risk weights of 100% for investor if originator could apply the same pre-securitization and NRPPD ≥ %SCRAs made by originator

For securitization regulation:

1. Risk retention under Article 6
   - Nominal value to take NRPPD into account
   - Independent servicer be entitled to discharge the obligation
2. Practical approach for credit-granting criteria under Article 9 for NPL securitizations

“The legislators and the regulatory authorities continue to work towards a more sustainable and resilient banking sector despite the progress made in the aftermath of the 2008 financial crisis

was permitted to apply the same, and the NRPPD is at least equal to or larger than the specific credit risk adjustments made by the originator.

In addition to the impediments under the capital requirement regime implemented by the Regulation (EU) No. 575/2013 of the European Parliament, and of the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms (CRR), the EBA opinion paper assesses how the new securitization framework that came into force in January 2019 and introduced rules for issuing simple, transparent and standardized transactions can hinder NPL securitization transactions.

The underpinning assumption of the Securitization Regulation is evident with the prescription of due diligence on the credit-granting requirements. It also draws the Commission’s attention to another set of constraints related to the determination of the retention amount based on “nominal values” of the underlying assets (again disregarding NRPPD) and exclusion of an independent servicer from the parties that may enable compliance with the retention requirements.

While the EBA opinion paper is a big step in the direction of adapting the prevailing regulatory regime for NPL securitization transactions, it will be some time before the recommendations become law. The proposal for a Directive of the European Parliament and of the Council on Credit Servicers, Credit Purchasers and the Recovery of Collateral has been subject to lengthy debate with contrasting views of the Council and the Parliament over more than one aspect.

The market may have revived, but the non-performing exposures traded through securitization remain small compared to bilateral sales. Also, NPL securitization has been more favorable in Member States that have extended auxiliary aids through other policy measures such as GACS. Stakeholders should take advantage of the current favorable market conditions—positive economic growth, prevailing lower interest rates and the decreasing unemployment. The reported declining numbers and the tenacious policy measures in this regard in the recent past are reassuring for both the banks holding the NPLs but looking to offload them, and those that regard distressed assets as a rewarding investment opportunity. We expect 2020 to be a promising year for the NPL securitization market as a tool for cleaning up European banks’ balance sheets and for the development of a secondary securitization distribution channel for distressed assets.

€123bn

With sales in gross NPL book value of approximately €123 billion, Italy has been the most active market for NPLs in Europe

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The uneasy road toward a single EU market for fintech

Current rules fall short of providing a clear framework for a single European market for fintech companies, as **Jonathan Rogers**, **Angelo Messore** and **Paula Melendez** explain.

The development of a single market for fintech has recently been placed at the center of the EU financial services agenda. In its 2018 "Fintech Action Plan", the European Commission identified a number of supervisory initiatives to help fintech companies reach scale across the EU through a more consistent supervisory framework and bespoke legislative proposals. Additional work has been done by European Supervisory Authorities to provide guidelines on certain key aspects of fintech business models and licensing procedures, as well as on other policy areas that are relevant to the development of fintech in the EU.

Based on the Commission's 2018 Action Plan, the European Banking Authority (EBA) presented its own "Roadmap to Fintech", identifying the regulatory priorities for 2018 – 2019. On the basis of the Roadmap, the EBA published a report on October 29, 2019 on potential impediments to the cross-border provision of banking and payment services.

The EBA report on cross-border banking and payment services

The EBA report identifies a number of important challenges for fintech firms seeking to expand their footprint in the EU and highlights the existence of national divergences across EU Member States that could hinder the ability of firms to operate on a cross-border basis.

This is a pressing issue. In 2016, only 7 percent of consumers used financial services from another EU Member State. While differences in language, degree of financial awareness or consumer preferences have been suggested as barriers, the EBA report focuses on divergences in national legislation.

2019
29
October

EBA published a report on potential impediments to the cross-border provision of banking and payment services

Although the EBA report is specifically focused on the provision of banking and payment services by credit institutions and payment service providers, the issues it raises apply to fintech firms and have wider implications for the entire industry.

Cross-border performance of digital activities

An important question faced by fintech entrants when seeking to provide cross-border financial services in the EU is whether a digital activity can be considered to be a cross-border provision of services and, if it is, whether it is carried out under the freedom to provide services or the right of establishment. The distinction is important to determine passporting requirements, rules of conduct and relevant supervisory authorities.

The EBA report says that there are currently no common EU rules in this area. Competent authorities follow a case-by-case approach by relying on the case law of the Court of Justice of the EU and a 22-year-old communication on the performance of cross-border banking services issued by the Commission.

It is also unclear whether the use of local agents or distributors by payment services providers or e-money institutions could amount to an establishment in the host Member States. Further, the EBA report highlights the lack of visibility on cross-border activities by competent authorities of the home and host Member States.

The EBA report accordingly advises the Commission to issue clearer guidelines on the cross-border performance of digital activities and to strengthen the applicable reporting requirements.

Consumer protection and conduct of business

Consumer protection and conduct of business requirements are critical areas of compliance for new fintech market entrants. They may be susceptible to enhanced scrutiny from local supervisory authorities and could be required to make significant investments in regulatory compliance before crossing the borders of a new EU jurisdiction.

The EBA report found that, despite the common framework applying under relevant EU Directives, the

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An important question faced by fintech entrants when seeking to provide financial services cross-border in the EU is whether a digital activity can be considered to be a cross-border provision of services

level of protection of consumers and the rules of conduct applicable to service providers tend to differ depending on national regulatory regimes, as well as on whether the services are performed under the freedom to provide services or right of establishment.

For instance, despite the fact that EU product-specific legislation usually contains disclosure requirements, there is a lack of harmonization in advertising and adequate explanations to consumers. This means that service providers may need to adjust disclosures—in terms of content or format—depending on the jurisdiction where consumers are located.

The EBA report suggests that further harmonization should be considered in consumer-facing disclosure requirements, allocation of home-host Member State responsibilities for supervisory practices and handling complaints and powers regarding the right of establishment and the freedom to provide services. Additional guidance on the means to comply with disclosure requirements through a "durable medium" is also recommended to promote convergence and adaptability to evolving technology.

Anti-money laundering

The fourth Anti-Money Laundering Directive sets out the anti-money laundering obligations that apply to financial services providers operating in the EU. However, the Directive provides for a minimum harmonization of national anti-money laundering regimes, meaning that EU Member States can go beyond the standards set at the EU level and include additional measures where this is necessary to mitigate money-laundering risks.

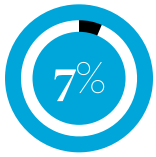
As noted in the EBA report, differences in supervisory practices are creating complexity and possibly hindering the provision of services. These difficulties are amplified when firms operate on a cross-border basis in different Member States, as they need to adjust their policies and compliance procedures in each jurisdiction where they operate.

According to the EBA report, the key areas where supervisory convergence is desirable are customer due diligence measures, digital identification, third-party reliance and the application of local regimes to service providers operating under the freedom to provide services.

Additional impediments to the cross-border provision of fintech services

The EBA report provides useful insights into the obstacles that limit the growth potential of EU fintech firms. Yet the list of legal barriers to the cross-border performance of services provided by the EBA is not exhaustive, and there are several additional hurdles that EU fintech companies should consider when performing services in the EU territory.

Notwithstanding the technological neutrality promoted by EU institutions and EU rules on digital signature, some national competent authorities are still reluctant to accept the use of paperless signature or pre-contractual disclosure processes. Similarly, there are no harmonized processes in the EU for electronic identification and remote know-your-customer activities. The need to adjust the client on-boarding procedures and signature or pre-contractual disclosure processes to national regimes can be a relevant obstacle to the performance of cross-border fintech services, considering that the offer of an intuitive and seamless customer digital experience is a key value proposition of fintech companies.



Only 7 percent of consumers used financial services from another EU Member State in 2016

The lack of common licensing regimes for certain fintech services is also among the obvious areas for improvement of EU legislation. Besides crowdfunding platforms—which the Commission is already in the process of regulating—the absence of a common framework for consumer credit and direct lending by non-bank institutions restricts the possibility for certain fintech lenders to operate on a cross-border basis without being subject to the burdensome requirements applying to banks under EU law.

Looking at the broader regulatory landscape, European authorities have already tried to adapt certain regulatory requirements to fintech firms in light of the proportionality principle, particularly regarding the suitability of shareholders and members of the management body. However, additional flexibility should be sought in other areas that typically affect venture capital-sponsored fintech companies, such as variable remuneration schemes for fintech firms providing banking, investment or asset management services.

Falling short

Fintech firms largely rely on the offer of long-distance services through the internet or mobile applications. The use of technology could be a powerful tool to scale up the EU internal market with limited investments and no local presence or personnel.

However, the current rules fall short of providing a clear framework for the cross-border performance of fintech business. In several cases, EU fintech firms perform services only domestically, or restrict the access to their digital platforms to customers located in a limited list of EU jurisdictions. This is also due to fear of navigating a shattered

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> **The absence of a common framework for consumer credit and direct lending by non-bank institutions restricts the ability of certain fintech lenders to operate on a cross-border basis**

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The level of protection of consumers and the rules of conduct applicable to service providers tend to differ depending on national regulatory regimes

legal ecosystem when providing cross-border services across the EU, as well as to the costs of compliance, which are proportionate to the level of fragmentation of the EU legal framework.

In addition to reducing the appetite of fintech firms to expand their EU operations, the existing legal barriers also hamper the ability of consumers to benefit from the wider offering available and limit market efficiency and competitiveness of the EU single market for financial services.

Further regulatory initiatives are desirable in this area, especially in the use of digital technologies in customer on-boarding and the compliance with applicable rules of conduct and disclosure requirements. It is clear that these initiatives will not eliminate some natural barriers to cross-border services deriving, for instance, from the lack of harmonization in national tax regimes, labor and contract law. Nonetheless, an enhanced level of harmonization of the regulatory framework could significantly help EU fintech companies fully exploit their growth potential and profit from the opportunities offered by the single market.

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Tailored enhanced prudential standards for non-US banks

Since the 2008 financial crisis, a non-US bank seeking to establish or maintain a US presence has been required to comply with a set of stringent regulatory requirements, but a recently adopted rule (Final Rule) limits their application. Recently approved by the Federal Reserve Board, limit the application of those requirements, as **Duane Wall**, **Glen Cuccinello**, **Max Bonici**, **John Wagner** and **Roseann Cook** explain.

The Final Rule, released by the Federal Reserve Board in October 2019, tailors the enhanced prudential standards—a series of stringent capital, liquidity, risk management, stress testing and other requirements—to a non-US bank with a traditional US banking presence, such as a US branch, in a number of important ways:

- The enhanced prudential standards are focused on non-US banking organizations with a significant US risk profile. Non-US banks that maintain a US branch but no US bank subsidiary, material US non-bank subsidiaries or US intermediate holding company (IHC), in general, may rely on home-country requirements to fulfill applicable enhanced prudential standards.
- New risk-based indicators place foreign banking organizations (FBOs) into categories based on US-focused indicators, rather than looking simply to an FBO's global asset size
- The threshold for an FBO to establish an IHC remains the same, but the enhanced prudential standards that apply focus on IHCs with a significant risk profile
- An FBO's US branch is not subject to any standalone capital or liquidity requirements

Four categories for enhanced prudential standards requirements

The Final Rule, which becomes effective on December 31, 2019, divides FBOs with US$100 billion or more in total consolidated assets into four categories based on a sliding scale of size and risk profile.

FBOs are classified into categories based on asset size and specific risk-based indicators: US non-bank assets; US off-balance sheet exposure; US weighted short-term wholesale funding; and US cross-jurisdictional activity. A non-US bank with less than US$100 billion in combined US assets, is subject to a more limited set of enhanced prudential standards.

- **Category I** requires compliance with the most stringent enhanced prudential standards and applies only to US global systemically important banks (US GSIBs)
- **Category II** standards apply to FBOs that have US$700 billion or more in combined US assets or US$75 billion or more in US cross-jurisdictional activity
- **Category III** covers FBOs that have US$250 billion or more in combined US assets or at least US$75 billion in US nonbank assets, US weighted short-term funding or US off-balance -sheet exposures
- **Category IV** applies to FBOs with US$100 billion to US$250 billion in combined US assets that do not meet any of the additional thresholds specified for Categories II or III
- **Other** An FBO with at least US$100 billion in total global assets but less than US$100 billion in combined US assets is not classified into a category and is subject only to limited enhanced prudential standards

The date the Final Rule become effective

Applying the risk-based indicators to FBOs

Under the Original Rule, an FBO with US$50 billion or more in total consolidated global assets was covered and the specific EPS that applied were determined based on the FBO's combined US assets, as well as its level of US non-branch assets. The Final Rule changes that approach by classifying FBOs into categories based on asset size and five specified risk-based indicators: combined US assets; non-bank assets; off-balance sheet exposure; weighted short-term wholesale funding (wSTWF) and cross-jurisdictional activity.

FBOs must calculate and report their level of risk-based indicators on Form FR Y-15, which is currently used by US banking organizations to report systemic risks. As a result, an FBO will need to establish new monitoring and reporting procedures for the new filing requirement. Each indicator must be calculated and reported based on the average of the trailing four quarters for a non-US bank with an existing US banking presence and based on the most recent quarter for a non-US bank establishing a US presence.

> **The enhanced prudential standards are focused on non-US banks with a significant US risk profile**

Categories of FBOs and level of compliance required with enhanced prudential standards

	No Category		Category IV	Category III	Category II
Total global assets	US$100 billion – US$250 billion	US$250 billion+	US$100 billion+	US$100 billion+	US$100 billion+
US combined assets	less than US$100 billion	less than US$100 billion	US$100 billion+ and less than US$75 billion nonbank assets, off-balance-sheet exposures, wSTWF or cross-jurisdictional activity	US$250 billion to US$700 billion or US$100 billion+ and US$75 billion+ nonbank assets, off-balance-sheet exposures or wSTWF	US$700 billion+ or US$100 billion+ and US$75 billion+ cross-jurisdictional activity
Home-country requirements					
Regulatory capital	Yes, if US$100 billion+ combined US assets	Yes	Yes	Yes	Yes
Liquidity stress testing	No	Yes	Yes	Yes	Yes
Capital stress testing	Yes, every two years	Yes, annually	Yes, every two years	Yes, annually	Yes, annually
Single counterparty credit limits				Yes	Yes
US requirements					
US IHC	Yes, if US$50 billion+ US non-branch assets	Yes, if US$50 billion+ US non-branch assets	Yes, if US$50 billion+ US non-branch assets	Yes, if US$50 billion+ US non-branch assets	Yes, if US$50 billion + US non-branch assets
US liquidity cash flow projections	No	No	Yes	Yes	Yes
US contingency funding plan	No	No	Yes	Yes	Yes
US liquidity risk limits	No	No	No	Yes	Yes
US asset/collateral monitoring	No	No	Yes, monthly	Yes, weekly	Yes, weekly
US liquidity stress testing	No	No	Yes, quarterly	Yes, monthly	Yes, monthly
US branch liquidity buffer	No	No	Yes	Yes	Yes
US risk committee	Yes	Yes	Yes	Yes	Yes
US chief risk officer	Yes, if US$50 billion+ in combined US assets	Yes, if US$50 billion+ in combined US assets	Yes	Yes	Yes
US risk management framework	Yes, if US$50 billion+ in combined US assets	Yes, if US$50 billion+ in combined US assets	Yes	Yes	Yes
US debt-to-equity limits	Yes, if a grave threat	Yes, if a grave threat	Yes, if a grave threat	Yes, if a grave threat	Yes, if a grave threat

Source: White & Case

IHC Requirement

An FBO with at least US$100 billion in total global consolidated assets is required to form an IHC if the FBO has US non-branch (i.e., subsidiary) assets of US$50 billion or more.

The enhanced prudential standards that apply to an IHC are the same as the asset thresholds and the US$75 billion risk-based indicator thresholds that apply to an FBO, but are based on the IHC's global assets and activities, rather than its US-only assets and activities.

In general, any IHC formed by an FBO is subject to the same type of US-specific enhanced prudential standards that apply to a BHC of a similar size, including regulatory capital, liquidity, capital stress testing, capital planning and long-term debt requirements.

Regulatory capital requirements

The US branches and other US operations of an FBO that sit outside the IHC are not subject to US regulatory capital and leverage requirements.

However, an FBO with either US$250 billion or more in global consolidated assets or US$100 billion or more in combined US assets (irrespective of its total global consolidated assets) must show that it complies with home-country regulatory capital and leverage requirements comparable to US capital standards.

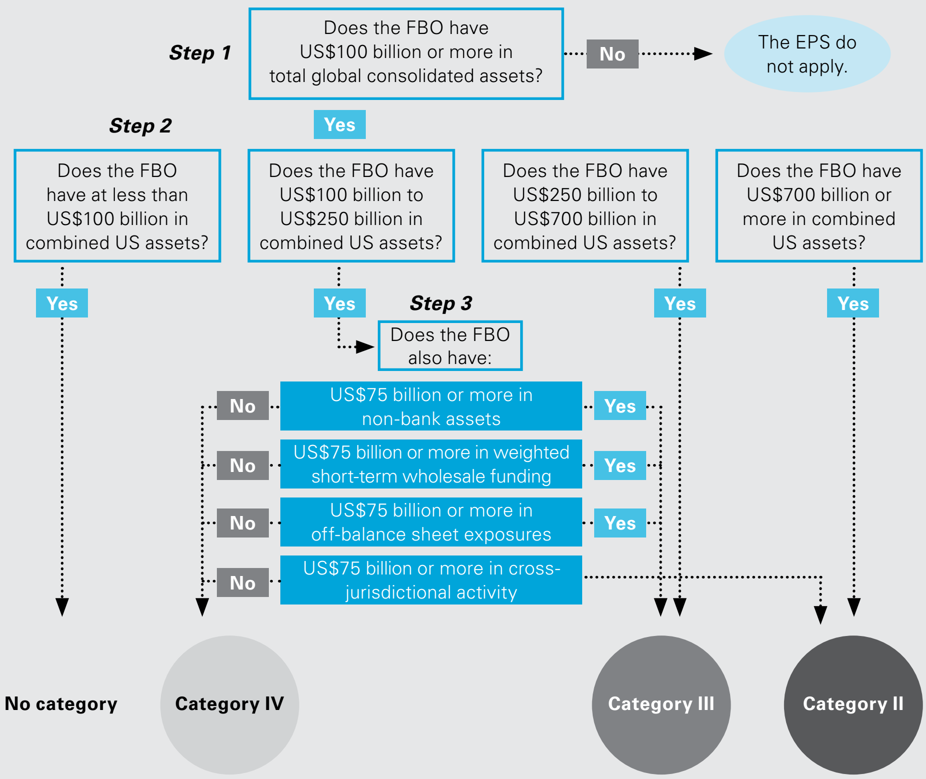
Liquidity stress testing

An FBO with US$250 billion or more in total global consolidated assets must conduct annual liquidity stress testing of its combined US operations, irrespective of the size of its US operations. The goal of the liquidity stress testing is to assess the potential impact of stress events on cash flows, liquidity, profitability and solvency.

An FBO can fulfil the liquidity stress-testing obligation using home country testing provided that tests covers its global activities, comply with Basel Committee requirements and incorporate 30-day, 90-day and one-year horizons.

An FBO that does not comply with the home-country liquidity stress testing requirement must limit the daily net aggregate amount due to its combined US operations from its non-US branches, subsidiaries and affiliates to no more than 25 percent of the third-party liabilities of its combined US operations.

Applying risk-based indicators to FBOs



Source: White & Case

$100 bn

An FBO with less than US$100 billion in combined US assets is not subject to US specific capital, liquidity and stress testing requirements

Capital stress tests

An FBO with total global consolidated assets of at least US$100 billion must show that it is subject to a home-country capital stress-testing regime, regardless of the size of its combined US operations.

An FBO that does not meet the home- country capital stress-testing standard must conduct stress tests of its US subsidiaries (or its global activities) to determine if it has sufficient capital to meet adverse economic conditions. It must also maintain, on a daily basis, eligible assets in its US branches equal to at least 105 percent of the average total liabilities of the branch, if the FBO has less than US$250 billion in total global consolidated assets, or at least 108 percent of average total branch liabilities if the FBO has US$100 billion or more in combined US assets.

Single counterparty credit limits

An FBO that falls into Category II or III must comply with single counterparty credit limits that prevent it from having aggregate credit exposure that exceeds 25 percent of its Tier 1 capital to a single counterparty—or 15 percent if the FBO is defined as a global systemically important bank.

US-specific requirements

While FBOs with a smaller US footprint may rely on home-country regulatory capital, liquidity and stress-testing requirements, FBOs with at least US$50 billion in combined US assets are subject to certain US-specific risk management requirements, and are required to form an IHC to ring-fence US subsidiaries if US non-branch assets total at least US$50 billion.

FBOs with US$100 billion or more in combined US assets or US$75 billion or more in nonbank assets, off-balance sheet exposure, weighted short-term wholesale funding or cross-jurisdictional activity, are also subject to US-specific enhanced prudential standards akin to those applicable to large US bank holding companies (BHCs).

FBOs that fall into this category must provide US liquidity cash flow projections, a US contingency funding plan, adhere to US liquidity risk limits, monitor US assets and collateral, conduct liquidity stress tests and maintain a US branch liquidity buffer.

They must also maintain a US risk committee, a chief risk officer and a risk management framework that includes risk governance and control policies, procedures and systems.

An FBO that is designated as posing a grave threat to US financial stability must limit the debt-to-equity ratio of any non-US subsidiary, including any IHC, to no more than 15-to-1.

The final enhanced prudential standards apply to those non-US banks with a significant US presence. While most non-US banks that have a US presence may have at least US$100 billion in total global consolidated assets, the majority of those banks will fall outside Categories II to IV and therefore will not need to comply with the more onerous standards.

Such banks, which fall into the "no category" will be subject only to compliance with home-country standards and the US-specific enhanced prudential requirements to maintain a risk committee, a risk management framework and a US chief risk officer. Similarly, while an FBO with US$50 billion or more in US non-branch assets is required to form an IHC to hold its US bank and nonbank subsidiaries, an IHC with less than US$100 billion in total consolidated assets is subject only to the same risk management requirements applicable to the combined US operations of an FBO and to compliance with US regulatory capital requirements.

A non-US bank that currently does not have a US presence but is considering entry to the US banking market typically would do so incrementally. A common approach used by non-US banks to establish initial entry into the US is to establish a representative office, which would not be subject to any enhanced prudential standards requirements, regardless of a non-US bank's US or global asset size.

Establishing a US branch would not cause a non-US bank to be required to comply with any EPS requirements, other than home-country requirements and US-specific risk committee and risk management requirements, until the assets of the branch (and any US bank or nonbank subsidiaries) reach at least US$100 billion.

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