

# RegCORE Client Alert

## Financial Services: Joint ESA Response to the EU Commission on Digital Finance

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### Joint ESA Response to the EU Commission on Digital Finance

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The three European supervisory authorities, EBA, EIOPA and ESMA (**ESAs**), published a joint report<sup>1</sup> on February 7, 2022, in response to the European Commission's February 2021 call for views on digital finance. The proposals pursue the objectives of both maintaining a high level of consumer protection and addressing the risks arising from the transformation of value chains, platformisation, and the emergence of new "mixed groups." These are groups that combine financial and non-financial activities.

The European Commission's Digital Finance Strategy of September 2020<sup>2</sup> sets out the European Commission's intention to review the existing regulatory framework for financial services. Reasons for this include protecting consumers, safeguarding financial stability, protecting the integrity of EU financial sectors, and ensuring a level playing field.

As part of this review, in February 2021, the European Commission requested technical advice from EBA, EIOPA, and ESMA on digital financial services and related issues<sup>3</sup>. The European Commission's request to the ESAs focused on advice on the regulation and supervision of more fragmented or non-integrated value chains (Section 3.1), platforms and bundling of different financial services (Section 3.2), and groups combining different activities (Section 3.3).

In line with the Call for Advice, the ESAs have conducted an analysis of market developments and the risks and opportunities of digitalisation in the financial sector. The resulting findings and recommendations were presented in the report to the European Commission.

In addition to the joint report, ESMA also published two reports outlining the results of a survey of national competent authorities (**NCA**s)<sup>4</sup> and the results of a public call for evidence<sup>5</sup> on fragmented value chains,

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<sup>1</sup> Available [here](#).

<sup>2</sup> Available [here](#).

<sup>3</sup> Available [here](#).

<sup>4</sup> Available [here](#).

<sup>5</sup> Available [here](#).



digital platforms and mixed activity groups (**MAGs**). These served as the basis for the work and recommendations of the ESAs.

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## Findings:

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The report presents the findings and advice of the ESAs in response to the European Commission's Call for Advice on digital finance and related issues. It addresses cross-sector and sector-specific market developments in the three key areas identified in the Call for Advice. It also highlights the risks and opportunities of digitalisation in finance. In addition, ten cross-sector and two insurance-specific recommendations for action are presented to ensure that the EU's regulatory and supervisory framework is fit for the digital age.

The ESAs note that the use of innovative technologies in the EU financial sector is facilitating changes in value chains. In addition, reliance on digital platforms is increasing rapidly. Consequently, new mixed activity groups are emerging.

These insights and trends open up a range of opportunities for both consumers and financial institutions in the EU, but also pose new risks.

Because of the emerging risks and opportunities, the ESAs recommend early action to ensure that the EU's regulatory and supervisory framework for financial services remains fit for purpose in the digital age.

In particular, the proposals include the following topics:

- A holistic approach to the regulation and supervision of the financial services value chain;
- Strengthened consumer protection in a digital context, including through enhanced disclosures, complaints handling mechanisms, measures aimed at preventing the mis-selling of tied/bundled products, and improved digital and financial literacy;
- Further convergence in the classification of cross-border services;
- Further convergence in addressing money laundering/financing of terrorism risks in a digital context;
- Effective regulation and supervision of 'mixed-activity groups', including a review of prudential consolidation requirements;
- Strengthened supervisory resources and cooperation between financial and other relevant authorities, including on a cross-border and multi-disciplinary basis; and
- Active monitoring of the use of social media in financial services.

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## Regulatory Recommendations:

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Due to digitalisation, financial institutions are increasingly relying on third-party providers to deliver services through outsourcing and other arrangements. This poses particular supervisory challenges because national competent authorities may be constrained in assessing risks and/or exercising supervisory powers across the value chain. In addition, concentration risks and thus risks to financial stability may also arise with critical third-party providers.

To this end, an initiative has been formed that will focus exclusively on information and communications technology (**ICT**) risks in the financial services value chain. This is the Digital Operational Resilience Act (**DORA**).

*Recommendation 1* proposes that the Commission take a holistic approach to the regulation and supervision of fragmented value chains. This is already explained in Recommendations 2, 3, 7, and 8, including digital platforms and mixed activity groups. In addition, there should be a regular assessment of whether financial institutions have a dependency on certain providers that may not be covered by DORA and pose a risk to financial stability.

New business models for financial services risk harming consumers. This is particularly true for those with lower levels of financial and/or digital literacy. For this reason, *Recommendation 2* highlights key issues for the Commission to consider ensuring that disclosure requirements in EU law are fit for the digital age. In addition, recommendations are presented for the revision of the Directive on the Distance Marketing of Consumer Financial Services. It is important to keep in mind that the ESAs may make specific sectoral recommendations on these issues in the context of other ongoing calls for Commission comments. Furthermore, Recommendation 2 calls on the Commission to improve consumer protection to address the risks of mis-selling and to address potential deficiencies in the handling of complaints at EU level.

Due to the cross-border nature of Digital Financial Services, the question arises as to when a reporting obligation for the "cross-border provision of services" is required. Moreover, how these services can be

classified under the "freedom of establishment" or the "freedom to provide services". This creates challenges for supervision, and at the same time difficulties for consumers in determining which authority is responsible for their concerns.

For this reason, *Recommendation 4* builds on previous Joint Committee recommendations as well as joint ESA and EBA proposals on this issue. It again invites the Commission to provide further guidance on the definition of cross-border services in a digital context.

Regulators may also have a lack of expertise and resources to monitor the market in the necessary manner. This is due to the rapid change and complexity seen in digital financial markets. For this reason, *Recommendation 5* includes a call to explore possible ways to strengthen the skills and resources of competent authorities. This is linked to the Digital Finance Supervisory Academy, which aims to help regulators and supervisors better understand, identify, and manage the risks and challenges of digitalisation by enhancing their skills and resources.

In addition to potential benefits, the fragmentation of financial services entails the risk of making it more difficult for financial service providers to comply with anti-money laundering and counter-terrorist financing regulations. This risk exists if compliance tasks are outsourced in whole or in part to external service providers. In addition, some participants in the digital financial services market do not have adequate anti-money laundering and counter-terrorist financing systems and controls.

*Recommendation 6* emphasises the need to clarify data protection obligations in the context of customer due diligence (**CDD**) and anti-money laundering and counter-terrorist financing more broadly. It also says that priority should be given to examining whether all crowdfunding platforms should be subject to EU anti-money laundering and counter-terrorist financing legislation. In addition, the Anti-Money Laundering Authority (**AMLCA**) should work closely with the ESAs to issue guidance on outsourcing and governance arrangements, and a thematic review of best practices should be undertaken.

Along with digital finance, new synergies have emerged between financial and non-financial activities. These pose potential systemic risks in the financial services market. To address potential regulatory risks posed by groups with mixed activities providing financial and other services, the ESAs have formulated *Recommendation 7*. The content is a call to update and possibly extend the consolidation rules, in order to ensure effective coverage. Furthermore, the ESAs recommend considering the creation of new additional supervisory structures along the lines of the Financial Conglomerates Directive.

Due to the increasing digitalisation and datafication of financial services, closer cooperation between financial and relevant non-financial authorities is becoming necessary. ESA supports that the Commission explore ways to foster a strengthened cooperation framework between financial data, cyber, consumer protection and competition authorities. *Recommendation 8* presents three complementary frameworks for structured cooperation to promote information sharing on policy developments in the agencies' respective sectors and to strengthen market surveillance.

Given the role of the ESAs in promoting supervisory convergence, *Recommendation 9* includes a recommendation for action that the ESAs explore ways to enhance cooperation between home and host Member State authorities. This should be done, for example, through additional guidance on reporting requirements, discussions of practical cases in supervisory fora, or procedures to be followed in situations where a financial firm is in breach of the rules of other Member States. In addition, increased coordination with third country authorities may also be required in the form of a review of existing Memoranda of Understanding. This is to ensure that they reflect specific issues related to digital financing.

Due to the growth of digital trading platforms in the securities markets with new trends such as "social trading" or investment advice shared via social media, both new opportunities and risks are emerging. *Recommendation 10* addresses the increasing use of social media in connection with financial services and the resulting need for active monitoring of this phenomenon.

ESMA has recently clarified certain aspects of the applicable rules in this regard. During the transition period, the ESAs will continue to monitor developments and consider where regulatory action may be warranted. This will also be done in the context of the Commission's requests for views on certain aspects of retail investor protection. This will include consideration of the need to communicate more effectively with consumers and to seek information predominantly through digital channels, including social media.

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### **Insurance-specific Recommendations:**

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Insurance-specific *Recommendation 1* addresses the limitation of the scope of (re)insurance activities under Solvency II. This topic came up frequently in the context of digitalisation and is considered to be linked to all parts of the Call for Advice.

EIOPA will consider further analysis of what is and is not considered "directly related insurance activities" in different Member States. The background is to provide some clarity when it comes to this question. This will consider the potential impact on consumers, the insurance sector, and its supervision, as well as any unintended consequences and additional risks. Legislative change is most likely not required. However, this will also depend on the results of further analysis.

The insurance-specific *Recommendation 2* concerns peer-to-peer (**P2P**) insurance. EIOPA has analysed P2P insurance regarding past activities. Due to the current relatively low market penetration of P2P insurance business models and the fact that most business models seem to fall under existing regulation, EIOPA does not see an urgent need for specific regulatory approaches or changes regarding P2P insurance. Nevertheless, market developments will continue to be monitored.

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## Outlook and next steps

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The ESAs will assist the Commission in transposing the proposals into national law and in providing the necessary guidance. In addition, the ESAs note that financial services and business models are evolving rapidly because of digitalisation and the use of innovative technologies, and that it may be necessary in the future to reassess the issues raised by these developments in due course.

# About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via [de\\_regcore@pwc.com](mailto:de_regcore@pwc.com) or our [website](#).

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