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THE EUROFI MAGAZINE

SEPTEMBER 2021

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EUROFI POLICY NOTES

PUBLIC AND PRIVATE SECTOR VIEWS

THE EUROFI
VIEWS MAGAZINE

SEPTEMBER 2021

This bi-annual Views Magazine comprises contributions from a wide range of public and private sector representatives on the challenges and conditions for relaunching growth post-Covid, on-going industry trends such as digitalisation and ESG and key on-going policy initiatives in the financial sector.

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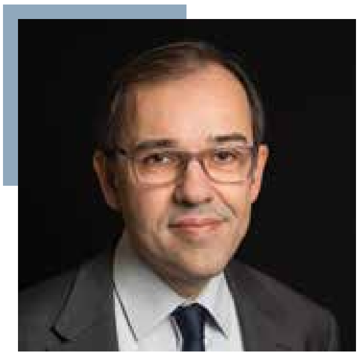
MAKING THE SINGLE MARKET FOR FINANCIAL SERVICES A REALITY

DIDIER CAHEN



MARC TRUCHET

JEAN-MARIE ANDRES

The 2021 Eurofi Forum organized in association with the Slovenian EU Presidency and the publication of this Magazine are taking place at a particularly challenging time, since the pandemic is not over in the world and in Europe.

The responses to the Covid-19 crisis, the appropriate ways to relaunch growth in the EU and the role that the financial sector may play in this regard will provide major topics of discussion during this event, and this Magazine is offering a wide range of views on the related challenges and opportunities.

The “Next Generation EU” Recovery plan in particular, which contributes to more fiscal cohesion and solidarity, is a significant policy initiative in this context. But money alone will not ensure recovery. One particular challenge at this point in time is the relaunching of productive investment and sustainable growth in the EU. Indeed, major investments are needed for supporting the post-Covid recovery, the EU Green Deal and digital transformation. However, one particular concern in this perspective is that real gross domestic product growth and productivity gains in the euro area have failed to catch up with the US, China and Japan over the past two decades, while lasting low interest rates have developed a preference for liquidity over productive investment among investors.

Potential risks to global and European financial stability are another challenge. Near term financial stability risks are contained by massive monetary, fiscal, regulatory and supervisory support. But we are not out of rough waters. At the top of the list of threats lie high levels of public and private debt in a number of Member States, which cannot be alleviated solely by monetary policy. In addition, pushing too hard and too long on the monetary pedal may generate further vulnerabilities and eventually create the conditions for future crises. More structural, supply-side oriented policies are also needed in order to enhance fiscal sustainability and foster sustainable growth. At the same time, although the recovery in Europe faces uncertainty due to the spread of virus variants, the return to normality needs to be prepared, since relief measures on the regulatory, supervisory, fiscal and monetary sides were designed to be temporary.

In terms of opportunities, major EU initiatives launched before the Covid crisis, such as the Banking Union, the Capital Markets Union, the sustainable finance taxonomy and new initiatives such as the Digital Finance Strategy have the potential to provide the EU with the vibrant single market for financial services that is needed for funding the EU economy. However, these projects still need to become a reality. How to implement these initiatives in an effective way will be at the centre of the discussions of this event.

In preparation for these debates, the Eurofi secretariat has prepared several papers on these issues that can be found in the September 2021 issue of the Eurofi Regulatory Update and the speakers participating in this event have been invited to express their views on these questions in this Magazine.

We are grateful to the 180 public and private sector representatives who have provided us with input on these issues, and we are sure that you will read their thoughts and proposals on these challenging questions with great interest.

DAVID WRIGHT
President of Eurofi

Capturing the massive benefits of European financial integration - an extraordinary opportunity for an EU "BREXIT dividend"

A very warm welcome to EUROFI Ljubljana. Like at Berlin a year ago, force majeure, this will be a hybrid event offering both physical presence on site in Ljubljana and at-distance virtual connectivity. I would like to thank all our distinguished guests, panelists and participants for their strong commitment to this event and especially the Slovenian Presidency of the European Union for their continuous, unstinting support and invaluable assistance.

The COVID crisis has tested and intensely stretched the sinews and solidarity of the European Union. Many problems there have been over the last 18 months, but by sticking together and acting together, the EU has emerged stronger institutionally. Its COVID vaccination rates are now among the very highest in the world, exceeding those who boasted earlier of being ahead.

According to the IMF and the European Commission, the European economy is growing faster than expected even though many of the collateral COVID impacts have not fully worked through the system because much public support has not yet been phased out. The EUs' pioneering Economic Recovery Programme is not just fit-for -purpose but it is also changing the way many Member States are thinking, notably convincing them that pan-European solutions based on solid, responsible, long-term investment and structural reform make sense - the European sum being bigger than the Member State parts.

The strong leadership the EU is demonstrating on climate change policy and in other environmental fields is in tune with the times, the desires of large swathes of European electorates and could yield first mover advantage. The stark, very recent IPCC report underlies just how vital and enduringly dangerous climate change has become. The fires and floods that have ravaged many Member States this summer underline, once again, the urgency to continue European leadership and to build a strong global consensus to move, rapidly, globally, to a "net zero" greenhouse gas emission economy.

Digitalisation, financial and otherwise, has also accelerated through the dark COVID days. Far more transactions are now only digital; cash the exception, rather than the rule. Working practices have changed, possibly forever. New instantaneous, digitalised trading methods are encouraging younger generations to trade financial instruments, leading at times to rapid market herding and unstable volatility triggered by messaging in the social media.

Blockchain technologies seem to be cementing their place in many market segments.

Central Banks are accelerating their appraisal of the utility and viability of central bank digital currencies leaving many unanswered questions about how CBDCs, Bitcoin, tokens etc will fit together in the future.

In short many new trends, issues, urgencies have emerged and accelerated over the last 18 months. What has not changed at all is the fact that if the EU can truly integrate its financial markets, huge benefits will become available, including:

- Higher European economic growth;
- More capital availability for pan- European investment, for environmental transition to net zero - some estimates suggest €350 billion per year will be required from the private sector alone to meet interim targets;
- Greater competitiveness and gravitas will build up in the EU financial sector itself and in the wider economy;

- A spur to digitalisation to enhance pan-European productivity can be expected as inward investment picks up;
- And crucially, EU financial integration will open up a plethora of new financial opportunities for European SMEs to grow inside the EU and for retail consumers to participate in fair, transparent markets rigorously regulated and supervised at the European and Member State levels.

But this requires decisive European political action to do the following:

1. Complete Banking Union by the end of the French Presidency in June 2022 without which the logic and benefits of eurozone banking and financial integration will remain sorely compromised;
2. Drive forward remorselessly Capital Markets Union on the basis of the European Commissions' comprehensive plan including setting binding tripartite political deadlines for delivery. Fast-track decision making should be considered, where necessary. The most recent Council conclusions have fallen far short of what is necessary and will not provide the political jolt that is needed;
3. Adapt the growth and stability pact into a set of policy parameters that this time will work and which will persuade Eurozone members to maintain to maintain their public expenditure at disciplined levels, reducing them over time;
4. Ensure the brilliantly conceived Member State New Generation Recovery Programmes deliver lasting economic reform on the ground to ratchet up, sustainably, EU economic performance catalysed by powerful environmental and digital investment;
5. Build on the success of mutualised EU bond issuance, including green bonds, to enhance the international role and lasting attractiveness of the euro;
6. Strengthen inter-institutional financial cooperation, including, inter alia, the swift nomination of the new ESMA Chair as a matter of priority. This vacancy has been open for 6 months already.

In essence a "six pack".

What a boost to the EU there would be if all the above could be delivered and deployed in an open EU trading framework over the next few EU Presidencies, well before the next European Parliamentary elections.

There is simply no time to waste to capture these huge financial benefits.

The main shortage, as usual, is the collective political will to act.

It must be found.

Q&A

ANDREJ ŠIRCELJ

Minister of Finance, Slovenia

The recovery will create opportunities for a more prosperous future

What are the priorities of the Slovenian EU Council Presidency in the economic and financial area to support the economic recovery in Europe?

Despite the uncertainties, the economic outlook has improved majorly. Due to vaccinations, the approaching months look brighter than the autumn of 2020. We have to remain cautious, but we also have to build on the fact that the current conditions speak in favor of a strong rebound and a comprehensive recovery.

The main goal of the Slovenian Presidency is to finish with the adoption process of the Council Implementing Decisions that we began with in July. The Member States whose recovery plans have already been adopted are already in the process of receiving the 13 % of prefinancing funds. We hope that the rest of the plans is adopted as soon as possible and that their successful implementation across the EU leads to further disbursements. We all need resources to further support the recovery and secure a better, stronger, and more resilient EU.

In addition to that, we will address digital and green transition in the remit of the financial sector, update the legislation to further strengthen the soundness of the EU banking and insurance sector, achieve progress on the Capital Markets Union action plan, and strengthen the anti-money laundering framework.

Does the Stability and Growth Pact need to be renovated once the Covid crisis is over? What should be the main elements of a reform of the Stability and Growth Pact and how to make it more effective?

During our Presidency, we will first focus on providing conditions for a strong recovery. We need to pursue well-targeted supportive fiscal policy as long as a sustained recovery is not secured. We also need to ensure that the European fiscal framework supports the recovery. The activation of the general escape clause enabled the much-needed swift introduction of extensive fiscal measures. The introduction of joint fiscal incentives (Recovery and Resilience Facility – RRF) is an important step toward ensuring that the crisis does not lead to prolonged demand shortfalls or to a structural lack in public investment. In fact, with the creation of the RRF, we started with a new approach and further fiscal policy coordination at the EU level.

The efficient implementation will be crucial also for the future fiscal framework. However, in the context of the new reality with high deficits and increased debts in percentage of GDP, we need to take the revision of the fiscal framework into consideration.

Clear, credible, and useful fiscal rules at the EU level are essential. So is fiscal coordination. I believe there is space for improvement. In my opinion, country-specific targets and procedures are especially relevant in the aftermath of the COVID-19 crisis, while the country-specific factors should be taken into account in normal times as well. In my opinion, we should strive for simplicity and efficiency when reviewing the rules. In addition to that, the revision should also consider the important questions, such as the demographic picture of the EU and the changes in the direction of the green and digital transformation. The new era calls for new rules that will comply with the goal of encouraging investments. To enable that, we should engage in a dialogue at the EU level.

I am convinced that a discussion which enables expressing opinions can bear fruitful results.

What are the expected economic benefits of the Next Generation Recovery instrument for the Slovenian economy?

The main expectation for the Recovery and Resilience Facility (RRF) is its further support of enhancing and strengthening the recovery in Slovenia. The combination of investments and reforms that the RRF requires will have a positive impact on growth, development, and public finance over the medium and longer term.

The latter will gradually reduce the deviation from the medium-term balance. In 2021, we plan a significant increase in investments; the general government investment ratio will rise above 6 % of GDP and then approach 5 % of GDP by 2024, also due to the RRF. This will positively influence job retainment and economic activity as well. According to the Eurostat data for June 2021, the level of unemployment in Slovenia is low, 4,8 %, while the EU average is at 7,1 %. This data also shows that there are less unemployed people in Slovenia today than before the COVID-19 crisis.

I believe that the RRF funds will not only contribute to preserving the existent jobs but will also create new ones. In line with that, the funds will be directed in providing education and reskilling needed for younger and older generations for the jobs of the future.

The RRF funds will be focused on green and digital investments, which will increase the competitiveness of Slovenia. The major investments envisaged under the Slovenian recovery plan will flow into digital transformation of the public administration, strengthening user-friendly digital services, construction of the Faculty of Medicine in Ljubljana and its campus, hospitals for infectious diseases in Ljubljana and Maribor, energy-efficient renovation of buildings, and railway infrastructure. These investments will pave the way to a better future that will surpass the precrisis levels, improve the lives of people, and secure long-term resilience.

What are the key structural challenges that the EU is facing in terms of growth and financing of its economy? How has the economic situation evolved with the pandemic? What impact can be expected from the Next Generation EU (NGEU) recovery package in the EU?

The main structural challenges for the EU are productivity, R&D investments, and digitalization. Here, we are not as advanced as our key competitors. We have also set high ambitions regarding the green transition, which will require substantial funds in the coming decades. It will also require structural changes of economies, including labor markets and educational and training systems. While adapting to changes, we must also be careful about inclusiveness – we need to consider the aging population and the fact that we will need to ensure that people can obtain the skills that will be needed due to the changes in economies.

The latest data from the Eurostat show that the EU GDP slightly contracted in the first quarter of this year. According to the European Commission summer forecast, a stronger rebound is expected in the second quarter due to rising in consumer spending. Economic developments in 2021 and 2022 (real GDP is projected to grow by 4,8 % and 4,5 % respectively) will be most significantly determined by the success of vaccination programs and further developments of the pandemic at the global level.

The recovery and growth will be importantly supported by public investments from the NGEU. I expect that the funds will also contribute to new quality jobs and improve competitiveness of the EU on the global stage. I believe that this crisis also brings a possibility of setting solid foundations for more prosperous economic environment – an environment that will also be prepared for the challenges that the future might bring.

I would like to point out that the creation of the NGEU demonstrated the EU solidarity, which we must now further develop and also upgrade with NGEU's successful implementation and wisely targeted spending of funds. The NGEU exists due to our strong cooperation. Now, it is our responsibility to ensure that the funds provide a further boost for a strong, inclusive, and sustainable recovery. A wholesome recovery will result in better living environment, opportunities for cooperation in the areas where it is needed the most, global benefits, increase in inventiveness and innovativeness, and long-term sustainable growth. All in all, this crisis took many things, but it also offered ample opportunities to learn from it and find possibilities for a better development and common wellbeing.

We started out well, and I believe that a successful journey is bound to continue.

Q&A

BOŠTJAN VASLE

Governor, Banka Slovenije

Supporting economic recovery and further financial integration

What are the key financial stability risks and the main vulnerabilities in the financial sector at the EU level in the context of lasting very low interest rates, the deterioration of credit risk, the inflationary pressures, and very accommodative fiscal policies ?

As the main challenge remains the pandemic with all the associated adverse effects, it is our priority to provide the necessary support for the economic recovery and in this way protect financial stability, economic potential and the sustained convergence of inflation to our target. Looking back, the prompt and bold response of macroeconomic policies was crucial for maintaining financial stability during the outbreak of the COVID-19 epidemic. In the Eurosystem, we acted early and decisively, deploying both monetary and supervisory policies. With such support, banks and thus businesses and households as well as sovereigns have had uninterrupted access to financing under favourable conditions throughout the crisis.

Nevertheless, due to uncertain developments regarding the health situation and consequently further rebound of our economies, we still see some financial risks. While the number of insolvencies of businesses and households has been limited so far due to extraordinary economic policy intervention measures and temporary suspension of initiation of insolvency proceedings, we may see their increase in the years ahead. Some sectors have been hit extremely hard and some businesses were highly indebted and vulnerable even before the pandemic crisis. Another challenge further exposed by the pandemic is the profitability of banks. So far, due to their favourable starting position and numerous policy measures, the position of banks has not deteriorated, and regarding credit risk management, they also have knowledge and experience from the previous crisis. Third, in some countries and regions, there are signs of residential real estate overvaluation, after house prices have been growing steadily for many years. But overall, rather than the realisation of individual risks, the stability of the financial system might be challenged by a combination thereof, potentially triggered by a significant deterioration in the economic situation or external shocks.

As we are getting out of the pandemic, what should be the appropriate approach to monetary policy: i.e. stick to the present unconventional stance or to start changing gears? To what extent does this depend on the level of inflation?

The unconventional monetary policy measures deployed during the pandemic prevented the effects of the shock from spilling over to financial markets, stimulated aggregate demand through maintaining generally favourable financing conditions and mitigated the negative effects of the crisis on inflation. Pandemic measures, temporary in their nature, will be phased out eventually, but the current situation still calls for monetary policy to remain highly accommodative. Recovery is underway, but new waves of the pandemic may slow it down, and we expect inflation to return below the 2-percent target after a temporary rise.

In addition, long-term trends will presumably continue to contribute to the narrowed monetary policy space and could warrant longer and more frequent use of unconventional measures in the post-pandemic recovery phase and beyond. Accordingly, the ECB's renewed monetary policy strategy reinforces so-called unconventional measures as an integral part of its toolkit.

Unconventional measures, such as negative overnight rates and asset purchases, not only serve our primary purpose, i.e.

price stabilisation, but also have side effects. One concern is that high dependence of the banking sector on longer-term refinancing operations might have longer-term consequences for their incentives to refinance themselves through financial markets. In addition, our measures have, alongside other factors, most probably contributed to relatively rapid growth in residential property prices, which have accelerated in the last year. Another concern is the large volumes of debt undertaken by sovereigns to tackle the pandemic-induced crisis, which could pose a risk for some sovereigns of a more marked increase in borrowing costs once monetary policy moves away from the pandemic measures.

Being aware of possible side effects, monetary policy decisions are accompanied by the assessment of the benefits of respective measures for the economy (in the pursuit of price stability) and their possible side effects. For now, the indication is that the benefits of a highly accommodative stance, supported by unconventional measures, outweigh the cost but that going forward vigilance is warranted. In this regard, an integral part of our new monetary policy strategy is an enhanced proportionality analysis.

When the pandemic is under control, what should be the timetable and measures for returning to normal prudential and accounting requirements in Europe? How to phase out current measures in an appropriate way?

Prompt and exceptional support measures taken in response to the outbreak of the pandemic have strongly limited the effects of the pandemic on our economies. Once we assess that the pandemic phase is over and that the rebound of the euro area economy is set to last, unwinding of the pandemic measures will take place.

The eventual unwinding of policy measures will be guided by the improvement of economic data and will be aligned with maintaining an appropriate monetary policy stance. Our decisions will therefore be significantly influenced by (dis) inflationary pressures and other concerns, including prevailing financing conditions for sovereigns, banks and thus also households and businesses.

Overall, introducing and to great extent maintaining support measures has been necessary to maintain financial and price stability, but structural changes should not be hindered. For instance, after a year of crisis, it was necessary to start restoring the transparency of bank balance sheets and to return to banks the responsibility to judge which companies are viable and eligible for loan restructuring. As regards policy support in this context, one possibility could be a more favourable prudential treatment for banks which support viable firms.

Which EU policy priorities are needed to overcome the fragmentation of the EU banking sector?

The pandemic crisis, with its asymmetric impact on sectors and national economies, has increased the risk of further fragmentation of the EU banking sector. At the ECB level, we have mitigated the risk by preserving generally favourable financing conditions, while the European Commission and EU leaders contributed their part by adopting stabilisation instruments, such as the Next Generation EU. In the face of future crises, it would make sense to strengthen the EU's fiscal stabilisation function with some degree of automation.

More generally, the issue of further integration of the banking system is closely linked to completion of the banking union, including the missing block – the EDIS. After years of discussions, views of stakeholders still differ in terms of the elements and their architecture and sequence of implementation. We at the Bank of Slovenia believe that the completion of the banking union would significantly strengthen financial stability across the EU, create a level playing field for banks operating in different EU countries, and thus stimulate cross-border financial and capital flows.

Harmonisation of bank insolvency laws and the completion of the resolution framework, including a common backstop, are important elements of the roadmap towards the banking union. Progress in this field would enhance the legal certainty and predictability of the resolution regime and inherent litigation risks. Implementation of EDIS together with an improved regulatory and resolution framework should be seen as a precondition and a starting point for further integration of the EU banking market. Only a complete institutional set-up can provide the basis for a more integrated and consequently also safer and more profitable EU banking sector.

The fragmentation of the EU banking sector and readiness to take steps forward at the EU level are importantly influenced by country-specific policies. Sound fiscal policies and speedier progress in pension, labour market and other structural reforms would thus help to improve the market perception of sovereign and bank credit risk and could help to dispel much of the atmosphere of distrust.

Q&A

VALDIS DOMBROVSKIS

Executive Vice-President,
Commissioner for Trade,
An Economy that Works for People,
European Commission

Common EU policies key to put our economies on the track of sustainable and inclusive growth

How to ensure that the Next Generation EU recovery instrument effectively contributes to increasing medium term sustainable growth across EU Member States? How to avoid its use for recurring public expenditure?

The Recovery and Resilience Facility (RRF) has a clear long-term orientation. As in the aftermath of any crisis, the sources of prosperity are likely to change. The pandemic came and profoundly affected our lives on top of other trends, such as climate change or digitalization.

The strength of the RRF is that it supports a transformational recovery. The main priorities are the green and digital transitions, where each national plan has to meet investment targets of 37% and 20% respectively. Yet, to make sure that the recovery is not short-lived but raises our growth potential, investments are not enough. The RRF pays equal attention to reforms and to meeting the challenges identified in the country-specific recommendations in the context of the European Semester. I think we can all be satisfied with the quality and ambition of Member States' plans. Implementation will require sustained efforts. On this, we have a clear and transparent process ahead of us. Each plan contains the path of milestones and targets chosen by each Member State. This will be the yardstick for assessing progress and delivering payments.

You mention recurring expenditures. The RRF Regulation is clear that support from the Facility should finance measures with a long-term impact and orientation. The Commission has followed this principle closely in is assessment of Member States´ plans. Some recurring expenditures can exceptionally be eligible if they are linked directly to the delivery of the reforms and investments in the plan and are temporary. For the plans approved until now, the share of recurrent expenditure is minimal.

Which types of reforms and investments are needed for boosting potential growth across EU Member States?

The Commission laid out the main priorities in its Annual Sustainable Growth Strategy back in September 2020. We identified seven flagship areas: "Power up" for the development and use of renewables and clean technologies. "Renovate" to improve the energy and resource efficiency of public and private buildings. "Recharge and refuel" to accelerate sustainable, accessible and smart transport. "Connect" to deploy fiber and 5G networks with the widest possible territorial coverage. "Modernise" to make digital public services accessible to all and develop EU-wide electronic identification and authentication. "Scale-up" to increase European industrial data cloud capacities and develop powerful and sustainable processors. And last but not least, "reskill and upskill" to help citizens get the knowledge and training they need to take advantage of the opportunities presented by the green and digital transitions, and help smooth labour-market transitions. Those dimensions are also reflected in the six pillars of the RRF Regulation to which all Plans need to adhere.

I would like to emphasize particularly the importance of human capital. As I mentioned before, some sectors will thrive after the pandemic and many others will have to adapt their business models. In this context, we must help workers to gain the skills required to thrive in the new growth sectors. This is not only a question of social inclusion, which is key, but also of economic potential, as we must address the skills shortages and develop our human capital to be able to seize future opportunities. That is why we have provided guidance to Member States to gradually move from the short-time work schemes, which have proven so effective during the pandemic, into active labour market measures

I am happy to say that Member States have overwhelmingly agreed with our priorities and most plans have projects across all of the seven flagships, including in the form of multi-country projects. We will track progress carefully on all of them.

With what mechanisms can Europe correct over time the growing heterogeneity of fiscal performance between euro area countries?

Limiting the extraordinary impact of the pandemic necessitated sizeable supportive fiscal measures. The General Escape Clause, which will continue to be active in 2022 and be deactivated as of 2023, plays an important role in that. While the economic outlook is now brighter, with the Commission forecasting GDP growth of 4.8% in 2021, the speed of recovery differs across countries. Some member states will go back to pre-crisis levels of GDP already this year while for others this will be next year.

We therefore need to maintain supportive fiscal policies this year and next. At the same time, fiscal policies should become more differentiated. Once economic conditions allow, fiscal positions should resume their structural improvement. This is at the heart of the guidance we gave Member States ahead of the preparation of their 2022 budgets, as part of our coordinated fiscal policy.

Unavoidably, the crisis and the supportive measures have led to a substantial increase in debt levels. While divergences across countries have further increased, this is not new. Already when we launched the economic governance review early last year, we noted that debt levels had remained stubbornly high in a few high--debt Member States, while they had on average declined over the last decade.

This will be a key issue when we return to the debate on the economic governance framework. We need a credible debt rule that works for all. Linked to that is the need to make use of good economic times to allow for additional spending in bad times.

Also improving the quality of public finances will matter. This will allow structurally improving fiscal positions and, at the same time, catering for the various needs. First, it is important for the Recovery Plans (RRPs) to include measures that improve the quality of public finances and support fiscal sustainability, and clearly distinguishing one-off from recurrent expenditures. Second, there is a link with the debate on the treatment of investment in the fiscal rules. I actually see this as a broader issue. We need an overall improvement of the composition of public finances, so that it is compatible with a gradual reduction of deficit and debt levels where those are high. We need to see what parts of our economic governance framework could be used to achieve this, without adding further complexity.

Finally, divergences in fiscal positions are also the result of differences in economic performance. Remedying this will be key, with the help of Next Generation EU. It is a key responsibility of Member States to boost growth and productivity with the help of the RRF and other EU funds.

What are the key structural challenges that the CEE region is facing in terms of growth and financing of its economy? How has the economic situation evolved with the pandemic? What impact can be expected from the Next Generation EU recovery package in the region?

The structural challenges of the CEE region, and of the EU economy as a whole, are well known thanks to the European Semester process. Let me just highlight one element that is relevant for future prosperity: the need to raise productivity growth and lift income levels for all. The country-specific recommendations for member states in the CEE region include many elements that can help to achieve this: skill improvements, active labour market measures, improvements in the business environment, the removal of investment bottlenecks, innovation policies and access to finance especially for SMEs.

The COVID-19 crisis has exposed and exacerbated many of those existing challenges. It has raised the stakes and the urgency of structural transformations. But the crisis has also given us an opportunity to agree on bold solutions and accelerate the adaptation of our economies. The RRF tackles these challenges head-on as we integrate principles of environmental sustainability, productivity, fairness and stability in member states' RRPs.

This is especially the case for the CEE region who will be among the biggest beneficiaries of the RRF as the allocation key takes also into account the inverse of the country's GDP per capita.
Specifically, regarding access to funding, particularly for SMEs in the CEE region, further progress in completing the Banking Union and the Capital Markets Union will be crucial.

Q&A

MAIREAD MCGUINNESS

Commissioner for Financial services,
Financial Stability and Capital Markets Union,
European Commission

Taking action in financial services

Before the summer break, the Commission published two major initiatives in financial services, on sustainable finance and on anti-money laundering.

Both step up our ambition in these areas in significant ways.

Climate change and environmental degradation are defining global challenges of our time. With the European Green Deal, the EU made ambitious commitments, in particular to become the first climate-neutral continent by 2050. The scale of investment needed to achieve these goals is beyond the capacity of the public sector alone. More sustainable private financing is required. Sustainable finance is key to achieving our climate and environmental objectives.

We have a number of tools already in place that enable the financing of sustainable activities, notably the EU Taxonomy. But we need a new framework that addresses the steps along the journey of the transition to climate neutrality and environmental sustainability.

That is why in July the Commission published the Strategy for financing the transition to a sustainable economy.

This strategy identifies four main areas where more action is needed. We want to help the transition to climate neutrality, be inclusive, support the resilience of the financial system, and encourage global action.

First, the strategy provides tools to enable companies to finance their transition plans and to reach climate and environmental goals, whatever their starting point.

For example, the Commission will consider options for extending the Taxonomy to cover activities with an intermediate level of environmental performance.

Secondly, the transition to climate neutrality needs to be inclusive, bringing everyone with us. We should pay particular attention to consumers, retail investors and SMEs. Our renewed strategy therefore provides opportunities for these groups to have greater access to sustainable finance. So we will explore the merits of green loans and green mortgages.

Third, the financial sector needs to be more resilient to sustainability risks. These risks will have adverse impacts on financial stability. So the Commission will take action to ensure relevant ESG factors are included in credit ratings and propose amendments to the prudential framework for banks and insurers. Furthermore, we will strengthen our cooperation with other institutions, such as the European Central Bank, to monitor and mitigate the systemic sustainability risks that affect long-term financial stability.

Fourth and finally, we need more ambition at the global level. We want all international partners to deepen cooperation on sustainable finance, in particular so that approaches can converge. Global efforts are key for tackling the financial stability implications of climate and environmental risks. We will seek an ambitious consensus in the international forums that deal with sustainable finance – including the International Platform on Sustainable Finance, which the EU co-chairs. We will also support low and middle-income countries increase their access to sustainable finance.

This action is ambitious, helping us scale up sustainable finance for everyone to participate in the climate transition. And given the extent of floods, forest fires and high temperatures this summer, we know that action to address climate change is urgently required and on a global scale.

The second area where the Commission has stepped up our ambition is on tackling money laundering.

We are all too well aware of financial scandals where criminals were able to launder money via mainstream financial institutions. These incidents hinders our fight against crime and terrorist activity – and they undermine trust in the financial system.

The EU already has some of the toughest anti-money laundering rules in the world. But we know those rules have not always been fully implemented or enforced.

In July, the Commission adopted an AML package setting out our vision for a system that will tackle money laundering with consistent rules, supervision and enforcement.

The flagship of the reforms is a new EU body: the AML Authority or AMLA. This authority will directly supervise the highest risk financial institutions that operate in a large number of EU countries and bodies that demonstrate major deficiencies in their approach to money laundering. AMLA will also coordinate all national supervisors.

We want to make sure that supervision is consistent across the EU - so no matter where the location, the supervision of the rules is consistent and clear.

Another key element of the AML package is a single rulebook for anti-money laundering.

Today, we rely on directives to implement anti-money laundering rules, which are then transposed into 27 national legislative frameworks. This has led to far too much divergence and inconsistency.

In future we will have a single rulebook to ensure consistency across the EU – while making sure that we continue to enforce the rules that are already in place.

The same rules will have to be applied throughout the EU directly by financial institutions, including customer due diligence – the rules needed for a full picture of the customer.

Transparency on beneficial ownership will also be strengthened so that there is clarity about who really owns or controls a company or trust.

We are also setting out in much greater detail how national frameworks should work, ensuring more harmonisation while respecting national structures. We want, in particular, to improve how financial intelligence units and national supervisors work, setting out clear standards and powers for all authorities, including a reinforced sanctioning regime, and enabling their smooth cooperation.

We are also proposing an upper limit of €10,000 euros for cash transactions.

Cash remains the preferred method for criminals to launder money. They can easily hide the illegal and illicit origins of their money by buying property or high-value goods like diamonds. A cash limit makes that much harder to do.

Two-thirds of Member States already have limits on cash transactions. Those with cash limits below €10,000 can, of course, keep those in place.

But we have decided that a limit of €10,000 across the EU is appropriate. We respect the vital role of cash, including for financial inclusion. And we recognise that cash will and must remain as legal tender.

Cash will still be king – but it will also be clean.

While large cash transactions are one of the oldest ways to launder money, crypto-currency is one of the newest.

So we need to adapt our AML rules. Currently, AML rules only apply to part of the crypto sector.

Our proposed measures extend the framework to the entire crypto sector. All crypto asset service providers will have to apply AML requirements. Crypto-asset transfers will be made fully traceable, just as other money transfers already are, bringing the EU in line with international standards.

Money laundering is a global phenomenon, and the EU works closely with other countries and with the Financial Action Task Force (FATF) - the global money laundering and terrorist financing watchdog.

We are updating our approach for high-risk countries outside the EU. We will stay in line with FATF – in fact we will continue to mirror their approach to a great extent. But the consequences of listing will be tailored to each specific country in accordance to the threat it poses to the EU financial system.

We will have an EU grey list for cooperative countries outside the EU which have deficiencies in their AML regimes. In these cases, the Commission will decide which enhanced due diligence procedures apply.

And we will have a black-list for non-cooperative countries. These countries will face not only the full set of enhanced due diligence measures, but also countermeasures decided by the Commission.

In addition to mirroring the FATF lists, the Commission will autonomously be able to list countries outside the EU and decide whether to include them on the grey or the blacklist.

With this new AML package, the Commission is going after dirty money and fighting financial crime.

Sustainable finance is vital for our future. Tackling money laundering is essential for the health of our financial system and to stop criminals in their tracks.

These two initiatives mark a step-change in our ambition on both fronts.

Q&A

ANDREA ENRIA

Chair of the Supervisory Board,
European Central Bank (ECB)

The banking sector remains vulnerable to potential sudden adjustments

What are the key financial stability risks and the main vulnerabilities in the financial sector at the EU level in the context of persistently very low interest rates, the deterioration of credit risk, inflationary pressures and very accommodative fiscal policies?

European banks have shown good resilience to the pandemic shock. Backed by strong national and European public support measures, they managed to avoid the flow of credit to the economy becoming clogged up throughout the most severe stages of this crisis. But looking ahead, they need to remain mindful of certain risks building up in the financial sector.

First, there are signs that the asset quality deterioration caused by the pandemic may not yet have peaked, as it has been somewhat masked and certainly delayed by the extraordinary pandemic-related public support measures. Euro area banks' non-performing loans (NPLs) increased slightly in the first quarter of 2021, but NPL ratios have otherwise fallen throughout the pandemic, driven by an uninterrupted effort to reduce legacy risk. Crucially, credit risk controls at some banks have not been sufficiently tailored to the specificities of this shock, meaning that they do not allow for a timely and proactive assessment of credit risk developments by looking past the public support measures. As this support is phased out, we can expect non-financial corporate defaults to increase, notably in the sectors hit hardest by the crisis. Taken together, these developments make it all the more important for banks to remain prudent and proactive. Delaying the recognition of loan losses can damage both banks' balance sheets and borrowers' recovery prospects, thus deepening the shock and hampering the economic recovery.

There are also growing signs of complacency on the part of market participants, which is leading to higher levels of leverage, financial complexity and opaqueness. Within the growing market for leveraged finance, banks have gradually loosened their underwriting standards and allowed for increasing levels of corporate leverage. In the market for equity instruments, where some banks provide prime brokerage services and structure complex derivative products, idiosyncratic accidents have shown the disruptive potential of leverage and opaqueness.

In an environment where banks and the shadow banking sector remain interconnected in numerous ways, the banking sector remains vulnerable to potential sudden adjustments, such as asset price corrections that may stem from changes in investors' expectations regarding inflation and the path of monetary policy.

Why has the banking union failed to provide the degree of financial integration that was expected? How to overcome the fragmentation of the EU banking sector going forward?

In many ways, the banking union has delivered a significantly more integrated and resilient European banking market.

Against the backdrop of the reforms that were implemented after the financial crisis, the banking union helped equip banks with higher capital and liquidity buffers. And when the pandemic broke out, the banking union enabled a swift and fully unified supervisory response that was in stark contrast with the "go-it-alone" responses to the previous crisis. That such a response was fully coordinated with the monetary and fiscal stimulus provided at European and national level is another sign that there has been a paradigm shift.

But we have not yet reached the finish line as far as financial integration in the banking union is concerned. First, we should introduce the European deposit insurance scheme. The great financial crisis left profound scars and, in the absence of a safety net that is fully integrated at the European level, Member States will continue to take measures that prevent cross-border groups from operating seamlessly in the euro area as a unified market. National options and discretions should be further reduced, as they undermine the single rulebook and can at times serve as a ring-fencing toolkit.

Second, we should strive to harmonise the crisis management framework across the banking union to ensure that there are consistent outcomes in resolution and liquidation. The efficiency of cross-border banking is also affected by whether or not there is a level playing field when banks exit the market. Finally, while we wait for concrete legislative progress, I believe that the industry could do more to make the market better integrated under the institutional setup and legislative framework that is currently in place. For example, banking groups could reorganise their structures and rely more widely on branches, rather than subsidiaries, thus fully exploiting the opportunities provided by the single passport. In the context of Brexit, we have seen a number of banks relocating their business from outside the EU by adopting a branch structure for their euro area operations, through the use of the legal form of a European Company, or Societas Europaea. We are currently looking at the banks under our direct supervision that have adopted a similar structure to understand what lessons can be learnt from them, and we intend to share these lessons with the industry to stimulate progress on this front.

How to foster further supervisory convergence in the EU? How to improve regulatory and supervisory practices for transnational banking groups in the EU?

We now have single supervisory and resolution authorities that are European by their very nature, and that are therefore committed to protecting the interests of all European citizens. However, there is still the fear that, in times of crisis, parent companies will protect their own interests, and home authorities will prioritise the fulfilment of their national aims, which is exactly what happened in the wake of the great financial crisis.

We should ensure that a cooperative and coordinated approach prevails when the situation of a cross-border group starts to deteriorate, and also when this develops into an outright crisis. One way we can do this is by strengthening the role of group recovery and resolution plans, as well as their practical implementation. Subsidiaries and their parent companies could enter into a formal agreement to provide each other with liquidity support, and this could be embedded in their group recovery plans. To foster solid forms of integration, the ECB could make the granting of cross-border liquidity waivers conditional on the use of such intragroup support agreements. In addition to this, bail-in tools will become easier to use once all banks have reached the final target for their minimum requirements for own funds and eligible liabilities. These tools will support the long-term viability, stability and efficiency of the financial system by promoting transparency, accountability and the better pricing of risk.

A truly integrated banking market can act as a powerful shock absorber in crisis times. When the banking sector is segmented along national lines, a shock that hits one country will have to be absorbed within that country, putting a huge burden on its economy. But if the European banking sector is more integrated, local losses can be smoothly offset with profits from other countries and the risk can thus be privately shared across borders. And in the event of a shock hitting the entire banking sector of a single Member State, the assets and liabilities of failing banks can be sold to banks from other Member States, thus limiting disruptions for local depositors and borrowers. Capital and liquidity are still excessively segmented into local pools in individual Member States, and the banking union is not fully delivering on its private risk-sharing potential. More work is needed in this area if we want to reap the full benefits of financial integration.

How to further support the development of an internal market for financial products and services particularly in the retail area? How can the development of cross-border banking in the euro area be encouraged?

First of all, introducing a European deposit insurance scheme will be a crucial milestone for integrating European financial markets, encouraging banks to expand across borders and providing a guarantee to European citizens that each euro on deposit carries the same value, irrespective of where the bank and the customer are located within the banking union.

We have also stated several times that a certain degree of sustainable consolidation would be useful in addressing the profitability challenges that European banks are currently facing, including by allowing them to achieve economies of scale, become more cost-efficient and improve their capacity to face a future that is increasingly digital and definitely global. For this reason, we have made it one of our priorities to streamline and clarify our supervisory expectations for the consolidation process as much as possible.

The coronavirus (COVID-19) pandemic caused a significant jump in bank customers' demand for digital products and showed that services can be offered even with no physical presence. In my view, this is likely to remain part of the new normal for the banking sector, meaning that banks will need to have competitive digital products on offer if they are to survive. The sustainability of banks' business models will depend much more on their digital growth and effectiveness and less on the need for them to set up local structures, including across borders. Indeed, banks should take advantage of the digital momentum created by the pandemic to revise their cost structures, channel their investments towards becoming more digitalised and optimise how they are structured. At the same time, we are aware that this transition into a more digital realm also implies that areas such as cyber risk, IT risk and operational resilience will demand greater supervisory attention from us, in the broader context of the EU's planned reforms in the area of digital operational resilience.

Q&A

PETRA HIELKEMA

Chair, European Insurance and Occupational Pensions Authority (EIOPA)

Climate change: a challenge for our time

How can insurance undertakings and pension funds contribute to the mitigation of climate change risks?

There is a growing urgency to tackle environmental, social and governance-related risks. As news of devastating natural catastrophes fills our screens and we see first-hand the impact on people and society, addressing the challenges of climate change is more pressing than ever.

The financial sector can act to contribute to climate change adaptation and mitigation. By considering environmental, social and governance (ESG) factors in their investment decisions, the financial sector can channel more investment to support the transition to a green economy.

Insurance companies – and occupational pension fund schemes – have a dual role. First, there is the 'stewardship' role. As large investors, insurers are well-placed to incentivise and engage with business to act and operate responsibly, ensuring sustainable long-term value creation.

Insurers can choose to invest in greener initiatives, facilitating the gradual transition to a more sustainable and resilient economy.

Second, insurers can mitigate the risks of climate change by considering the impact of their own underwriting practices on the environment. In this way, insurers can increase market and citizens' awareness and resilience to climate change.

The European Insurance and Occupational Pensions Authority (EIOPA) continues to work on a number of initiatives that will support the insurance and occupational sectors to foster a sustainable economy, as well as mitigation and adaptation to the risks of climate change.

What has been achieved so far in the insurance sector to embed sustainability and climate change risk mitigation in risk management and internal decision-making processes? How is EIOPA contributing to these efforts?

Natural catastrophes cause immense human and economic loss. This summer alone, there have been devastating floods, storms and forest fires across Europe and, given the growing frequency and intensity of natural catastrophes, climate-related losses are expected to grow.

It is important that insurers consider their own exposure to climate-change risk. While most insurers have some degree of exposure, only a minority assess climate change risk in the own risk and solvency assessment (ORSA) using scenario analysis.

In its recent Opinion, EIOPA set out expectations on the supervision of the integration of climate change risk scenarios by insurers in their ORSA. In addition to integrating climate change risks into governance and risk-management systems, risks should also be assessed in the short and long term, using different climate change scenarios.

EIOPA also recently published a methodological paper outlining steps for integrating climate change in the underwriting risk capital charge of the Solvency II standard formula. The methodology supports the need to formalise an approach to re-assess and, where needed, recalibrate parameters for the natural catastrophe risk module of the Solvency II standard formula on a regular basis.

The overarching goal is for the solvency capital requirements for natural catastrophe underwriting risk to reflect the expected impact of climate change to ensure the financial resilience of (re)insurers covering natural catastrophes.

As climate-related losses increase, there is the risk that gaps in insurance coverage will widen. In Europe, only 35% of climate-related losses are insured. There is also the risk that premiums become too expensive.

Ensuring the availability and affordability of insurance is also becoming more pressing. More than any other player in the financial sector, insurance companies play a vital role in building resilience, by encouraging and incentivising policyholders to take preventive measures. EIOPA has therefore been investigating how the insurance industry can reflect prevention measures in the design and pricing of products to incentivise policyholders to reduce risks. As outlined in a recent report, through risk-based pricing, contractual terms, and underwriting strategy (re)insurers should consider implementing measures for climate change adaptation and/or mitigation. EIOPA aims to incentivise (re)insurers' efforts in taking a forward-looking approach to covering risks arising from climate change.

Good data is key for insurers to make better-informed decisions. To promote awareness among stakeholders through a science-based approach, EIOPA has developed a pilot dashboard assessing the drivers of the natural catastrophe protection gap.

The dashboard brings together data on economic and insured losses, vulnerabilities and exposure, as well as insurance coverage across the EU Member States. It will help in identifying regions at risk, the drivers of a climate-related insurance protection gap, as well as defining proactive prevention measures. It should also allow for evidence-based decision-making on measures to improve society's resilience against natural catastrophes at a time when losses to properties and businesses are likely to increase because of climate change.

What is the role of ESG disclosures in fostering sustainable investment? How do disclosures enable informed decision-making by stakeholders?

There is no doubt of the growing interest in sustainable investment – both from the industry and from consumers – and accurate information will enable informed decision-making.

As a first step, there needs to be a common understanding of what is meant by a sustainable investment. This is where the EU taxonomy is essential. It provides common definitions for those economic activities that can be considered environmentally sustainable.

Disclosures are the second step. According to a recent consultation by the European Commission on its renewed sustainable finance strategy, only 15% of respondents knew if their insurance or pension assets were invested in sustainable finance assets. Of those that did not know, most asked for more – and more transparent – information about the environmental and social impact of their investments.

Disclosures will also help provide investors with information to make sustainable investment choices, as well as prevent greenwashing. Together with the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA), EIOPA has been working on regulatory technical standards setting out disclosure obligations for manufacturers of sustainable products under the Sustainable Finance Disclosure Regulation.

Together, the taxonomy and disclosures will help insurers and consumers identify where to invest for sustainable impact, how green their investment portfolios are, as well as empowering consumers to make informed decisions about the ESG profile of their investments.

Recent consultations have highlighted the challenges involved in achieving a disclosure that consumers can easily understand and also meets the different needs and requirements across all financial market participants. Nonetheless, given the importance of identifying key performance indicators for insurers' non-financial reporting regarding sustainability, EIOPA will continue to work closely with EBA and ESMA on this.

How to ensure that the European insurance sector adapts appropriately to climate change?

Climate change – along with cyber risk and pandemics – is just one of a number of challenges faced by society. These threats are too big to be addressed by single entities alone and there needs to be dialogue between different stakeholders to strike a constructive balance and achieve shared solutions.

With all these challenges, as society evolves, the insurance sector must also adapt quickly, but it must do so in an orderly way.

Good supervision will help the sector evolve – in both the way it operates and products offered. With a pan-European supervisory role, EIOPA can help to ensure that regulation (and its changes) remains relevant, proportionate and consistently applied; and that there is a common approach to terminology, data collection and supervision.

Climate change is bringing with it many challenges, but it also brings with it opportunities in shaping how society adapts. Insurers and supervisors must work together to develop pragmatic approaches while ensuring policyholder protection. Here, EIOPA can bring together the supervisory community and industry, to share knowledge, build expertise and ensure good cooperation.

We are only at the start of the journey to much-needed change. EIOPA will continue to work closely with supervisors, industry, consumer groups and policymakers to bring about better outcomes for consumers, the sector and society.

Q&A

BENOÎT CŒURÉ

Head of BIS Innovation Hub -
Bank for International Settlements (BIS)

Together on the journey towards central bank digital currencies (CBDCs)

How are Central Banks addressing Central Bank Digital Currencies (CBDC)? What are the key issues being tackled?

Central banks have embarked on the CBDC journey. As the Bank for International Settlements (BIS) has emphasised in its Annual Economic Report, this journey is designed to ensure that the unique advantages of central bank money -safety, finality, liquidity, and integrity- are preserved in a changing world, that the new world of digital payments is open and competitive, and that privacy can be kept to the highest standard.

Last year, a report from the BIS and the central banks of Canada, Euro Area, Japan, Sweden, Switzerland, United Kingdom and United States offered a guide for this journey. As such, official digital currencies should do no harm to monetary and financial stability, coexist in a flexible and innovative payment system, and promote innovation and efficiency.

The exact design will vary by jurisdiction and the issues they raise will have to be addressed along the way: system design, privacy, resilience, scalability, and interoperability in the areas of retail and wholesale CBDC. In the case of multiple CBDC arrangements for cross-border transactions, additional questions related to governance, integration and cross-border interoperability will arise.

What are the main objectives and use cases of CBDCs at the international level?

When we look around the world, we see that digital payments rise and CBDC projects are moving ahead ever faster as cash use falls. The pandemic has only reinforced this trend. Earlier this year, 86% of the world's central banks had already started to conceptualize and research the potential for digitalising their currency, 60% were building proofs of concept (PoCs) and 14% were deploying pilot projects, according to BIS research. As of August 2021, there are two live retails CBDCs: the Sand Dollar in the Bahamas and DCash in the Eastern Caribbean Currency Union. The People's Bank of China is performing large-scale pilots of its e-CNY project across China, and the European Central Bank just approved the investigation phase of a digital euro.

For the majority of central banks the introduction of a CBDC is likely some years away. Most of the jurisdictions are looking into both the wholesale and retail sides. The strategic objectives differ, however, somewhat across countries. In emerging markets, financial inclusion is a key driver. In advanced economies, efficiency and safety of payments are the main areas of interest. Despite the many different motivations, deep down it is all about payments, the historical raison d'être of central banks: a common focus on providing the public with a digitally advanced representation of central bank money and make payment system more diverse and resilient.

While the focus of most research and development projects is a matter of national taste, several projects explicitly consider or target cross-border use. A recent survey of central banks' initial thinking on cross-border use of CBDCs revealed that more than a quarter of 50 central banks are studying how to create multi-CBDC arrangements, and considering whether to allow its use by non-residents.

How is the BIS Innovation Hub contributing to the development of CBDCs?

The BIS Innovation Hub comes in on the experimentation that is a key part of any CBDC journey. Our role is to scout the trail. We are collaborating with a number of central banks to establish prototypes and PoCs to explore different uses of CBDC, primarily in a cross-border context. On the retail side, project Aurum explores a two-tiered distribution model. Project Arena builds the core platform and modules for wholesale CBDC settlement and a liquidity saving mechanism. Project mCBDC Bridge develops a prototype to support instant cross-border payments in multiple currencies among multiple jurisdictions. Project Dunbar explores shared settlement platforms for transactions with multiple CBDCs, and connectivity mechanisms to link up multiple shared platforms.

Project Jura, building on Phase I of project Helvetia, explores the use of a wholesale CBDC for cross-border settlement.

What are the expected interoperability challenges anticipated and how may they be addressed? Which other issues need to be explored further?

Making various national CBDCs interoperable has the potential to improve cross-border payments, as long as countries work together. Facilitating international payments with CBDCs can be achieved through different degrees of integration and cooperation, ranging from basic compatibility with common standards to the establishment of international payment infrastructures. This is the main message of a joint report to the G20 published last July by the Committee on Payments and Market Infrastructures, the BIS Innovation Hub, the International Monetary Fund and the World Bank.

To achieve the potential benefits for public welfare while preserving financial stability, further exploration of design choices and their macro-financial implications is essential.

Money is an essential attribute of sovereignty, and financial systems, payment preferences and attitudes towards privacy all differ across jurisdictions. Decisions on CBDC will be national, but they will have consequences across borders even when the initial motivation is purely domestic.

Central banks need to be on this journey together, and the BIS will help them map out the path.

Q&A

TOMOKO AMAYA

Vice Minister for International Affairs
Financial Services Agency, Japan

Global market access challenge and Covid-19

Do you see increasing signs of market fragmentation at the global level due to Covid-19 events?

The uncertainty stemming from the pandemic and from the associated possible paths which our economies may take has brought new challenges to authorities across jurisdictions. The magnitude and shape of the impacts posed by market fragmentation on financial institutions, markets, and end users may now be both increasing and decreasing.

Obviously, the global economy has been subject to a significant economic shock caused by the rapid spread of Covid-19. In light of this, authorities rushed to reconstruct and implement policy measures in an expeditious manner under new operational settings and constraints.

There was no time to consult and coordinate, and these circumstances may have contributed to the risk of market fragmentation.

On the other hand, facing the same challenges, authorities across jurisdictions have taken similar measures even without prior coordination. Precautionary lockdown measures have tested the contingency plans of all financial market participants.

Financial institutions as well as authorities adopted work-from-home (WFH) arrangements at very short notice. Many jurisdictions introduced extraordinary support measures to alleviate the financial and economic impact of Covid-19.

These include a range of payment moratoria and government guarantees for bank loans. As time progresses, divergence among industries has been becoming apparent. At the same time, authorities have begun to consider how to phase out emergency measures.

Faced with these challenges, authorities have widely shared largely common policy objectives and priorities, which have formed an important factor for decreasing fragmentation.

What are the impacts of this increasing financial fragmentation? How have authorities responded?

How the authorities work closely and coordinate action to maintain global financial stability is the right place to start. Before touching upon specific measures, I should mention that effective international regulatory and supervisory cooperation is an important precondition for integrated financial markets and cross-border financial activity.

From the beginning of the pandemic, the FSB, working with the standard-setting bodies, has facilitated a timely and effective information sharing mechanism with regard to the policy measures that the authorities are taking or are considering.

Authorities also took concerted communication strategies. For example, the Basel Committee on Banking Supervision published a series of statements and papers since March 2020 in order to announce authorities' objectives and priorities, provide the technical interpretations of the standards, and stress the flexibility embedded in the standards.

More generally, in April 2020, the FSB set five principles for official sectors, namely: to monitor and share information on a timely basis to assess and address financial stability risks from Covid-19; to recognize and use the flexibility built into existing financial standards to support the response; to seek opportunities to temporarily reduce operational burdens on firms and authorities; to act consistently with international standards rather than rolling back reforms or compromising the underlying objectives of existing international standards; and to coordinate on the future timely unwinding of the temporary measures taken. These principles underpinned the official community's rapid and coordinated response to support the real economy, maintain financial stability and minimize the risk of market fragmentation.

Authorities faced the pandemic almost simultaneously; however the timing and route to start moving toward exits may differ depending on the risk of premature lifting of multiple measures and the cliff arising from the cumulative effects of unwinding them. That is why monitoring is so important.

While the current events demonstrate once again the importance of a resilient financial system, G20 financial regulatory reforms will contribute to further reinforcement. Also, full, timely and consistent adoption and implementation of Basel III will benefit financial stability.

In addition to this, what kind of challenges are there and how can we address and mitigate these challenges from the perspectives of market fragmentation?

In the "conventional" sense, we have discussed market fragmentation with the assumption that the financial activities are still bounded by the jurisdictional borders with the physical presence of entities providing services. Thus, different regulatory and supervisory approaches to such entities in different jurisdictions cause fragmentation among international markets. However, such an assumption may not be the case for rapidly developing more borderless financial activity without, in some cases, a physical presence.

The case of global stablecoins is typical of such new developments, as entities within a global stablecoin arrangement may spread in multiple jurisdictions. In addition, a large, globally operating platform easily allows users to perform financial transactions across the globe. As a result, financial authorities are required to address associated risks through global regulatory and supervisory actions even before implementation.

More recently, so-called decentralized finance, which is provided by a combination of computer codes of smart contracts, enables completely borderless financial activities in cyberspace. Coordinated and comprehensive regulatory approaches are essential for the effective supervision and sound development of these activities.

Technology is there to migrate more financial activities to cyberspace for more frictionless financial transactions; however, jurisdictional borders between their own regulatory and supervisory approaches still prevent users from enjoying the full benefits. For example, we are still frustrated by expensive, slow and less-transparent cross-border payment and remittance, which the FSB and other international organizations are tackling with guidance from the G20.

In addition, the more financial activities migrate to cyberspace, the more important global response to cyber risks will become. In a broader sense, jurisdictionally fragmented response to operational incidents would not be enough to achieve a sufficient level of operational resilience of financial service providers.

In short, we are facing new challenges, as the nature of financial services changes from jurisdictionally bounded financial institutions with a physical presence to borderless financial activities in cyberspace without a physical presence.

What do we need to do going forward with regard to market fragmentation?

The last eighteen months of the fight against the Covid-19 pandemic reminds us that even the closing of physical borders can neither stop financial activities across borders nor break the financial system into pieces. The financial system is still global and becoming even more borderless, as we are all aware. Thus, avoiding harmful fragmentation is becoming even more important.

The good news we have learned through these difficult last eighteen months, is that financial authorities have been capable of maintaining close cooperation and coordination even without travel and physical meetings thanks to technological developments, such as rapidly developing video conference systems. As we are entering a new normal and may be becoming a world with a more borderless financial system, at financial authorities, we need to prepare ourselves for this new reality in a forward-looking manner. And I believe we can.

Q&A

JACQUES DE LAROSIÈRE

Central banks must change course to avoid possible financial crisis

High leverage poses great dangers

Central banks around the world appeared to wish to stick to the 'static approach' of monetary policy, maintaining their present unconventional stance. This policy was clearly inadequate to solve the world's real challenges and was fraught with danger.

Since then, the Fed plans to start withdrawing in the coming months its massive pandemic stimulus programme. The minutes from the July meeting of the Federal Open Market Committee stated that "most participants noted that, provided the economy were to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year". Maintaining the present unconventional monetary stance could have eventually triggered a financial crisis, bringing with it all the associated negative economic and social consequences. It would have weakened banking and insurance systems whose profitability has been hit – especially in Europe – by low or negative interest rates. Moreover, it would have unjustifiably kept alive over-indebted and uncompetitive 'zombie' firms that are surviving only because monetary policy grants them an interest rate subsidy.

Monetary policy was already at an impasse before Covid-19 struck. The system had been swamped with liquidity through the highly accommodative monetary stance of the past decade. This has pushed global debt to 355% of world gross domestic product, a record for peace time.

Huge leverage has weakened the financial system and endangered stability. Consumer price inflation has remained subdued but prices of financial assets and real estate have skyrocketed.

The continuation of very low interest rates for a couple of more years would have intensified already negative consequences for growth and employment. Abundant liquidity and low interest rates result not in higher productive investment but in liquidity hoarding. Since 2008, the M0 money supply (banknotes in circulation and bank reserves held at the central banks) has increased by 13.5% per year in major countries, four times faster than nominal economic growth. During the same period, M3, which includes bank deposits (and therefore reflects the transformation function of the banking sector), grew much more moderately – 3.5% per year in the euro area – showing that central bank money creation had not seeped into the economy.

It is indeed time for central banks to start changing gears and tighten policy. Various factors – the US fiscal stimulus, shortages of qualified labour, supply chain bottlenecks and the first signs of inflation of 4% and more – all point in one direction. It would seem prudent for the Fed to move gradually out of the present trap, by reducing monthly bond purchases and not systematically reinvesting all bonds coming to maturity. If the Fed does not start shifting course now, it could face a much tougher task if inflation takes hold in coming years. By delaying, the Fed might have to resort to much more intensive tightening with still worse consequences for growth. The world has grown accustomed to ever higher public and private debt. High leverage has massively increased market valuations. This poses great dangers if inflation and higher interest rates re-establish themselves. This is far from improbable, given the structural and demographic factors at play. In that case, heavily over-extended institutions would start facing debt payment difficulties and market reversal could well lead to a recession. Central banks would then face an unenviable choice: to fight inflation with much higher interest rates, to the detriment of growth, or allow inflation to explode, running the risk of stagflation.

Beyond this, the fiscal dominance now taking place brings two further hazards. It puts into question the independence of central banks. More importantly, it is a major disincentive preventing governments from engaging in the structural reforms that are vital to meet the fundamental challenges of the world's climate crisis. These challenges cannot be solved by printing ever more money.

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POST-COVID RECOVERY AND GROWTH

ISSUES AT STAKE

According to the EU Commission, the EU economy should expand by 4.2% in 2021 and by 4.4% in 2022 and all Member States should see their economies return to pre-crisis levels by the end of 2022. The Recovery and Resilience Facility (RFF), with an envelope up to € 672.5 billion will give a sizable recovery boost to the pandemic-stricken EU economy. This is specially the case for the CEE region which will be among the main beneficiaries of the RFF.

The Covid-19 crisis and the supportive measures that have been put in place have increased the heterogeneity of fiscal performance across EU Member States and led to a substantial increase in debt levels, which is a potential source of under competitiveness. In such a context, the EU needs a credible European fiscal framework for a common discipline. In addition, structural reforms are needed to increase productivity and sustainable growth and mitigate the risk of further economic divergence across Member States.

Lasting ultra-loose monetary policy is also increasing imbalances and risks for the EU economy and cannot solve the problems arising from excessive debt. However, initiating a change of the current approach remains challenging for Central Banks and requires international cooperation in order to avoid a “currency war” and excessive movements of capital flows.

IMPLEMENTING THE EU RECOVERY PACKAGE

GERT JAN KOOPMAN
Director General,
DG Budget, European Commission

Borrowing to finance the EU's recovery

Policy-making in 2021 is all about delivery. For the EU, this has meant turning the €800 billion NextGenerationEU – also NextGenEU - recovery instrument, funded through borrowing on the capital markets, into a reality. What have been the challenges and what is the expected added value?

NextGenEU – turning a concept into a reality

To finance NextGenEU, the European Commission – on behalf of the EU – will borrow on the capital markets some €150 billion per year between mid-2021 and 2026. This will turn the EU one of the biggest issuers in euro.

Challenge number 1 – to raise these amounts efficiently under the changing market conditions while securing optimal financial terms. To address this challenge the Commission decided to use a sovereign-style diversified funding strategy and sovereign-style funding techniques. To that end:

- In April, we adopted the underlying legislation, which allows us to regularly issue large benchmark bonds across the yield curve and to establish an EU-Bill programme to access the money market;
- In May, we chose the auction system TELSAT operated by Banque de France to auction our EU-Bills and part of our long-term EU-Bonds and; set up the necessary accounts with the European Central Bank;
- On 31 May, we published the first list of EU primary dealers – 39 institutions to support us in the successful placement of NextGenEU issuances;
- Finally, we announced our funding plan for 2021 to enable it to address, over the second half of the year, all NextGenEU funding needs.

In the meantime, EU countries completed the approval of the Own Resources Decision – the piece of legislation to enable the borrowing under NextGenEU as a result of which it entered into force on 1 June. The time had come for the first big test – and challenge number 2 - the NextGenEU market debut. The moment to prove if we had done our homework right. The expectations were high and it was important to deliver on them.

Ready, steady... first issuances

On 15 June, the European Commission raised €20 billion in a 10-year bond, the largest-ever institutional bond issuance in Europe. Two more record-breaking issuances followed, one of them a dual-tranche transaction combining funding under the back-to-back EFSM and MFA programmes. Thus, from mid-June to mid-July, in the course of just 4 weeks, the Commission raised more than €50 billion in 3 transactions, with tenors across the maturity curve. Each of the issuances attracted a strong interest by investors and priced under very attractive terms. All transactions performed well in the secondary market. From a policy perspective, this meant that the Commission has been well-placed to carry out all planned NextGenEU payments to EU countries over the summer.

Our success also meant that the Commission passed its first big market test. We showed that calling NextGenerationEU a game changer was fully justified. Challenge number 3 is now ahead of us – how to sustain this success and deliver on lasting positive effects for the EU and its capital markets.

Delivering on a lasting success

This autumn, we will continue implementing our diversified funding strategy. We will adopt the NextGenEU green bonds framework and issue the first NextGenEU green bonds. We will also start auctioning our EU-Bills and part of our EU-Bonds. With all of this, we expect to continue ensuring the necessary funding for NextGenEU.

In addition, NextGenEU will:

- Offer global investors a new highly rated and liquid asset in euro, thus attracting them to the EU capital markets;
- Ensure a regular presence on all parts of the maturity curve of liquid EU-Bonds, thus creating an additional reference point for market participants;
- Introduce the EU into the money market, thanks to the regular issuance of EU-Bills. Investors will thus have access to a liquid money market instru-ment, which benefits from the EU credit rating;
- Strengthen further the role of the euro in the sustainable finance market. The up to €100 billion SURE programme doubled the social bonds mar-ket. The expected €250 billion green bonds under NextGenEU will now significantly boost the size of the green bonds market.

All of this will strengthen the international role of the euro and will increase the attractiveness of the EU as an invest-ment destination. Many more challenges will follow on the way to achieving this. We are ready to address them!

JEAN LEMIERRE

Chairman, BNP Paribas

How to ensure smooth financing of the Green and Digital Recovery?

As Europe is progressively exiting an unprecedented health crisis, the focus is now turning to the economic recovery. We already observe a strong momentum in the economy, even if some challenges lie ahead, requiring banks to closely monitor their clients, and adapt their financial structure on a case by case basis.

Our collective ambition should be, not only to recover the pre-crisis GDP, but to invest to increase Europe's potential growth, leveraging in particular the Green and Digital transition.

We fully welcome the focus of the Next Generation EU program, which allocates a significant part to the Green and Digital agenda. These priorities are fully supported by the European banks and by their clients.

Such a transformation of the EU economy will require, on top of the public investment programs, massive private investments which will need to be financed.

In this context, European authorities should focus on three top priorities:

- Encourage the mobilization of EU's savings in European productive investments. This is indeed needed as at present a significant part of EU's savings is financing productive investments in other jurisdictions, fostering their competitiveness instead of the European one. This requires in particular the recalibration of some burdensome constraints in MIFID and PRIIPs, which, with the intention of protecting consumers, result in a disproportionate reduction of investors' risk appetite.
- Recognize that most of the financing will continue to come from banks. Therefore, EU policy makers should avoid piling up additional regulatory constraints which, as demonstrated by the recent crisis and a good number of official statements, are no longer needed and, if implemented, would reduce banks' financing capacities. In particular, the implementation of the final Basel III Accord should not result in a "significant capital increase", as mandated by the G20, European Council and European Parliament.
- Truly engage in the development of EU's Capital Markets, as a complement to bank funding. In particular, two aspects are essential to fund the Green and Digital recovery: the reinforcement of corporates' own funds, given the current high level of gearing, and the relaunching of securitization, so that banks can continue to play their credit origination role, while sharing the returns and the risks with non-bank investors. At the same time, given the progress made in developing a safe securitization model in Europe, this will create new investment opportunities in Europe for insurers, asset managers and pension funds, which are desperately looking for investments products with positive yields.

There cannot be a CMU without strong EU CIBs, and we fully welcome the January communication on "open strategic autonomy". Therefore, it is essential that the Basel III finalization is implemented in Europe without jeopardizing capital markets businesses, which will be highly penalized, through FRTB, SA-CCR, and securities financing businesses, as shown by the EBA impact studies. The Commission needs to ensure that capital requirements remain proportionate to the risks, and that there is enough flexibility in the text to ensure alignment in timing and substance with the main jurisdictions.

Finally on Environmental Social and Governance matters (ESG), we fully welcome the move by the G20 towards global ESG standards, indeed necessary in order to accelerate the global ESG momentum among public authorities, financial institutions, non-financial corporates and civil society at large. There is obviously a need to intensify and foster the existing dialogue among the different jurisdictions, in particular US and EU, to reach a consensus on globally harmonized standards and align as soon as possible on methodologies and metrics for monitoring progress. This means that the EU and US need to address some already discussed legitimate concerns. For instance, the US should accept the impact of companies on climate has to be taken into account as well as the impact of climate on companies (the double materiality concept). At the same time, the EU, without compromising on its level of ambitions, should better take into account companies' green transition in the Taxonomy, which currently focuses on the narrow scope of "already green" assets. To attain our collective climate transition objectives, the EU framework, and any global taxonomy to be defined, needs to be complemented by sectorial pathways that would encourage capital allocation towards the "greening" of the economy, i.e. towards investments most needed to transform the business model of companies to a greener one. That way, the EU's extensive work and recognized leadership could be leveraged to become the cornerstone of global ESG standards.

Finally, we hope that further steps will be made in the run-up to COP26 towards mandatory ESG disclosure for all large (both listed and non-listed) corporates in all jurisdictions. The availability of high-quality, reliable and accessible ESG data disclosed under harmonized standards is key to channel funding to both green and transitional activities, as well as to monitor national commitments and investment plans to comply with the Paris Agreement.

We all live on the same planet and we share the same (or very similar) net zero commitments. We now need the same metrics to monitor progress.

EMMANUEL MOULIN

Director General of the Treasury,
Ministry of the Economy, Finance and the Recovery Plan, France

Ensuring the return of sustainable and inclusive growth in the European Union

Looking back, we can be proud of what the European Union has achieved during this unprecedented economic and health crisis, at a time when many doubted its added value and effectiveness.

In record time, Member States agreed on a historic plan financed by a common debt issuance, to support the recovery efforts of Member States, in particular those most affected by the crisis, and to sustainably transform European economies, notably to meet the climate and digital challenges. This is a strong signal of the European Union's solidarity and ability to react timely and jointly.

They have also successfully submitted ambitious national recovery and resilience plans. As of early August, 16 plans have been adopted without difficulty by the ECOFIN Council and more should follow by September. This demonstrates the high quality of these plans, whose investments and reforms will stimulate recovery while addressing long-term challenges. The first disbursements of pre-financing is a victory for Europe, especially for citizens who will concretely benefit from the European recovery plan.

As for France, our recovery and resilience plan adopted at the July ECOFIN council, finds its origin in the €100Bn national plan France Relance. Focusing on three key priorities, green transition, competitiveness, and cohesion, it has the ambition to transform the French economy and enable it to meet the challenges of 2030. As a top priority, about half of the plan's investments are dedicated to the climate transition: we invest massively in the energy retrofitting of buildings, the development of green infrastructure, mobility and technologies. To foster innovation, we will also invest in innovative sectors such as artificial intelligence and cloud, in research and development and for the digitalization of the economy. Nearly a quarter of our plan is devoted to the digital transition. Finally, to avoid long time scarring of the crisis, we are investing in skills and human capital, notably for young people who were particularly hit by the crisis, in order to lower the unemployment rate and facilitate the reallocation of resources.

In the coming months and years, I identify three priorities to make the European recovery plan a success and for it to boost potential growth. We should ensure the adoption of the recovery and resilience plans of the remaining Member States to foster a coordinated rebound. The value of the Recovery and Resilience Facility is to deploy a coordinated recovery strategy. We need to invest collectively and massively in sectors rich in growth and jobs, while ensuring that each plan adopted fully respects the Regulation criteria.

We must also ensure that disbursements of the European recovery plan materialize swiftly. France has already committed €36 billion of the France Relance plan, but other Member States are waiting for European funds to finance the stimulus. Thus, it is up to the Commission and Member States to strike the right balance between the oversight necessary to ensure a proper implementation of the plans and the flexibility and pragmatism necessary to ensure swift disbursements that will be beneficial to European economy as a whole.

Finally, it will be crucial to guarantee that the measures included in plans, notably the ones addressing the structural challenges identified in the country recommendations, are effectively implemented. This is key to reduce persisting macroeconomic imbalances as well as to ensure that EU funds effectively boost potential output growth. As for France, our plan pursues the ambitious reform agenda launched by President Macron in 2017. Among others, the Climate and Resilience law will accelerate the climate transition and the law to accelerate and simplify public action will simplify the regulatory environment for businesses.

We can be proud of what the EU has achieved during this unprecedented economic and health crisis.

The European economy is recovering but there is still a long way to go before we reach the pre-crisis growth trends. This is the next challenge Europe has to tackle and this will be one of our common priorities during the French Presidency of the European Union starting in January 2022. The responsibility of Member States and the Commission is to make the recovery strong and sustainable. To this end, as we emerge from the crisis, we must prove our ability to coordinate our economic policies, as ambitiously as we did at the height of the crisis.

HARALD WAIGLEIN

Director General for Economic Policy, Financial Markets and Customs Duties, Federal Ministry of Finance, Austria & Chair, FSC

Ambitious implementation of recovery plans is a joint responsibility

With the majority of recovery and resilience plans already endorsed by the Council, two more positively assessed by the Commission and the pending approvals expected after the summer break, the Recovery and Resilience Facility (RRF) is approaching its implementation phase in large strides.

While no conditions are imposed on the first disbursement of RRF funds, in the form of 13% pre-financing of the allocated amount, the following pay-outs are tied to the successful fulfilment of agreed upon milestones and targets. Indispensably, member states, which have not yet put in place the required governance and control structures, need to do so before their first regular request for payment. These structures are vital to ensure proper implementation and monitoring of Recovery and Resilience Plans (RRP) as well as to ensure the correct use of the funds.

The RRF, with an envelope up to € 672.5 billion, will give a sizable recovery boost to the pandemic-stricken EU economy, with a focus on the green and digital transition. Due to the requirement that RRPs address all or a significant subset of country-specific recommendations, the RRF provides incentives for reforms and holds the potential to increase the efficiency of the EU Semester.

If the RRF fails to meet its objectives, there will be budgetary as well as severe political repercussions for the EU. Thus, ensuring effective and ambitious implementation of RRPs is key to its success. The performance-based nature of the instrument, with milestones and targets reflecting progress with reforms and investments tied to disbursements, is intended to mitigate some implementation risks, e.g. those linked to changes in government.

Yet, challenges remain with regard to the implementation of certain key structural reforms with relatively unspecific milestones. This concerns reforms of pension systems and labour markets, which require social partner involvement and therefore impede clear ex ante commitments by governments. In these cases, the Council has to rely on a strong role by the Commission to ensure flesh is put on the bone. Another threat that may undermine the objectives of the Facility is the backloading of certain reforms towards the end of the plan, which diminishes peer pressure and foregoes some of the positive growth impact from the RRF.

Overall, I see three main areas of concern that pose a risk to the effective and successful implementation of RRPs. First, absorption capacity in conjunction with administrative capacities will pose a key challenge in member states with a high allocation. In a welcome step, many member states, with a history of comparatively low absorption rates of EU funds, have passed or committed to pass important enabling reforms to strengthen the administrative capacity and efficiency of the public sector.

Second, funds will need to be channeled into the productive parts of the economy and viable businesses to support green investments and gain ground in the race for digitization. SMEs will indirectly also benefit from reforms liberalizing the business environment. Third, national control systems will be put to the test.

The milestones and targets agreed by the Council shall not be watered down.

The Commission shall apply the necessary stringency when it comes to payout requests, only approving them when all the proposed milestones and targets have been completed. But peer pressure and the scrutiny of the European and national Parliaments are also important. The milestones and targets agreed by the Council shall not be watered down.

As a final note, the question of how the mutually guaranteed EU debt will be re-payed cannot be left out of sight. Recently, doubts have emerged over the three proposed new “own resources”, among them the now postponed EU digital levy, which should have been used to repay joint NGEU debts. Facilitating a timely redemption of the debt is imperative, otherwise the next generation will be left to pay the bill.

ALESSANDRO RIVERA

Director General of the Treasury,
Ministry of Economy and Finance, Italy

Unlocking Italy's growth potential

Italy's Recovery and Resilience Plan (RRP) is the outcome of a long and complex preparatory work. It is a substantial plan in terms of scope, ambition and innovation. It is fully consistent with the goals of the European Green Deal and the six pillars of the Recovery and Resilience Facility (RRF) Regulation. In addition to the full utilisation of RRF grants, the Italian government has applied for the maximum allowable amount of loans from the facility. Including 13 billion from REACT-EU and 30.5 billion from a dedicated national fund, the plan is worth 235 billion euros, or 12 percent of GDP[1].

The RRP tackles Italy's structural economic and social issues, as well as the global challenges of the green and digital transitions. Indeed, its three strategic axes are digitisation and innovation, ecological transition and social inclusion. The digital transition will absorb almost 30 percent of the available resources, while the green objectives will take up 40 percent of the funds. Moreover, the Plan addresses three horizontal priorities: gender equality, youth employment and regional cohesion. The South will receive 40 percent of the 206 billion available for distribution according to geographical criteria.

The RRP also includes a broad reform program that addresses most of the 2019-2020 Country Specific Recommendations (CSRs) from the EU Council. The key structural reforms in the RRP aim to improve the efficiency of the justice system, the functioning of the public sector and the quality of services provided to firms and citizens. A second cluster of reforms focuses on promoting competition, simplifying bureaucratic procedures and enhancing the planning, approval and execution of public investment and infrastructural projects. Finally, the government will deliver to the Parliament an enabling legislation proposal to reform the tax system and a draft reform of active labour market policies.

Successful implementation of the RRP will improve Italy's public debt sustainability through higher real GDP growth. According to the commonly agreed estimation method, before the pandemic Italy's potential growth rate was 0.6 percent. A prudential assessment of the RRP is that it will raise the growth potential to 1.4 percent, with 0.5 percentage points of the improvement coming from increased investment and 0.3 from structural reforms. The projected growth rate in the early years of the Plan will be significantly higher than the potential one, as unused factors of production are put to work.

As far as the numerator of the debt ratio is concerned, projects financed by RRF grants will not affect gross public debt. Only 44 percent of RRF loans will be debt creating with respect to existing budgetary plans. Moreover, the government has committed to prudent management of the public finances and to discontinue extraordinary fiscal support measures as soon as the Covid-19 restrictions are lifted. Over the next six years, net borrowing of the general government will consistently decline. The debt ratio will return to the pre-crisis level by the end of the decade.

Given its breadth, ambition and resources, the RRP will pose significant implementation challenges. In the past, Italy has shown a relatively low absorption capacity of European Structural Investment Funds (ESIFs). A mixture of bureaucratic obstacles, multiple decision-making levels, veto powers and legal uncertainty have hampered the planning and execution of public investment and infrastructure development. Furthermore, the rush to absorb funds in the final stages of EU budgetary cycles has affected the quality of public investment expenditure.

The Recovery and Resilience Plan will boost GDP growth and the green and digital transitions.

In order to overcome these issues, the government will put in place a lean but carefully designed governance structure and a series of reforms aimed at reducing administrative and bureaucratic bottlenecks.

Stronger growth and healthy public finances are the two key goals of Italy's economic and financial policy. We will spare no effort to ensure that the RRP's potential to revitalise our economy is fully realised.

[1] The ratio uses the average nominal GDP level projected for 2023-2024, the middle years of the Plan.

IRENE TINAGLI

Chair & MEP, Committee on Economic and Monetary Affairs, European Parliament

Recovery and resilience facility: new challenges and new opportunities

With the approval of the first bunch of National Recovery and Resilience Plans by the ECOFIN, we are finally at a decisive milestone in the European strategy towards the Recovery. The Union showed all its strength in finalizing this process. This is part of a worldwide extraordinary effort towards the recovery: according to the IMF, the global economic contraction recorded last year would have been three times worse without such swift and worldwide policy support.

So far, we have been able to avoid a multi-annual deep recessions, which may have had long-lasting effects on potential output. Thanks to fiscal and monetary actions, we contributed to prevent structural damages to the economy, avoiding a generalized tightening of credit and preventing the destruction of viable physical, intangible and human capital. Now, we are entering in a new phase in Europe, we are facing a new time, named after the two evocative pillar of our Recovery strategy: "Recovery" and "Resilience". "Recovery" and "Resilience" represent ambitious targets for the Union as a whole. These two objectives are and must be interconnected, but they also require diversified approaches and tools, and each will have to be evaluated with appropriate criteria.

The RRF is an essential part of the necessary response to the risks of disintegration of the single market. But it is only a part. "Recovery" and "Resilience" requires something more than an ambitious program, and call into question national and supernational economic policies. Their design is fundamental for the future of the Union. This time, even more than in the past, we cannot make mistakes.

The phase we have ahead still shows much of the uncertainty we have been experiencing over the last time. We should been able to swift implement measure and economic support on the basis of local lockdown or severe impact on some sectors of the economy, but we should also be able to reflect about the medium term, avoiding cliff-edge effects, which may endanger what we have achieved so far. At the same time, our thinking should also be concentrated over the new "business as usual". There are new challenges and new opportunities to be seized, from the digital transformation to the ecological transition. This is what is behind the Recovery and Resilience Facility.

So far, a lot of attention has been devoted on what are considered the structural problems pre-existing to the pandemic and on the policies to be implemented to overcome them in order to achieve a permanently higher level of production and employment. Of course, this is not wrong, but it may not be enough if the specific structural effects of the recession on production methods, on the composition of aggregate demand or on citizens' expectations for the future are also hampering recovery. These new structural effects must also be considered when we discuss about economic policies. There are a number of the areas where we realised the importance of further action: infrastructures for home-based education and work, investments, including in digital, for the whole public administration, a more local-focused approach in the designing social infrastructure and the resilience of the health care system.

Recovery and resilience call into question national and supernational economic policies.

A crucial pillar of the reflections over the next years is represented by the challenge relates to medium-term fiscal sustainability. Here the challenge is to find the correct national and European fiscal stance in the coming months and years. On the one hand, we must avoid that fiscal consolidation happens too soon, because this could undermine the economic recovery in the short run and the growth potential in the long term. But at the same time, we must avoid that fiscal consolidation is postponed indefinitely, because we would risk facing a possible new crisis without adequate margins for manoeuvre. For this reason, it would be important that the debate on the review of macroeconomic governance precedes the deactivation of the general escape clause, as the European Fiscal Board well pointed out last year in its report.

A clear predictability on the budgetary rules is important not only for the sustainability of public finances, but also - and above all - to give a multi-year perspective to national governments in their choices regarding spending and investments, a key element to achieve a strong recovery and to foster the resilience of our economy.

VITORIO GRILLI

Chairman of the Corporate and Investment Bank EMEA,
J.P. Morgan

NGEU as an instrument for increasing medium-term sustainable growth in the EU

The NextGenerationEU (NGEU) recovery plan could be an important instrument for deeper European fiscal and political integration. Developed with the COVID-19 crisis in mind, NGEU's focus on investment could be a game-changer for Europe's economic growth dynamics and could help lift the continent out of secular stagnation. It also has the potential to contribute towards broader EU priorities, such as the internationalisation of the euro and improving the EU's future competitiveness.

I have quoted these figures before, but average annual (inflation-adjusted) growth in EU investment declined from c.3.4% (1999-2007) to c.2.6% (2011-2019), before the COVID-19 crisis. The euro-destabilising variance in investment across Member States has been even more dramatic across the same period.

With their long tenors, NGEU loans could be an excellent vehicle for Member States to invest in projects that take longer to yield returns, most notably improving the quality of STEM-focused education. This could be particularly helpful for countries which have experienced negative average investment growth over recent years, such as Italy, Greece, and Portugal, and help bring GDP growth in-line with the rest of the EU. Even France and the Netherlands have seen a decline in investment growth of nearly half.

As such, it's important to avoid creating a stigma around the NGEU loans and ensure that Members States want to use them. Such incentivisation would be best achieved by appropriately pricing loans with rates based on simple, clear, and time-consistent formulas that do not risk creating large payment fluctuations for Member States.

To maximize the NGEU's return on investment, it is not only important that the use of proceeds is done properly, but also that the source of funding is fit for purpose. The Recovery and Resilience Facility's focus on the green and digital transition will support post-pandemic methods of working, with investment in rapid broadband and 5G connectivity; both 'flagship areas' identified by the European Commission where investment and reform should focus. We look forward to the publication of the NGEU Green Bond Framework in September. We expect green bond issuances to start thereafter, comprising 30% of the entire NGEU Fund and boosting the climate transition by up to €250bn. This should allow the EU to further diversify its investor base, boost the green bond market and demonstrate the EU's commitment to long-term sustainable finance.

Both the European Commission and Member States should remain serious about committing to the reforms outlined in their recovery and resilience plans, as those by themselves tend to greatly enhance productivity. For instance, Italy's reform of the judiciary is set to substantially lower the effective cost of doing business in the country, freeing up resources currently tied up in unproductive activities, increasing investment and productivity, and supporting asset prices (e.g. real estate).

Premature fiscal or monetary tightening should be avoided as this would reduce the progress the NGEU could make. The policies and reforms announced need to work together to be successful and most importantly give the EU economy enough "escape velocity" to leave its secular stagnation behind for good.

It's important to avoid a stigma around NGEU loans and ensure that Members States want to use them.

JPMorgan was proud to be among the financial institutions included as part of the EU's Primary Dealer Network, announced at the end of May, as well as joint-lead managers on the second NGEU transaction this year and the SURE transaction in 2020. Investor interest was strong for the most recent NGEU transaction, which was more than eleven times oversubscribed and with bids exceeding €170 billion. Consequently, this translated into favourable pricing conditions for the Commission.

Operating in the region for close to 200 years, our commitment remains unwavering and we endeavour to continue supporting the deployment of the Recovery Fund. We are confident that the European Commission will continue to work with best-in-class institutions to be well-positioned for successful issuance in different market conditions.

WERNER HOYER

President, European Investment Bank (EIB)

Accelerating a green, digital recovery in Europe after COVID-19

The digital transition

The pandemic has exacerbated the digital gap between European companies. Firms that already had a strong digital presence maintained contact with their clients, suppliers and employees when European economies were forced to close. Without a digital presence, firms shut for weeks or months on end and are struggling to survive. Beyond that, the failure to adopt recent digital technologies weighs on firms' competitiveness: firms that have implemented advanced digital technologies tend to perform better than non-digital firms.

European Investment Bank research shows that median labour productivity is 37% higher for digital firms in Finland – the country with the highest digital adoption rates in the EU – than for non-digital ones. In addition to innovating more, these companies also invest more, have better management practices, grow faster and create higher-paying jobs. European companies are global leaders in many traditional industries. They are less of a presence in fast-growing digital sectors. Unlike China and the US, the European Union doesn't appear to be investing enough in research and development to generate new digital leaders.

Europe's weakness in digitalisation could jeopardise its long-term competitiveness and also have negative consequences for European strategic autonomy.

The pandemic has also exposed stark differences in digital skills. To strengthen access and inclusion in learning, we need to focus on equipping young people and adult learners, teachers and businesses with digital skills.

Research by the European Investment Bank Economics Department shows that skill gaps pose persistent barriers to investment. In recent years, more than 70% of firms have reported skill gaps as an obstacle.

The COVID-19 pandemic has reinforced the need to transform skills, accelerated structural shifts and raised unemployment risks. Scaling up investment in skills is essential to mitigate the polarization of labour markets across the EU and the risks that structural unemployment may increase regional inequality.

The need to accelerate the green transition

The digital transition can support and accelerate the fundamental green transition to a net zero-carbon economy. The climate crisis is the defining challenge of our time, but we are moving too slowly. Over the next decade we need to transform the way our economies produce goods and use energy. This means investing heavily in innovation and technologies that don't yet exist, improving education and infrastructure, focusing on projects that help us adapt to environmental changes and supporting a just transition. To achieve the 2030 greenhouse gas reduction goals, we need an estimated €350 billion in extra investment annually — going to the right sectors. The European Investment Bank will play its part by mobilising €1 trillion of climate action and environmental sustainability investment by 2030. Let's not forget, we have a lot to gain by addressing climate change. A group of countries representing half the world's greenhouse gas emissions have already adopted net-zero carbon targets. Others will surely follow.

They will all need technologies and investments to meet their climate goals. Solutions and products that support clean hydrogen, offshore renewable energy and energy storage could, therefore, all become vibrant European export sectors.

The twin challenge of digitalisation and climate change must be cornerstone of the EU's recovery.

The way forward

The European economy faces a twin transition. Increased digitalisation is conducive to a green transition, innovation and a more cohesive European economy. To accelerate digital innovation and the adoption of green technology, Europe should focus on three elements:

i) an enabling and supporting ecosystem to foster the birth and growth of innovative companies;
ii) the right kind of financial support for investment in companies at different stages of development;
and iii) a European vision to counter existing imbalances across the European Union in terms of skills and the adoption of digital and green technologies.

Addressing the challenges of climate change and digitalisation is key to sustainable growth.

Europe needs to make it happen now.

PIERRE HEILBRONN

Vice President, Policy & Partnerships, European Bank for Reconstruction and Development (EBRD)

Recovering sustainably from the Covid-19 crisis in the CEE region

The economic crisis precipitated by the Covid-19 pandemic has had a profound and damaging impact on the EBRD's Countries of Operations. Across our regions, output has contracted, foreign investment has declined, and public debt has increased dramatically.

When we take a closer look at some of the countries in Central and Eastern Europe (CEE), however, a more nuanced picture emerges. Slovenia's economy was significantly impacted in 2020, with GDP declining by 5.5% while in the Czech Republic, robust pre-Covid-19 growth was followed by 5.6% reduction in GDP in 2020, qualifying as a "one in 25 years event". In Hungary, GDP declined by 5% in 2020, while the recession in Poland turned out to be milder than anticipated, with GDP contracting by 2.7 % in 2020, mostly due to its diversified economic structure and generous public.[1] There are some signs of recovery, however. At the time of writing, output in Central Europe and the Baltic (CEB) states is projected to increase by 4.8% in 2021 and 4.6% in 2022.[2]

Throughout the crisis, the EBRD has supported economies not only through our investments but also by providing governments and other state institutions with high quality, straightforward and usable policy advice. While vaccination programmes across Europe begin to ramp up, and the end of ongoing strict lockdowns appears to be in sight, it will take many years for the European economy to recover from the shock of the pandemic.

The €750bn EU recovery package, known as Next Generation EU, in addition to the more than €1tn EU budget for 2021-2027, are therefore crucial for the recovery in Central and Eastern Europe. Some have argued, given the scale of the crisis, these funds are not large enough, but one cannot deny that they could help catalyse the transformation to a more green and digital economy.[3] They are likely to add between 0.6 and 1% to annual GDP growth rates in the CEB region, depending on the use of the funds. So effective mobilisation by member state governments will be critical. The recovery funds seem to focus on raising potential growth and improving long-term fiscal sustainability rather than achieving short-term fiscal stabilisation.[4]

Used properly, Next Generation EU can help to deliver a genuine, social and sustainable European economy. Countries now need to take advantage of the recent tentative economic upswing and take steps to mobilise additional private sector funds to "build back better" towards more inclusive, digital and green economies. These broad themes should underpin every aspect of the recovery - but we also need to get the basics right. We cannot layer a vibrant green bond market on top of an underdeveloped or illiquid capital market. EBRD recognises this and is assisting CEE countries in strengthening capital markets infrastructure, diversifying the local investor base, crowding in private sector investors (and not just the international big-ticket players), and promoting the expanded issuance of securities in domestic markets and in local currency.

The region will see an uneven recovery from the pandemic but EU recovery packages will help.

A stable foundation will help countries in the region to develop resilience against any further shocks down the line. If the pandemic has taught us anything it is that we should always be prepared for the next crisis. This requires a more holistic view of what it means to recover sustainably: not just relating to environmental challenges but social and corporate governance aspects as well. Not only focused on digital developments, but innovation and research too. The crisis was a universal yet uneven shock to the globe; we must recognise those asymmetries as we re-emerge from it. We have a rare chance now to change our economies for the better - let us hope we do not squander the opportunity.

[1] "Regional Economic Prospects: Recovery Gathering Pace" (EBRD, June 2021).
[2] "Regional Economic Prospects: Recovery Gathering Pace" (EBRD, June 2021).
[3] https://www.spglobal.com/ratings/en/research/articles/210427-next-generation-eu-will-shift-european-growth-into-a-higher-gear-11929949
[4] https://blogs.lse.ac.uk/europpblog/2021/05/18/the-eus-recovery-funds-should-be-released-when-europes-economies-can-reopen/

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EXIT FROM COVID MEASURES

ROLF STRAUCH

Chief Economist and Member of the Management Board, European Stability Mechanism (ESM)

Exiting from Covid-19 measures: policy challenges and the impact on EU banks

The EU banking sector has shown remarkable resilience over the pandemic crisis. In the future, however, EU banks will still have to cope with high uncertainty related to the economic recovery and the impact it will have on the financial system.

The latest stress test conducted by the European Banking Authority confirms that the euro area banks are able to withstand a crisis even under severe assumptions. This hinges, among other things, on the mitigating impact of the public guarantee schemes and their continued positive impact on credit risk parameters.

Clear signs of vulnerabilities continue to affect traditional banks with high dependency on net interest income. With this in mind, a considerable gap remains between euro area and US banks on how they are perceived by investors, as testified by the significant difference in the price-to-earnings ratios. US banks recovered faster and continued to improve suggesting greater prospects for the near future. This is – at least partly – explained by the uncertainties surrounding the recovery in Europe.

Although the immediate danger in the private sector has been averted, the exit from Covid-19 measures poses several policy challenges.

First, legacies from the pandemic need to be tackled in the best way to preserve sufficient lending capacity. The amount of legacy Non-Performing-Loans (NPLs) has been contained so far, but the economic outlook and implications of policy actions are still uncertain. In line with the results of the stress test, there will be a need to address the NPLs emerging from the pandemic efficiently, maximising the residual value. The European Commission has proposed an NPL action plan, which outlines ambitious reforms and measures to mitigate the build-up of new NPLs both at national and European level.

Exiting Covid-19 measures poses challenges despite dangers in the private sector averted so far.

Second, the timing and sequence of withdrawal needs to be well calibrated. On the one hand, a premature withdrawal of regulatory and government support could turn viable banks and companies into non-viable ones, which would destroy the capacities that are pivotal for a fast and sustainable recovery. On the other hand, extended support of non-viable firms and banks can lead to misallocation of financial resources and slower economic recovery. Tensions may arise among the "optimal" regulatory responses – given the interplay among government, regulatory and monetary policy measures in support of credit extension. Coordinating this interplay will require extraordinary efforts. Different assessment of risks or structural changes and inexperience in withdrawing the support measures can complicate matters.

Third, exiting from these pandemic measures also opens the door to defining a new state of the banking sector. The pandemic provides some lessons on how to best deal with certain regulatory measures such as prudential buffers, which can now be taken on board. At the same time, the phasing out of the pandemic policy measures will also interact with the ongoing regulatory developments, such as the implementation of the final Basel III package and full implementation of the revised Bank Recovery and Resolution Directive (BRRD).

Exiting from these policy support measures is not in itself conducive to the long-overdue structural changes in the EU banking sector that would secure banks' ability to support growth going forward. The completion of Banking Union – with its EU-wide coordinated approach – will help to create the right incentives for banks to implement these structural changes and reduce their related adjustment costs.

The treaty reform of the European Stability Mechanism with the early introduction of the common backstop to the Single Resolution Fund, brings us closer to completing banking union. This backstop serves as a supplemental safety net as it can lend funds to the Single Resolution Fund to finance a resolution in case failing banks deplete the Fund's resources.

However, several important building blocks are still missing. Key elements for the completion of Banking Union is the proper functioning of the crisis management framework and a common deposit insurance scheme. A European deposit insurance would facilitate further financial integration across Europe. Europe will be best prepared for any future crisis only if it is equipped with a strong and uniform protection and crisis management framework. Strong political commitment to pursue greater legal and institutional harmonisation and centralisation will be necessary to make that happen.

FRANCESCO MAZZAFERRO

Head of the European Systemic Risk Board Secretariat (ESRB)

The gradual withdrawal of support measures and implications for systemic risk

In the spring of 2020 EU Member States took a wide range of support measures to dampen the impact of the coronavirus (COVID-19) pandemic on the economy. These mainly took the form of public loan guarantees, direct grants, tax reliefs and loan moratoria. Non-financial corporations (NFCs) and households have been the main beneficiaries of these measures which, at the end of March 2021, amounted €1,329 billion (9.3% of EU GDP for 2019). In May 2020 the European Systemic Risk Board (ESRB) issued a recommendation to national macroprudential authorities to define a framework for monitoring the impact of these support measures on financial stability. It also asked national macroprudential authorities to submit data to the ESRB, which has since carried out its own analysis.

One of the ESRB's main concerns at that time was the possibility of cliff effects from the simultaneous withdrawal of many support measures in the fourth quarter of 2020, which could have led to a sharp deterioration of banks' asset quality and hampered the recovery if measures were withdrawn before the economy had been able to fully recover. However, these concerns have been alleviated as support measures were broadly extended. As a result, our latest data indicate a gradual withdrawal of support measures through 2021 and 2022, which should in principle avoid cliff effects.

The gradual withdrawal of support measures may also affect the EU banking system. In the case of loan moratoria, we expect a gradual increase in the number of loans subject to forbearance measures, as banks may renegotiate the loans of troubled borrowers and the related European Banking Authority (EBA) guidelines have now expired. For public loan guarantees, the possibility of liquidity tensions in the NFC sectors as a whole seems small, as loans increased significantly during the first half of 2020 and deposits at banks are at an all-time high. The reopening of European economies should also favour cash flow generation, and the possibility of a large increase in non-performing loans now seems smaller than a few months ago.

An optimal allocation of resources towards innovative and sustainable uses must be ensured...

However, some sectors of activity, such as hotels and restaurants, remain heavily affected and could require further support or face widespread restructuring. These are sectors with a significant number of small and medium-sized entities (SMEs), which may not have the resources to withstand such a prolonged period of distressed cash flows. As a result, the capacity of insolvency frameworks across the EU to absorb a large number of insolvencies in a short period could be put into question, particularly as insolvency filings were suspended for several months at the peak of the COVID-19 pandemic and SMEs are primarily affected.

Looking back to the dynamics of the support measures, European economies have moved from the reactive phase in crisis management[1] – which occurred during spring 2020 and where broad measures were taken to alleviate liquidity tensions and avoid large economic disruptions – to the reassess phase, where measures should be more targeted in scope and focus on the solvency of viable NFCs. This entails the daunting task of identifying which NFCs are viable in the new normal and, as such, merit further support and which ones are not, and thus should be subject to orderly insolvency procedures.

For financial institutions, supervisory and regulatory authorities across the EU took operational and regulatory relief measures to complement those taken by national governments. These measures included guidance on the application of IFRS 9, postponing several supervisory reporting requirements and allowing banks to exclude certain central bank exposures from the leverage ratio. There are good reasons to unwind these measures soon: (i) the public support measures taken so far have prevented the expected disruption from the pandemic on the European economy from fully materialising; (ii) the economic recovery seems grounded on a sound path; and (iii) the 2021 EBA stress test exercise has revealed that the EU banking system is in an overall strong position to absorb losses in a deteriorated macroeconomic environment.

Looking ahead, the expected recovery in the coming months should lead Europe towards the rebuild phase, but pockets of excessive indebtedness in viable NFCs still need to be addressed. Here, it is important that banks intensify their monitoring of borrowers so that they can identify possible vulnerabilities early and act on them swiftly. Moreover, an environment of low interest rates, despite recent inflationary pressures, should facilitate the debt servicing of borrowers in the coming years. In this phase, an optimal allocation of resources towards innovative and sustainable uses must be ensured in order to guide European economies to a dynamic macroeconomic environment that will also benefit the financial system.

[1] For details on the three phases, see Figure 2 in European Systemic Risk Board (2021), "Prevention and management of a large number of corporate insolvencies".

STEVEN MAIJOOR
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Exiting from COVID-19 opens the way for Basel implementation

Now that most people in the EU have had the opportunity to get vaccinated, we are facing less uncertainty about the period ahead. Growth figures for the second half of 2021 and for 2022 look promising, with many countries re-opening their economies. At the same time, risks related to COVID-19 remain, and the unique situation caused by this pandemic will continue to present uncertainties. Potential variants of the virus could delay the recovery, but we are much better prepared to address new challenges related to the pandemic than we were in early 2020. This means we are now in a position to allow ourselves to look ahead, and to outline the path to normality.

Following the Great Financial Crisis of 2008-09, policymakers and supervisors have been working hard to implement the lessons learned by reforming the Basel standards. This has resulted in banks holding more and better quality capital to absorb potential losses. As the COVID-19 crisis unfolded, the European implementation of the final set of Basel 3 reforms was put on hold. Although the pandemic did not alter the underlying reasons for addressing the remaining shortcomings in the prudential framework, the need to ensure that banks were able to support the economy justified this pause. During the COVID-19 crisis we clearly benefitted from the stronger position of the banking sector compared to the GFC. Thanks to their larger capital buffers, banks have been better able to provide corporates and households with the support they needed.

In addition to the better starting position of the banking sector, supervisors took timely a number of supervisory measures, which helped banks to continue to play their key role in the economy. We allowed banks to temporarily operate below their Pillar 2 Guidance (P2G) and the Liquidity Coverage Ratio (LCR), while also recommending to refrain from paying out dividends. As we move back to normality, we should think about how best to reverse these supervisory measures.

The ECB recently decided to repeal the dividend recommendation by the end of September and return to case by case assessments as part of the regular supervisory cycle. This is in line with our stance that the measures taken were adopted in exceptional circumstances and should be reversed once appropriate. Also, most of the operational relief measures have already been reversed. With respect to the relief measures that are still in place, we should be prepared to return to normality. For the measures related to the P2G and LCR, we have provided forward-looking guidance and they remain in place according to their logic. In particular, banks will not be asked to replenish their Pillar 2 Guidance too early in the capital cycle, and in any case not before end 2022.

The COVID-19 crisis has demonstrated the importance of a robust prudential framework.

We must indeed remain aware that problems in loan books may become more visible ahead, particularly as government support measures are withdrawn across countries. We should not be concealing these problems if they come. An important lesson from the GFC is that payment problems of customers and the buildup of NPLs should be tackled head on. Our immediate priority as supervisors is therefore to ensure that banks have a detailed understanding of the credit quality of their loan books. Management strategies such as loan restructuring and write-downs should be used by banks where necessary, taking also into account customers' interests. If NPLs do build up, the EU action plan on NPLs provides an important set of initiatives to address these.

As we exit from the COVID-19 pandemic, we should resume our work on further strengthening the prudential framework. It is therefore very much welcomed that the European Commission is expected to publish their legislative proposals for CRR3/CRD6 this autumn.

The COVID-19 crisis has demonstrated the importance of a robust prudential framework. Implementing the final Basel 3 reforms fully, consistently and timely in the EU is crucial for further strengthening the credibility of banks' capital requirement calculations.

Complying with these global standards also prevents a risky race to the bottom which could ultimately undermine financial stability. As the process to agree and fully implement the CRR3/CRD6 package is expected to take some time, strengthening future bank capital requirements should not affect banks' current efforts to support the economic recovery, as some have suggested.

With the EBA showing a continuing decline in banks' capital shortfall from the Basel 3 reforms, and the ECB demonstrating the long-term economic benefits of the package, we should strongly support a full, consistent and timely implementation of these prudential reforms in the EU.

LORENZO BINI SMAGHI
Chairman of the Board of Directors, Société Générale

Three trends reshaping banking beyond the pandemic

On the exit path from the pandemic, banks will inevitably be confronted by tough questions on a host of key topics. Fears related to high debt levels and a potential wave of NPLs have already been discussed at length elsewhere. Similarly, questions regarding evolving prudential and normative requirements abound, with regard to the usability of capital buffers or the efficiency of forward-looking provisioning notably. Beyond these immediate issues however, the Covid-19 crisis has accelerated structural shifts that banks will have to tackle.

A first major shift is the structurally different policy mix that is likely to remain in developed economies. The successful use of fiscal stimulus in this crisis has increased the propensity of governments to push for more stimulative fiscal policy, as evidenced by the Biden administration's successive stimulus and infrastructure plans or by the Next Generation EU plan in Europe. Monetary policy strategy is also in motion; both the European Central Bank and the Federal Reserve have made significant changes opening to door to steeper yield curves. Macroprudential policies are set to play an increased role against this backdrop, with the risk of higher levels of counter-cyclical or systemic risk buffers, as well as sectoral constraints on lending. In the case of the euro area, climate considerations have, moreover, become an integral part of monetary policy. The result could well see banks benefitting from slightly steeper yield curves, and not least in the US as the euro area seems likely to be bound by a more hawkish stance on fiscal policy rules. On the other hand, the administrative and equity costs of macroprudential policies seem likely to increase and competition from non-bank channels could well intensify.

The three transitions of our time, namely climate, digital and way of life, have also been accelerated by this crisis: policies to mitigate climate change and adapt to it are gaining traction, especially in Europe where the financial sector is placed at the center of the effort. At the same time, the pace of adoption of digital in our everyday life has moved up a sizable notch. Finally, new ways of consuming (leasing vs. purchase, re-use…), and of working (remotely, as a contractor rather than an employee…) are also changing demand for banking services. These three transitions generate opportunities for banks in terms of financing needs, cost optimization and new products. They also add or reveal new costs such as climate transition risks, and cybersecurity risks, while generating agile new competitors to which incumbents must react.

The pandemic has accelerated structural shifts that banks will have to tackle.

Given the hardening of the geopolitical fault lines, sovereignty considerations are also gaining in importance. This trend is likely to magnify the changes brought by the three transitions, with an additional twist: the sovereignty factor will increasingly conflict with business and prudential considerations. Banks, as fundamental instruments of sovereignty, could well be caught in the crosswinds. Here again, agility will be key, sometimes with a rightsizing of geographical footprints to limit the number of possible frictions.

Indeed, several emerging developments already underline how sovereignty considerations may change banks' business environment. The prospect of central bank digital currencies is largely driven by fears for the sovereignty of money, despite the risks they may present, not least for financial stability. Sovereignty considerations are also accelerating the comeback of competition policies from the US to China, which may have a transformational impact on investment banks' clients and activities, while possibly also curbing some of the threats to incumbent banks from large technology companies.

On another front, the push for the relocation of certain industries in the US or in Europe has the potential, if sustained, to curb international trade flows in some sectors while requiring bank financing for industrial projects whose business case rests more than ever on public support.

The post-pandemic world is arriving fast, and banks need to meet the challenge.

CHRISTIAN CASTRO

Head of Public Affairs, CaixaBank

Regulatory and supervisory approaches in the third phase of the Covid-19 crisis

The nature of the Covid-19 shock – exogenous, temporary and global – made it clear from the beginning the need of joint public and private efforts to help mitigate its potentially massive negative effects on the financial system and the economy. As such, policy responses from international, regional and national authorities, including regulatory and supervisory bodies, were central. The accompanying contribution from the banking sector clearly was as well.

Responses during the first phase of the crisis focused on maintaining lending the real economy, thus preventing a credit crunch with adverse feedbacks for all market participants. Regulatory treatments for relief measures such as moratoria and loan guarantee scheme were rapidly introduced.

As the crisis moved to a second phase, policy measures turned more selective and tailored to specific needs and sectors. Banks' own risk assessments also step up at the pace that more information became available. This was a dynamic process still in motion since the underlying risk factors, the effects of support policies, and borrowers' performance continue evolving as we speak.

At present, in a still developing third phase, and when the road to recovery is being paved, it is expected that regulators and supervisors will continue playing a key role. As in previous phases, decisions will not be free of trade-offs. A main one is the need to strike a right balance between continue strengthening the banking sector while providing enough flexibility for banks to help support the road to recovery. Against this background, to draw some early lessons from previous phases may be useful for this ongoing phase.

First, gradualism and adaptability seem to remain two sensible guides also in the current context. Economic prospects have improved but remain uneven among countries and sectors, and are not free yet of uncertainty or short-term reversals. In this context, exit strategies should still aim to avoid cliff-effects that may lead to pointed deteriorations in borrowers' repayment capacity. In particular, it would be necessary to accelerate additional support measures focused on those SMEs that have been able to get through the crisis, but their new level of indebtedness may hinder their future development.

Regulators and supervisors should continue playing a key role to support the road to recovery

Second, it would be appropriate to apply well adapted measures to the current extraordinary circumstances. Given the characteristics of the Covid-19 crisis, regulatory rules and supervisory practices thought to tackle fault lines from previous crises may not work that well this time. Non-Performing Loans (NPLs) is a prime example.

Affected sectors and assets are now different, with NPLs largely concentrated among SMEs – a very heterogeneous sector and mostly without much collateral, what justifies a differentiated treatment in comparison with other exposures such as mortgages and consumer credit. Regulatory frameworks should provide enough flexibility for banks to be able to differentiate among viable and non-viable companies, avoiding any 'automatism bias' in the regulation applicable to exposures classification, especially to SMEs. This will help viable companies to get access to the finance they need or to restructure their financial obligations.

Third, 'Covid-adjusted' regulatory approaches as the ones previously described can usefully be complemented by adequately graduated supervisory practices. It is well known that, to be effective, regulatory and supervisory efforts should go hand in hand. In this sense, it would be helpful to avoid a possible 'inertia bias' in the application of approaches that were aimed to address legacy issues from previous crises or that may be more suitable for normal times. A search for consistency between applicable supervisory approaches and Covid-adjusted rules suggests that provisions should in principle be allocated to exposures to non-viable companies, while refinancing of viable projects should be encouraged by avoiding undue penalisations.

More prospective measures could include a revision of rules affecting the usability of capital and liquidity buffers. Buffers were useful innovations in the regulatory framework in order to increase actual loss-absorbency capacity on an on-going basis, contributing as such to sustain credit to the economy. The Covid-19 pandemic have tested this and other features of the regulatory frameworks for banks. It would be useful to evaluate, based on solid analytical and empirical evidence whether there is room for improvements to maximise buffers' effectiveness in practice.

Ultimately, all these regulatory and supervisory actions should help to sustain credit, supporting the road to the economic recovery.

Credit availability is a significant factor explaining the viability of sustainable businesses, something very much linked to banks' own financial strength.

MARK
GEISLER

Group Chief Risk Officer,
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Withdrawal of support measures is a fact and is necessary to return to normal

How far and how efficient is the EU financial sector being vaccinated? The vaccination is not based on messenger-RNA but on a complex recipe of European and local policies and measures, the global economic and geo-political situation, and above all, the trust and confidence of the people which is the engine of growth, development and consumption.

How can we ensure that the current shield is not hiding a more severe crisis to come? We must hope that the human vaccine and protective measures will be sufficient to eradicate, at least partially, the virus in the global population. We must also ensure that the global economy will recover properly over the short, medium and long term. The harder part can come once the effects of this vaccine vanish. Monetary and fiscal policies have shown a degree of effectiveness and the return to "normal" should be sufficiently well controlled. The economic vaccine should not have side effect, such as the so-called cliff-edge or cliff-effect. The EU regulations, the global situation (including trades, investment and state indebtedness) and the degree of confidence amongst the population are the key axis to properly recover and build the next chapter of our society.

The Policy Department for Economic, Scientific and Quality of Life Policies Directorate-General for Internal Policies of the European Parliament issued a study in March 2021 "Path to Recovery: Dangers of Cliff Effects".

The banks and the financial sector are looking for a stable and predictable environment: This is essential. From a regulatory and supervisory perspective, the banks anticipate, with a certain (low) degree of efficiency, the regulations to come. During the time of Covid, all the measures taken were focusing on the support to face the economic consequences of the crisis (fiscal, monetary and moratoria). All of these measures helped the banks to continue to operate to support investments and to diminish the consequences of the deteriorating situation of some of their clients. Despite the fact that many banks suffered from the crisis, especially on their profitability, globally the sector resisted well. It is therefore of paramount importance for the financial sector to ensure stability and predictability in the next "moves" of the policy makers. The banks are an element of stability this time! They were present to support, in close collaboration with the States, large funding of different industrial sectors to resist the crisis. This temporary artificial shield, based on large funding and public guarantees, will end soon or later. The danger that companies go bankrupt will have an effect on the banks but also on the states liabilities. Considering the danger of indebted countries, we may face the same situation as of 2010. The bank resolution burden is on the shoulders of the member states.

> **The challenge is to avoid a cliff-edge effect that can jeopardize all the efforts accomplished.**

The current low (EUR) interest rate has a double effect. In the past, the intention of the ECB to lower the EUR interest rate was well understood at the time, but the intention was never to keep this level so low for so long. Today, it helps states to face the repayment burdens but our economic situation has worsened with the pandemic crisis. The ECB should anticipate – and it is certain that they do – the next moves. Again, the sky is not the limit and increasing, in a strict and managed way, the EUR interest rate could send a very strong signal to the financial markets that the situation is controlled and in the way to normalization.

The reduction of monetary and fiscal measures could be implemented for a series of economic sectors (financial sector and industries for instance) while, at the same moment, the cliff-edge effect has little likelihood to occur. One of the solutions is thus to ensure that the pace of withdrawal of crisis measures is closely aligned with the recovery of the economy. Financial markets have now recovered from 2020 and are more stable. Risk aversion (following the first lock-down of the population) is now better managed but cannot be considered as low. The banks are anticipating a second wave of bankruptcies amongst their more fragile clients.

Indeed, the term cliff-edge or cliff effect refers to a situation where a sudden small change leads to big problems. For companies, the effect is materialized when, for instance, a rating agency is downgrading the credit rating. The effect is that these companies may enter into a vicious cycle of downgrades due to their new poor abilities to get financed. Any sudden ending of the support measures may create a negative shock leading to an undesired increase of risk for the financial sector. One last point.

It is worth reminding that Europe is embedded in a global environment where our partners are also acting to exit the crisis in the best manner.

Close understanding and cooperation with other actors are another key point of success.

STABILITY AND GROWTH PACT REFORM

KATJA LAUTAR
Secretary of State,
Ministry of Finance, Slovenia

European fiscal framework should ensure resilient recovery and future growth

The COVID-19 crisis has shown how interdependent European economies are and how effective strong economic and fiscal coordination in the EU can be. The creation of the Recovery and Resilience facility is, in fact, a new approach and further fiscal policy coordination at the EU level. With this, we have created a "temporary mechanism" to stimulate the implementation of the reforms and to support the transition of the economies into digital and green future. This has an impact also on the structure of the public expenditures, particularly in the members states with large scale plans. Finding an appropriate link between the quality of public finance to safeguard investments and structural reforms is crucially important to ensure sustainable public finance, competitiveness, and convergence.

During the COVID-19 crisis, the SGP proved to be efficient, as the activation of the general escape clause enabled the much-needed swift introduction of extensive fiscal measures. In this moment, it is equally important to ensure a resilient recovery in mid-term. A country-specific appropriate length of the recovery path is needed. Too fast and too large fiscal efforts could hinder the recovery.

It is without doubt that fiscal rules are needed. Having rules is better than not having them. As the recent review shows, the existing rules had certain positive effects on fiscal positions in the member states. After the financial and sovereign debt crisis, the nominal deficits decreased; however, debts expressed in % of GDP did not. It also became obvious that the adjustment path in the preventive arm is unrealistically demanding in some cases. In the past year, debts substantially increased. Considering we are no longer in the world of Maastricht, a revision of the European fiscal framework is warranted. As shown during the crisis, fiscal coordination is also essential.

At the heart of the application of the Pact is the principle of equal treatment of all member states. Equal treatment, however, does not mean "one-size-fits-all" rules. Sustainability of public finance very much depends on country specific factors, and rules should acknowledge this. While the Pact envisages certain extent of flexibility in the way rules are applied, revised framework ought to show more serious commitment to consideration of countries' underlying public finance position, level of economic development, and their (to fiscal policy exogenous) characteristics.

The Fiscal rules ought to promote long run growth.

The structures of the economies are different today than 25 years ago when the reference thresholds governing the corrective arm of the Pact were agreed. Current low interest payments and limited effectiveness of monetary policy, as a result of very low or even negative natural rate of interest, call for re-evaluation of the role of fiscal policy in reducing both permanent and persistent shortfalls in aggregate demand. Debts indeed need to be reduced to (or kept at) sustainable level, but the debt reduction target should not jeopardise growth, as this oftentimes leads to raise in debt-to-GDP ratio. In the light of this, more weight on country-specific debt reduction targets could also prove to be efficient.

Also, the preventive arm of the Pact should more realistically capture the economic environment. The preventive arm relies heavily on the unobservable variables. The estimations of the medium-term objective, fiscal efforts, and structural balance are highly uncertain, as estimates of potential output have proved to be very biased and are subject to frequent revision, especially in bad times. The preventive arm is also not realistic in terms of the determination of the speed of the adjustment path as indicated above. We should focus more on parameters that are within the control of the government, like nominal growth of expenditures.

Fiscal rules ought to promote long run growth. Hitting the fiscal objectives should in no way result in hampering productive spending as we have commonly seen in the past. Excluding net public investment from the considered expenditure aggregate in bad times, for instance, could create valuable extra fiscal space. Separating current and investment budgets with investment costs being distributed over the entire service-life, for example, is also an intriguing option. It is important, however, that fiscal rules remain simple and that they do not provide much space for political debate. The distinction between investment expenditures and other growth-enhancing expenditures could, for example, do just that.

An introduction of joint fiscal incentives could be an important step toward ensuring that crises do not lead to prolonged demand shortfalls or to a structural lack in public investment. In this regard, the efficient implementation of Recovery and Resilience Facility will have important implications for the future fiscal framework.

GINTARĖ SKAISTĖ
Minister of Finance, The Republic of Lithuania

Any SGP changes should enhance, not undermine fiscal sustainability

The coordination of economic policy is one of the main pillars of the Union, giving rise to positive spill-overs and fostering convergence. Despite a comprehensive review of the SGP in 2011, there is still room for improvements. As the pandemic subsides, the question of fiscal coordination and governance is as important as ever, given the recent developments, especially elevated public debt levels in many Member States and the need to start gradually rebuilding buffers as economic recovery strengthens.

In this vein, we should approach the review of our fiscal framework with an open mind, making it more adapted to the post-pandemic realities. At the same time, we should not weaken our rules-based framework or engage in a fundamental overhaul of the key principles underpinning it. Furthermore, there is no merit in trying to rush the process by aligning it with the upcoming General Escape Clause deactivation, as the SGP review should be geared towards addressing longer-term challenges, not merely short-term ones.

It is evident that the current framework has some issues worth reconsidering, such as its complexity and ambiguity, element of discretion in formal surveillance procedures, challenges in determining the business cycle, and rules enforcement. In practice, these issues tend to obscure effective implementation of the framework and may lead to undesirable fiscal situation in individual countries and the EU as a whole.

The re-evaluation of fiscal rules should lead to a more effective framework. Certain fundamental elements of the framework need to be retained, namely ensuring fiscal sustainability over the medium-long term and avoiding the build-up of macroeconomic imbalances. Our common aim should be to make the rules more effective, while ensuring enhanced transparency of their application, their predictability and increased commitment of the Member States to comply. In other words, the outcome of the review should be a transparent and predictable rules-based system with equal treatment and objective implementation, avoiding the need for discretionary decisions as much as possible.

We must not forgo and forget the "G" in the "SGP".

Furthermore, there is indeed room to simplify the rules, making them easier to comprehend for policymakers and the general public. However, simplification should not be the end goal in itself. Arguably, some level of simplification could be achieved by putting more emphasis on observable indicators, such as growth rate of government expenditure, in the assessment process. At the same time, it is important to retain indicators, which allow capturing the state of the business cycle in order to avoid unwarranted pro-cyclicality of fiscal policy. We should also strive to reinforce the counter-cyclicality of the current framework both during "bad times", when fiscal expansion is needed, and during „good times", when the focus should be on reducing debt and deficit levels, and on the build-up buffers in preparation for future shocks.

Our fiscal framework should not only ensure sustainability of public finances, but also foster economic growth, as well respond to long-term structural challenges, such as ageing populations and the need to foster green and digital transitions. One of the ways to strengthen fiscal sustainability is to increase potential as well as actual economic growth. In this regard, it would be feasible to consider a certain degree of flexibility regarding the treatment of productive public investments. Such a "golden rule" should come with appropriate safeguards to ensure fiscal sustainability and expenditure quality. Ultimately, if we want strong commitment to comply from all Member States, we need to provide a clear and sustainable path to growth and prosperity. We must not forgo and forget the "G" in the "SGP".

Last but not least, there is scope to improve our main instrument in coordinating economic policy – the European Semester. It is a success story when it comes to identifying fiscal, macroeconomic and structural issues. However, in terms of actually solving these issues it has proven less effective. Hopefully the introduction of the RRF will make a real qualitative difference in this respect. As numerous complex issues are identified under the Semester's procedures, covering a broad range of policy areas, strict prioritisation is important, especially in a rather short time frame of one year to implement the necessary changes. Hence, a leaner Semester with more focused recommendations could be more efficient in reaching the desired outcomes. A more targeted approach could arguably also better contribute to the prevention of macroeconomic and fiscal imbalances in the short run and as a result – to long term sustainability.

To conclude, the EU has faced many challenges yet every time it has emerged stronger and united. I firmly believe that the challenges of today and the future will be met with sufficient resolve and solidarity as they have been in the past. The particular issue of an effective common fiscal framework is no different.

HARALD WAIGLEIN

Director General for Economic Policy, Financial Markets and Customs Duties, Federal Ministry of Finance, Austria & Chair, FSC

The European fiscal framework: Quo Vadis?

It's a well-established practice that European regulation gets reviewed every five years. The review of the fiscal rules was due end of 2019. First, the review was delayed by the establishment of the new European Commission. Then, the pandemic disrupted public consultations. Notably, also elections in big Member States can delay European processes. Currently, the review is expected for autumn 2021.

Meanwhile, and as a response to the economic effects of the pandemic, the general escape clause (GEC) was activated, with full support by Member States. Thus, only soft fiscal guidance is currently applied by the European Commission, with the notable exception of one excessive deficit procedure, which was opened already before the crisis.

The good news about the de facto non-application of fiscal rules is that markets and rating agencies are - at most – only slightly concerned, despite the addition of significant public debt, in most countries to record-high levels. The obvious reason is that a big buyer of public debt stepped-up its effort, the ECB. Could this be the end of the story?

Yes, if you believe the Europe is like Japan. I don't think that we can compare the European set-up with Japan. Nor, do I think that Europe would politically survive 30 years of economic stagnation.

The other reason for market calmness could be that a one-off debt increase does not change fiscal sustainability, as, whatever the debt level currently is, the debt-to-GDP ratio would converge to the (long-run) deficit ratio (or medium-term objective) divided by nominal GDP-growth. As public debt was mostly used to preserve the productive potential, returning to the original debt and growth trajectories is not out of reach. The most recent forecasts by the European Commission, the ECB or international organisations seem to confirm this view.

So keeping the existing rules would be a reasonable option. Under the impression of the pandemic, some policy makers, advisors and academics have found arguments, why one should not/cannot continue with the existing rules. Thus, the debate on the optimal fiscal rule-set will continue.

Whatever the outcome of the discussion, credible implementation will be key.

Whatever the outcome of the discussion, credible implementation will be key. Whilst one could think that implementation was a weaker point of in the last decade, actually only two Member States did not manage primary fiscal surpluses in any year. Two thoughts on that: 1) Any adjustment of the framework that accommodates full debt financing of interest payments for a considerable period would not appear economically or politically sustainable. 2) If 25 of 27 Member States can do (partly much) better, why should any Member State be allowed to take the others plus the ECB hostage in the event of a next crisis? (To take an analogy from the pandemic: Is there a good reason why the 80 % vaccinated people shall suffer from lockdowns/restrictions and/or pay for the remaining 20 % not willing to be vaccinated?).

The green transition will be on the political agenda for the next two decades. Is there any need to accommodate the fiscal rules to this policy priority? My answer is no: fiscal policy has always been there to reflect political priorities. If those priorities shift, also the budget composition will change. If you want to do away with "brown" public activities, instruments like spending reviews will create savings on the expenditure side or create extra tax revenues. So, unlike the difficult choices that politicians usually have to take as regards social equilibrium, the green transition itself will create its financing. This does not mean that there cannot be any policy mistakes, but this responsibility has to be kept in the Member States. Moreover, the greening of the economy cannot be managed by fiscal policy alone. Regulations across many political fields have to be changed too.

Is there a risk that the GEC would be applied for a long time because of long negotiations on the (new) rules? I don't think so: there is regular reporting on deficit and debt developments. The argument of a deep economic recession has become weaker already. With each fiscal notification date more Member States will resume fiscal normality. For the most likely few remaining Member States the argument that something might have to be fixed there will become stronger and stronger.

We thank **the partner institutions**
for their support to the organisation
of the Eurofi September 2021 Forum

NORMALIZING MONETARY POLICY

ROBERT HOLZMANN

Governor, Oesterreichische Nationalbank and Member of the Governing Council of the ECB

The contribution of the new ECB's strategy to normalizing monetary policy

In July 2021, the members of the Governing Council of the ECB – including myself – agreed unanimously to a new monetary policy strategy. The most important change is the new definition of price stability aiming for a symmetric inflation target of 2% over the medium term. The charm of this new definition is its simplicity and clarity. We are confident that this improvement makes our target easier to understand. Moreover, it reflects better the symmetry already pursued by the ECB's Governing Council in recent years. We consider negative and positive deviations from this target over the medium-term as equally undesirable.

Currently, our projections – as many others from well-known international organizations – expect inflation rates in the euro area to hover around 1½% in 2022 and 2023, despite the fact that current inflation is higher. In our strategy we should see through these short-term increases and focus on the medium-term, and the forecasts for the medium term are clearly below our 2% target. Consequently, we will stick to our ultra-loose monetary policy stance until we see inflation reaching 2%. Yet, there is the possibility that we may be able to normalize monetary policy sooner than most financial market experts expect. I see potential upward price pressures coming from (1) persisting global supply bottlenecks, (2) mounting labor shortages in several sectors, (3) pent-up demand and higher savings triggering a stronger spending spree, (4) cost effects from effectively implementing climate change policies, and (5) last but not least, higher headline inflation getting entrenched into inflation expectations.

Let me emphasize that a persistent rise in inflation and inflation expectations towards the ECB's inflation target of 2% would be welcome. In accordance with our new monetary policy strategy, we will tolerate a transitory period in which inflation is moderately above target. This is also consistent with our medium-term orientation and this should contribute to re-anchor inflation expectations at 2% more persistently. However, the overshooting should be moderate and temporary, and more importantly we do not aim to compensate later with an undershooting, as would have been implied by an average inflation targeting regime.

Not losing sight of the side effects of our measures is an important contribution for normalization.

Our monetary policy measures will stay in place until the crisis is over and inflation is projected to reach our target. This may happen rather sooner than later if my view on inflation developments is correct. This does not mean that we will withdraw accommodation prematurely, but rather that accommodation will be needed for a shorter period than what markets expect.

I consider that not losing sight of diminishing returns, increasing negative side-effects as well as legal constraints and the proportionality of our non-standard measures is an equally important part of our strategy. These considerations could become more important the longer we keep this ultra-loose monetary policy stance, and therefore we should also avoid withdrawing monetary policy accommodation too late. Negative side effects include the build-up of financial imbalances, adverse distributional effects as well as long-term effects on capital allocation. Moreover, this can turn into a vicious circle if there are side-effects that hinder us in achieving our target. For example, low interest rates may exacerbate financial booms, rapid credit growth and the accumulation of debt, which distorts capital allocation through the banking sector by allowing for lax lending standards and low risk margins. The resulting high growth in debt, in combination with distorted production and investment decisions, might make it difficult to raise interest rates again without damaging the economy. Low interest rates risk becoming entrenched.

Additionally, due to low interest rates more low productive projects become profitable, facilitating their entry, while there is less pressure for unproductive firms to exit, which contributes to the misallocation of resources. Eventually, this could lead to the emergence of zombie firms. This slows down aggregate productivity growth by reducing the cleansing effect of the business cycle.

To be clear, the reason for these outcomes lies not only in low interest rates but are rather the product of the interaction with the institutional framework. For example, supervisory forbearance delays restructuring and could lower productivity growth. Also, the design of insolvency laws affects banks' attitude towards non-performing loans and the allocation of resources.

In any case, an ultra-loose monetary policy and a delayed withdrawal of monetary policy accommodation also carries risks and may hinder our target and delay normalization. We should keep an eye on these effects, try to understand better the interaction with the institutional framework and design our policies accordingly. If we consider more systematically the negative feedbacks from our policies, monetary policy normalization will happen sooner rather than later.

BORIS VUJČIĆ
Governor,
Croatian National Bank

Treading through policy normalization: navigating recovery and balancing risks

The Covid-19 pandemic has all the elements of a great Hollywood movie. First, there is a threat to end «the world as we know it». Then, there are heroes of the pandemic: scientists who rapidly developed vaccines and the pharmaceutical industry quickly scaling up the production.

And finally, there is a happy ending, as the swift pace of recovery continues to defy expectations throughout the recurring waves of the pandemic, with vaccines propelling economies further as populations in advanced countries are getting close to herd immunity. But vaccination efforts had powerful sidekicks: fiscal and monetary policies, which supported the global economy during the critical period.

Unlike the global financial crisis, when monetary policy was pretty much «the only game in town», a strong fiscal impulse was now concerted with an unprecedented monetary accommodation. Fiscal and monetary policies reinforced each other and fed into a virtuous cycle. Maintaining favourable borrowing conditions by central banks eased the financing of fiscal expansion, while government deficits strengthened the traction of monetary policy. Yet, despite the improving prospects, the recovery remains uneven within countries and across different parts of the world. Downside risks related to new virus variants and limits to vaccine availability, as well as to reluctance to vaccination, still loom large. Most policymakers in advanced economies are therefore in no hurry to wind down their exceptional policies.

For the first time since the start of the pandemic the improving prospects have opened room for discussion about the path to policy normalization. There is a broad consensus on the sequencing of monetary policy normalization: assets purchases will be the first to go away, followed by interest rate increases, with redemptions of government bonds, and maybe even outright sales, gradually reducing the size of the central bank balance sheets only at a later stage. But there is much less of a consensus on the timing and pace of policy normalization.

The central banks of the two largest economic blocs have so far avoided communication on the start of normalization, assuming that the mere discussion would amount to monetary policy tightening. But a batch of central banks from smaller advanced economies, such as Canada or Australia, has already announced tapering or even embarked on it. Even the Bank of Japan has stabilized the size of its balance sheet under the guise of yield curve control.

> **It is necessary to tread carefully through the recovery.**

Some differences in the timing of actions between central banks can be explained by idiosyncratic fundamentals. However, different views on the balance of risks account for the bulk of divergence in central bank communications. The prevailing view in central banks of the largest economic blocs is that the current inflation surge is of a transitory nature.

The stabilization of energy and commodity prices as well as a gradual repair of overstretched production chains and resolution of mismatches in the labour market are considered sufficient to tame the inflationary pressures. Further on, inflation expectations appear to be firmly anchored – regardless of our preferred indicator of future inflation. Finally, erring on monetary policy with inflation on the upside is considered to be less costly than the premature tightening of monetary policy, as we possess adequate tools and knowledge to deal with excess inflation.

The leniency of central banks in major advanced economies towards the build-up of inflationary pressures is not unexpected. Inflation surprised us on the down-side many times over the last decade, so many times that constant inflation undershooting has instilled fear of deflation into the minds of central bankers. But the drivers of inflation may also work in the opposite direction, as we do not have a firm grasp on them.

The pandemic has cracked the globalization process, which may start unwinding disinflationary forces. This may also quickly alter the expectations – we know that consumers, businesses and participants in the financial markets are no better at forecasting inflation than central banks.

Following a prolonged period of exceptionally low interest rates, elevated public and private debts and stretched asset prices may induce surprising market reactions if central banks get forced into strong action.

Finally, recent tweaks to monetary policy strategies may also complicate matters, as new policy reaction functions are not yet obvious to markets, potentially forcing central bank actions even if there was no need for any.

To conclude, we need to tread carefully through the recovery, constantly re-evaluating the balance of risks and avoiding strategies that may force excessive reactions somewhere down the road.

MĀRTIŅŠ KAZĀKS
Member of the Governing Council of the ECB & Governor, Bank of Latvia

Monetary and fiscal policy: independent, not unconditional alignment

Monetary policy has supported the economy during the Covid-19 crisis. So has fiscal policy, being able to provide targeted support to those most affected. Yet, none of them can resolve a health crisis, which needs medical solutions – comprehensive vaccination, effective and affordable treatment.

What are the lessons for monetary policy? First, the effectiveness of instruments is state-dependent. Second, a mix of instruments may yield a better result than a single instrument. Third, continued proportionality assessment is critical to assess appropriateness of policies and instrument choices.

The ECB has reviewed its strategy. Our target is 2% inflation symmetric over the medium term. We have committed to a forceful or persistent monetary policy action in the presence of effective lower bound (ELB), to avoid negative deviations from the inflation target becoming entrenched. The implementation of our monetary policy can result in a transitory period when inflation is moderately above target.

The strategy is supported by forward guidance on interest rates, i.e., to keep them at the current or lower levels until: we see inflation reaching 2% well ahead of the end of the projection horizon; inflation stays durably at this level for the rest of the projection horizon; we see sufficiently advanced progress in the observed underlying inflation.

Does this mean a longer period of negative interest rates than envisaged before? Our actions will be determined by the actual data, our projections and judgement on medium term outlook, and proportionality analysis. Yes, the hurdle for action in our policy rates has been raised. But the precise timing of the rate lift-off will be data driven. With now clearer inflation target and appropriate forward guidance, credibility can be improved, and the lift-off may well be brought closer rather than pushed further away.

For effective monetary policy and general policy mix, the former must preserve its independence.

The strategy allows for a forceful action, and we have instruments to achieve our target. But an interplay with other policies would help. With r*, the natural rate of interest, down to about zero and actual interest rates close to ELB, monetary policy space has narrowed. Fiscal policy is especially effective at ELB, its multipliers are higher. Bold fiscal and structural measures help close the output gap faster with less side effects from expansionary monetary policy. Quality (read: growth-friendly) fiscal spending complemented by structural reforms can boost productivity and r*, both sustainably raising living standards and increasing monetary policy space and its efficacy by reducing incidences of ELB. Low yields due to monetary policy do provide a unique opportunity to boost public investment, especially as investment activity over the past decade has been weak.

Currently, Covid-19 uncertainty is high, output gap is open, and supportive monetary and fiscal policies are warranted. Higher inflation is mainly driven by transitory factors and currently can be looked through. It won't stay so forever. Rates will rise. Accommodative monetary and loose fiscal policy are complementary during a crisis, but not when recovery roots in and inflation closes in on its target. Then tensions between monetary and fiscal policy are inevitable, especially when debt levels are high.

The Treaty puts price stability as the ECB's primary objective which the new strategy defines as 2% inflation symmetric over medium term. Phasing out support and raising rates is unpopular and ridden with economic risks. A central bank should reduce such tensions and risks by: (i) communicating clearly on economic outlook and its actions depending on economic developments, and (ii) moving carefully. For effective monetary policy and general policy mix, the former must preserve its independence and not allow for fiscal dominance. Monetary policy and fiscal policy should be independently aligned, not an unconditional alignment a la "till death do us part".

Thus, fiscal policy will need to come back to ensuring debt sustainability. When the output gap is closed, fiscal policy must be tightened accordingly. Such a countercyclical switch on and off model of fiscal policy to support a working and effective monetary and fiscal policy mix that is run independently and mutually complementary is a tough task. With fiscal policy still mainly at national level, the incomplete fiscal architecture is obvious. NextGen EU is a step in the right direction, but many more steps need to be made, including that of a sizeable common fiscal capacity.

Opportunities provided by such a painful crisis as the current one should be used to the full.

CYRIL ROUX

Deputy Chief Executive Officer, Groupama

Unconventional monetary policies weigh on insurers' profitability

Insurance companies are adept at managing diversifiable risk but they are no better suited than other economic actors to face systemic investment risks. On the contrary, because of their constrained liabilities, and the prudential and accounting regulations they operate under, insurers' fortunes are uncomfortably tied to the monetary policies which central banks now use to affect directly financial markets, such as assets purchase programs, on top of traditional channels of monetary transmission.

Investors should have little reason to complain today. Indeed, the fortunes of billionaires have famously ballooned since the beginning of the Covid-19 pandemic, thanks to the records reached by listed equity and real estate, two asset classes buoyed by unconventional monetary policies. Insurers, however, cannot emulate billionaires, family offices or even sovereign wealth funds with respect to their asset allocation. Notwithstanding their real economic and investment horizons, born out of their liabilities, insurers are bound by regulation to be mostly invested in sovereign and corporate credit markets and thus their fortunes are bound to follow those of these markets.

In recent years insurers have rightfully bemoaned the effect of negative interest rates on their business models. Because interest rates are still very depressed, by the massive use of conventional and unconventional monetary policies, it remains topical to recall the corrosive effects of such financial repression on insurance companies, despite the accompanying growth of the value of their fixed income assets. Let us count the ways.

First, life insurers have offered guaranteed returns (if only a zero return) to their policyholders ; depressed fixed-income coupons challenge their ability to honor those guarantees.

Second, as sellers of packaged fixed income returns, life insurers have seen part of their value proposition to individual savers dwindle or vanish.

Third, long tail non life insurance policies, such as those of liability insurance, are priced with some investment returns in mind – when these investment returns fail to materialize, this line of insurance business ends up unprofitable, years after having been sold.

Negative interests rates and benign neglect of inflation are detrimental to insurers and the economy.

Fourth, both life and non life insurers are structurally cash rich, due to the inversion of the production cycle of insurance, in which premiums are paid before claims. Because of this structural excess liquidity, insurers suffer from negative interest rates charged by banks on their cash holdings.

Finally, European insurers, operating under Solvency II, have to maintain solvency ratios calculated with regulation-mandated formulae which overstate their risk of ruin when computed using a negative interest rate curve. As a consequence, European insurers have had (i) to divest from equity markets and (ii) to issue debt for no other reason than to compensate for this model error.

Yet negative or zero interest rates on credit aren't any longer the only detrimental effect of monetary policies on insurance business. The recent increase of inflation may not be solely a monetary phenomenon- pace Milton Friedman. But it would be quite rich for central banks to argue it isn't at all a monetary one, wholly explained by the rebound from the economic suppression of lockdowns, production bottlenecks and generous unemployment payouts. An unexpected step increase of inflation is seriously detrimental to non life insurers, whose liabilities are paid in real, not nominal terms. Prior year developments will deteriorate under this scenario and can wipe out several years of underlying technical insurance margins.

Combined with depressed investment returns, an increased inflation rate can make the non life insurance sector durably unprofitable. Hence the benign neglect of 2021 inflation figures by central banks, the increase of which they explain away as transitory, and that they welcome at the same time as a boost away from the too low inflation figures of the recent past, is a serious concern for the insurance industry. As insurers cannot reprice policies already issued, they will have to try to pass on to their clients the burgeoning wage pressures and the extra costs of property and casualty claims which come from elevated hourly repair costs, rising health providers wages and higher prices of raw materials and replacement parts.

Together will the relentless increase in weather events, this will push non life insurers to become, willy-nilly, a new inflation transmission channel in the economy.

Negative interest rates and benign neglect of inflation are detrimental to insurers and the economy as a whole.

A return to a normalized monetary policy, ensuring subdued and stable inflation, anchored expectations, and positive returns on fixed income assets, commensurate with credit risks, would be a much more advisable regimen.

DINO KOS
Special Advisor to Chief Executive Officer, CLS Bank International

Normalizing monetary policy - when and how?

Mervyn King, former Governor of the Bank of England, recently said that unconventional monetary policy "tends to be deployed in response to bad news, but isn't reversed when the bad news ends." Indeed, central bank balance sheets have expanded massively since 2008. For example, the Federal Reserve's balance sheet has grown ten-fold in several stages, and attempts to shrink it or increase interest rates in the period since the global financial crisis (GFC) have all but been abandoned. In 2013 the Federal Reserve quickly reversed its messaging in response to the "taper tantrum"; stopped a tightening cycle after risk assets sold off in late 2018; and of course reduced interest rates to zero and resumed massive asset purchases when the pandemic arrived in March 2020. Looking back at the 13-year period since the GFC, United States interest rates have mostly been at or near zero, typically accompanied by some form of unconventional lending or asset purchase program.

The series of measures taken by the Fed, and other central banks, were "emergency" tools in response to crisis conditions. Arguably the "emergency" has passed, and fiscal policy has responded aggressively in this cycle, which should give central banks more flexibility. GDP is growing vigorously but alas the Fed has been unable to unwind (nor has it yet signaled a willingness to consider an unwinding of) its emergency measures.

The Federal Reserve is not alone in going through this experience. The Bank of Japan set interest rates near zero (and negative at times) for more than two decades. Several initiatives to normalize policy were introduced; in each case they were quickly abandoned, then reversed, and then ultimately supplemented with ever larger asset purchases, including acquisition of riskier assets such as equity exchange traded funds.

In both US and Japanese cases, the problem was not about "how" to normalize or what sequence of actions to take. Those issues have been well studied. The problem is the impact such a "normalization" will have on asset markets. Normalizing monetary policy such that (1) interest rates can move off the zero bound, and (2) asset purchases align with future growth of liabilities such as currency, implies that bank reserves would contract. Overall liquidity would also contract and long duration assets, such as equities, would fall – perhaps quite sharply. We saw glimpses of this in 2013 and 2018, when asset prices fell modestly, and the Federal Reserve quickly reversed itself.

The problem is not about how to normalize monetary policy.It's the impact this will have on markets.

To get a better appreciation of this dynamic one should go back to the origin of quantitative easing (QE). Recall the raging debate a decade ago on whether QE was "effective". Scholarly papers by central bank economists and others concluded that acquiring government bonds both reduced financing costs (and so spurred investment), but also increased the value of other asset markets by pushing investors out on the maturity and risk curves. Those higher prices would spur higher consumption by making consumers feel richer through the "wealth effect".

If that is the channel where central banks are buying, then the reverse should also apply. As interest rates rise and government bonds are either allowed to mature or sold outright, financial conditions will tighten, and high-priced risk assets will decline. Indeed, investors seem very conscious about the elevated valuations in both equity and bond markets. They will be sensitive to any hint of a reversal in policy and be ready to run through what will, no doubt, be a very small door.

Alas the central banks know this, and the Federal Reserve has been especially sensitive to asset markets - so much so, that it is now communicating its intention to keep policy steady even if inflation rises (which it recently has with easing of pandemic restrictions), so long as any uptick is "transitory". The Fed knows that a true "normalization" of policy would devastate markets and force another reversal. And so, it is stuck: it cannot and will not normalize policy pre-emptively and will only do so if forced by circumstances, which is to say by higher inflation. But if inflation really gets going then a tightening will happen "too late" and will not avoid the asset market cataclysm.

The bottom line is that full normalization will come - but much later than many expect - and when it does come the adjustment will be severe. Since central banks seek to push back that day of reckoning well into the future, investors will continue to take disproportionate risks while keeping one eye on that small exit door.

DIDIER BOROWSKI

Head of Global Views, Amundi

The policy mix is not the only game in town

The economic crisis caused by the Covid epidemic has been contained thanks to the stabilisation policies implemented by governments and central banks. At the European level, the NGEU recovery fund, voted in the summer of 2020, became fully operational this summer. The first issues of common debt have met with great success with investors. The ball is now in the court of the governments who must respect their commitments and implement the promised reforms.

The challenges are multiple. On the economic side, potential growth is as low or even lower than before the crisis, while public and private debts are higher than before the crisis. Paradoxically, the Eurozone lacks investment, even though it has abundant savings. On the financial side, Europe's capital markets are still too fragmented and the system is over-banked, which limits the resilience of the Eurozone in the event of a new shock.

There is insufficient cross-border investment. On the environmental front, the «social demand» for change has increased further with this crisis across Europe. The probable breakthrough of the Greens in the next German elections (26 September 2021) will show once again that the lines are shifting. Finally, on the geopolitical level, Europe must strengthen itself more than ever in order to confront the two hyperpowers, the United States and China.

The NGEU, coupled with historically low real interest rates, offers a historic opportunity to get the EU back on track and meet these challenges. Improving Europe's position in the renewable energy sector, speeding up the digitalisation of entire sectors of the economy, enabling the economies hardest hit by Covid crisis to catch up and, ultimately, increasing potential growth, are all necessary conditions. The debt constraint is alleviated by low real interest rates, which increases the fiscal room for manoeuvre in the short term. But the mistake would be to believe that rates will remain at their current level indefinitely. Inflation could resurface at some point, putting the ECB in serious difficulty.

Looking ahead, the burden of macroeconomic stabilisation cannot rest solely on the policy mix. Negative interest rates and ECB asset purchases help governments cope with new spending but, at the same time, weaken the financial system as a whole, leading to a misallocation of savings. In a way, it can be argued that the expansionist policy mix is, at this stage of the cycle, the worst policy mix, except for all the others.

> **The expansionist policy mix is the worst policy mix, except for all the others.**

Indeed, while it is far too early to normalise economic policy, it must also be recognised that the capacity for stabilisation cannot be reduced solely to the ability to mobilise fiscal and monetary levers. In particular, it is certainly not through fiscal policy alone that European competitiveness will be improved. It is not only a question of increasing external competitiveness, but above all of improving the attractiveness of the Eurozone for investment. Structural reforms are key.

The Eurozone is penalised by a financial architecture that is too fragile for foreign investors. The result is a form of "political risk premium" on European assets which are more affected by mistrust as soon as the situation deteriorates. It is therefore essential that the current expansionist policy mix be accompanied by an improvement in the financial architecture.

The Eurozone benefits from an excess of savings and paradoxically does not invest enough. It is thus necessary to encourage the circulation of savings within the zone. Households have a sub-optimal allocation of their savings, with excessive holding of debt securities. The financial education of savers should be strengthened and they should be encouraged to diversify their savings into riskier assets, including through cross-border European investments. Finally, the Eurozone is still over-banked and the authorities must therefore facilitate SMEs' access to capital markets. This is all the more important as banks are weakened by low interest rates and by holding their own sovereign debt (doom loop). Finally, progress needs to be made on the harmonisation of tax rules.

Since the Covid crisis, however, it must be acknowledged that no progress has been made in the capital markets union. European monetary union is often compared to the US when it comes to demonstrating the need for a common federal budget and debt instrument.

However, empirical work shows that risk sharing - much more than fiscal integration - is what allows the US economy to absorb asymmetric shocks. The resilience of the US economy comes in particular from the fact that companies finance themselves more on the markets. In Europe, a more integrated financial system will increase the resilience of the system to future shocks.

Europe's needs and challenges are clearly identified. The NGEU and the common European debt offer a historic opportunity to make a difference. But this is not enough. There is an urgent need to complete the European edifice with a process of further financial integration.

ANDREAS DOMBRET
Global Senior Advisor, Oliver Wyman

Overburdening the ECB will hurt its credibility

The decisive and extensive interventions by the ECB were one of the lifesavers of the Eurozone when the Covid crisis hit. They prevented liquidity crunches in the markets at the peak of uncertainty and helped Euro countries to provide extensive fiscal support to protect individuals and businesses. It is fair to say that without the ECB's swift actions the Eurozone would have fared much worse in the peak days of the Covid crisis, would have faced a deeper recession as well as the destruction of economic and social capital.

Although the end of the crisis still is some time off with the appearance of new variants around the world, it is emerging consensus that Covid 19 is becoming manageable not least because of the acceleration of vaccination programs in Europe, the U.S. and elsewhere. Economic recovery, albeit very unevenly distributed, is now putting pressure on labour and commodity markets as well as supply chains. Some economies are on the verge of overheating, and inflation is expected to go beyond 5 percent year-on-year in Germany and the United States. We need to ask whether the actions of the ECB, as necessary and effective they have been a year ago, are still appropriate today and will be so in the medium-term.

On the one hand, the ECB's accommodative stance is clearly supporting those parts of the Eurozone economy that are still struggling and which require ample fiscal space to kick-start recovery and long-term structural reforms despite record-high debt levels. On the other hand, we see stock-market valuations that exceed pre-Covid levels, and real estate in many regions is reaching bubble territory. The ECB's actions at least do not stand against such overheating tendencies, and any moves of the ECB to counter these might suffocate the recovery in the more vulnerable Eurozone economies or may cause volatility and uncertainty in capital markets.

One might wonder how far the ECB can go in accepting these side effects, also as they pertain to politically sensitive issues like housing and retirement savings, the latter being obliged by law to hold a significant share of their portfolios in low-risk assets. While President Christine Lagarde has a point when saying „We Should Be Happier to Have a Job Than to Have Our Savings Protected" it is difficult to expand this argument to housing and pensions. Indeed, the ECB's policy toolkit is by design ill-suited to deal with divergences, also as constraints such as market neutrality and the capital key assume the existence of Mundell's „perfect monetary union" the Eurozone never was.

Effective post-crisis monetary policy requires the Eurozone to deal with persistent structural imbalances.

It is therefore good to see that fiscal policy is stepping up after President Mario Draghi's calls for governments to take on responsibility had gone unheard for all too long. This not only includes the NextGenEU initiative that establishes a one-off debt capacity at Eurozone level. Another example are the government-sponsored lending programs that governments were quick to introduce for Covid-related backstops such as grants and guarantees, and many Eurozone countries are working on follow-ons for the post-Covid area. These programs have done more to ease access to financing than comparable ECB measures such as TLTRO ever achieved. It is fair to assume that governments will not leave the stage anytime soon, although the jury is still out whether their support really fosters sustainable economic growth.

Still, one cannot ignore that the root cause of Eurozone divergences is deeply structural, and that it will take quite some time for them to narrow, if at all. After we have finally come to terms with the fact that the ECB cannot solve it alone we now need to have a discussion on how to deal with persistent structural imbalances in the Eurozone. Unfortunately, that difficult discussion is still in its early stages.

What will force the hand of policy makers is the elephant in the room: Inflation. We do all follow the debates on whether the marked increase of inflation is temporary or not. Convincing arguments are put forward by both camps, and I will not rehash them here. The track record of inflation forecasting by central banks, including the ECB, has been particularly weak over the last few years. It seems that the impact of structural shifts of society and the economy on inflation dynamics are only partially understood at this time. So it might be important to look at a few practical signs in the economy.

For example, in several markets we see labour shortages driving up salaries. Such raises do not only impact the most important inflation indicator – wages – but they are particularly sticky. And we must not forget that inflation is driven by expectations. If individuals and businesses believe that the relevant drivers are not of temporary nature, their expectations will change.

With many important Eurozone economies not having had experienced inflationary episodes for several decades, it is unclear how economic agents, public opinion and eventually political leadership will react to it – and central bank strategy statements might only have a limited impact on such dynamics. So we may well be reaching the point where the ECB needs to tighten, and the Eurozone policy framework then needs to come up with the right answer.

We should start looking at these answers now and do so – given the potential implications – in a transparent and open process. "Getting it right" is not only a question of monetary policy but might well determine the role and credibility of the ECB in a post-Covid Eurozone as well as the survival of the economic union as such.

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European Bank for Reconstruction and Development
European Investment Bank The EU bank
Federated Hermes
Fidelity International
Finanzgruppe
Generali
Goldman Sachs
Google Cloud
Le Groupe Groupama
HSBC
ice
ING
Invesco
J.P.Morgan
KPMG
La Banque Postale
LSEG
MetLife
Mizuho
Moody's
Morgan Stanley
MUFG
Nasdaq
Nordea
OliverWyman
pwc
Raiffeisen
Santander
SMBC
Societe Generale
Standard Chartered
S&P Global
State Street
SWIFT
Swiss Re
Tradition
UniCredit
UBS
VISA
WesternUnion WU
Zurich

OVER-INDEBTEDNESS: WAY FORWARD

MARKUS FERBER

MEP, Committee on Economic and Monetary Affairs, European Parliament

The reform of the SGP must focus on simplicity and strict enforcement

The Stability and Growth Pact (SGP) is one of the critical elements of economic governance within the European Union. The SGP's purpose is to ensure sound public finances in all Member States in order to guarantee a solid foundation to the Single Currency. Despite ambitious reforms following the sovereign debt crisis, the past years have shown, that even the reformed SGP did not live up to expectations. On the one hand, the interpretation of the SGP continued to be a point of contention between the Commission and Member States. On the other hand, the SGP failed to prevent the build-up of excessive debt levels in many Member States. Even during a relatively benign macroeconomic environment, the debt-to-GDP ratio continued to climb in many Member States during the 2012-2019 period.

The fallout of the Covid-19 crisis has significantly increased already elevated debt levels. The debt-to-GDP ratio in the Eurozone is expected to surpass 100% this year, which is simply unsustainable. While the European Commission has temporary suspended the EU's fiscal framework for the time of the Covid-19 crisis, there can be no doubt that in the medium-term the EU's fiscal framework must be revised.

How could an effective revision of the EU's fiscal rules could look like? To identify what we need to improve, we should look at the most obvious shortcomings of the current framework. Right now, the Stability and Growth Pact is excessively complex and suffers from poor enforcement. A successful reform of the fiscal rules must address these two issues.

The Stability and Growth Pact has become more and more complex over the years. By now, the official handbook on the application of the SGP has grown to an impressive length of 108 pages. This level of complexity makes the application of the SGP unnecessarily complicated and opaque to outside observers. Furthermore, the plethora of exemptions and interpretations provides the European Commission with excessive discretion and has often lead to disagreements with Member States.

When it comes to the EU's fiscal rules, there is value in simplicity.

When it comes to the EU's fiscal rules, there is value in simplicity. Instead of going for a specific rule for every conceivable situation, the SGP needs to focus on a few core principles that are easily understood by everyone involved. Such a streamlined process also implies to refrain from introducing new exemptions (e.g. preferential treatment for sustainable investments).

Currently, the analysis underpinning the stability and growth pact relies heavily on metrics that either have to be estimated (such as the output gap or potential GDP growth rate), cannot be entirely influenced by policymakers (such as the annual deficit as a percentage of the GDP) or are prone to frequent revisions (GDP growth). As result, the process often looks more like art than like an exact science. This causes the decision making to be somewhat opaque and prone to manipulation. Building on the proposals by the European Fiscal Board (EFB), we should therefore move towards a system that focusses on variables that are easily observable and under full control by policy makers. Expenditure growth could therefore serve as the central variable. If the expenditure grows slower than a country's gross domestic product, that Member State should gradually grow out of its debts.

One of the key shortcomings of the EU's fiscal framework is poor enforcement. Despite the fact that there were numerous violations of the reference values - sometimes justified, sometimes less so - the European Commission has never proposed meaningful sanctions. An effective enforcement of the fiscal rules requires a capable and impartial referee though. A Commission that considers itself to be first and foremost a political actor, cannot credibly take that role. Therefore, a comprehensive review of the SGP must not stop at the rules itself, but also look at the institutional framework.

For the fiscal rules to be credible, they must be applied in a fair, objective and equal manner to all Member States. During the past years, the European Fiscal Board has built up a considerable expertise and has proven that it can provide fair and independent fiscal analysis. Therefore, the important task of fiscal surveillance should be progressively entrusted to the EFB, which needs complete political independence for that purpose. To ensure political accountability, the final decision in relation to possible sanctions should remain at the level of EU finance ministers.

Implementing such reforms would result in a significantly more robust and effective fiscal framework.

GEDIMINAS ŠIMKUS
Chair of the Board,
Bank of Lithuania

Rethinking debt in the current low-interest rate environment

The EU response to the COVID-19 crisis proved that a coherent fiscal and monetary policy coordination can effectively lift the European economy out of a state of emergency. Looking forward, the main challenge is to ensure that these policies continue to reinforce each other in the post-pandemic period, as the premature withdrawal of policy support could hold back the recovery and increase the risk of long-term scarring effects.

To help the European economy survive the pandemic-induced disruption, the European Central Bank (ECB) undertook extraordinary measures to ensure highly accommodative financing conditions, while national governments rolled out a number of fiscal initiatives, complemented by a comprehensive and coordinated European-level response. The unprecedented policy action to counter economic downturn had an impact on public finances – government deficit and public debt ratios increased sharply across the board: the euro area debt-to-GDP ratio is forecasted to peak at 102 % this year before decreasing slightly in 2022.

Despite elevated debt levels, there is a strong case to maintain an overall supportive fiscal policy stance in 2022, in line with the European Commission recommendations. The current low-interest rate environment and the new ECB symmetric inflation-rate targeting strategy enables fiscal policy to act more effectively, as fiscal multipliers are assessed to be greater when monetary policy is constrained by the effective lower bound. In such an environment, fiscal expansion can even improve debt sustainability. If spent in a targeted and prudent manner, the additional fiscal support can contribute to long-term economic growth and competitiveness, thus eventually raising the GDP more than the debt level. A return to the sustainable growth path would also imply smoother fiscal consolidation which will be needed to rebuild fiscal capacities once the European Commission deactivates the General Escape Clause of the Stability and Growth Pact.

The "Next Generation EU" instruments, and most notably the Recovery and Resilience Facility, provide an excellent opportunity for Member States to reinforce growth-enhancing policies and necessary reforms without affecting the sustainability of public finances in the medium term. Targeted use of European Union funds can propel the green and digital transformation, as well as increase convergence among Member States.

Growth enhancing public investment should not be undermined by over-fixation on debt.

Finally, fiscal policy is an important tool, along with structural reforms, that affect conditions shaping the current low real equilibrium interest rate environment. A stronger counter-cyclical fiscal stimulus would not only support employment and income but would help reverse the trend in the equilibrium interest rate and lift the inflation trajectory that has been lagging behind the central bank target for many years. This, in turn, would increase monetary policy space in the future.

Looking forward, efforts to achieve better synergies between fiscal and monetary policies should be encompassed in a revision of the European fiscal framework. The Stability and Growth Pact (SGP) – a cornerstone of the EU fiscal framework – should be more cognisant of the diversity of national public finances, especially given the current debt levels. Over-fixation on debt might be damaging, as the rigid 60 % debt rule could potentially undermine productive public investment to promote future growth. The SGP reform should ensure sufficient flexibility on public investment linked to long-term growth and employment, in particular related to climate change and digitalization.

Furthermore, the SGP should better fit the macro stabilization function of fiscal policy during economic downturns, especially when monetary policy is near the effective lower bound. In the current framework, public spending is constrained by the estimates of structural balance, which has tended to be pro-cyclical. Thus, to increase counter-cyclicality, the expenditure rule may be considered as the main operational target. Once included in the SGP, the stabilization clause would make the EU fiscal policy more effective and counter-cyclical which, in turn, would contribute to a less constrained monetary policy.

The review of the SGP is expected to be resumed by the end of the year and it will offer policy-makers an opportunity to take into account the new reality in which monetary and fiscal policies interact.

We have learnt many lessons from the current crisis, and we must recognize them in order to better prepare for challenges that the future might hold.

JUKKA VESALA
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Macro-prudential policy lacks common EU approach

In Nordic countries and elsewhere in Europe, authorities have expressed concern about increasing household indebtedness. We fully share the objective of curbing excessive indebtedness and to be well-prepared for an eventual increase in interest rates. While consumer loan growth has recently reduced, Covid-19 has boosted housing loans as households have cut back spending and become more interested in their own dwellings.

Macro-prudential instruments have taken increasing role in public policies aimed at preventing excessive lending growth and indebtedness. While micro-prudential supervision has been subject to strong integration via the creation of the Single Rulebook and SSM supervision, macro-prudential policies are still largely national. Macro-prudential measures are regulated in the EU via Directives rather than Regulation, leaving room for national discretion, and there is only coordination and consultation at the EU level.

Lack of a unified European approach has created uneven playing field for banks and obstacles to cross-border consolidation, while risking effective macro-prudential policy in the Single Market.

Macro-prudential instruments have been applied at greatly different levels when it comes to anti-cyclical or even structural systemic risk measures, while the differences are not obviously explained by the characteristics of the national financial markets. Unlevel playing field in capital requirements causes differences in the actual capitalisation levels of banks, thus interfering with effective allocation of capital across banks in Europe. Furthermore, when applied from a domestic perspective, macro-prudential policies may not be well-coordinated across national designated authorities, or with micro-prudential authorities, causing overlaps or underlaps in capital requirements.

Coordination between micro- and macro-prudential tools is already well laid out in the EU framework (CRD). Notably, authorities should ensure before applying macro-prudential measures that none of the existing micro- or macro-prudential measures is sufficient to address the identified risk. One risk should be covered by only one prudential requirement and the priority should start from the Pillar 1 requirements, moving then to Pillar 2 and the various capital buffer requirements. Avoiding overlaps is difficult when supervisors have adopted different requirements on Pillar 1 capital models (such as the SSM TRIM), or when the approaches to macro-prudential measures are different.

Lack of a unified European approach has created uneven playing field for banks.

When macro-prudential measures are, for instance, based on lending volumes they easily overlap with Pillar 1 requirements. Also macro-prudential requirements often grow automatically when Risk-Weighted-Assets increase. Achieving a truly level-playing-field would require stronger macro-prudential powers at the EU level. It would also prevent the risk of a 'race to bottom' by national authorities. As authorities exit the Covid-19 relaxations in capital requirements, effective European coordination will become even more topical.

Another important development has been the welcome strengthening of consumer protection standards. These measures, aimed at safeguarding sufficient repayment capacity and remaining income for household expenditures, also limit the possibility of excessive indebtedness. Over-indebted households can have negative implications for the overall economic development as well as they may need to cut spending sharply when becoming unemployed, or when interest rates increase. Consumer protection standards also help safeguarding sound lending practices across banks and non-bank lenders. We have a fully aligned mutual interest with authorities in keeping sound debt-to-service and LTV levels in place in household lending.

In this area too, European harmonisation and coordination would be usefully strengthened. For instance, stress testing clients' debt servicing capability to withstand increases in interest rates is not formally required in all countries, and many practical aspects of the client interaction are not harmonised regarding e.g. 'money at disposal' and income verification requirements. Further, not all countries yet have established credit registries that greatly assist banks in making sure that the overall level of indebtedness of their clients remains in check, taking into account the amount of borrowing from all different sources.

Nordic authorities have tended to be frontrunners in applying the new tools in order to reduce the risk of uncontrolled increase in household indebtedness. This has already been effective in maintaining strong economic and banking sector stability.

At the same time, issues arising from the differing Euro Area/EU/EEA regimes and differences in practices across the Single Market have become visible, supporting stronger European level harmonisation of both macro-prudential and consumer protection standards.

MARIE DIRON

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Regaining fiscal strength post Covid will require sustained higher growth and proactive fiscal policy

One legacy of the Covid pandemic will be the significant increase in debt for sovereigns globally, with most EU countries likely to carry higher debt burdens for years to come. Together with demands for greater social equity and investments to finance the transition to net-zero carbon emissions and a more sustainable economy, higher government debt will shape policies. A combination of robust growth and proactive fiscal policy that unwinds the COVID-related widening of deficits can bring down debt burdens. The key will be achieving these outcomes ahead of the next economic and financial shock, which will invariably come.

Government debt in the EU has jumped by nearly 15% of GDP on average since 2019. By 2025, Moody's expects most EU countries to still carry a higher debt burden than pre-pandemic – with debt levels materially higher for some. And just like before the shock, debt prospects will vary greatly among countries. While Moody's expects that nearly half of the EU members will carry debt burdens below 60% of GDP in 2025, six will likely still have debt levels that exceed 100% of GDP by that time.

Monetary policy will help keep debt manageable by preserving price stability. Already, the average cost of government debt across the EU is around 1.5%. By refinancing at low interest rates, governments will see that cost fall somewhat. However, the monetary policy stance will not drive EU fiscal balances and debt dynamics. Instead, a material and prolonged expansion of QE would probably happen for negative reasons, namely that the economic recovery and, with it, inflation prospects, are much weaker than currently expected. And expanding or even maintaining QE beyond what is warranted to ensure price stability would quickly undermine the credibility of monetary policy, prompting a sharp adverse market response, with a highly negative impact on governments' finances.

Moody's expects that fully unwinding asset purchase programmes will become increasingly challenging, leaving central banks holding a higher share of government debt from one cycle to another. However, deciding outright to either monetise deficits and/or write off some of that debt would blur the respective responsibilities and objectives of policymaking institutions, jeopardising their credibility.

Robust growth and proactive fiscal policy can bring down debt burdens; the key will be to achieve this ahead of the next shock.

Fiscal policy that proactively narrows primary deficits will contribute to bringing down debt burdens. However, a rapid tightening of fiscal policy does not seem to be on EU governments' agenda so far. Rather, political economy and social considerations suggest that primary balances will remain lower than they were pre-pandemic and, for a number of EU countries, lower than the levels that would stabilise debt.

In particular, some of the spending that began or was extended during the pandemic will likely remain in place for years, especially for initiatives that aim to mitigate the income and wealth inequality that COVID has highlighted. Raising taxes is not entirely off the agenda, as indicated by a few noteworthy points of agreement between global leaders, such as the proposal to set a 15% minimum effective tax rate and the G-20's endorsement of carbon taxes as a policy tool. However, none of the more detailed policy agendas of EU governments for the next several years indicate that they will attempt to raise more than a few percent of GDP over a number of years from new or extended taxes.

That leaves higher growth as the primary means to reduce debt burdens. In the years before the COVID pandemic, the role of growth in determining debt dynamics became clear, with a close correlation between changes in debt-to-GDP ratios and real GDP growth. Achieving strong growth will likely involve a clear impulse from governments in the form of public investment.

The EU offers numerous investment opportunities that would facilitate the transition to net zero, strengthen climate resilience and develop a world-class digital economy, for instance. But public investment can be a double-edged sword. As the IMF has shown, sound project selection and execution can deliver growth benefits and multipliers that activate positive debt dynamics.

The opposite – poorly designed and implemented investments – leaves governments and populations worse off financially, economically and socially.

JEAN-JACQUES BONNAUD
Treasurer,
EUROFI

Fiscal discipline is essential in Europe's Monetary Union

The Covid crisis has prompted governments to roll out unprecedented fiscal initiatives to protect economies and societies. However public debt has increased between 2007 and 2019 at the EU level at a time when the level of public debt was already worrying. In the euro area, the aggregate government debt-to-GDP ratio in the same period rose from 65,9 % to 85,9% - one-third more debt compared to the pre-crisis level. In France, the public debt ratio compared to GDP has increased even more from 64,5 to 98,1% of GDP between 2007 and 2019. In Italy the public debt ratio has grown from 99,8% to 134,7% and in Spain from 35,6% to 97%. However, by contrast, in Germany public debt has decreased from 63,7% in 2007 to 59% in 2019.

We have come to this situation for two main reasons: the ECB's monetary policy has always been ultra-accommodating and the Stability and Growth Pact has not been enforced most of the time over the last two decades. The continuation of very low interest rates during the past two decades has pushed many countries to implement active fiscal policies and economics agents to borrow more. Moreover, negative interest rates have been disincentivizing fiscal discipline and the implementation of structural reforms.

The economic and social consequences of the current Covid-19 crisis are worsening the situation and increasing the heterogeneity of fiscal performance across euro area member states. In the euro area, the ratio of public debt to GDP is now forecast to peak at 102% in 2021 and the fiscal divergences are projected to increase further this year in terms of public-debt-to-GDP ratio. Indeed, seven EU Member States should have their public debt exceeding 110% of GDP in 2021: Greece (208,8%), Italy (156,6%), Portugal (127,2%), Spain (116,9%), France (116,4%), Belgium (115,3%) and Cyprus (112,2%). By contrast, sixteen EU countries will keep their ratio at or below 75% of GDP in 2021. Among them, Germany, the Netherlands and Finland will see their public debt compared to GDP hovering respectively at 72,1% of GDP, 56,8% and 71% in 2021.

As long as it is not sufficiently understood, notably in indebted countries, that excessive debt is a source of under competitiveness, the economic situation in these countries will continue to deteriorate.

As long as it is not sufficiently understood, notably in indebted countries (France, Italy, Spain etc), that excessive debt is a source of under competitiveness, the economic situation in these countries will continue to deteriorate. Only domestic structural reforms can resolve structural issues and increase productivity and growth. It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that will inevitably pose systemic risks to financial stability and therefore to future growth.

Furthermore, fiscal discipline is essential in Europe's monetary union. The reason stems from the fact that the European Union is not a state and that negative externalities - stemming from questionable national policies - should be considered and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination and the involvement of a monetary policy of fiscal policies.

Some may think that fiscal discipline is no more indispensable because of low interest rates. This is a profound misconception: interest rates will not stay at zero level for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetization of public debt is not consistent with the functioning of our monetary union.

In such a context, the following guidelines could inspire the reform of the Stability and Growth Pact:

- Instead of uniform quantitative fiscal rules, each Member State should outline a specific path for reducing its public debt which would take account of specific local parameters (level of savings, economic potential...) but it should be up to the EU Institutions to discuss and formally validate these plans.

- When the percentage of GDP devoted to public expenditure is too high, it must be reduced and brought closer to the average of the eurozone if we want to achieve a degree of homogeneity in budgetary performance, which is essential for the proper functioning of any monetary union.

- For countries with debt levels of 100% or more, it is essential to maintain their ratings, which requires that public debt be stabilised. The way to do this is to achieve a primary surplus (without taking into account the interest on the public debt) as a number of European countries such as Italy understood before the crisis.

- The quality of public spending should be an important criterion for assessing fiscal policies. Countries that tend to perpetuate very high ratios of public spending to GDP should be discouraged from doing so, and these Member States should be encouraged to maintain investment spending for the future.

- Early warning mechanisms should be put in place to prevent unsustainable public finance trajectories.

If the revised Stability and Growth Pact is not implemented, the result would be an inevitable new crisis of the euro zone...

DECLAN COSTELLO
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Europe's RRF: A swift start to meet pressing problems

As a second, difficult summer of living with the pandemic draws to an end, we can start to see the fruits of vaccinations and the forceful policy responses materialising. While challenges and risks remain, we can take some reassurance from the fact that the statistical link between new Covid infections and serious health complications has been weakened, thereby reducing pressure on health systems and allowing a certain degree of normalisation of social and economic life in Europe's Member States and beyond.

The Commission's latest economic forecast of July reflects these improved prospects, revising up its GDP growth estimate for both the EU and the euro area to 4.8% this year and 4.5% in 2022. The better-than-expected data for second-quarter GDP that were released subsequently suggest that growth momentum in the short term may be even stronger than the Commission forecast suggests. However, uncertainty surrounding the outlook will remain elevated as long as the pandemic hangs over the economy, and the risks to any projections are high.

The pervasive uncertainty caused by the pandemic was also the reason why the standard aspects of economic policy coordination at the European level were scaled back and adjusted, in particular through the activation of the general escape clause for the Stability and Growth Pact. The gradual normalisation of economic activity should hopefully allow for a normalisation of the operation of European fiscal rules to begin in 2023, as is currently envisaged. The Commission also intends to relaunch the public debate on the economic governance framework, in particular on the fiscal rules, in the autumn of 2021. The pandemic has significantly changed the context of this public debate, with higher levels of debt and deficit and significant output losses, increased investment needs and the related introduction of new policy tools at EU level, notably the Recovery and Resilience Facility (RRF) and SURE.

The RRF has gotten off to a promising start, now determined implementation must follow.

Europe has been making remarkable progress with implementing the RRF since its formal adoption in February 2021. To date, the Commission has officially received Recovery and Resilience Plans from 25 Member States. Work on the few national plans still to be submitted continues and discussions are ongoing. After a thorough assessment, the Commission has tabled proposals for a positive assessment of 18 plans to the Council for adoption, of which 16 have already been approved by the Council. The first instalments of RRF grant funding were already paid in August to a number of Member States, amongst them countries badly affected by the pandemic, such as Spain, Greece, Italy and Portugal.

Faced with perhaps the greatest challenge in its history, the European Union has pulled together quickly and effectively to deliver with the RRF a ground-breaking tool to help secure our economic and social recovery. More important still, the reforms and investments supported by the RRF it will help us tackle the increasingly pressing challenges of the green and digital transition. To see just how urgent we need to act to tackle climate change, one need to look no further than this summer's devastating weather events that caused an immense loss of lives and livelihoods across our continent. The European Commission's adoption in July 2021 of the 'Fit for 55' package of proposals to support the reduction in net greenhouse gas emissions by at least 55% by 2030, compared to 1990 levels, marks the start of a further major EU initiative to get real on tackling climate change.

The RRF has undoubtedly gotten off to a promising start. What must follow now is the determined implementation by Member States of the agreed investments and reforms initially proposed in the national Recovery and Resilience Plans. The Commission will play its institutional part by supporting Member States in the design of policy measures and ensuring their correct evaluation and validation. The potential benefits of a successfully implemented RRF are vast – not only on economic activity and, indirectly, on the sustainability of public finances, but also on the environmental sustainability of our continent itself. Time then to meet the pressing problems facing us with resolve and courage.

GROWTH CHALLENGES IN THE CEE REGION

MARIO NAVA
Director General,
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Rebuilding the European economy after the pandemic: solidarity and resilience

A crisis and a policy response like no other

Needless to state that the Covid-19 crisis has been extremely violent for all of us. But the pandemic has shown that some economies or regions were more fragile than others. Indeed, due to its nature, the crisis has disproportionately hit economies structured around tourism, hospitality, culture and local services. These disparities exist even between Member States: Croatia for instance saw its GDP contract by 8% in 2020 while Poland a drop of 2.7%[1]. The shock is such that one cannot be tempted to say that those most affected must adapt, diversify.

We must not forget that each shock is specific. Different kind of shock may hit other activities from the previous shock. One day's losers can be tomorrow's winners. That is why what matters above all is solidarity, namely being able to temporarily support and compensate those unfairly most affected, whilst helping them reforming their system so they can perform better. This is what the EU has done thanks to the support mechanisms such as the SURE instrument, the emergency aid by the Structural Funds, the temporary framework for State Aid Rules, the Pandemic Emergency Purchase Programme of the ECB and, last but not least, our joint recovery plan – NextGenerationEU (NGEU).

This solidarity will continue in the coming years with the deployment of the NGEU since, by design, the Recovery and Resilience Facility (RRF) takes into account the relative impact of the pandemic by Member State to better calibrate the allocation of recovery funds. Croatia, for example, will benefit from €6.3 billion in grants under the RRF, which is equivalent to nearly 12% of its pre-crisis (2019) GDP and is obviously macro-economically significant.

We can be proud of this achievement which was not a given. The policy reaction to the Covid-19 crisis has shown that we can collectively be stronger and up to the task. I am deeply convinced that the EU will emerge stronger from this ordeal. The economic rebound anticipated by the Commission in 2021 is already very good, and is even higher on average in the Member States than the EU average as a whole.

> One day's losers can be tomorrow's winners.

Significant structural challenges persist and must be addressed

The crisis has also highlighted certain weaknesses or flaws in our development model that pre-existed to COVID and should be still addressed by building back better. Carrying out reforms to strengthen our resilience is critical. Here again, the EU is there to help Member States. Through the Technical Support Instrument, the Commission support Member States carrying out reforms by providing expertise. In the latest EU Industrial R&D Investment Scoreboard[2], the EU lags its American and Chinese peers in ICT industries. Our economy is still insufficiently driven by digital technology even though the state of European tech has improved considerably in recent years. The EU is an exceptional breeding ground, as shown by the success of UiPath, one model among others. But we do not yet have the depth and liquidity of the U.S. capital market. Still too many European companies have no choice but to raise funds in the U.S. to scale-up. Building a more integrated capital market and a stronger risk culture among European capital providers is therefore essential.

The crisis has also shown the importance of infrastructure and skills, in particular health-related. Tomorrow, it is the green infrastructure and skills that could be in short supply. With the "Fit for 55" package, the Commission has laid out an ambitious policy agenda to reach the 55% emission reduction by 2030. For this to materialize, massive investments in green technologies (e.g. renewables, EV charging networks) and reforms in workforce education/training will have to be made, especially in EU regions which still rely heavily on coal and need to ensure a just transition towards a climate-neutral economy.

Our Recovery Plan is well calibrated to help meet these challenges. In addition, we have, with the Technical Support Instrument, a tool to support the design and implementation of reforms in Member States. That being said, the health crisis is still not over and we must remain vigilant. Thanks to the vaccine, we have a highly effective technology at preventing severe forms of the disease that is widely available in the EU. We can already be proud of the high share of the population who received at least one dose. However, this is not the time to boast: we must continue the effort and help vaccinate the world. This is the only way to leave this dark period behind us.

[1] European Commission, Summer 2021 Economic Forecast https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/summer-2021-economic-forecast_en
[2] https://iri.jrc.ec.europa.eu/scoreboard/2020-eu-industrial-rd-investment-scoreboard

PIERRE HEILBRONN

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Rebuilding from the crisis - the role of the EBRD and the EU in the CEE

The impact of the economic crisis caused by the Covid pandemic has been deeply damaging for countries in Central and Eastern Europe (CEE). The crisis has exacerbated weaknesses underpinning the macroeconomic models in the region, including their vulnerability to external shocks. International markets became volatile and it was difficult to access financing without existing banking relationships. The region remains bank-dominated with shallow and illiquid capital markets compared to their western peers, despite relatively developed legal and regulatory frameworks. The pandemic has shown that there is a need to upgrade their existing growth paradigms towards more digital, green, and innovative growth.[1] The assistance of Multilateral Development Banks (MDB), including the EBRD, and the European Commission's rescue package, Next Generation EU, should help these economies rebuild from the crisis in a greener and smarter way.

In March 2020, the EBRD became the first MDB to develop a support package aimed at helping economies, including those in the CEE, respond to the Covid-19 crisis and prepare for the post-pandemic recovery. Under our Solidarity Package, we established a Resilience Framework to meet the short-term liquidity and working capital needs of existing clients; expanded financing under our Trade Facilitation Programme; provided fast-track restructuring for distressed clients; and enhanced frameworks for SMEs and larger companies that are not existing clients. Our interventions paid particular attention to those most affected by the downturn. These included SMEs, which are extremely vulnerable to disruption caused by the virus, and women, who are more likely to work in sectors worst hit by the pandemic, such as services, tourism and trade. Through targeted policy dialogue and technical assistance, we focused on mobilising private sector capital, expanding the local investor base, and strengthening capital markets infrastructure in our regions. As well as responding to the immediate effects of the crisis, we helped lay the groundwork for a post-pandemic recovery.[2]

The rescue funds being provided by the EU are attempting to do the same. Next Generation EU, including its centrepiece, the Recovery and Resilience Facility (RRF), is a more than €800 billion temporary recovery instrument to help repair the immediate economic and social damage brought by the coronavirus pandemic. It is the first time in recent history that the EU will directly issue a significant form of mutual debt to redistribute and stabilise the region's economy. Some commentators have called this Europe's "Hamiltonian moment" reminiscent of the federalisation of American states' debt in the 18th century.[3]

The CEE economies are beginning to recover but it is clear we cannot rebuild in the same way.

The sheer scale of the funds involved explains the Commission's insistence on digital and green investments, including the adoption of economic and administrative reforms. This aligns with the EU's Green Deal and the EBRD's Strategic Capital Framework (SCF) 2021-2025. Unlike previous crisis recovery funds, the goal of Next Generation EU is focused on raising potential growth, improving long-term fiscal sustainability, and helping economic convergence across the EU area, rather than achieving short-term fiscal stabilisation.[4] The EU has rightly recognised the importance of devoting funds to regions such as the CEE; while the region accounts for around 11% of the 27-member European Union's gross domestic product, it has been provisionally allocated 187 billion euros, or 25%, of the Next Generation EU plan's money. In gross terms, Poland and Romania would receive the largest sums in CEE at 65 billion euros and 33 billion euros respectively. Scaled as share of GDP, Croatia and Bulgaria would get the biggest boost.[5]

The CEE economies are beginning to recover but it is clear we cannot rebuild in the same way. It has been widely acknowledged that research and innovation are crucial in achieving the green and digital transitions. This is good news for the region, because in 2019, Hungary had the second-highest percentage of employment in fast-growing firms in innovative sectors in the EU, with Slovakia, the Czech Republic, Bulgaria, Poland and Latvia also performing above the EU average. [6] We need to capitalise on the many attributes the region has to offer: a highly educated population, an adept and mobile workforce. These advantages will be crucial for the CEE on its road to recovery.

[1] https://blogs.lse.ac.uk/covid19/2021/01/22/how-central-and-eastern-europe-can-overhaul-its-dated-growth-narrative/
[2] EBRD Annual Review 2020.
[3] https://www.intereconomics.eu/contents/year/2020/number/5/article/spillover-effects-from-next-generation-eu.html
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PIER CARLO PADOAN

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CEE and NGEU: a unique opportunity to support reforms

Despite the Covid-19 pandemic, Central Eastern Europe (CEE) economies have never been in a better situation. After emerging from the global financial crisis battered and bruised, CEE adapted by reducing its reliance on foreign capital, sharply closing current account deficits and running more sustainable fiscal policies than pre-2008. As a result, public and external debt fell across the region, as opposed to other emerging markets.

However macroeconomic stabilization must be doubled by reforms to ensure further convergence to developed European economies, at a time when potential growth is slowing down across CEE. The Next Generation EU (NGEU) and its main component, the Recovery and Resilience Facility (RRF), offer a great opportunity for the EU members of CEE (EU-CEE) to reaccelerate growth and convergence.

EU-CEE countries plan to absorb 2.5-10% of the average GDP expected between 2021 and 2027 from the RRF. Adding the 2021-27 EU budget and SURE funding, EU-CEE countries stand to receive 14-30% of GDP before the end of the decade. Over the same period, the Western Balkans could receive at least 3-6% of GDP in financial aid, with 60% coming from the EU, 20% from the IMF, and 10% each from the World Bank and other international financial institutions. In return, EU candidate countries in the Western Balkans will have to pursue a reform agenda that could benefit the economy and the rule of law. The RRF's focus on digital transition offers a good opportunity to improve the infrastructure of telecommunications in CEE. Together with investments in road and rail infrastructures, this could help reduce regional disparities.

The delocalization of services and competitive labor costs could allow CEE to attract jobs if internet penetration and quality of service are placed up to international standards. It is well known that capital cities in EU-CEE rank among the highest per-capita GDP regions in the EU (measured at purchase power parity), while countryside regions in EU-CEE are the poorest in the EU. The underdeveloped transport and telecom infrastructures reduce business opportunities and labor mobility. Since joining the EU, many people from poor EU-CEE regions chose to emigrate, rather than commute.

The NGEU and its main components (RRF) offer a great opportunity for the EU members of CEE (EU-CEE) to reaccelerate growth and convergence.

While COVID-19 partly reversed this labor drain, more needs to be done to repatriate economic migrants. This leads to a second, very important chapter of reforms that target human capital. Over the past two decades, both EU-CEE and the Western Balkans have benefited from EU funds to retrain the unemployed, increase labor participation and create a structure of lifelong learning. Unfortunately, no CEE country managed to build such a framework and global competitiveness indices show an increasing gap between acquired education and skills requested by companies. Labor participation, especially among women, remains very low.

The German experience of the Hartz reforms could be a blueprint for the entire region when it comes to matching labor supply to demand, but few governments may be willing to assume the electoral cost of reforming social security. The tradeoff is however clear: the less governments do the more work force is likely to migrate due to labor mobility in the EU. This is valid for both high-skilled and low-skilled workers, as shown by the rapidly increasing labor shortages across economic sectors in CEE.

Fostering human capital requires investments in healthcare. COVID-19 laid bare the poor quality of emergency healthcare systems in CEE, with Central Europe leading the continent in the percent of fatalities among hospitalizations. Primary healthcare systems are under strain and undermanned, as a consequence of emigration. Inefficient spending is a bigger issue than underfunding for secondary healthcare systems. NGEU funds can be used to streamline spending and cut waste.

Finally, the EU's green transition offers CEE the opportunity to reduce its reliance on coal-generated power. Nonetheless this transition carries additional social costs as many loss-making coal mines will have to be closed.

It is very difficult to turn around mono-industrial regions without retraining the work force and giving incentives to entrepreneurs, yet many governments have chosen the easy way out, pledging their support for an industry with a bleak future. Tackling climate change includes a focus on fighting desertification and deforestation. Governments will have to take the lead in both areas, where the private sector's interest is limited due to low potential profits.

Banks must be a partner in implementing the NGEU by offering loans for each stage of the project: prefunding, bridge loans for the implementation, investment loans for later stages and revolving lines for operating projects.

The region suffers from underdeveloped capital markets that fail to be a viable funding alternative for CEE companies.

As a result, banks are likely to provide most of the financial support underpinning economic development in CEE during this decade.

MIROSLAV SINGER

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Financial markets in the CEE – The current state and the way forward

The discussion on foreign investments in CEE should not only aim at the means of their increase. The narrowing of interest rate spreads of sovereign debt or the macroeconomic policies focusing on controlling the pace of real appreciation of their currencies of several countries in the region indicate that not all foreign investments are welcomed. Still, most of the economies, including the region's most developed ones, would significantly benefit from diversification of sources of foreign investments. In terms of reform steps needed to achieve such outcome, the insurance industry has been playing a helpful role in terms of catalyzing such changes and promoting chiefly the development of qualitative debt markets.

The Covid-19 crisis could be viewed as a type of stress test of the ability of the economies to finance their needed fiscal expansion from the open market sources. In that respect, the CEE region held better than expected. Despite some signs of market disturbances and widening of sovereign spreads at the eve of pandemic, no country experienced plain financial crises. In addition to those Central European economies were able to use, if desired, QE tools without harming their ratings or seeing the trust in their sovereign debt declining.

Of course, macroeconomic fundamentals still played a role. It could be seen that the foreign indebtedness limited in some extent the ability of Treasuries to relax their fiscal focus in pre-Covid times. Countries with higher debt, like Croatia or Hungary, had pursued relatively stricter fiscal policies. This logic could be also observed during the crises. Low-indebted countries like Czech Republic, Poland and Romania used much more widely their fiscal tools to support their economies than higher indebted Croatia and Hungary.

Nonetheless, policymakers of the so-called Visegrad Group (Poland, Hungary, Czech Republic and Slovakia) correctly accounted to the fact that the domestic savings are rather sufficient to cover their needs even during the pandemic and that plain vanilla foreign financial inflows bringing no other benefits such as know-how, or political advantages which are no longer needed to finance their development. Perhaps the most developed financial markets including the deep and functional equity one could be observed in Poland. The QE motivated purchases of the Hungarian National Bank (MNB) have contributed significantly to the creation of the vivid corporate bond market in Hungary; however, the Hungarian stock market remains very modest and has significant opportunities to grow.

The insurance industry is a helpful catalyst in transforming financial markets in the CEE region.

The Czech financial markets stand somewhat between the Polish and Hungarian ones. Currently, the Czech stock market is significantly less deep than the Polish one, but this may change, given new developments. As to the bond market, the Eurobonds prevail but the local issues are not marginal. It is worth mentioning that the major players in the Czech market are multinational banking and insurance groups, where Generali is playing an important role. This may play a role in the future in the context of Green Deal, where investments in sustainable, long-term infrastructures are greatly needed in the CEE region.

However, national policy options between Poland and Hungary on one side and Czech Republic in regards to fossil energy may lead to unlevelled playing field situations for financing opportunities of thermal power infrastructures.

As to the Balkan countries, their financial markets remain underdeveloped and the more significant activities center primarily around governmental debt; this nonetheless opens significant growth opportunities. The conceivable steps to develop capital markets in CEE countries may focus on the bond issuance of the State-regulated and/or controlled – utilities, energy groups etc. Insurance groups would be certainly interested to diversify their investment activities in those which are in line with ESG policies. This would also contribute to build up of the deeper local corporate bond markets.

In terms of the development of the local financial markets, it is worth stressing that insurers, in their capacity as long-term investors, welcome new benchmarks in the areas of mandatory disclosures and integration of ESG risks.

Looking ahead, the development of capital markets in the CEE could be generally enhanced by greater financial literacy of the younger generations participating in the markets, with a focus on saving and long-term planning, as well as initiatives to encourage and incentivize the take-up of second and third pillar pensions. In this respect, the first PEPPs, which will be offered on the markets in Spring 2022, are a very welcomed tool to build-up and strengthen capital markets in the CEE region. Moreover, the sustainability of second-pillar pensions across the region should remain a policy priority of Governments.

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No shortcuts to success

Give a man a fish and you feed him for a day; teach a man to fish and you feed him for a lifetime.

The honeymoon period of fast convergence is long over for the CEE region - and Slovakia in particular. The country is still facing long-standing structural challenges and investment gaps in key areas such as education and health. The stagnation of reforms in recent decade has opened a middle-income trap, which is exacerbated by a vulnerable growth model built in particular on export oriented automotive industry and energy-intensive manufacturing. The business environment continues to be disrupted by red tape, the capacity to absorb EU funds remains a challenge. Reaching only for low hanging fruit in terms of reforms is therefore no longer an option. The recent crisis caused by the COVID-19 pandemic highlighted this further.

To be sure, the economic impact of the COVID-19 crisis in Slovakia was milder compared to other member states. The Slovak economy is expected to rebound to pre-crisis output levels already in third quarter of this year, according to the most recent Commission forecast. The pandemic has nevertheless highlighted Slovakia's weak spots - particularly in health and education systems. Slovakia has one of the highest COVID-19 death rates among EU member states; Slovak schools remained fully closed for longer, offering fewer strategies to address learning gaps.

The key to long-term success is an active involvement of private sector.

In the current recovery phase, Slovakia must therefore address wider range of challenges, both long-standing, and newer ones. The tools created on the European level to foster the recovery, particularly the NextGenerationEU (NGEU) instrument, provide a unique opportunity to make this leap forward. The ambition to tackle structural shortcomings has been confirmed in the Slovak Recovery and Resilience Plan (RRP), which includes comprehensive reforms in the above mentioned areas of health and education, but also justice, public administration and public finance. Importantly, the RRP also addresses challenges in green and digital transitions.

It would however be naive to believe that everything can be solved by the RRP and the NGEU. The key to long-term success is an active involvement of private sector. Here, the role of the governments is to create and maintain a stable environment for the private sector to prosper. For example, the much needed improvement in access to financing to micro and SMEs - which are the corerstone of employment - can only be achieved with a functioning Capital Markets Union.

The list of tasks for policy-makers is long - from support of innovation and local development in energy and agriculture to maintaining effective public expenditure (value for money) - yet, there are no shortcuts to success.

DEBORA REVOLTELLA
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Covid-re-start as an opportunity to re-build better

The need for a structural transformation of the economy in CESEE is a long-standing issue, pre-dating the Covid-19 crisis. The CESEE traditional growth model, focused on exploiting the benefits of EU markets integration, thanks to a combination of low labour costs, exports and capital inflows, worked quite well for almost 25 years. Going forwards, slowdowns in productivity, increasing labour shortages and costs, as well lower capital inflows and possible readjustment in global value chains, challenge the traditional convergence path.

The Covid-19 re-set adds to unavoidable global and local macro trends, but also offers the opportunity for the region to re-build better and re-position. In this context, the new growth model for CESEE needs to embrace 4 key dimensions (see Gereben and Wruuck 2021): digitalisation, innovation, economic transformation towards a carbon-neutral economy and skills management. Resources are available, as a combination of national efforts and the Next Generation EU. Managing policies right is crucial, with appropriate combination of resources, reforms and skills development.

The Covid-19 re-set favoured a push for digitalisation in CESEE. EIBIS (forthcoming), a survey of some 12,500 firms in Europe, shows that as of today, the share of firms with advanced digital technologies is slightly above 60% in CESEE, matching advance digitalisation standards in the EU. Due to Covid-19, as a short-term response, some 40% of CESEE firms increased digitalisation. On the long-term, some 70% of firms in CESEE, as well as in the EU, expect Covid to require even more digitalisation, but also possibly downwards adjustment in employment (20%). As skills remain a key concerns for firms in CESEE, accounting for a barrier to investment for some 80%, of firms appropriate policies to rip the benefits of digitalisation, while addressing the re-training needs, both for digital technologies and labour shading, are crucial.

> The region is highly sensitive to the economic shift towards a net zero emission economy.

Remaining competitive in times of radical technological shifts requires continued imported and home-growth productivity enhancing innovation. A broader set of private firms needs to invest into intangible assets, particularly into R&D, to translate research into tangible innovation and strengthen the innovation ecosystems. Fostering capital market development and increasing the set of capital providers that are able to finance and support innovative companies - notably growth and risk capital, new venture debt products and alternative funding sources- is key to support the innovation process. In this context, Capital Market Union should be more and more interpreted as a system for full integration of EU capital markets, rather than only deepening of domestic capital markets. Exploiting the benefits of innovation requires also a flexible environment, which allows reallocation of resources. This becomes crucial at times of radical technological shifts.

The region is highly sensitive to the economic shift towards a net zero emission economy. CESEE countries have improved their carbon footprint over the last decades but the energy intensity of the economies of the region is still excessive compared to the EU average. The transformation challenge is important, with potentially huge redistribution issues emerging. At the same time, the transformation towards carbon neutrality is bound to unlock a new business opportunities. Strong policy action is necessary to drive the transition, to mitigate possible adverse social impacts of the low carbon transformation and to embrace related opportunities. Municipalities in CESEE feel the gaps in terms of climate related investment. Some 60% of CESEE firms are aware of physical risk, while only 40% perceive the effect of the transition to a net zero carbon emission economy. Still, only 35% firms in CESEE invest to accompany the net zero economy, vs 45% in the EU. Clear policy guidance, regulation and incentives, as well as finance and skills are needed for a kick-start.

Digitalisation and the net zero emissions economy reemphasizes the case for investment in skills and human capital across the region. Digitalisation can contribute to innovation as an enabling factor and new technologies can alleviate labour shortages. However, absent adequate policy measures, it can add to the strains of the labour market by increasing skill mismatches, substituting human work with technology and adding to social polarisation. The combination of a favourable business environment and availability of digital talent is the basis to broaden adoption, foster digital innovation in the region and new quality jobs to emerge. At the same time, the green transition will have winners and losers, but also has the potential to develop new jobs.

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OPTIMIZING THE FINANCING OF EU CORPORATES

CARMINE DI NOIA
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Sustainable financing structures for a sustainable recovery

Before getting commonly associated with ESG issues, "sustainability" used to be, in finance, a word linked with the term "debt". As we all know, debt sustainability – notably with regard to corporate dimension - has been seriously put a risk, as the health emergency hit severely both advanced and emerging economies. The support measures adopted by governments in many advanced countries only partially mitigated the negative impact of the crisis.

In 2020, bank loans to Non-Financial Corporations (NFCs) increased sharply as a consequence of various measures – such as public guarantees adopted to support firms' funding. This has lessened the impact of the crisis, but it has also increased the weight of debt on corporate funding, heightening concerns about its final repayment. As shown by the recent CONSOB Report 'Trends and risks of the Italian financial system in a comparative perspective', the leverage of large listed NFCs increased in all European main countries, especially in Spain and Italy (where, however, the debt structure of large NFCs is more stable because of a lower incidence of short-term debt on total debt). At the same time, revenues declined substantially - especially in the services sector that suffered the most from the restrictions against the spread of Covid-19 - reducing firms' cash flow generation and so their future ease to repayments. In a recent publication, however, OECD frames such developments in a longer trend, finding that listed companies, at global level, experienced an increase in the aggregate debt-to-EBITDA ratio from 2x to 3x between 2005 and 2019 (*see: The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*).

Private contribution to recapitalization essential only if associated with efficient public markets.

In a low interest rate environment, excessive debt appears to be less worrying than it was in the past. However, in the medium term the increasing imbalances in the funding structure of firms may be a problem, especially in those countries where main industries experienced a deterioration both in profitability and financial indicators compared to their 10-years average. Huge equity injections are consequently needed to rebalance corporate capital structures.

Sustainability of debt, however, is only a first step: growth must follow. Corporate long-term profitability is driven by investments: notably, in the modern digital economy, R&D investments. Again, capital structure matters, according to OECD findings. Low-leverage firms are definitely more inclined to R&D compared to high leverage companies (more keen to Capex). Enhanced equity financing is then required also to finance riskier projects and boost European (companies') growth.

The CMU project has already put in place several measures to facilitate the access of enterprises, especially SMEs, to capital markets and to increase the recourse to sources of financing alternative to bank loans. Moreover, the implementation of the National Recovery and Resilience Plans under the Next Generation EU (NGEU) recovery package by the Member States is the occasion to improve the economic resilience of European NFCs (in particular of SMEs) and to make them more attractive to new investors. Indeed, fostering firms' investments in digitalization, promoting the enhancement of digital skills, encouraging the use of digital tools, facilitating the access to adequate digital infrastructures as well as strengthening firms' attention to sustainability issues and their ability to deal with climate risks can be crucial for their growth in the medium term and can represent a key factor in facilitating the access to alternative sources of finance.

However, further measures may be needed. For example, a rebalancing of tax incentives between debt and equity has been frequently suggested. In addition, the development of an appropriate information ecosystem on SMEs should be encouraged in order to mitigate information asymmetries that can impair investment.

The increasing private- equity funds' contribution to firms' recapitalizations is undoubtedly crucial, but only if associated with vibrant and efficient public markets, whose vital role in price discovery and corporate governance discipline can never be replaced. OECD data, unfortunately, highlight a dramatically clear trend in the opposite direction, with 30.000 companies globally delisted since 2005 and negative net listings since 2011, even if the very last data display an important increase of IPOs everywhere. Stronger financing structures, higher profitable investments and, in conclusion, robust prospects of growth for European economies need well-functioning equity markets: re-launching them must be the goal of policymakers and regulators.

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Improving the debt-equity mix: moving past the Covid shock

Dutch corporates, as well as European ones, are still more dependent on bank capital compared to their counterparts across the Atlantic. This is a longstanding issue, yet there is much room for improvement.

Overdependence on bank funding increases the risk of procyclicality in the economic system, as banks may cut credit flows during financial crises while market funding could serve as a 'spare tyre'. In addition, market financing focuses also on a higher-risk segment of firms, which are associated with innovations and higher productivity, leading to a more dynamic economy. Lastly, in the EMU context, cross-border market financing has the potential to reduce systemic risk and enhance financial stability, making the monetary union more robust. To sum up, a deeper European capital market can help support a) financial access, b) productivity and c) internal convergence.

Five quarters past the Covid shock of March 2020, the first data points suggest that the funding mix of corporates in Europe has not changed much. According to the BIS, 40% of the funding mix of Dutch corporates is bank-based. In the euro area, this is 55%. In the US, it stands at 33%. For Europe, the funding mix has barely budged since the Covid outbreak. If anything, government interventions following the Covid shock – which were needed and effective - have highlighted the bank-centered focus of the financial system and the wedge between smaller and bigger firms. First, governments in the EU have intervened by guaranteeing bank lending to corporates, strengthening the interdependence of the state, the banking system and the corporates. This 'nexus' can create risks for financial stability.

Second, central bank intervention kept capital markets afloat, but with only the larger firms able to access cheap bond market funding and smaller ones left dependent on banks.

Moving past the Covid shock ensuring the development of a true European Capital Markets Union is now a main priority. For both Dutch and European firms, the balance needs to be tilted further from debt to equity and from bank to market financing, while cross-border market integration in the EU needs to develop faster. Tackling the debt bias and the home bias can be done, although it will take a multitude of policy actions to get there. As regards the debt bias, in the Netherlands, for example, debt financing receives favorable tax treatment vis-à-vis equity financing, incentivizing firms to take on more debt than economically optimal.

Moving past the Covid shock ensuring the development of a true European CMU is now a main priority.

As regards the home bias, European financial markets can be further integrated by implementing a series of actions identified by the European Commission in its CMU Action Plan. These actions would make information on assets and markets more readily available to investors, ideally clustered in a European Single Access Point. Simplifying and streamlining regulation for listings is another obvious candidate here, as is more convergence between national corporate insolvency regimes.

Moving away from these supply-side measures, strengthening the demand side is also necessary to complete markets. For decades, US household participation in financial markets and venture capital has been much higher than in the Netherlands or the EU. Here, one could refer to the Dutch system of pension fund saving. Dutch pension funds essentially take up the role of indirect investor while supplying retirement benefits. Increasing savings in capital-based pension funds in the EU would aid deeper and more complete European equity and bond markets.

In the end, one can think of an eco-system in which European corporates and savers operate and facilitate each other's needs. Both investors and firms can then ideally find each other across the market, based on the risk/return structure that suits the participant. This deep market should range from risk-free bonds to venture capital.

All in all, we seem to recover from the Covid shock rapidly and decisively, thanks also to swift policy action. These interventions nonetheless highlight the bank-centered nature of the European financial system, and the divergence between larger and smaller firms in terms of funding opportunities.

Decisive action on the CMU by the EU and its member states has the potential to make the debt-equity mix more robust, increase funding opportunities for more firms and strengthen European savers, investors and firms in the long term.

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Alternative financing platforms in the era of digitalisation

As we are cautiously coming out of the crisis, policy-makers across the EU are considering the best ways to extend a supporting hand to the most hard-hit – and smallest – actors of the economy. We have already seen a plethora of government support measures and an unprecedented EU response, including in the form of the European Guarantee Fund and the Recovery and Resilience Facility.

But given the European traditional over-reliance on debt, there is a very real danger of over-indebtedness. Smart debt is of course one way to tackle this, with a targeted offering of debt support.

Yet even with strong public support, the share of insolvent firms could increase by 6% across the EU, putting at risk the jobs of around 8% of the workforce.

The solution cannot simply be more of the same type of debt. Diversifying financing sources and securing more flexible alternatives that are designed to meet the needs of SMEs is a must.

This is not only about offering a variety of alternative financing possibilities to the SMEs and family businesses that we want to support, but also about drawing from institutional and private investors precious dry powder for investments in SMEs, marrying the need for flexible financing with investor demand for yield in today's low-interest climate.

What does that diversification look like? Boosting equity financing is one clear avenue. While the EU Solvency Instrument didn't see the light of day, we are nevertheless witnessing an increased appetite from public actors to mobilise private equity investments as a tool to support innovation and SMEs across Europe. The European equity market has been growing but we're still a few clicks behind the US, and while indispensable, this is only part of the response.

Alternative financing platforms harbour a lot of potential that needs to be harnessed and put to good use. Loan funds and crowd-funding platforms offer prospective investors access to an asset class that wouldn't usually fall into their line of work, and at the same time a new funding source for SMEs and family businesses.

As the digital wave revolutionises the world as we knew it, this potential only grows. Such alternative online, digital financing platforms often rely on very smart software, artificial intelligence and machine-learning capabilities to assess risk in record time and generate the sort of security that traditional financial institutions have spent generations trying to perfect.

Alternative financing platforms harbour a lot of potential that needs to be harnessed and put to good use.

This predictive analysis can boost the attractiveness of the sector, despite its relatively limited track record. The tools at their disposal are also quite broad, ranging from convertible bonds to equity, cashflow financing or more classic debt instruments, bringing a plethora of alternative financing options to the table for SMEs across Europe. And as digitalisation and big data only grow and grow, so does the potential of this new sector. The digital dimension also means that we are seeing a lot of cross-border activity, which can help it scale and constitute an attractive option for institutional investors.

The European crowd-lending market is expected to exceed EUR 10bn in size very soon and the entry into force this coming November of the ECSP Regulation will add more clarity and certainty to the online alternative lending market. It is an opportunity that both policy-makers and policy takers should not be missing. We are already seeing European institutions channelling targeted support towards alternative finance providers and digitalisation and more can be expected through InvestEU, further catalysing private investment in this direction.

This of course does not take away from the importance of supporting the European traditional lending markets, where most of the business will still be taking place, or, for that matter, the private equity and venture capital ecosystem, which has been growing but still lags behind other regions like the US. And nowhere is this gap more evident than in the scale-up stage that still impedes innovative European businesses from reaching their full potential right here in Europe.

A sober mix of different instruments will constitute the best approach but the potential of alternative financing platforms is not to be taken lightly. Digitalisation has helped alternative finance take a critical step forward, increasing the volume and range of financing available for European SMEs at a time when it is badly needed.

As policy-makers focus on making sure the economy emerges from the crisis in good shape, helping the smallest actors to recover and become more resilient, alternative finance could prove to be a very useful tool.

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Equity and debt in the mix for growth

The European Commission's Capital Markets Union initiative continues to be a key policy priority for the creation of sustainable and inclusive growth across Europe. Multiple efforts both locally and at an EU level are needed to create long-term opportunities for both small and large companies and investors. This has become even more urgent in light of the immediate need for recovery from the economic effects of the pandemic.

Companies that opt for equity funding on the public markets create more jobs than companies that stay private, and it also allows a broader investor community to share the growth journey. This is why I am convinced of the societal benefits of equity funding.

In the Nordic and Baltic markets where Nasdaq operates both regulated markets and growth markets (Nasdaq First North), we see record number of companies leveraging the equity markets for financing. Multiple factors contribute to this, but one reason is that local policies since many years have promoted and achieved a relatively well-developed equity culture among private investors. As a result, there is now a financial ecosystem with many types of actors supporting companies on their journey through the funding escalator.

I strongly welcome the European Commission's initiative on rebalancing the current bias towards debt financing by alleviating the burdens on equity finance. This initiative should be at the core of CMU. Equity is more heavily taxed than debt in many countries. Interest payments on debt may be deducted from profits before they are taxed, whereas equity financing does not receive any form of tax relief. On top of that, equity is subject to significant taxation both in terms of capital gains and dividend payments. Hence, this structural bias towards debt financing incentivises companies to take on debt rather than equity. Tax policies should not discriminate between debt and equity.

While taxation is the competence of individual EU member states, any efforts by the European Commission in terms of coordination, sharing best – and worst – practices and finding common solutions have great potential to lead to positive outcomes for European companies and investors and the growth of stable economies as a whole.

Measures taken will gather more support and confidence by the business community if long-term foreseeability is guaranteed. As an operator of public markets, Nasdaq believes that long-term investments by engaged shareholders are crucial for supporting growth. Stable tax policies play an important part.

Tax policies should not discriminate between debt and equity.

Another factor is simplicity. One example of successful simplicity is the various versions of 'investment savings accounts' which have been introduced in different countries in recent years. For instance, in Sweden the tax reporting related to such investment saving accounts is automatic and relieves the investor of significant administration. It has attracted a lot of private investors, which plays an important role especially for the success of our growth market Nasdaq First North. Among several factors, I believe this simplicity has been one of the more important ones behind the success of these types of accounts.

Further measures to increase retail investor participation should also be prioritized, including considering if investor protection provisions in MiFID can be adapted to non-professional but still experienced investors.

Additionally, ensuring that the MiFID framework delivers a market structure that serves both larger and smaller investors fairly and efficiently, and provide equal growth opportunities for small and large companies alike, is key. For this, transparency and a robust price formation process is fundamental.

To support and ensure a good financing mix, I finally want to highlight the role of the corporate bond markets. Corporate bonds can often be a very appropriate financial instrument for a company as well as an investor. However, there is room to realize the potential of corporate bonds for smaller companies and smaller investors.

The regulatory framework currently incentivizes market participants to use the wholesale markets and instruments with relatively high denominations. For smaller companies, as well as smaller investors, instruments with lower denominations can often be more suitable. Seeing how the green bond market, which Nasdaq launched in the Nordics a few years ago, has grown exponentially, this also illustrates the importance and usefulness of green corporate bonds for the transition to a more sustainable society.

Equal opportunities for investors, companies and also financing should be a fundamental part of the Capital Markets Union, and Nasdaq supports any action that enables a more dynamic financial landscape where companies of all sizes are able to choose from a mix of different sources of capital, where investors are able to enjoy growth opportunities, regardless of if they want to invest €10 or €10 billion and where sources of funding are treated the same way no matter if they are debt- or equity based.

ED COOK

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Improving equity funding opportunities in the CMU

The past 18 months have shown the critical role that capital markets play as a financing tool for companies. In addition to the bank funding provided during the COVID crisis, many companies were able to tap debt markets to raise money, and the listing boom in recent months show that equity markets remain a deep and attractive source of (often transformational) investment opportunity for companies.

The bellwether of success in equity finance is often seen through the lens of the number of IPOs of high growth firms. Indeed, the debate over incubating equity finance tends to focus on the 'funding escalator' – a linear path through various stages of specialist venture and growth financing, ending with an IPO. But this path may not be in sync with the needs of many companies, and it is increasingly out of sync with how many investors look at company financing.

The more linear path may fit best with the trajectory of innovative high-growth firms (despite the perception that Europe loses its highest potential companies to the allure of US venture capital and the US consumer market, many exceptional young companies do indeed choose to stay put in Europe).

But Europe is also home to a significant number of more mature private companies who are, in many ways, world-leading firms. For these firms, the 'funding escalator' narrative resonates less – this should not constrain their access to equity finance. Indeed, these companies can be exciting investment opportunities for many investors, and the companies themselves should be able to benefit immensely from access to capital market funding solutions in complement to bank finance

Companies can stay private or go public, depending on their needs, but the crucial point should be providing opportunities for companies meet the financing needs of their businesses at any given time. We see two important areas for focus:

The final report of the High Level Forum (HLF) on CMU provides a strong policy roadmap to improve the ability of companies to raise both equity and debt financing.

For companies who do choose to list, improvements to the listing process can be made. Europe has a much higher rate of IPO failures than in other major capital markets – largely due to the pricing expectations of the companies not being met. Promoting direct listings, where a firm lists without actually raising capital can be positive step that can help bridge this barrier. In a limited sample size in Europe to date, direct listings have resulted in companies finding it easier to eventually meet capital raising goals than they had previously attempted in their IPO processes.

From an investor perspective, the line between public and private market financing is becoming less clear cut. Where once, most 'mainstream' investors focused on public markets, while specialist alternative investors focused on private equity and debt finance, increasingly many investors are positioning themselves to capitalise on opportunities on both sides of the listing divide. This trend should be welcomed, and built upon to maximise opportunities for financing corporates no matter what their profile or growth ambitions.

Widening the part of the investor base who can play a robust 'cross-over' financing role – that is investing in both private and public companies – is critical. We see exciting possibilities as well for bringing investment strategies focused on exposure to a range of growth companies at different points in their growth trajectory – from early stage providing continuous investment through to their development into more mature listed companies – to certain types of retail investors with long-term investment outlooks. The ELTIF provides a unique platform to grow this market and targeted amendments to the framework could help facilitate this further and really accelerate the investor interest in this space.

A key objective of the Capital Market Union (CMU) initiatives has been to help ensure that EU capital markets are able to more effectively serve the funding needs of European companies, and we strongly believe that targeted initiatives can help realise this aim. The final report of the High Level Forum (HLF) on CMU provides a strong policy roadmap to improve the ability of companies to raise both equity and debt financing.

THE **EUROFI** FINANCIAL FORUM **2021**

LJUBLJANA | 8, 9 & 10 SEPTEMBER

EU-UK RELATIONS: WHAT PERSPECTIVES?

NATASHA CAZENAVE

Executive Director, European Securities and Markets Authority (ESMA)

EU-UK developments and relations in financial services

More than eight months have passed since the end of the transition period on 31 December 2020 and the establishment of the EU and the UK as two separate markets. Transitional measures put in place by the European Commission (EC), the EU and the UK authorities, as well as preparation by the firms, have proven effective, with no notable market disruption or impact upon financial stability.

Regulatory divergence, on the other hand, while expected, is becoming apparent. This was anticipated since the UK had expressed its intention to regain rule-making autonomy. A natural consequence of the UK withdrawal is that rules in each market follow their own course of evolution and updates. It was only recently, however, that evidence started to emerge as to the direction of such changes, as the UK authorities look into setting a new UK regulatory architecture and the EU is launching new initiatives that will no longer apply to the UK.

Regarding specific changes, ongoing reviews of the prospectus regime, PRIIPs, and rules applicable to the wholesale market have illustrated where the UK intends to move away from existing EU requirements. These reviews provide some clarity on the UK regulatory agenda, but many initiatives are still at their initial consultation stage and further changes could be proposed in due course. The full extent of the EU-UK regulatory divergences is therefore yet to be seen and, given the historic interconnexion between the EU and UK markets, analysing their impact and potential risks is essential. ESMA will be monitoring developments carefully and will provide technical support to the EC, where required.

From a wider angle, the impact of COVID-19 on economies triggered various responses by regulators and supervisors across the globe to ensure the recovery of their markets and economies, including in the EU and the UK. As the effects of the pandemic drag on, further responses to ensure the recovery could be expected in different jurisdictions, which might bring more fragmentation to global financial markets if common objectives are not coordinated. This adds a significant layer of complexity to the work of ESMA and other European authorities.

It is key to ensure that the EU and the UK continue to share common global regulatory objectives and cooperation and information sharing remains operational and constructive.

Against this background, significant divergences will need to be carefully considered by the EC bearing in mind the objective to maintain open and competitive European financial markets, while preserving financial stability and high standards of investor protection. While time limited equivalence decisions were taken to ensure a smooth Brexit transition, the Commission has clearly stated that regulatory equivalence in the area of EU financial services is to be unilateral and in the interest of the EU.

Owing to the lack of certainty in the regulatory landscape, supervisory cooperation has been crucial to Brexit preparation and remains critical in this new phase. ESMA acted promptly by concluding bilateral and multilateral arrangements with the UK authorities to ensure continuous cooperation and exchange of information after the end of the Brexit transition period. These have proved to be useful tools to exchange information on supervisory matters and to effectively remediate risks posed by certain supervised entities. ESMA has established and maintains solid ongoing relations with the UK FCA as part of its coordination of horizontal EU issues as well as in the context of our cooperation in relation to supervisory matters in areas where ESMA has direct supervisory powers.

Looking ahead, it is key to ensure that, in light of the historic interconnectedness of both economies and markets, the EU and the UK continue to share common global regulatory objectives and that cooperation and information sharing between both jurisdictions remains operational and constructive.

On a high note, both the EU and the UK have committed to work towards important global goals, such as assisting the design of sustainable finance standards to improve disclosures and to ultimately attenuate associated risks upon economies and financial markets. Confluence at the international level is of utmost importance to mitigate market fragmentation and effectively regulate financial services which are by nature cross-border.

JOHN BERRIGAN
Director General,
DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

An overview of key elements of the EU financial services strategy

A stable and competitive EU financial system is crucial to support our economy and to contribute to sustainable growth for the benefit of all EU citizens. Our priority is the recovery from the Covid-19 pandemic. Extraordinary measures have been adopted to protect households, companies and jobs. The EU banking sector has also benefited from a swift response by public authorities, coordinated at EU level. Having entered this crisis in a stronger position than during the global financial crisis, banks are part of the solution. As the recovery from the pandemic will hopefully continue to gather pace in the second half of this year, now is the time to advance our key strategic priorities.

Achieving further market integration and preserving financial stability and market integrity remain our key policy priorities. In two areas – sustainable finance and digital finance – the pandemic has accelerated change. The EU's ambition on sustainability is set out clearly in the European Green Deal. We have taken substantial steps to enable finance to play its full part in the transition to sustainability. Our sustainable finance package from July this year is a further step in our work to establish a sound framework for sustainable investments, that works for investors, the real economy and financial intermediaries, and that enables the EU to remain a leader in this area.

To ensure efficiency and avoid duplications, it is critical that efforts are coordinated globally, in particular at G20 and FSB level. On digital finance, the Digital Finance Strategy is part of the Commission's overarching priority of making Europe fit for the digital age. Amongst other initiatives, we have brought forward ambitious legislative proposals on operational resilience (DORA) and crypto-currencies (MiCA). As is the case with sustainable finance, international cooperation is key. Delivering a financial system fit for the digital age relies on our ability to work together to set international standards. These standards should promote innovation and safeguard market integrity.

A stable and competitive EU financial system is crucial to support our economy.

The threat posed by money laundering to our financial system is a key concern. The Commission recently presented an ambitious anti-money laundering and counter terrorism financing (AML/CFT) package, including a proposal to create a new authority to fight money laundering. I have no doubt that the measures proposed will significantly enhance the integrity of the EU financial system and the single market. Progress on the Capital Markets Union (CMU) and the Banking Union are more urgent than ever. The Covid crisis revealed, for the second time after the 2008 financial crisis, the opportunity cost of not having strong European capital markets.

Besides the economic recovery, the CMU is key to deliver on all other EU economic objectives including the digital and sustainable transition, a more resilient economy, more competitive European firms, and a globally strong EU. While there are difficult and sensitive challenges to overcome, it is important to remain ambitious. That being said, CMU is a long-term project that needs to be built incrementally.

The CMU is one obvious pillar of the EU's autonomy. Strategic autonomy does not imply protectionism, but rather ensuring a stronger more resilient financial system and minimising financial stability risk. The EU remains committed to an open global economy, international financial markets, and the rules-based multilateral order.

Open strategic autonomy will therefore require further development of the EU's domestic financial system, addressing any over-reliance on financial services provided from third-country sources. Our main objective is to ensure we have an open, strong and resilient economic and financial system, based on solid domestic market infrastructures. As indicated in the Communication on fostering openness, strength and resilience in our economic and financial system published in January 2021, the UK's exit from the EU has exposed some vulnerabilities in our financial system linked to dependence on market infrastructure outside the EU.

Needless to say, the EU will continue to engage actively with the rest of the global financial system – including the United Kingdom – but that engagement will be on a basis that is fair, balanced and so politically sustainable over time. In addition to our high-level strategic financial services priorities, we also continue to focus on other equally important issues. The final set of Basel III reforms in the EU will be key in tackling outstanding problems in bank regulation, and we expect to come forward with a legislative proposal soon. We will also look to strengthen the rules on investor protection in MIFID, and review the MIFIR rules that govern market infrastructure for securities trading in the EU.

Work also continues on the AIFMD review and, in relation to the Solvency II Directive, to ensure the robustness of the regulatory framework, adequacy of prudential requirements and issues related to recovery and resolution.

2

FINANCIAL RISKS AND STABILITY CHALLENGES

ISSUES AT STAKE

The Covid-19 pandemic and its impact on macroeconomic prospects and the sovereign, corporate and household balance sheets dominate the outlook for EU financial stability, as well as the return of inflation in some countries. Near-term financial stability risks are contained by massive monetary, fiscal, regulatory and supervisory support. However, lasting very low interest rates and actions taken during the pandemic may generate further financial vulnerabilities related in particular to stretched valuations, high leverage and levels of indebtedness never reached before in peacetime.

Liquidity issues experienced by some money market funds and open-ended investment funds in March-April 2020 have moreover revived the debate about fund liquidity and more generally about the resilience of non-bank financial intermediation (NBFI), although the sector generally demonstrated resilience during this period in Europe. Further liquidity management rules and tools are being considered together with a reinforcement of the macro-prudential toolkit.

Alongside financial stability challenges, further reducing money laundering and better countering terrorism financing in the EU require completing the deep redesign of the related EU regulatory and supervisory framework that has been initiated.

ADDRESSING FINANCIAL STABILITY RISKS

BORIS VUJČIĆ
Governor,
Croatian National Bank

We are not out of the woods yet

In horror movies, every time that the main character seemingly escapes a suspenseful situation, you can expect a jump-scare to immediately follow. On the way out of a dark forest, there is always something awaiting the main character at its very edge. The audience knows this, but never fails to get shocked when the plot delivers on expectations. First, the emergence of a pandemic after the GFC, and now even the potential implications of the current pandemic crisis for financial stability appear to follow such a script. The remarkable recovery on the back of vaccines and extremely supportive economic policies have prevented the fallout in the financial sector. Reforms pursued over the post global financial crisis decade also helped to turn the financial system into a part of the solution, rather than the source of problems. However, the potential issues that are lurking in the background while we are heading for the exit are worrisome. And very much like in a horror movie, we cannot know in advance whether a sudden strange noise in the bushes will turn out to be just a small animal passing by or a Roubini-style mother of all crises.

The first warning sign of trouble ahead is an «overwhelming silence» - the number of corporate bankruptcies tanked during the pandemic, which is in a sharp contrast to any previous crisis episode. Exceptional public support and temporary regulatory forbearance allowed for the continuous operations even of the companies that would have exited the market under normal circumstances. Certainly, when faced with such a major shock it makes perfect sense to postpone corporate bankruptcies until uncertainty created by the pandemic somewhat recedes and to spread the inevitable bankruptcies over time in order to ease labour reallocation. But maintaining the support for too long – in another apt reference to the movie industry – creates a zombification risk over the large swathes of the corporate sector. Also, at the moment we cannot be sure how large the final tab for corporate bankruptcies will be, once it comes. Banks have heavily provisioned for potential risks arising from latent non-performing loans, but until the ending we cannot assess residual risks with a fair degree of reliability.

The unprecedented fiscal expansion has supported the corporate sector and shielded household incomes from the crisis. But it has saddled governments with substantial additional debt. The rise in indebtedness comes on top of an unfinished banking union, where the sovereign-bank nexus remains one of key vulnerabilities of the monetary union. Admittedly, the prolonged low interest rate environment eased the management of government debt, but the cost savings have already been to a great extent absorbed by government budgets and the remaining risk is for the CBs asset purchases to come to an end and rates to rise. Even if such a scenario turns out to be benign as economic growth keeps track with higher inflation and interest rates, it exacerbates the risk of a sudden asset price collapse.

There is a long and constantly evolving list of things to do and things to avoid for any movie character. Unfortunately, in the case of a financial crisis, the to-do list for policymakers mostly comprises actions that need to be taken well in advance. Yet, there are still some things than can be done in order to cushion the blow.

As to use policy tools effectively in another crisis, we need to seek to regain our policy space.

The first on the list are bankruptcy procedures. In many European countries it takes far too long to complete a bankruptcy, which incurs losses for creditors and destroys economic value in the process. Improving these procedures may not yield much gain under normal conditions, but there is a large upside in terms of economic recovery in the crisis aftermath. Moreover, we need to take a fresh look at nascent risks, such as bubbles in the residential real estate market. Indeed, a number of countries has already resumed their previous course of tightening macroprudential tools aimed at real estate, in a sharp contrast to what was done during the pandemic crisis. Finally, the same principle applies to all other policy tools: in order to be able to use them effectively in another crisis, we need to start regaining policy space as soon as realistically possible. Only if we take these steps, we will be able to shrug off the jump-scare that awaits us at some point before or at the edge of the forest.

MARIO CENTENO

Governor, Banco de Portugal and Member of the Governing Council of the ECB

Underlying trade-offs of policies promoting growth and financial stability

"Great things are not done by impulse, but by a seires of small things brought together"

- Vincent van Gogh

In a context of heightened vulnerabilities and risks to financial stability, the COVID 19 pandemic confirmed the importance of the regulatory reforms adopted in the aftermath of the Great Financial Crisis (GFC) and of the economic and financial adjustments observed in European Union countries. The authorities were able to curb, promptly, the effect of the shock, redistributing the underlying costs across agents, sectors and over time. Significant, swift and broad-based action was taken by monetary authorities, by supra and national government entities and by supervisory and regulatory authorities, both at the micro and macroprudential levels.

The materialization of risks has been limited, but the build-up of vulnerabilities was inevitable. The policy action was proportionate, but we must be cautious about possible side effects. For instance, policies adopted to mitigate corporate insolvencies and to preserve employment and household income had a positive impact on the financial sector, but led also to an increase in sovereign debt and, to a lesser extent, in firms' indebtedness. Thus, the reversal of the current benign financing conditions is a challenging task, requiring a fine-tuning equilibrium between these opposing forces.

The low profitability of the banking sector, in a low-interest-rate context and with increased competition from technology companies, may hamper banks' capacity to deal with the current challenges, including an increased credit risk due to the pandemic crisis. The extraordinary effort of coordination of fiscal, monetary and regulatory and supervision policies must continue and be adapted to each stage of the crisis.

Climate change and cyber risks arising from increased digitalization in our economies and, in particular, in the financial sector, have been gaining relevance. The frequency of events related with these risks is reinforcing the urge to adopt adequate policy initiatives. In what concerns climate change risks, the transition itself will be a challenge to be faced, with potential relevant financial implications. Despite subsisting insufficiencies in data gathering and concept harmonization, regulators, supervisors and supervised entities are preparing to face and mitigate these emerging risks.

When assessing the importance of the existing challenges, we need to take into account the existence of important mitigants. Among these, it is worth mention several pre-crisis outcomes. The reduction in private sector debt in many European countries, in particular in those most affected by the GFC; the improvement in government primary balance and the compliance with European fiscal targets, namely, the medium-term objective; the increased resilience of the banking sector, namely in terms of liquidity, solvency and reduction of NPLs; and the deepening of the European financial institutional framework. All of which have evolved favorably in recent years, even if we should resume them as they remain incomplete.

We have reasons to be optimistic. Uncertainty about the recovery path subsists, in terms of timing but also of its nature/composition, considering the uneven position among sectors.

It is the overlapping of painstakingly and thoroughly thought solutions that will lead us out of this crisis.

The mile ahead of us is the one where we can expect more intense economic adjustment – in a context of increased insolvencies and changes in consumer patterns. We do not need to be a devoted Schumpeterian to express this expectation. Consumers will resume benefiting from a substantial accumulation of savings, but again low-income households may face strong challenge in the recovery and in the adjustment to the digitization and automation processes, and those firms ill prepared to face a crisis like this will require some degree of restructuring.

We cannot be complacent and rest on the early signs of recovery that economic data already reveal. We need to remain vigilant. As in Vicent van Gogh's painting, it is the overlapping of painstakingly and thoroughly thought solutions that will lead us out of this crisis to great things. Policy by impulse must be avoided; existing measures must be phased out, adapted and new measures adopted in tandem with the evolving economic situation. Maintaining measures for a too long may introduce distortions and contribute to the build-up of vulnerabilities, but their premature withdrawal is going to jeopardize economic recovery, which we should aim to be robust, sustainable and inclusive.

The pandemic reinforced our Economic and Monetary Union and strengthened the ground for further integration. European initiatives should maintain the same ambition. The Banking Union and the Capital Market Union have to be part of this effort. This is a privileged position to agree on the necessary adjustments to our single rulebook and for an improved framework design.

ADDRESSING FUND LIQUIDITY RISKS

ROBERT OPHÈLE

Président, Autorité des Marchés Financiers (AMF)

Vulnerabilities for MMFs and other OEFs

The covid-19 crisis severely hit the real economy and this put the financial system under acute stress. In March 2020, stock prices plummeted, interest rates spiked driving bond valuations down, margin calls increased and the short term funding market (STFM) froze completely. Unprecedented government support was (and still is) provided to households and private companies, while central bank interventions restored liquidity on the fixed income markets by the beginning of April.

In the asset management industry, concerns arose about open-ended funds (OEFs), and in particular with money market funds (MMFs), corporate bond funds and real estate funds, which had to withstand significant redemption pressures. While we must acknowledge that in general, they coped with the crisis reasonably well, much work is undertaken at the international level to improve their resilience.

MMFs are key intermediaries in the STFM, as they collect investors' excess cash to purchase short-term debt instruments issued by banks, corporates and public administrations. In the decade following the 2008 Global Financial Crisis, their regulatory framework was substantially strengthened, first in the US with the 2014 SEC reform and then in the EU with the 2017 MMF Regulation. Yet the March 2020 turmoil still put some segments of the market under severe pressure: broadly speaking, private-debt MMFs faced a massive wave of redemption, while public-debt funds accumulated inflows. Despite this general pattern, the various jurisdictions dealt with very different situations, due to national specificities in terms of regulatory regimes (stable vs. floating NAV, sponsor support), currencies (EUR, USD, GBP), or composition of the investor base.

The crisis highlighted several vulnerabilities of the STFM ecosystem: First and foremost, the market for short-term debt paper is opaque (OTC essentially) and segmented (NEU-CP, Euro-CP, with the overlapping STEP label). Investors are typically buy-and-hold, and the secondary market is thus extremely thin.

The March 2020 turmoil revealed structural vulnerabilities in the short-term funding markets.

Paper issues are poorly covered by commercial data providers, scarcely rated by large CRAs, usually not targeted by central bank interventions and it is difficult to get an accurate picture of prices or outstanding. Eventually, the STFM is not regulated by market authorities, no fully fledged market-making mechanism has been designed, and no last-resort liquidity provision is embedded. During the March turmoil, central banks had to intervene to re-open the STFM (i.e. provide short-term funding to banks and corporates) which eased the redemption pressure on MMFs. Improving the functioning of the STFM should be the primary objective of any ambitious policy reform.

Second, beyond investors' actual need for cash, it seems that some redemption behaviors were motivated by first mover advantages (FMA) introduced by regulatory features, such as amortized cost valuation which creates an artificial discrepancy between the funds' NAV and its actual market value, or automatic imposition of fees and gates when ratios reach predefined limits. Removing so-called "stable NAV" funds to allow them to reflect the actual value of the portfolio, as well as avoiding as much as possible automatic cliff-effects should help mitigate FMA in the future.

Last, assuming we have a fully operational STFM which allows to efficiently value funds and price them at their actual market value, we should encourage the adoption of liquidity management tools (LMTs) such as swing pricing to ensure that redeeming investors bear the cost of the low liquidity encountered in stressed situations. Activating such tools should remain the sole responsibility of fund managers. Indeed, supervisory action within a macroprudential framework might feed moral hazard or even have unintended effects on investors' incentives.

Other open-ended funds (bond and real-estate funds) faced acute redemption pressures together with a drying-up of the liquidity (with associated valuation uncertainties) on the underlying market. We have to insist on the need to align the dealing/NAV frequency with asset side liquidity and introduce liquidity management tools (such as swing pricing or gates) more broadly: these elements seem to have been very efficient in helping funds withstand the crisis (only a very limited number had to resort to suspension).

Yet, the crisis put to the forefront three issues: First, the consequences of vertical slicing vs. waterfall in terms of equal treatment of investors must be assessed. LMTs should avoid that redeeming investors be paid with the most liquid assets, leaving remaining holders with a distorted portfolio. More data on effective portfolio management must be gathered. Second, we heard that a wider implementation of some LMTs could be compromised by technical constraints (e.g. for custodians): this remains to be investigated. Eventually, a clearer regulatory framework for those LMTs currently only governed by professional guidelines might be needed to ensure proper calibration.

FRANCESCO MAZZAFERRO

Head of the European Systemic Risk Board Secretariat (ESRB)

Investment fund risk – The macroprudential perspective

Investment funds play an important role in the EU financial system. Their investments in equity and corporate debt help firms to raise financing and to grow. And the ability to spread investments across a range of assets enables households to participate in the gains from economic growth while diversifying the risk any investment entails.

But investment funds can also pose risks to the financial system. Although the European Systemic Risk Board (ESRB) is mindful of the benefits of investment funds, its mandate is to look at risks to financial stability. In this vein, the ESRB issued a recommendation in December 2017 to address vulnerabilities stemming from investment funds that have short redemption periods and invest in less liquid assets and those that use excessive leverage. During times of stress, liquidity mismatches increase the risk of further pressures on asset valuations. This can happen if investment funds seek to sell assets that are inherently illiquid, or that turn illiquid during stressed periods, over a short period of time to meet redemptions. Such fire sales could lead to higher mark-to-market losses for other financial institutions with exposures to the same or correlated assets, or to an abrupt tightening in financial conditions. Excessive leverage in investment funds can further amplify this transmission mechanism.

The market turmoil at the onset of the coronavirus (COVID-19) pandemic showed that the regulatory reforms implemented after the global financial crisis did not address all sources of systemic risks in the investment fund sector. The ESRB identified money market funds (MMFs) and open-ended investment funds with large exposures to real estate and/or corporate debt as particularly vulnerable. The ESRB issued a recommendation in May 2020 to address risks in real estate/corporate debt funds and in January 2021 provided input to the forthcoming review of the Alternative Investment Fund Manager Directive (AIFMD). Therefore, this article primarily covers MMFs, which are the focus of the policy proposals currently being developed.

> **The March 2020 turmoil showed reforms are needed to address vulnerabilities in investment funds.**

There is an underlying tension between the economic functions performed by MMFs. MMFs perform two primary economic functions for the financial system and the real economy: (i) providing short-term funding to issuers, mainly banks; and (ii) being used as cash management vehicles by investors. Tension arises because MMFs offer on-demand liquidity to investors and are often assumed to be cash-like instruments, but the instruments in which they invest are not reliably liquid, especially during periods of stress. The tension can be exacerbated in funds that offer a quasi-stable net asset value (low-volatility net asset value – LVNAV), as such funds face an additional valuation constraint.

This underlying tension can become of systemic concern during market stress and require policy intervention. Under normal market conditions, MMFs are largely able to meet investor redemption requests from the liquidity within their portfolio. But the onset of the pandemic brought this underlying tension to the fore: some MMFs investing in private sector debt securities experienced acute liquidity strains when faced with a high level of redemptions by investors combined with a lack of liquidity in private debt money markets. This led to concerns that liquidity strains in those MMFs could amplify the effects of the COVID-19 shock in other parts of the financial system. The situation was particularly serious in the United States and the EU and improved only after exceptional measures were taken by the Federal Reserve System and the European Central Bank under their respective monetary policy mandates.

The ESRB will refine policy options for reforming the MMF Regulation in the second half of 2021. The ESRB set out policy options to reform MMFs in an Issues Note published in July 2021. Some of these options consider the functioning and structure of the underlying markets in which MMFs operate, the investors holding MMF shares/units, and the regulatory framework for MMFs. In view of the forthcoming review of the MMF Regulation in 2022, the ESRB will focus on those policy options that would address vulnerabilities within MMFs themselves. This policy work will be guided by three key desired outcomes: (i) removing first-mover advantages for investors, which was also a key consideration in the previous ESRB recommendation on MMFs of December 2012; (ii) not limiting the proposals to LVNAV funds but considering the vulnerabilities of the entire sector; and (iii) ensuring the resilience and functioning of MMFs without the need for central banks to step in during crises.

To summarise, the March 2020 turmoil showed reforms are needed to address vulnerabilities in investment funds. The ESRB issued a recommendation to address risks in open-ended investment funds with large exposures to real estate and/or corporate debt. It also provided input into the review of the AIFMD and will make proposals to address risks within MMFs.

This article has been co-written with Olaf Weeken, Adviser, ESRB Secretariat.

GERRY CROSS
Director Financial Regulation – Policy and Risk,
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Responding to liquidity risks in investment funds

Since the global financial crisis of 2008, regulators have focused on mitigating liquidity risks in investment funds. The COVID-induced shock of March 2020 has demonstrated that more work needs to be done to ensure investors are protected, and risks to the financial system are minimised.

We know that during periods of financial stress, a flight to safety and heightened demand for cash can suddenly increase redemption requests received by investment funds, making it challenging to maintain adequate liquidity. Last year, this unanticipated increase in redemptions was not seen universally across the asset management sector. However, it was most pronounced in funds that were exposed to illiquid assets, or assets that had become temporarily illiquid.

From a regulatory perspective, the inherent first mover advantage of open-ended funds, which incentivises investors to redeem early to get ahead of other redeeming investors, must be addressed. Redemptions of this kind contributed to the strain on investment funds in March 2020, and measures to address first mover advantage, such as swing pricing, feature in the recent FSB consultation on Money Market Funds (MMFs).

Pre-emptive redemptions occur for a range of reasons, including because investors fear that transaction costs (which can be abnormally high during periods of stress) will be borne by those who remain in the fund. To address this, we must consider how the costs of liquidity can be passed on to redeeming investors. The use of anti-dilution mechanisms, like swing pricing, has important potential in this regard and there is some evidence of increased usage in recent years. However, this is not universal with some asset managers still reluctant to deploy such tools. Moreover, there are important calibration challenges to be addressed if such tools are to contribute to addressing financial stability risks arising from the funds sector.

If carried out effectively, swing pricing can improve liquidity management during market stress in two ways. Firstly, it internalises the cost of liquidity so that redeeming investors pay the associated costs and remaining investors are not left worse off. Secondly, there is a behavioural impact – when swing pricing is in operation the incentive to pre-emptively redeem from the fund is minimised. This helps to limit the total redemptions experienced by the fund and helps to avoid a fire sale whereby the fund must immediately sell assets to meet its liabilities.

Funds' liquidity management should be strengthened, particularly for MMFs.

Strengthening the liquidity management framework is particularly relevant for Money Market Funds (MMFs), given the acute liquidity strains experienced by some MMFs in March 2020. Underpinning the work on MMF reform is a consideration of the extent to which resilience can be increased, while retaining both the sector's cash management function and its provision of funding to the real economy. In normal times, there is no conflict between these two roles, as MMFs provide daily liquidity to investors and hold short-dated commercial paper without any adverse liquidity challenges. However, during periods of stress, MMFs simultaneously encounter an increase in redemptions and a reduction in market liquidity for the securities they hold. In these situations, there appears to be a misalignment between the liquidity expected by investors, and the liquidity of the securities held by the fund.

Considering the role of regulatory thresholds in MMFs is also important. During the Covid-19 shock, MMF managers were reluctant to dip below the 30% weekly liquid asset requirement set out in the EU Money Market Fund Regulation. This was partly due to the fact that this threshold created a first mover advantage, whereby investors, conscious that the fund would have to consider using fees or gates, would seek to redeem from the fund before such liquidity management tools were applied.

It is worth noting that as policymakers we do not face a binary choice, and must consider how the eventual MMF reform package can retain both funding and cash management functions to the greatest extent possible, while reducing the sector's contribution to systemic risk.

It is true that the vast majority of investment funds were resilient to the Covid-19 shock, but this was in the context of significant central bank interventions which supported the return of normal market functioning. Enhancing the liquidity risk management framework for investment funds is needed to ensure that funds can continue to operate in the best interest of investors during periods of stress, as well as during normal times.

SIMON JANIN
Head of Group Public Affairs, Amundi

Money Market Funds: a precious asset of the European financial sector

As their name rightly suggests, Money Market Funds (MMFs) are collective schemes invested in money markets. Should the latter face a serious liquidity crisis, it would be unrealistic to expect zero impact on the former. Which is exactly what happened in March 2020 at the time of the COVID-19 pandemic outburst. As lock-down measures spreading across the world, especially in the currency-areas where MMFs are present, a significant number of real economy actors faced either a sudden drop in their revenues (mainly corporates), or a sudden rise in their immediate or near term spending (mainly Institutions and public agencies). This exogenous, unprecedented shock led to a rapid "dash for cash" behavior where big clients of banks massively drew down their credit facilities with a consequential sizable outflows for MMFs.

That said, while it is certainly essential to try to achieve further resilience of MMFs, it's also of paramount importance not to overemphasize the role of MMFs during the crisis and thus avoid trying to fix something that is not broken. In a context where MMFs are under greater regulators' scrutiny, it's then important to recall that these funds are rather the "canary in the coal mine", than the source or an amplifying element of the crisis.

COVID-19 pandemic triggered a liquidity crisis, not a credit crisis. This makes a huge difference when compared with the Great Financial Crisis of 2007-2008. Such fundamental point should has to be kept in mind when reflecting on what should be reviewed in existing legislations (MMFR in the EU). And in this respect, we can only subscribe to the Financial Stability Board (FSB) assertion that "MMF reforms by themselves will not likely solve the structural fragilities of STFMs [short-term funding markets][1]".

In addition, it should be reminded the various benefits that these investment vehicles bring to the real economy thanks to their key role in the financial sector. By purchasing and, most of the time, rolling, a significant part of money market instruments (including financial and non-financial Commercial Papers), MMFs represent an efficient, stable and reliable source of funding for great part of real economy actors, in both public and private sectors. By providing their holders with diversified, low volatile, competitive, strongly-regulated collective schemes, MMFs are one of the most efficient means to invest excess liquidity, and represent a valuable alternative to bank deposits. In other words, by smartly and regularly linking borrowers and investors within the short-term markets, MMFs play their role to favor financial stability.

MMFs are rather the "canary in the coal mine" than the source or an amplifying element of the crisis.

This being said, we do not believe that we should remain complacent and do nothing. In our opinion the regulatory responses to COVID-19 crisis should pursue two objectives: (i) improve money markets liquidity and (ii) enhance MMFs' resilience by providing targeted additional rules or targeted adjustments to existing regulations that have proven to be resilient during the crisis.

As regards the first objective, underlying markets should benefit from more transparency and smoother functioning. And a lot can be achieved: standardization of instruments, market transparency (with the Banque de France - sponsored NeuCP market as an example to follow), incentivisation of dealers, and facilitation of processes granting CPs' eligibility to refinancing operations. While we fully understand Central Banks' reluctance to intervene, we also believe that ensuring the good functioning of markets is in their remit.

With respect to the regulatory options, we do not believe that reopening MMFR should be a path to follow. However, targeted amendments could definitely be made and they should mostly focus on liability management of MMFs.

First, Article 27 of MMFR, on Know Your Customer (KYC) could be clarified and enriched through level 2 or 3 additional guidance, as it is already the case for Credit Quality Assessment.

Second, and consequently to the above proposal, asset management companies would assess their own need for an additional bucket of liquid assets. The level of this additional liquidity buffer would derive from each MMF's stressed liability structure and the assets to be considered as "liquid" (thus eligible to the composition of the liquidity buffer) would have to be defined. These evolutions could be specified through levels 2 or 3 guidance as well.

Third, adjustable exit fees could be made mandatorily available for all MMFs, as a Liquidity Management Tool (LMT), taking the shape of an anti-dilution levy (ADL), used in times of exceptionally stressed market conditions.

Given the specific features of MMFs, like "same-day settlement", we consider that adjustable exit fees represent the only workable ADL on an operational standpoint.

[1] FSB, Policy Proposals to Enhance Money Market Fund Resilience, June 2021

DENNIS GEPP
Senior Vice President, Managing Director and Chief Investment Officer, Cash,
Federated Hermes (UK) LLP

Money Market Funds have passed the "mother-of-all" stress tests

When addressing the perceived vulnerabilities of money market funds (MMFs), policymakers should follow the data, adopt a holistic approach and watch for the survivor bias. If policymakers consider the wealth of data available, and a broad view of the short-term funding markets (STFMs), they should realise that the March 2020 stresses were not due to the vulnerability of MMFs.

The dislocation in March was caused by a global economic shock to the system, resulting from the decisions of governments around the world to shut down their economies to prevent the spread of Covid-19.

If policymakers watch for the survivor bias, they should look at the MMFs that did not pass the real-life stress test in March to figure out the vulnerabilities to address. Hold on! "All redemptions have been honoured, no MMFs have suspended redemptions, imposed fees and/or gates, or converted from LVNAV to VNAV" IOSCO reminds us.

So, what are the vulnerabilities that March 2020 events highlighted? There are two:

- An artificial regulatory incentive for MMF investors to redeem. This is because in the US and the EU certain MMFs have to consider the imposition of liquidity fees and gates if weekly liquid assets (WLA) fall below a 30% threshold. This proved to be an accelerant for redemptions and was an unfortunate unintended consequence of policy reforms.

- Vulnerability in the STFM structure and functioning. "The lack of a market-maker of last-resort makes this market very vulnerable to liquidity crises" rightly observes the French Autorité des marchés financiers (AMF) in its 2021 Markets and Risk Outlook. The way in which short-term finance markets operate remains very opaque and characterised by an extremely limited secondary market.

The March 2020 stresses were not due to the vulnerability of MMFs.

Let's address these two policy priorities, by adopting a two-pronged approach:

1. Delinking the liquidity requirements and potential imposition of a fee or gate. Data supports that delinking the 30% WLA threshold from the consideration of fees and gates would have greatly alleviated the liquidity stress in the EU money markets and would have removed an artificial regulatory incentive for MMF investors to redeem; and

2. Enhancing the resiliency of STFMs with considering, among others, reforms to the secondary market structure, standardisation of issuances, improving transparency, reviewing regulations that affect market-making, and the creation of a permanent standing repo facility. Economic analysis shows that any policy that increases the STFM depth and liquidity will have a very large influence on the ability for MMFs to face larger redemptions. In its Report on Trends, Risks and Vulnerabilities 1/2021, ESMA concludes that "increasing the liquidity of the underlying markets has, in that simulation, a very large effect on the resilience of MMFs". Improving the functioning and liquidity of money markets, would encompass a range of reforms related to market structure and transparency, as well as reforms related to incentives for dealers to provide liquidity in time of stress. [...] In our model, improving the liquidity of money markets has a very large effect on MMF resilience.

The other policy options the Financial Stability Board (FSB) advances are either unnecessary or inappropriate. A couple of examples:

- Swing pricing would not only eliminate a critical element of MMFs (same day and intra-day settlement), effectively regulating MMFs out of existence, but swing pricing is entirely unnecessary for MMFs as they already not only have the ability to apply liquidity fees generally, but are also required to price securities in their portfolio at the more conservative of the bid/ask spread.

- A minimum balance at risk (MBR) would eliminate the very liquidity of MMFs that has been central to their widespread use in a variety of applications.

- A capital buffer does not prevent large scale redemptions or stop them once they have begun. Capital buffers do not serve a purpose in an investment product such as MMFs where the investor bears the risk of loss of a portion of its investment.

There is a tremendous value to having a market in short-term securities – for companies to fund their operations and manage their cash, for savers to have investments with market returns and for capital formation in the intersection of this supply and demand.

Questioning or limiting the role of MMFs, or worse, regulating them out of existence, would prevent millions of investors from benefiting from them and would be a very bad outcome for issuers and markets.

OMAR CHANAN

Head of Global Risk Management, Capital Group

Drawing the right conclusions from last year's market turmoil is necessary ahead of the next regulatory steps

With the peak of the Covid-19 pandemic's impact on capital markets being a year past, the international regulatory community is working on drawing the appropriate lessons and obtaining insight to address future liquidity crisis. Understanding what went wrong and working together on the kinds of failures that can and should be prevented in the future is critical both from a financial stability and an investor protection perspective.

Amid the heightened market volatility and with much of the world rushing into lockdown in spring of last year, open-ended funds were faced with significant deterioration in market liquidity. In addition, segments of the funds industry were faced either with valuation constraints or large-scale redemption requests and investor outflows. These key market dislocations that occurred had effectively been a "real-life liquidity stress test" for open-ended funds.

In this setting, only a limited number of funds suspended subscriptions and redemptions while the vast majority were able to meet redemption requests and maintain their portfolio structure (ESMA, Nov 2020). One important conclusion to draw from this real-life stress test is that this can be seen as a confirmation of the sector's overall resilience to such market pressures and of the liquidity risk management processes and tools available in Europe as a key line of defence.

We saw successful liquidity risk management processes focused on the portfolio composition and underlying securities' liquidity characteristics, market conditions, asset eligibility and the funds' liquidity demands. During both normative and stressed environments, the redemption process is typically designed to maintain the investment profile of the fund. A pro-rata approach may be applied when certain redemption size thresholds are met with the focus on keeping the portfolio risk positioning and investment profile consistent with the investment strategy. To this end, a range of liquidity management tools are available for risk management functions to address different scenarios of stressed market conditions.

This real-life stress test can be seen as a confirmation of the liquidity risk management processes and tools available in Europe as a key line of defence.

Based on these available processes and toolkit, UCITS funds were largely able to effectively address the recent crisis. Even after the recent turmoil fund management companies are remaining vigilant against any further liquidity crisis, which also includes refining the documentation and processes related to contingency plans to ensure any identified issues are well understood internally and externally.

If we consider the liquidity tools utilised during the recent crisis, the regulatory focus has shifted towards the use of swing pricing. What is important from a regulatory perspective is not prescribing the cases in which swing pricing can or should be called to address liquidity risks, but ensuring its availability and possibility to be operational in every jurisdiction, leaving it to the manager to assess its usefulness under certain conditions. It is ultimately at the risk management team's discretion to assess whether in a given scenario it can help achieve the goal of protecting the interests of remaining investors in the fund, against the costs of facilitating subscriptions and redemptions.

While we believe the recent turmoil demonstrated the ability of open-ended funds to monitor and respond to external risks and the appropriateness of the existing liquidity risk management tools, there is merit in further investigating the reasons for specific pressures in some market segments and preventing potential wider market disruptions and spill over effects.

For those market segments that were faced with increased liquidity pressures it is important to further assess the specific conditions that led to the recent challenges and understand whether these are connected to funds' own structure and characteristics or if they are linked to market-wide dislocations and volatility aspects not inherent to funds. In this context, regulatory changes for particular segments of open-ended funds can be useful to the extent they address identified flaws linked to their design and operation.

However, trying to impose a one size fits all approach and additional layers of regulation for all open ended-funds, as a way to address the specific conditions and root causes of those actors which faced increased liquidity pressures, could lead to ineffectiveness and entail unintended pro-cyclical risks, as it would incentivize an identical approach for all funds in view of similar market dislocations.

We believe there is room to use the very useful findings of the recent market turmoil to address any remaining gaps while at the same time acknowledging the need for measures that best apply to the specificities of the sector. Post this COVID-driven period of stress, it remains crucial to balance further regulatory steps with the need to maintain the industry's ability to contribute towards the economic recovery and future growth.

REDESIGNING EU AML POLICY

DOMINIQUE LABOUREIX

Secretary General,
Autorité de Contrôle Prudentiel et de Résolution (ACPR)

AML-CFT challenges in an era of pandemic and accelerated digitalisation

The last two years have been marked by an upheaval and by the continuation of a deep trend: the upheaval is of course the COVID-19 pandemic, with all its impacts on our daily life, from the way we work to the way we shop; the deep trend is the digitalisation of finance. No need to say that both have a strong impact on multiple aspects of the economy: international interconnectedness, customers and firms behavior, materiality of risks… AML-CFT is no exception.

The pandemic renews the opportunities for all kind of scammers (fake medical material, frauds facilitated by the lockdown, etc.) but also offers specific money laundering opportunities to criminal networks. The freezing of the economic activities created urgent needs of funds once the activity has started again: real estate operations, need for own funds, firms restructurings, etc. All these operations become more urgent than ever… and with urgency come lesser awareness and diligences regarding the origin of funds. Since the very beginning of the pandemic, FATF, FIUs and Supervisors have alerted the public and the obliged entities on these increased AML-CFT risks. As an example for France, ACPR published on its website (https://acpr.banque-france.fr/communications-de-lacpr-dans-le-contexte-de-la-pandemie-covid-19) a series of communications for banks, insurance companies and also for the public. In addition, ACPR intensified its bilateral dialogue with all major obliged entities during this period.

Digitalisation of finance is now an "old" new trend as it started with traditional actors recruiting new clients online. What is new is more the multiplication of status and regimes: traditional banks or insurances companies, electronic money institutions, payment institutions, virtual assets services providers, FinTechs, Big Techs… not all of them being regulated and subject to AML-CFT regulation. The challenge here is to avoid anonymity and to maintain traceability: new technologies could help for both if AML-CFT risks are taken into account from the very beginning in every project. The role of the authorities is therefore to give clear and quick guidance to all actors.

As money laundering ignores the borders more than ever, an appropriate EU wide solution is needed.

Regarding the limitation of anonymity, it is important to develop secure digital identity solutions, which could be easily used by all digital finance actors. To achieve solutions efficient for business and robust from an AML-CFT point of view, it is particularly useful to gather all competencies and stakeholders: Authorities, private sector (traditional and digital economy) and Cybersecurity Agencies. Such a wide range of participants allows to share experiences, to examine AML-CFT obligations before developing technical solutions and to remain technologically neutral.

Regarding the need for traceability, two aspects are of the utmost importance in this sector, where the business models frequently involve dozens of participants: first, the implication in the fight against money laundering and terrorism financing of every participant in the operation or transaction, irrespective of its status or location; and second, the quality and integrity of information collected regarding the operation, its originator and its beneficiary, from its initiation to its conclusion. All actors shall therefore be subject to sufficient AML-CFT obligations to be able to detect suspicious activities. Additionally, the so called "travel rule" is absolutely essential to allow every actor to efficiently conduct its diligences and to give relevant information to the FIUs or Law Enforcement Agencies.

Money laundering of criminal profits ignores the boarders and especially with the pandemic and the development of digital finance. AML-CFT regulations shall be established at European or even worldwide level to limit the possibility for criminal networks to make use of their illicit profits. At European level, the future legal framework should ensure a greater harmonization of AML-CFT obligations to ensure level-playing field and to avoid divergences in their practical enforcement. This is particularly true as regards online services and remote onboarding of customers, activities where the freedom to provide services is particularly developed. This future framework shall of course meet all current FATF standards but also proactively inspire the future standards.

The July Commission AML package is an attempt to provide for a global answer to all these challenges. In particular, the launch of a new dedicated authority could be a real leap towards more efficiency if an appropriate balance is found to preserve the existing mechanisms, when proved efficient. For instance, complementarity of permanent off-site and punctual on-site supervision is essential as well as close interaction with the obliged entities for their outreach.

MARTIN MERLIN

Director, Banking, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

AMLA – institutional heart of the new European AML/CFT framework

The EU-level AML/CFT Authority (AMLA) is the embodiment of the institutional reform of the Union AML/CFT framework in the areas of supervision and work of financial intelligence units.

AML/CFT supervision within the EU is currently Member State-based. Its quality and effectiveness are uneven, due to significant variations in resources and practices across Member States. As recent cases of alleged money laundering involving EU credit institutions show, the approaches to cross-border situations are not consistent.

AMLA will become the centre of the new integrated Union AML/CFT supervisory system. This system will be stronger and more effective than the sum of its current parts – individual national supervisory authorities without the coordinating centre.

The Authority will have direct and indirect supervisory powers in the financial sector and indirect oversight tasks in the non-financial sector.

AMLA will directly supervise some of the riskiest financial sector entities. In the spirit of the system-based approach, supervision will be carried out by Joint Supervisory Teams – including staff of AMLA and supervisors from relevant national authorities. AMLA staff and national JST members will work together on the ground, and propose common decisions to be taken and enforced by the independent Executive Board of AMLA. The decisions and enforcement tools will be just as comprehensive as they are at national level, with the possibility to address binding decisions and to impose significant sanctions in cases of non-compliance with Union requirements.

It is important to keep in mind that AMLA is not meant to replace national supervision for all high-risk financial sector entities, and indeed many risky ones will remain supervised at national level – simply because in most cases national supervision is adequate. However, the single supervisory system is about more than just direct supervision and joint supervisory teams. This system will be underpinned by common supervisory methodologies and convergent practices, as well as centrally enabled and coordinated knowledge and information-sharing. The legislative proposal envisages mechanisms of mutual assistance, including the exchange of staff, expertise and best practices, as well as some joint supervisory exercises.

AML/CFT supervisors & FIUs need a single support centre, the heart of the system – it will be AMLA.

We aim at better supervision across the Union, also at national level. Therefore, regulatory, convergence and indirect supervision tasks are all equally important to ensure the success of the new AML/CFT supervisory system.

The improvement in the exchange of information and cooperation between FIUs is an equally critical rationale for the institutional reform. All recent major money laundering cases reported in the EU had a cross-border dimension. The absence of a common structure to underpin cooperation between FIUs leads to situations where necessary joint analyses are not performed for lack of common tools or resources. These divergences reduce the capacity to detect money laundering and terrorism financing early and effectively, resulting in a fragmented approach that is exposed to misuse for money laundering and terrorism financing.

For FIUs across the Union, AMLA will become an enabler for more effective and efficient execution of FIUs' strategic and operational tasks. It will provide stable hosting of the communications network FIU.net and will ensure organisation and conduct of joint analyses of suspicious cross-border transactions and activities. AMLA will also be the centre of mutual assistance and the guardian of convergence of practices among all EU FIUs.

Timely identification of trends and typologies at Union level and facilitation of joint analyses of suspicious activities and reports will directly contribute to the prevention of incidents of money laundering and terrorism financing in the Union.

In both capacities, AMLA will be empowered and mandated to cooperate closely with all other relevant Union bodies and entities, as well as relevant national authorities, such as prudential supervisors. AMLA will also be entrusted with a leading role in interactions with third country authorities for matters with a cross-border dimension and falling within the remit of its tasks.

Both AML/CFT supervisors and FIUs need a single support centre, the heart of the system – it will be AMLA.

FRANÇOIS-LOUIS MICHAUD

Executive Director, European Banking Authority (EBA)

Fighting ML/TF in the age of digitalisation: the importance of a tech-led fight

The use of technology in financial services is not new.

The industry has always been evolving to look for better, faster, and more efficient ways of conducting its business. What is new is the pace at which technology develops, and the pace at which it transforms lives.

Like in other areas, technology has the potential to reshape what effective anti-money laundering and counter-terrorist financing (AML/CFT) measures look like: it can be a game changer for institutions, who can take a commercial advantage of more effective and efficient compliance systems and processes; it can be a game-changer for supervisors, who can transform their money laundering and terrorist financing (ML/TF) risk assessment processes using a dynamic data-led approach; and it can be a game-changer for consumers, as long as due to the implementation of such measures they can benefit from better and more secure access to financial services. And still, the use of the most innovative technologies to fight ML/TF is not as widespread as desirable.

The challenge for regulators is to ensure that the new digital tools and processes to fight ML/TF are used in a way that harnesses the benefits innovative technology offers, while keeping the risks associated with them under control.

In the area of AML/CFT, this means:

Firstly, putting in place a legal and regulatory framework that is technology neutral and supports the continuous development and implementation of new approaches to tackling ML/TF in Member States and across borders. The European Commission's move towards greater harmonisation of Customer Due Diligence (CDD) requirements constitutes an important first step in this regard and needs to be complemented by clear rules on data pooling, data sharing and data processing.

Secondly, creating a supervisory culture where technology and innovation is understood and embraced, rather than viewed with suspicion. The EBA has put in place cooperation platforms such as the FinTech Knowledge Hub, that bring together institutions, technology providers, supervisors, and many other relevant stakeholders, to raise awareness of innovative technologies, share information on relevant regulatory developments and close knowledge gaps that may hamper the scaling up of financial innovation.

Digitalisation is a game changer to fight ML/TF - but some associated risks need proper mitigation.

Thirdly, developing a common understanding of the risks associated with the use of new and emerging innovative technologies such as data privacy requirements and user friendliness to all categories of consumers and how to address them to ensure the responsible use of innovation for AML/CFT compliance purposes. The EBA has been leading the debate in this field since 2018 with guidance on the use of innovative solutions in the CDD context and regular updates on market developments, vulnerabilities, and threats.

The EBA's 2021 stocktake on the use of RegTech in the EU Financial Sector shows that this for AML/CFT that such solutions are by far the most frequently used. Yet, risks exist that relate inter alia to the over-reliance on the same AML/CFT compliance solutions in and uneven awareness of the limitations of RegTech in the AML/CFT compliance space. Technology enhances, but cannot replace, human skills and expertise in the fight against financial crime.

The EBA works to facilitate the safe and sound uptake of technological innovation and remains committed to leading, coordinating and monitoring the EU financial sector's transition towards a better and more effective, technology-led fight against financial crime.

JESPER BERG
Director General,
Danish Financial Supervisory Authority (Finanstilsynet)

Efficient use of technology and data is key in fighting financial crime

To my mind, there is no doubt that technology and data must be leveraged more efficiently if we are to succeed in the fight against financial crime.

A recent report by the Danish Financial Supervisory Authority (DFSA) highlights exactly this.[1] Technology can support increased automation of static and manual procedures, thereby allowing resources to be allocated where the risk of money laundering is highest. It can also help increase the accuracy of risk assessments and classifications of customers as well as transaction monitoring.

The feedback on the report, internally known as project AML/TEK, has mainly been supportive of the initiatives analyzed in the report, inter alia:

Create (or enhance) national electronic IDs to verify customer identity. eIDs can ease the onboarding of most customers, as banks would no longer need copies of passports and other documents. It would also reduce hassle for the customers.

Build digital data registers to verify business identity. Registers should be able to provide high-quality information (e.g. certified by lawyers or auditors) that banks can use when onboarding businesses.

Encourage banks to build shared KYC utilities. The banking sector would greatly benefit from a centralized database of customer information that can also be fed by to public registers – and customers with several banking partners would also benefit.

Allow banks to share risk flags. Money launderers often use multiple banks, making it difficult for any one of them to identify suspicious transactions. Being able to share data will give everyone a fuller picture of a customer's banking activity. It would also prevent those who are barred from one bank for suspicious activity from simply moving to another bank across the street.

Make it easier to screen for politically exposed people. Governments often have information on individuals, which can be used to identify relatives and close associates of politically exposed persons (PEPs). Making this information available for bank queries would improve the PEP-screening process while at the same time ensuring data minimization.

Give banks access to other relevant data. Public authorities hold all kinds of information that could be useful for banks trying to prevent laundering. Police could also share what they know about how criminals behave to help banks identify suspicious transactions.

Technology and data must be leveraged better to succeed in the fight against financial crime.

Unfortunately, there is no such thing as a free lunch. Increased data-sharing raises important questions about privacy and legal rights. For example, granting increased access to authorities' data and allowing banks to share risk flags could conflict with data protection regulations (in the EU the GDPR), anti-money laundering legislation (in the EU the AMLD) and even banking secrecy norms. Sharing data also creates a risk that an individual or a business becomes non-bankable without being able to challenge this. We need a public, transparent debate on the issues to ensure that we reach the right balance of this trade-off.

It is also necessary to ensure that the regulatory framework allows for the use of technology, which presupposes increased harmonization and guidance.

There is a natural barrier to being a first mover in applying new and advanced technologies. For example, it can be costly to implement and adapt new technologies, while the reputational costs can be huge if unsuccessful and the regulatory response can be uncertain. It can be also difficult to predict all new risks associated with new technologies, and the efficient use of new technologies for some tasks requires that consensus is reached on e.g. data harmonization. Regulators thus need to set out clear regulatory expectations.

Denmark is a highly digitized society with a strong tradition for public-private cooperation, which is the perfect environment for a move towards increased use of technology. Hence, the DFSA believes that some of the less complex initiatives presented in project AML/TEK can be implemented within a couple of years. However, the DFSA is also of the view that the full potential of technology cannot be achieved without more collaboration, both nationally and internationally. This includes developing public-private partnerships, providing guidance on the right use of technologies, as well as increasing the room for data sharing.

Financial crime is a societal problem, and criminals use advanced methods that often put them one step ahead of those trying to stop them. To be successful in this pivotal fight – and we have to succeed - we need to make the right tools available - and for obliged entities and authorities stand together, as no chain is stronger than its weakest link. This will give us a much greater chance of succeeding than the continuous tweaking of rules and governance arrangements that seems to be e.g. the EUs answer to any problem, including this.

[1] See An analysis on developing the digital infrastructure and strengthening the "Know Your Customer"-procedures (dfsa.dk).

RIMANTAS ŠADŽIUS
Member, European Court of Auditors (ECA)

Expectations for the EU's AML Authority – The auditors' view

As the EU's independent external auditor, the European Court of Auditors (ECA) not only assesses implementation of the EU budget, but also the performance of EU institutions and bodies in reaching their objectives. We evaluate actions of the European Commission, the European Supervisory Authorities (ESAs), ECB Banking Supervision, and the Single Resolution Board.

Our recent audit of the EU's efforts to fight money laundering in the banking sector highlighted several weaknesses. First, the sharing of information relating to money laundering was often delayed between different AML authorities and even within the same authority, especially in the context of cross-border cases. Second, shared data was frequently of mixed quality, differed in scope and was not consistent between authorities. Third, due to limited harmonisation and differing risk methodologies, national AML supervisors took different approaches, which negatively affected the consistent factoring of AML risks in the context of prudential supervision. The EU level lacks powers to follow up on actions of national AML authorities.

We recommended that EU bodies should address the above issues through updated guidelines and more efficient information sharing practices. We also had findings and recommendations relating to late transposition of EU AML directives by Member States, how the Commission identifies money laundering risk, as well as governance issues at the EBA.

The Commission's July 2021 proposal foresees the establishment of a new EU AML Authority with supervisory powers and a new Single Rulebook on AML. However to be effective, the new EU body has to be set up properly, to be adequately resourced and to enjoy appropriate powers and responsibilities. As it will be the centerpiece of an integrated EU AML supervisory system, the governance arrangements need to be effective. The scope of its powers and its rights to access information need to be clearly defined.

The Authority has to be incentivised to impose effective sanctions when AML breaches are identified.

Our comprehensive audit experience shows that the setting-up of new agencies from scratch can be challenging. Key issues include the effective and timely recruitment of numerous staff starting from limited human and financial resources. It will be essential, once the co-legislators have approved the set-up of the new EU AML Authority, that the Commission provides sufficient skilled staff to the new agency on a temporary basis to ensure rapid, large-scale recruitment and efficient procurement. Numerous internal policies, IT solutions and the Single Rulebook will need to be established. Thus, any slow growth in staff numbers risks to cause delays in launching actual full-scale AML supervision and convergence work. Given the pressing issues at hand, we clearly cannot afford any such delays if caused by organisational hurdles.

The lessons learned from the setting up of the ESAs, the Single Supervisory Mechanism and the Single Resolution Mechanism should be taken into account. In this regard, for direct AML supervision, the model used by the SSM for resourcing its Joint Supervisory Teams could act as a good example.

As we observed in our reports in recent years, the ESAs face governance issues, which hamper their effectiveness. Therefore, the Commission's proposal rightly suggests differing governance arrangements. They need to allow for efficient decision making while ensuring independence of the EU AML Authority in executing its tasks. This can be facilitated by clear rules that the members of the board act solely in favour of the EU's interests as a whole. The Authority has to be incentivised to impose effective sanctions when AML breaches are identified.

The proposed EU AML Authority would have direct supervisory powers over the most risky financial operators. For effective supervision, an appropriate risk model needs to capture the most risky entities and mitigate the loopholes identified, especially in cross-border supervision. It needs to be equipped to perform off-site supervision but also on-site inspections.

A clear co-operation mechanism to ensure efficient data sharing, both for the AML national authorities and the financial intelligence units, will be key for the EU AML authority to perform effective oversight and managing cross-border issues. This will be the foundation for consistent, high-quality supervision. The EU AML authority will also require a strong co-operation framework with prudential bank supervisors, including the ECB, in order to ensure efficient data exchange and improve cross-sectoral supervision and co-operation.

The ECA will continue to report on the EU's efforts to ensure sound financial markets. We intend to publish a report on the Single Market for investment funds in early 2022. In addition, we have recently started an audit to assess the ECB's supervision of non-performing loans in the banking sector.

MARCUS PLEYER

Deputy Director General, International Financial Markets, Digitization, Anti-Money Laundering & Counter Terrorist Financing, Federal Ministry of Finance, Germany

Why the uniform application of anti-money laundering law throughout the EU is so important to combat illicit financial flows

In the absence of a single rulebook, the diverging implementations of the existing Anti-Money Laundering Directive by the Member States have led to a lack of a level playing field - and sometimes even to a race to the bottom. Not only does this make life easier for money launderers, it also endangers the entire internal market and distorts fair competition. The Commission is addressing these weaknesses in the current system with its legislative package, which also includes a proposal for the extensive transfer of provisions from the Directive to a directly applicable Regulation.

However, it must be borne in mind that harmonisation alone is only one piece of the puzzle: even the most ambitious single rulebook will prove inadequate if it is not applied uniformly.

The planned establishment of a European anti-money laundering supervisory authority – known as the AMLA – will play a significant role in this regard.

The AMLA's first task will be to define its approach to risk-based supervision, especially by developing a common and EU-wide risk matrix. It will only be possible to apply the legislation uniformly if there is a shared awareness of money laundering risks throughout the Union.

As well as establishing this common risk orientation, the AMLA will be able to set common standards for supervisors and – through AML colleges as well as thematic and peer reviews of supervisory practices – ensure that these standards are uniformly enforced. For obliged entities with intensive cross-border activities and particularly distinctive risk profiles, the AMLA will be able to supervise such entities directly and, where national supervision is not sufficient, take over supervision from national supervisors in individual cases.

A single rulebook must go hand in hand with EU-wide uniform enforcement of such a rulebook in order to effectively combat money laundering.

Although uniform enforcement and supervision of anti-money laundering provisions in both the financial and non-financial sectors is desirable at the EU level, we must also take the reality of implementing these ambitious plans into considerations. A far higher degree of harmonisation exists in the financial sector than in the non-financial sector, so that European coordination and supervision practices can be implemented here more swiftly.

The very heterogeneously structured non-financial sector – which is still subject to less harmonised rules and encompasses a vast number of obliged entities – can therefore only be tackled in a second step.

This will also reduce the burden on the AMLA, which like any EU agency will probably have to deal with teething problems to begin with. Once AMLA is set up and running for the financial sector, we can turn our attention to the non-financial sector.

AGATA STROZYNSKA

RVP, Head of Compliance Europe - Western Union Payment Services Ireland Limited

Anti-moneylaundering: combining pragmatism with results

Compliance with anti-money laundering and anti-terrorism financing requirements (AML) is one of the single largest cost factors for Western Union. Over twenty percent of all our staff is working directly or indirectly on this important compliance issue. We have invested heavily in technology-based solutions to track AML risks.

While some might believe that the remittance business of transferring cash or electronic money at short notice from one part of the globe to another is inherently high-risk from an AML perspective, the sophistication demonstrated by Western Union actually speaks to the exact opposite.

Western Union is a strong supporter of the legislative package presented by the European Commission in July to strengthen the EU's AML regime. At the centre of the proposals is more harmonization of the rules, reporting standards but also day-to-day supervision. Common rules allow companies to streamline their processes and invest in single IT solutions while at the same time improving AML compliance.

Let me give you a few examples how small changes in the rules will have a big impact. At present, each Member States has its own template for the reporting of suspicious transactions. A single template will increase cross-border comparability and allow companies to introduce a single EU-wide reporting framework. Similarly, proposals to align customer due diligence requirements across the EU will bring more safety to the financial system and allow companies to streamline their on-boarding process. We welcome also combining this with an EU-wide e-ID system. If a customer could carry their information with them this would mean no additional customer due diligence is required when entering a new commercial relationship, allowing customers to switch between providers and increase competition in the European market.

Western Union also welcomes plans to create an EU AML authority and to reinforce the cooperation between Financial Intelligence Units. Today the uncertainty of what information can be shared with whom in a cross-border context means not all the valuable information provided by the industry is being acted upon.

It should be possible for a company to voluntarily opt into EU-wide supervision if it wishes to streamline its AML compliance within the EU.

Improved EU-wide AML supervision should give all parties along a payment chain comfort about their counterparties. The remittance industry has suffered from decisions by banks to terminate their commercial relationships with this sector. AML related de-risking by the banking sector has similarly affected correspondence banking relationships and the entry to market for many FinTech start-ups. While many of these concerns are generally unfounded, a harmonised approach to AML rules and supervision would nonetheless give banks more certainty.

Additionally, giving the AML authority the power of direct supervision could be a real improvement if it genuinely replaces the existing obligations in the 27 Member States. At the same time, we remain concerned about the designation process. The Commission's proposal bases the decision of direct supervision on two criteria: the perceived level of risk of the business model and the cross-border nature of the business. We believe the designation process needs to be objective. It should balance the risk of the business model with the level and sophistication of the compliance mechanisms already in place. Moreover, it needs to reflect that by their very nature payment services are cross-border services. Any decision on direct supervision should therefore be carefully considered.

At present, the proposal does not consider one other important possibility. It should be possible for a company to voluntarily opt into EU-wide supervision if it wishes to streamline its AML compliance within the EU.

3

BANKING AND INSURANCE REGULATION

ISSUES AT STAKE

European banks entered the Covid-19 pandemic with stronger capital positions, higher liquidity buffers and better asset quality than the 2008 financial crisis. So, this time European banks have been part of the solution. The EU banking crisis management framework however needs reviewing to ensure that the banking system can face future episodes of stress. In addition, European banks suffer from a persistent low level of profitability caused by excess capacity, low interest rates and insufficient efficiency that need tackling for preserving their capacity to support the post-Covid recovery going forward.

Further challenges include the competition from non-banks and tech companies, significant digitalisation costs and the implementation of additional Basel III standards. How the European banking sector may preserve its current diversity, which is beneficial for the financing of the EU economy with on-going evolutions in the EU regulatory framework is a further question to be considered.

Policy changes are also needed for supporting the role that insurers play in the long-term financing of the economy. In this perspective, the European Commission has launched a review of Solvency II aiming to adapt the framework to new risks such as cyber-risks, climate and environment-related ones, and to the new opportunities offered by digitalization, AI and the EU green deal, while preserving the soundness of the European insurance sector.

IMPLEMENTING BASEL III IN THE EU

PABLO HERNÁNDEZ DE COS

Governor, Banco de España & Chair, Basel Committee on Banking Supervision (BCBS)

Covid-19 and the Basel framework: emerging lessons

The financial turmoil caused by the Covid-19 pandemic is the first global system-wide stress since the finalisation of the Basel III framework. While the pandemic is still far from over, the Basel Committee has started to evaluate the impact of the Basel III reforms on the global banking system and the economy. What early lessons can be drawn thus far?

First, in contrast to the Great Financial Crisis, when banks were a source and propagator of stress, the banking system has thus far remained resilient and has continued to provide core financial services to help cushion the impact of the pandemic on the broader economy.

Two main factors are behind this positive outcome. First, Basel III greatly enhanced the resilience of the global banking system, with banks entering the pandemic with higher levels of truly loss-absorbing capital and liquidity. Better capitalised banks increased lending to households and businesses more than other banks, highlighting the positive impact of higher capital requirements. Banks would have faced greater stress had the initial set of Basel III reforms not been adopted. Second, the unprecedented scale and scope of public sector measures adopted to mitigate the impact of Covid-19, spanning fiscal, monetary and regulatory measures, have largely shielded banks from losses to date.

Second, while the Basel III framework has largely met its objectives thus far, some features may warrant further evaluation. These include the functioning of capital and liquidity buffers, the degree of countercyclicality provided by prudential standards and the treatment of central bank reserves in the leverage ratio. Insufficient empirical evidence to date, coupled with the stabilising impact of public support measures, means that it is not yet possible to make any conclusive assessments as to whether any targeted revisions to the Basel framework are necessary. The Committee will continue to evaluate these issues over the coming year, alongside an evaluation of the broader impact of the initial Basel III reforms during the past decade.

Banks would have faced greater stress had the initial set of Basel III reforms not been adopted.

Third, the resilience of the global banking system cannot be taken for granted. As the pandemic continues to unwind, and as public support measures are unwound, additional bank losses could emerge. Rising public and corporate debt levels could increase the longer-term structural fragilities of banks' balance sheets. Additionally, recent vulnerabilities in non-bank financial intermediation (NBFI) have further highlighted the high degree of interconnectivity between NBFI and banks; the risk of spillovers to the latter cannot be excluded.

What are my takeaways from these early lessons? First, the implementation of the initial Basel III reforms has produced clear net benefits to the global economy and society more generally. We have collectively reaped the benefits from Basel III during this pandemic. Let us not forget this lesson.

Second, there is unfinished business in implementing Basel III. The outstanding reforms – encompassing a series of standards aimed at enhancing the robustness and credibility of the risk-weighted capital framework – address regulatory fault lines which remain as important today as they were pre-pandemic. The drafting of this series of standards benefited from an extensive consultation process.

Failure to implement these measures in a full, timely and consistent manner – as repeatedly agreed by G20 Leaders – would result in the remaining structural flaws and fragilities in the global banking system being left unaddressed, at significant cost to the economy and to global financial stability. Covid-19 has highlighted the vital importance of having necessary safeguards in place before the emergence of a shock; this certainly applies to prudential standards and the safety and soundness of the banking system.

Third, in parallel with the Committee's ongoing "backward-looking" evaluation programme, it is crucial to pursue a forward-looking supervisory approach to identifying, assessing and mitigating emerging risks and structural trends impacting the global banking system. Some of these risks and trends – including the digitalisation of finance, climate-related financial risks, and the evolution and sustainability of banks' business models – had already been identified before the pandemic. Covid-19 has further underlined the importance of addressing them.

EVA WIMMER

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Striking the right balance – Financial stability and financing the real economy

Implementing the Basel III finalisation package in European Union law will be one of the major projects for the Slovenian Council Presidency and the following French Presidency. We are expecting the Commission to present a legislative proposal this autumn.

After the Basel Committee had postponed the implementation date by one year, from 2022 to 2023, at the beginning of the Covid-19 pandemic, there is broad political support for initiating the negotiations on the transposition of the finalisation of Basel III. We should continue to aim for a timely stepwise implementation and full implementation by January 2028.

Implementing the final Basel III standards in the EU is an important and complex task. We need to strike the right balance between increasing the resilience of banks and preserving their ability to finance the real economy.

Firstly, a recent report[1]by the Basel Committee on early lessons of the pandemic found the Basel reforms had an overall positive effect on banks' ability to weather the impact of the crisis. As the Covid-19 pandemic unfolded last year, it became apparent that adequate capital and liquidity buffers help banks to withstand stressed situations and enable them to provide necessary financing to the real economy in times of crisis. Therefore, the focus of the final part of the reform on reducing undue variability of risk-weighted assets is contributing to further strengthening the stability of the financial system.

At the same time, the Basel III finalisation package is not expected to result in a significant increase in the overall capital requirements for the banking sector, as agreed on by the ECOFIN finance ministers in July 2016 and by the G20 finance ministers and central bank governors in March 2017. A consistent and timely implementation in the EU that is in line with ECOFIN and G20 resolutions is thus essential to allow banks to continue to be part of the solution rather than the problem in potential future crises.

The package will be a milestone in ensuring banks' resilience and the financing of the real economy.

Secondly, banks' capacity to provide financing for the real economy must be maintained – not just for the immediate recovery from the pandemic, but also in the long term. We should ensure that banks are able to perform this function by taking into account the structure of the European economy and the financial sector. Negative side effects for companies that have not been externally rated (including small and medium-sized enterprises), and which are sound borrowers, should be avoided. This requires a short-term solution that allows institutions to adequately determine risk weights for such exposures. Additionally, we should also seek long-term solutions to increase the rating coverage in the EU for such sound corporate borrowers.

Thirdly, when it comes to smaller and less complex banks, we should not rest on the achievements of the last banking package. Instead, proportionality should remain a guiding principle and driving force of the Basel implementation process. We should continue to reduce the administrative burden for such smaller institutions. In this regard, the recent European Banking Authority (EBA) study on the cost of compliance with supervisory reporting provides a clear path forward. Additionally, disclosure requirements could be waived or reduced for non-listed institutions. Simplifying remuneration-related requirements where variable remuneration is relatively low could also reduce the administrative burden. Additionally, new elements from Basel III such as due diligence requirements for external ratings need to be implemented in a practical manner for banks that do not operate internationally.

The aforementioned goals will require further discussion once the European Commission has tabled its legislative proposal. We want to work constructively on the implementation of Basel III. It is our goal to find sensible solutions for a common approach within the Council of the European Union and to conclude the legislative work on this important file with the European Parliament and the Commission. The package will be a milestone in ensuring banks' resilience and the financing of the real economy.

[1] Basel Committee on Banking Supervision: Early lessons from the Covid-19 pandemic on the Basel reforms. (July 2021). https://www.bis.org/bcbs/publ/d521.pdf

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The case for an in-depth thinking on how to transpose the output floor right

In December 2017, Governors and Heads of Supervision have agreed on the final Basel III package, destined to be the last major regulatory change in the Basel framework. According to the BCBS, the prime objective of this package is to restrict the use of internal models, "restore their credibility", "improve the level playing field", and "increase the comparability of capital ratios". To achieve this, the package further limits the use of modelling of certain risks, introduces several model input floors, and most noticeably imposes an "output floor" (OF) on the risk weighed assets (RWAs).

There is no question that this agreement must be faithfully and timely transposed in every jurisdiction. But it is equally undeniable that in the EU it is up to co-legislators to ensure that the changes to the regulatory framework, given all EU specificities, deliver the intended results while respecting the other constraints set by policy makers.

EU leaders have expressed two such constraints early on, whereby the package should preserve the global level playing field across jurisdictions and ensure no significant increase of banks' capital requirements (see G20 2016/02 and ECOFIN 2016/07).

These political preconditions are legitimate and should not be overlooked: global competition is fierce and EU banks are losing ground; and there is no demonstrable need to increase capital ratios in the EU. In fact, EU supervisors have repeatedly confirmed the strong capital position of EU banks in the aftermath of the COVID shock, and the robustness of their modelling practices via the multiyear TRIM exercise, which has, according to the ECB, "boosted reliability and comparability of banks' internal models".

Looking at the preliminary impact studies of the new package, neither of these two conditions would be met. The EBA estimates that its preferred implementation option would increase capital requirements by +18.5% in the EU, mostly for GSIIs, versus a decrease in capital requirements for G-SIIs in the Americas. This striking result is mainly due to the OF and to risk-weights in the standard approach that inaccurately reflect the EU specificities on crucial markets, such as mortgages. This leaves no other option for EU co-legislators but to look for adjustments when transposing the package.

These design flaws are further reasons to pragmatically adjust the package where required.

Equally concerning is that parts of the package are actually not delivering the intended results. Indeed, the questionable design choice to compute the OF as 72.5% of the sum of standardized RWAs entails that:

- Floored RWAs will not be available at a granular (i.e. portfolio/activity) level, so the OF will not improve comparability, but only add complexity with a second set of RWAs – whatever the option to implement it;

- Banks will be incentivized to increase the relative share of activities for which the impact of the OF is nil or low – without making them safer nor better satisfying the needs of their clients, on the contrary;

- The OF will not discriminate between robust modelling and excessively aggressive modelling since the SA is poorly risk-sensitive, so the size of the add-on will not inform on modelling quality nor riskiness of assets;

- The OF will not be neutral in terms of bank structure – without any rationale for such an output – even if, rightly, the final Basel III package only requires the OF to be applied at the consolidated level, not at the solo level.

These design flaws are further reasons for co-legislators to pragmatically adjust the package where required.

Even if all Basel-compliant options to implement the OF will suffer from these structural flaws, one of these options, known as the "parallel stack approach", provides a way to minimize disruption to the status quo of previous EU banking packages (notably on EU specific buffers) and to reduce its actual impact on requirements (first by avoiding goldplating) while limiting deviations to Basel.

This should be enough for the co-legislators, and firstly for the Commission, to take due consideration of the parallel stack approach. Otherwise, we might be headed to dance yet another tango with usual "goldplating" and more "deviating" from «Basel».

Let's try to do better this time.

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Implementing Basel III in the EU: remaining challenges and timing

Owing to the stricter requirements established by Basel III, in the past several years banks have vastly improved their capital and liquidity position and begun to account for key risks in a more satisfactory manner. This process has significantly increased their ability to withstand external shocks. Faced with the COVID-19 pandemic, banks were in a position to continue supporting the global economy. They did not amplify financial disturbances, as they had during the financial crisis that started in 2008; in fact, they contributed to preserving financial stability and mitigated the real effects of the crisis.

The pandemic has been an especially challenging real-life test. Basel III has passed it successfully. However, not all the features of the new standards were equally put to the test by the circumstances, and complacency would not be warranted. Some important building blocks of Basel III still need to be fully implemented by jurisdiction. While it was right to suspend the Basel III timetable under the exceptional circumstances of the crisis, its implementation should now be resumed.

In Europe, the process will be initiated by the EU Commission, which is expected to publish a proposal by September. The negotiations on the future EU regulatory framework are likely to be complex. One hopes the co-legislator will be able to act in a reasonably swift and comprehensive way. Additional delays should be avoided as they would risk impairing banks' ability to withstand future shocks, which may well be different from the latest one.

Europe's diversity regarding bank business models should be preserved through an appropriate use of the proportionality principle. The process of implementing Basel III in the EU should not be an occasion for reopening settled issues or weakening the framework. Deviations should be kept to a minimum.

The new framework will increase the risk sensitivity of the revised rules and at the same time further reduce undue RWA variability and aggressive modelling practices. The actual impact on capital requirements will depend on the final policy choices. On the whole, it is not expected to be dramatic. Furthermore, recent analyses by the EBA showed that just confirming existing regulatory specificities would halve the potential increase in capital requirements. At the macro level, there is evidence that the economic costs of implementing the reforms are modest and temporary and that they are clearly outweighed by the longer-term benefits of a stronger financial system.

While it was right to suspend the Basel III timetable, its implementation should now be resumed.

Having said that, the Basel supervisory body, the GHoS, has committed to a regulatory pause after Basel III. A similar position has been adopted by the European Commission. The work on Basel III must be finished; beyond that, no further significant capital requirement increases are envisaged.

This by no means implies that regulators (or banks for that matter) can relax and ignore developments in the risk landscape. Technology offers the most obvious example. FinTech is an opportunity, but it also entails ever growing and changing risks. Under Basel III, technology risk is classified as an operational risk. This is quite possibly the least satisfactory piece of Basel III and the one that will age most quickly. Further thought on the issue of FinTech/cyber risk is in order. A better prudential treatment might recognise that capital charges are not the only, nor are they necessarily the best way to account for operational risk; organisational and governance requirements may take on a more prominent role alongside capital.

There is much debate about how the regulatory framework should take account of environmental issues. In principle, financial regulation is not the best way to provide direct incentives for the net-zero transition. Policy action in this direction, which I most welcome, should be within the remit of fiscal and general government policies and obey the rules of a democratically accountable process.

Regulation, entrusted to independent technical authorities, should remain risk-based and evidence-driven. Any special treatment of 'green' assets should therefore only be considered on the basis of robust evidence of lower credit or market risk.

OTHMAR KARAS
Vice-President,
European Parliament

Tailor-made implementation of Basel-III in Europe

It has been nearly four years since the Basel Committee has endorsed the outstanding Basel-III post-crisis regulatory reforms. Implementing global banking standards is and will remain essential to promote financial stability and to enhance the quality of banking regulation and supervision in a multilateral world. There is evidence: Banks are much stronger now than over ten years ago. They have better liquidity, capitalization and leverage, which serves us well – also during the Covid-19 pandemic. While I strongly welcome the deferred timeline for Basel-III to increase the operational capacity of banks and supervisors to support our economy during the current crisis, the work on a full, timely and consistent implementation must now swiftly continue. Clearly, it is no longer about the "if", it is about the "how".

Ahead of the European Commission's legislative proposal announced for the third quarter of 2021, it is worthwhile to define clear guiding principles for the implementation of Basel-III in Europe:

First, it should be timely and faithful to the global standards to provide for legal certainty and signal the European Union's commitment.

Second, it should respect the mandate adopted by the European Parliament in November 2016 to ensure "no significant increase in the overall capital requirements".

Third, it must take due account of our structural specificities with a primarily bank-financed economy. The diversity of our banking landscape and business models is a strength. The flexibilities of the Basel standards should therefore be exploited and new adjustments considered, wherever duly justified.

Fourth, the principle of proportionality must be respected by further reducing compliance costs for smaller and less complex institutions without watering down prudential standards.

Fifth, competitive disadvantages for European banks should be avoided, especially in the area of trading activities where they compete directly at international level.

And sixth, the overall approach must be in line with the goals of our Banking Union and avoid any further fragmentation of the single rulebook. In short: all the consequences for banks, end users and citizens must be duly considered.

We must continue to implement global standards while taking due account of European specificities.

In this context, some existing elements that address EU specificities such as the SME Supporting Factor and the exemptions from the CVA framework must in my view remain undisputed. Concerning the Output Floor – our "elephant in the room" – a Basel-compliant solution should be achieved which implements our common objective of reducing excessive risk-weight variability and promoting comparability of risk-weighted capital ratios. "European solutions" are needed in the treatment for equity investments, unrated corporates and specialized lending. Using the discretion for historic losses in the operational risk framework would offer a simple and harmonized solution to decrease the overall impact without deviating from Basel. On the FRTB, disproportionate impacts for certain trading activities which are key to our economy would justify targeted calibration adjustments.

As the SA-CCR may have detrimental impacts on the availability and cost of financial hedges to end-users, it is essential to allow for targeted adjustments while pursuing an in-depth review of the appropriateness of its calibration. At the same, we should not shy away to address structural necessities: We need to move forward on capital and liquidity waivers to improve the integration of cross-border banking groups and complete our Banking Union.

It is of course the European Parliament and the Council that will adopt the legislation based on the Commission's proposal, not the Basel Committee. I am optimistic that we will find the right balance to square the circle of Basel-III – together with all affected authorities, central banks and stakeholders. The awareness about all the key elements is high. In parallel to the implementation of Basel-III, the global banking standards need to evolve.

We must find answers to our future common challenges, such as climate related risk, digitalization, cyber risk, operational resilience and increasing debt levels. These risks are crossing borders and sectors and we need global baselines to address them effectively.

This is not least a huge opportunity we must seize to strengthen Europe's role as 'rule-maker' of global standards.

JONÁS FERNÁNDEZ ÁLVAREZ

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Implementing Basel IV in the EU

Recent years have been especially negative for those of us who believe in an international order based on liberal values, with the social emphasis that exists in Europe, and founded upon solid global institutions.

It is important to underline this principle before discussing how to implement the recent recommendations of the Basel Committee within the European legislative acquis. The defence of multilateral organisations is best served by ensuring that global agreements are applied with continuity across the different represented jurisdictions. The latest Basel recommendations is no exception. Of course, there is always a certain margin for interpretation or adaptation, which in turn strengthens the democratic legitimacy of transferring these global agreements to each one of the jurisdictions.

Even so, before analysing how to approach the regulatory reform of capital requirements, we must have one thing clear: European law should respect the international framework and integrate, in this case, the recommendations that are given within the scope of the agreement.

Secondly, the update to capital requirements must also incorporate an assessment of the current standards, especially after the economic and financial impact of COVID-19. It is worth pointing out that current prudential rules work well and have so far enabled us to address a downturn in activity while avoiding systemic problems in the European banking sector. The changes incorporated in the CRR quick fix in 2020, together with the rest of the policies to support the production sector in the framework of more stable regulation, have made it possible to get through a very complex period without major blows. Therefore, the implementation of Basel IV should not be seen as an opportunity to water down or reduce our prudential rules, but rather a chance to maintain current standards.

Turning now to how to transpose Basel IV into the EU legal framework, perhaps the most problematic point is applying the output floor. This instrument is supposed to set a floor for capital requirements irrespective of risk assessment. It is a challenge for the European banking sector, which has a significantly greater role in financing the real economy than the banking sectors in other jurisdictions, where capital markets play a more important role.

EU law should integrate (...) the recommendations that are given within the scope of the agreement.

In any case, and irrespective of the necessary push towards the Capital Markets Union (CMU), the Basel recommendations leave open different options for implementation in different jurisdictions. On the one hand, these additional output floor requirements can be calibrated on a consolidated and individual basis, as is already the case for all other requirements. Moreover, they could be applied exclusively on a consolidated basis. There are good arguments in this debate, linked to the development of the banking union, for applying the output floor on a consolidated basis only, although in some ways this would imply a revision of the European strategy to date. Finally, proposals for a possible parallel stack approach are, thus far, not Basel compliant, according to the analysis of the European Banking Authority.

In addition, the possibility of incorporating differential treatment of some kind for unrated corporations has been widely discussed. In this case, the EU's regulatory acquis already includes an SME Supporting Factor that could partially compensate for the effects of the greater weight of bank financing for the European productive sector. Certainly, the realities implied by the current SME Supporting Factor and a possible adjustment for unrated corporations are not exactly the same, but there is so much overlap that we cannot separate the two entirely. Moreover, we should not introduce regulatory elements that would clearly contradict the CMU project.

There are other European elements or specificities in the current debate that will need to be discussed in the coming months. In any case, I do not wish to conclude this article without making an additional reference to the internalisation of climate risks, which the ECB will incorporate into the implementation of monetary policy. The banking sector as a whole should be provided with more transparent regulations to not only help reorient its activity as part of an ecological transition, but also as a way to better quantify a source of additional risks that have not been sufficiently internalised.

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Basel IV: implementation is key

The Basel III reform decided in 2017 should be implemented faithfully to the philosophy of this reform and the political mandate given by the G20 and the European authorities. We are not questioning that consistency in capital rules' implementation is important both across EU institutions and globally across regions. Nor are we arguing for a policy shift towards deregulation.

When looking at the many successive reports from public authorities and from independent economists, the reform will increase total capital requirements for EU banks by 19% (compared to a 0.3% decrease for Americas) translated in a capital need of € 170-230bn, largely driven by the application of the output floor. We are far from the political mandate given by the European Council and Parliament of no significant increase in the overall capital requirements for the banking sector and no significant differences across regions of the world.

The philosophy behind the finalisation of the Basel Accord was indeed not to further increase capital requirements but to avoid unwarranted variability in risk-weighted assets and improve the comparability of banks 'risks profiles amongst different banking models at global level.

In that regard, the implementation of the output floor as the cornerstone of this reform is key, especially for universal banks using internal models, and is expected to have the single largest impact on banks' capital requirements.

The use of IRB approaches may be restricted, although they are validated by the supervisors and regularly recalibrated through the EBA repair work and the ECB TRIM exercise. Paradoxically the output floor may thus be damaging to banks with a low risk profile and create disincentives for the lowest risk portfolios. Were the output floor introduced at entity level it would therefore penalize decentralised banking models willing to diversify risks at group level. To avoid such unfortunate consequence, it is crucial that its implementation meets the policy intention behind its design.

We strongly support the application of the output floor at the consolidated group level. First the Basel committee provides recommendations at the consolidated level. Second it would be consistent with the ambition of the Banking Union. A solo approach would exacerbate fragmentation of the European banking market. Finally, it is the only way to ensure business model neutrality. Indeed, for the same risks, if the output floor applies at solo level, the more decentralised a bank, the more it is penalised by the output floor. In the case of a centralised organisation using internal models, low and high risks are mixed in the same structure so that the average risk is closer to the standard, reducing the impact of the output floor.

We strongly support the application of the output floor at the consolidated group level.

The output floor should also work primarily as a backstop, basically keeping the risk-based capital requirements approach through un-floored risk-weighted assets. To this end, we strongly support an application on international requirements only, to guarantee a level playing field. A recent legal opinion by a European Network of continental law firms found that such approach would be Basel Accord compliant.

Real estate financing is a concrete example. Based on a "Loan to Income and fixed rate" model the French market has historically very low default rates thanks to prudent lending practices and efficient credit protection mechanisms. And yet, the risk weights for such low risk asset would double due to the output floor and changes to the credit risk framework. The Commission should then consider other options that improve risk-sensitivity and granularity in the standardised approach.

It should be the same for specialised lending. The Basel methodology does not recognize properly the financial protective structures nor low risks portfolios while data show a low level of default over a long period of time. There is almost non-risk sensitivity in the standard approach nor in the internal model approach due to the level of LGD input floor and that no distinction is made between highly qualitative transactions and others. Adaptations are then required to maintain consistency between prudential rules and observed risks. The solution is to set a more granular standardized approach and to set a direct LGD input floor of 10 % for the A-IRB method.

The transposition should be faithful to the political mandate and the very intention of the Basel committee not to increase the capital requirements, but also the make sense in the European context. That means and targeted improvements and adaptations to the European post-crisis economic reality and to the structure of its banking sector. Otherwise, the package would have significant adverse impact on banks' capacity to finance the economy and support the recovery from the pandemic shock.

ALICIA SANCHIS

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Basel III impact in Europe: operational risk revised requirements matter

As the deadline to approve the final Basel III text approaches, Europe still has some important decisions to make.

Although the Basel III agreement has been discussed at great length in recent years, Europe needs the right balance between financial stability and economic growth and competitiveness.

Basel III's significant impact on European banks' capital requirements, coupled with the high dependence of households and SMEs on bank funding, will reduce Europe's growth prospects significantly.

According to some analyses, GDP could see a permanent decline of 0.5%. Higher capital requirements will inevitably drive up funding costs for households and SMEs, whose access to capital markets is limited.

We are reaching a point where the benefits of higher bank capital requirements to financial stability do not offset the detriment to economic growth.

The Basel III agreement will have a disparate effect on banks and economy in Europe. It is bound to cause the gap in growth ratios to increase with respect to other regions. Four years ago, the Basel Committee did not expect banks' capital requirements to rise significantly; however, capital requirements for European banks are going to increase substantially, while in all other jurisdictions they are expected to stay almost the same or even fall! And experience with Pillar I shows that new requirements are always amplified by the other two pillars through supervisory add-ons and market buffers over the supervisory minimums. On top of which management buffers should also be built.

Moreover, uncertainty remains higher than usual.

Recovery from the pandemic will be asymmetric, as countries regain economic activity at different speeds. Furthermore, we have yet to fully understand the structural changes occurred in the last year and must keep our guard up.

Against this backdrop, Europe should take advantage of the Basel III agreement's flexibility and make necessary adjustments, particularly with regard to operational risk.

Europe needs strong banks to aid its recovery and drive its digital and green transformation.

The final Basel III package contains several critical elements for Europe, notably the output floor and the new operational risk framework. While much has been said about the output floor and its effect on capital and risk sensitivity, much less has been said on operational risk. The EBA estimates that 20% of the total capital increase resulting from Basel III is due to operational risk, which is the second largest impact after the output floor.

To reduce it, European authorities should not link capital requirements to past losses.

Because the Basel Committee considers operational risk a "tail risk", and, thus, even the most accurate models based on past data are not an adequate proxy to measure it, Basel III no longer allows internal models. However, it keeps historic data as the driver of requirements, a solution that takes the worst of two worlds: On the one hand, it undervalues accurate models able to recognize past signals that help forecast the future; on the other, it applies an overly simplistic rule based on past data. Basel gives national authorities discretion to build operational risk models based on past losses or not. Europe should take the right decision and make use of this discretion. Even if they use their discretion, it would only reduce the total capital increase by half due to the other methodological changes introduced by Basel III on operational risk requirements.

The framework should introduce the right incentives.

A tail risk is not an unmanageable risk, and regulation should give the right incentives that reward institutions with strong governance, sound risk controls, advanced metrics and scenario analysis to prevent or mitigate operational risk, and with effective business continuity plans to ensure operational resilience.

All in all, Europe needs strong banks now more than ever to aid its recovery, drive its digital and green transformation, and bolster its strategic sovereignty.

Therefore, European banks must be allowed to compete on equal footing with other players worldwide to allocate financial resources where needed in the economy.

PHILIPPE BORDENAVE

Senior Executive Advisor to General Management and Chair of the Board, BNP Paribas

Basel III: a search for consistency

The COVID crisis evidenced that EU banks had enough capital. Banks brought a substantial support to their clients, well beyond public guarantee schemes, and even under the extremely severe stress scenarios applied on already stressed 2020 balance-sheets, their CET1 ratio would remain largely above the 4.5% minimum Basel requirement.

However, the capital requirement framework was deemed by supervisors to lack the necessary flexibility, and to require targeted softening to allow banks to play their shock-absorbing role and to continue to finance the economy, some of those measures being recently extended into 2022.

Nevertheless, 12 years after the Global Financial Crisis, the EU is facing the implementation of yet another piece of the post-crisis reform agenda, at a time where the EU economy needs to recover from an unprecedented health crisis, which provided a successful real-life test to the existing prudential framework, and in addition needs to finance huge green and digital investments.

How to reconcile those contradictions? It would be wise to draw the lessons of this real-life experience, as policy makers engage the transposition of the final Basel III: 1. Banks don't need more capital. The mandate given by the G20 to the BCBS, and by the European Council and Parliament to the Commission is all the more relevant.

The EBA "EU-specific scenario" with a 7.7% overall RWA increase, and a 19% RWA increase for G-SIBs, which represent a large part of the EU banking sector, is not a viable option.2. If the framework is deemed to need more flexibility, it needs even more to be predictable, with self-triggered mechanisms embedded in the rules, rather than arbitrary supervisory decisions. For example, some existing buffers should be automatically released in crisis time, for the buffers to play their intended loss-absorbing role.3. The CRR3 proposal needs to preserve the diversity of banks' business models.a.

As regards smaller banks, the revised, more complex, standardized approaches should not impose a significant implementation and reporting burden, for limited financial stability benefits. Otherwise, this would work as an implicit incentive to consolidate.b. On the other end of the spectrum, G-SIBs and D-SIBs, which finance 70% of the EU economy, should not be inflicted a significant increase in capital requirements.

Let's draw the lessons of this real-life stress test and preserve the diversity of EU banks' business models.

Otherwise, this would work as an implicit incentive to downsize, and the ability of those banks to compete with already dominant US players would be permanently damaged, and would ruin any EU ambition to develop its "open strategic autonomy" for the financing of its major corporates and sovereign debt.

Technical solutions exist to solve these issues while remaining faithful in the implementation of the international Basel standards. It is essential in particular to ensure consistent implementation of capital markets rules (FRTB, SA-CCR, SFTs) with the US and UK, in both timing and substance.

FOLLOWING EUROFI EVENT

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PRAGUE - CZECH REPUBLIC
7, 8 & 9 SEPTEMBER 2022

BANK FRAGMENTATION AND CONSOLIDATION

JOSÉ MANUEL CAMPA

Chairperson, European Banking Authority (EBA)

Banking fragmentation and consolidation: enhancing a single market for banks

The COVID-19 pandemic is a strong reminder that cooperation and coordination provide a solid basis for reaching an effective response to common challenges on the European level. The coordinated monetary, fiscal and prudential relief measures showcase the positive impact of supranational action. The pandemic also pushed the frontier of European integration with the Next Generation EU providing for the largest-ever institutional bond issuance in Europe. However, the European Banking Union remains incomplete, and the banking market remains fragmented along national lines. Besides commercial considerations, regulatory obstacles continue to be an important factor impeding the emergence of a true single market for financial services in the European Union.

The recently published EBA stress test results show that even under a very severe scenario, the EU banking sector would maintain adequate capital levels. Nevertheless, those institutions with higher exposures towards the sectors most affected by the pandemic such as hospitality and travel, or with a higher pre-pandemic ratio of non-performing loans (NPL) are still vulnerable. Future divergence triggered by NPLs, defaults and insolvencies may drag on banks' balance sheets in the absence of a single banking market. Furthermore, profitability remains subdued and return on equity is still below the estimated cost of equity for many banks.

Beyond finalising Banking Union, actions can be taken to enhance cross border banking services in EU.

The pandemic has not yet proven to be a catalyst to push the Roadmap to complete the Banking Union beyond the finishing line. There is no rationale for Europe to keep the Banking Union resting on two pillars only. Proper risk and capital allocation need the foundation of a common deposit insurance scheme. Of course, we need to consider the remaining concerns from both sides, from European cross-border perspective as well as from Member States' perspective. However, after more than five years of negotiations, we would need to converge those concerns into a European compromise solution which may forcefully counter any erosion of trust in a single banking market in Europe.

Beyond the finalisation of the Banking Union, we should continue to exploit the existing framework to enhance cross-border activity within the EU. The use of waivers to allow for free flow of liquidity and capital within European banking groups should increase. A complete achievement of this objective can only be ensured through the mentioned legislative reforms, but some advancement may also be explored under the current framework. Options include the setup of internal support agreements between parent and subsidiaries within banking groups and the enhancement of the links between such agreements and the institution recovery plans. The flow of liquidity within the group may be eased if supervisors were able to use their early intervention powers before any more substantial crisis materialises. The assessment of group recovery plans should be the appropriate forum where supervisory and resolution authorities prepare for a cooperative and operable solution in case an emergency situation arises.

In addition to that, we must join forces with securities market regulators as the Banking Union and the Capital Market Union share many obstacles to reach their full potential. Banks and capital markets would need to play complementary roles to support businesses and citizens. We should capitalise on synergies between both if we would like securitisation to play a prominent role during the recovery. Added collaboration is also needed to assure that technological innovation in financial services becomes a catalyst to further increase in the provision of cross-border banking services within the EU.

Finally, building up the single market within the EU and implementing Basel III must not result in new fragmentation from global financial markets. European banks as much as European businesses rely on international business.

Global cooperation and assuring a consistent implementation of internationally agreed standards also remain key ingredients to the international level playing field.

EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board, Member of the Steering Committee,
European Central Bank (ECB)

Market fragmentation in the Banking Union

As in the previous crisis, safety nets for banks remained completely national during the pandemic. The policy response resulted in banking markets fragmenting along national lines: cross-border banking groups were broken down, and ring-fencing measures were introduced to prevent local establishments from importing risks from other group entities and to ensure they remained viable on a standalone basis. Banks supported by government funds were asked to refocus their business on a domestic basis. This drop in cross-border banking within the euro area was the main driver of the fall in financial integration.

The present pandemic crisis, six years after banking union began, is thus a crucial test of the progress achieved. The results, while mixed, do have promising elements. On the one hand there is a degree of frustration that all these years of banking union have not brought about a substantial increase in integration, as measured by the ECB composite indicator of financial integration. But it is remarkable, however, that throughout the crisis the indicator for banking market integration – which captures the dispersion in comparable bank lending rates across the euro area (the lower the dispersion, the higher the level of integration) – has remained almost completely stable, in stark contrast to the steep decline seen during the great financial and sovereign debt crises.

This shows how the post-crisis financial reforms, together with the swift and fully unified public response to the shock, have created a stronger and more unified banking system, where centrifugal forces have been much less powerful compared with the past. These findings point to the possibility that banking union is indeed transforming the European banking market from a shock amplifier into a shock absorber. But we are not quite there yet. There is still a risk that in the event of a major systemic shock, European banking groups may be prevented from functioning as shock absorbers, since their capital and liquidity remain largely segmented in local pools in individual Member States.

As long as deposit insurance schemes remain at national level only, Member States will still have an incentive to ring-fence their banking sectors. Completing banking union by setting up a European deposit insurance scheme (EDIS) would be the most direct route to fostering integration. Since it is also clear that this scheme will take some time to materialise, we should take steps to try to advance integration as much as possible, building on the possibilities already offered by the present framework.

The aftermath of the pandemic offers us an opportunity to pursue pragmatic avenues to increase integration in the banking union.

As the driving force of the Single Supervisory Mechanism of the banking union, the ECB is ready to take this pragmatic route and explore all the possible avenues offered by the existing framework. We have already published our expectations regarding the prudential assessment of consolidation projects, which apply equally to all projects within the banking union. We have also shown our willingness to use the option of putting in place, in a prudent and progressive manner, the waivers that are already provided for by the liquidity coverage ratio and the net stable funding ratio. This includes making more use of recovery plans to build concrete mechanisms to ensure that banking groups can operationalise group-wide mechanisms of global risk management and support in a safe way, taking into account the legitimate interests of all the stakeholders involved.

We also stand ready to apply the revised regulatory standard related to the indicators of global systemic importance for cross-border activities in the banking union. In addition, we intend to use our exclusive powers in the field of establishing branches of European credit institutions in the banking union and the free provision of services by banking union credit institutions, to see how projects building more integration can be safely developed, taking full account of the legitimate concerns of all parties involved.

But supervisors can only play their part in this process of integration. Their role is to assess the projects and ensure that they are developed in a safe and sound way. But these projects themselves should always be built on an industry-driven, solid economic basis, and should be sustainable and well-managed. The real motor of integration can thus only be sound business projects, developed as a result of strategic thinking within the governance of the institutions, with a view to reaping the economic benefits of the further integration that the financing of the recovery will need to mobilise.

FERNANDO VICARIO
Chief Executive Officer, Bank of America Europe

Post-crisis reform is coming to an end: time to cater for sustainable growth

With vaccine rollouts extending, it seems the world may be finally starting to get the upper hand on the pandemic, providing much-needed optimism and the opportunity for policy-makers and regulators to focus more immediately on rebuilding their hard-hit economies while gearing towards a more digital and sustainable long term future.

This time, the banking sector has proven to be much better prepared in terms of resilience, capital, and liquidity than during the financial crisis. Overall, banks are now structurally healthier, which has undoubtedly helped them weather the pandemic without constraining credit to the real economy.

In the EU, various authorities, and in particular the ECB, responded swiftly to the pandemic by providing banks with regulatory and supervisory relief to encourage continued lending to the economy. Such decisive and coherent action, which helped calm markets and boost confidence, would not have been possible without having a single supervisor. The pandemic showed us not only how important the recent reforms are, but also reminded us that completing the Banking Union – and the Capital Markets Union – remains fundamental to improving the efficiency of the EU financial sector, as well as enhancing the financing options available for the real economy.

As a first positive step towards completing and strengthening the Banking Union, the EU should finalize the implementation of Basel III in a manner that is as consistent as possible with the internationally agreed Basel capital framework. This will help ensure a level global playing field and will limit the costs and risks of global regulatory fragmentation.

Adjusting business models to reflect stricter prudential requirements has incentivised banks to manage risk more efficiently. Yet, leverage and risk reduction have often translated into lower profitability, making cost reduction a top priority to ensure sustainability of business models through the cycle.

Regulation should foster capital and liquidity movement within European cross-border banking groups.

As a consequence, the EU should focus on sector consolidation, which could play a key role in creating the capacity to reduce costs and clean up NPLs. To achieve that, we need a regulatory environment fostering the circulation of capital and liquidity within European cross-border banking groups. The ECB's guidance on the prudential treatment of mergers and acquisitions is an important step in providing greater transparency. However, several obstacles to consolidation remain to be addressed:

First, harmonisation of rules is crucial. The EU should use the opportunity coming from the review of the CRR, CRD and BRRD to remove or reduce excessive room for national discretion and goldplating of European rules. A greater use of regulations could be particularly relevant for this purpose. Even if more operationally cumbersome, we should eventually aim for a more uniform insolvency framework in the long term, which would also support a common securitisation market.

Second, we need to solve the conflicts between host and home authorities that often causes the emergence of national ring-fencing practices. On the one hand, the use of capital, liquidity and MREL waivers should be expanded to treat the Banking Union as a truly single jurisdiction from a prudential perspective. On the other hand, we should also address the concerns of national supervisors of seeing parent companies failing to support local subsidiaries in times of stress. Recent proposals from the ECB go in the right direction.

Finally, a true European deposit insurance scheme (EDIS) is a fundamental building block to a fully-functioning Banking Union. As long as deposit insurance remains national, the resolvability of larger cross-border groups will remain hard to operationalize. In turn, this will continue to incentive ring-fencing in going concern as well.

A true European cross-border banking sector should be fully integrated, alongside deep and liquid capital markets, to reap the benefits of the single market. With fewer, stronger players and improved profitability, the EU banking sector must play an even greater role in financing the transition towards carbon-neutrality. With the end of the global reform of the regulatory framework on sight, it is now time to reflect on the lessons learned and take the necessary action to support sustainable growth. In doing so, regulators and supervisors should create favourable conditions for cross-border consolidation so that banks can continue to serve global customers and markets and increase the overall sum of available credit to the economy.

PIER CARLO PADOAN

Chairman of the Board of Directors,
UniCredit S.p.A.

An effective European banking market as a key driver to allocate resources efficiently

From both a theoretical and experience based perspective taken from other currency and federal unions, it is clear that integrated and well-functioning banking markets play a crucial role in allocating capital efficiently across the economies, both in "normal times" and as shock absorbers in a crisis environment. But for that to happen (private money becoming counter-cyclical), we need integrated financial markets and a significant emphasis on (cross-border) mobility of capital and liquidity. This is particularly true in a post pandemic scenario characterized by different speeds of recovery from the crisis across countries.

First, the lack of fully harmonized banking rules prevents European banks to compete effectively with US peers as the EU banking system is fragmented, resulting from a sum of national entities rather than as a single integrated system. Such a perception weakens its ability to attract international investors. This is also reflected in the supervisory dimension.

The current split of supervisory tasks between SSM (i.e. direct supervision of Significant Institutions) and NCAs (direct supervision of Less Significant Institutions) may be a source of differentiated supervisory practices. To cope with this issue an extension of SSM competencies may be envisaged, for example by bringing under the supervision of the SSM not only the legal entities of a banking group but also the legal entities the group has a significant participation in.

A more integrated EU banking sector requires harmonization of European rules that still reside with local regulators and that impair the efficient management of cross border banking groups, supervision.

Two opportunities to reduce ring fencing practices and supervision inefficiency without requiring legislative changes (which would be difficult to put in place in reasonable time) would be the relinquishments of the liquidity requirements and a possible application of the Pillar 2 requirements at consolidated level only (P2R and P2G). In this respect, we would have expected the ECB – during the recent consultation of its options and discretions policies review – to be more proactive in enhancing waivers from the liquidity requirements at cross-border level.

Integrated and well-functioning banking markets play a crucial role in allocating capital efficiently across the economies.

Furthermore, it is essential – as the EC and SSM chair continue to support – to put in place the third pillar of the Banking Union (namely EDIS, i.e. European Deposit Insurance Scheme) which is not yet in place due to a lack of consensus among member states. It is undisputed that the establishment of an EDIS would grant stronger and more balanced protection for EU depositors.

The activation of EDIS is crucial to reduce the vulnerability of national Deposit Guarantee Schemes to large local shocks, as the level of depositors' confidence in a bank would not depend on the bank's location but on its own individual strength thus weakening the link between banks and sovereigns.
Though we are firm supporters of a fully-fledged EDIS - with full loss mutualization - we acknowledge that a step-by-step approach is most likely to succeed. In this respect, we would also welcome the creation of a hybrid EDIS (i.e. with only liquidity support) as this may represent a key intermediate step to unlock the discussions around long-standing issues, such as ring fencing of capital and liquidity. However, the progressive mutualization of losses in the steady state should remain the ultimate goal to achieve an equal level of protection for all depositors, completing the Banking Union.

Finally, we understand that a reassurance to host countries - with regards to the minimization of the losses to be faced by an ailing subsidiary located in their territory - is needed. It could thus be worth exploring a waterfall payment scheme that sets out how available funds should be distributed to the subsidiaries in host countries in times of crises. However, such allocation of capital and liquidity within entities of a group should be defined only in the event of a resolution and applied by the SRB only for those banks likely to fail or failing.

LUIGI FEDERICO SIGNORINI
Senior Deputy Governor and Member of the Governing Board, Banca d'Italia

Fragmentation/ consolidation: are prospects improving for a single banking market?

EU banks are sometimes compared unfavourably with their American and Asian peers. Overcapacity, persistent pressure on profitability, and lower cost-efficiency, have brought the market valuations of European lenders well below their book value.

One reason for this may be that reaping the full benefits of the single market has proven difficult. Financial markets remain highly fragmented along national lines. According to an ECB report published in 2020, financial integration in the euro area was strong until 2015; thereafter, cross-border price differentials have become volatile, while cross-border banking activity has remained low and stable.

Similarly, cross-border M&As in Europe's banking sector is weak. Deals are fewer than might have been expected following the creation of the Banking Union. A genuinely pan-European banking market still appears a long way off, despite all the progress that has been made.

The most rapid advances have been seen on the regulatory front. The first two pillars of the banking union, supervision and resolution, have been built effectively. The establishment of first the EBA, and then the SSM, have implied a broad-based cross-border harmonisation of the regulatory framework and have greatly increased the consistency and transparency of the supervisory approach.

Seen from this angle, the European regulatory landscape has improved beyond recognition compared to what it was ten or twelve years ago, when first the Great Financial Crisis and then the sovereign debt crisis struck. The self-defeating attempts by many EU supervisors to protect their own national banking systems from the effects of the crisis by erecting capital and liquidity barriers along national borders actually contributed to making the crisis worse.

Along with a single set of rules, a single decision making process and a single set of common practices, the very fact of different national supervisors becoming accustomed to working together for years within a coherent system has changed the supervisory framework immensely, and mostly for the better.

Despite all this progress, the regulatory framework is still fragmented in some important ways.

On the specific issue of mergers, the recent ECB Guide on the supervisory approach to consolidation has increased transparency and clarified supervisory expectations, thus removing potential obstacles to successful deals within the euro area. A key element of the Guide is that the supervisor will adopt a neutral stance in the treatment of mergers, without imposing higher Pillar 2 capital requirements to credible integration plans.

However, despite all this progress, the regulatory framework is still fragmented in some important ways. National discretions remain in some key areas. Macroprudential tools, especially macro capital buffers, have sometimes been used to ring-fence national markets. The third pillar of the Banking Union, common deposit insurance, has proven to be an elusive goal.

The completion of the Banking Union is a priority. By providing a uniform degree of insurance for all retail depositors, the European deposit insurance scheme has the potential to disentangle confidence in banks from their headquarters' location, a key impediment to integration. In my opinion, it is also high time to revise national discretions and improve the macroprudential framework, in order to simplify and streamline the regulatory system, while preserving national leeway wherever it is really needed to adapt the framework to local conditions.

The roots of regulatory fragmentation, however, extend well beyond banking regulation. Progress towards a capital market union would also be beneficial. In a more integrated framework, banks would no longer need to develop local expertise for each national market. They would increase their cross-border holdings of assets and, crucially, could count on a wider investor base.

A Capital Market Union, in turn, entails some minimum element of harmonisation in the trinity of tax, company and bankruptcy law. It is not for me to assess the political likelihood of anything happening on these fronts. It is, however, fair to observe that without some progress in legal harmonisation, it makes little sense to lament the lack of a truly continental basis for the European banking sector. One could also observe that, in fact, the second pillar of banking union is in itself an inchoate harmonisation of bankruptcy law, and could work much more smoothly if a more sweeping process of convergence took place.

Much remains to be done, including on the supervisory front, where integration is most advanced: but without a more harmonised general framework, the responsibility for which falls well outside the remit of supervisory authorities, fragmentation cannot be entirely avoided, and – specifically – cross-border M&As will be unable to achieve their full economic potential.

CHRISTIAN EDELMANN

Managing Partner Europe, Oliver Wyman (UK)

Banks must embrace cross-border consolidation to lead Europe out of the pandemic

The global economy is on a mergers and acquisitions tear, with more tie-ups in the first half of 2021 than in any year this century. Flush with cash and able to borrow at rock-bottom rates, companies around the world are seizing the opportunity to reimagine, reorganize and refashion themselves for the post-COVID-19 economy.

Except for European banks, that is.

In the United States, the market share of the five largest banks has increased to over 60% from 40% in the decade following the global financial crisis. But in Europe, which has experienced anemic economic growth, the industry remains highly fragmented, with the largest five banks still controlling just 20% of the market and no bank operating on a truly pan-European basis. In fact, many have started to streamline their country footprints and business lines in an effort to rein in cost.

Yet European banks stand at the precipice of an enormous opportunity. By supporting the recovery from the COVID-19 pandemic and helping to tackle some of the big issues facing Europe's economy, such as the transition to a carbon-neutral future, the industry can regain a strong sense of purpose, increase profits and ensure its ongoing relevance all at the same time.

Many of the industry's best opportunities for growth and cost reduction present themselves at a European level, making the need for European champions ever more pronounced -- particularly during a time when US competitors use the excess profits from their home markets to fund international expansion.

The European Central Bank has long supported consolidation and is putting considerable effort into removing burdens and challenges from a supervisory perspective. For example, in January it announced it would relax Pillar 2 capital requirements in case of consolidation, recognize bad will as capital and allow banks to use internal risk models during the transition period of a merger or acquisition.

The ECB has long supported consolidation and is trying to remove supervisory burdens and challenges.

But plenty of stumbling blocks to consolidation remain. The lack of a European deposit insurance scheme, for example, forces banks to manage country-by-country deposits. This extends to liquidity and capital pools and hence overall balance sheets -- a hugely inefficient and costly burden that makes it difficult for banks to combine across borders.

Yet perhaps the biggest hurdle to European bank mergers isn't regulatory or structural – it's strategic. New fintech and big tech challengers continue to emerge and many of the more established players are moving from one trick ponies toward offering broader banking services. Meanwhile Europe's universal banks are still dealing with hard-to-update legacy technology and suffer from costly operating models across too many markets, products and client segments. They also suffer from huge compliance costs, much of which fails to deliver any economic benefit.

Make no mistake: consolidation alone will not solve the European banking problem or close the valuation gap to US firms and fintech players. Banks need to rid themselves of their "compliance mindset" and use consolidation to shift toward an "innovation mindset". This will require a willingness to embrace what has worked in other industries.

Regulators can help in that regard by allowing more flexibility in terms of the senior leaders they deem fit and proper for the banking industry. Most if not all European banks lack the necessary post-merger integration skills, given the dearth of meaningful M&A in Europe over the past few years. Banks will have to draw on expertise from other industries – and regulators should support this.

There are glimmers of hope that a new era of deal-making could be at hand. The pandemic has allowed banks to make operating model changes that few would have been willing to try in normal times — closing branches, requiring all staff to work from home, redesigning processes virtually overnight.

Many of Europe's banking leaders understand the appeal of cross-border consolidation, and some are likely to start to act over the next 12 months. A strong divergence between leaders and laggards will spur more activity as the laggards seek to catch up.

But the longer banks wait, the greater the chances that this historic opportunity to reshape themselves for the next decade could slip away.

EU BANK CRISIS MANAGEMENT FRAMEWORK

ELKE KÖNIG
Chair,
Single Resolution Board (SRB)

Where could we improve the framework for medium-sized banks?

A centralisation of tools and funding at EU level would increase the credibility of the Banking Union.

One of the main goals of the ongoing review of the Crisis Management and Deposit Insurance framework is to enhance how we address the failure of medium-sized banks. The lack of diversification of their liabilities (mainly equity and deposits) potentially puts into question their ability to bear losses in resolution, as own funds may be exhausted at that point, and bailing-in deposits may hamper financial stability.

This might undermine the credibility of their resolution strategies, as resolution is not a free lunch and access to the Single Resolution Fund (SRF) is subject to bail-in of not less than 8% of total liabilities and own funds (TLOF). As for any other bank, it is crucial to address operational resolvability and build up the mandatory minimum requirements for own funds and eligible liabilities (MREL) buffers by 2024. However, some of these banks have not yet been able to tap – or at least historically have not tapped – the markets to build up adequate MREL.

The SRB is working to better adapt its resolution framework to these banks, using the proportionality principle, but without undermining the end goal: resolvability. This work relies on the following three main pillars: transfer strategies, tailored MREL calibration and access to funding. On the first two, the SRB is in the driving seat, but legislative changes are required for the third.

First, transfer strategies seem to be the best tools for medium-sized banks. The SRB is working to enhance its preparation for using these strategies. For instance, in the first half of 2021, the SRB has made substantial progress in making transfer tools fully operational. The SRB will also prepare additional policies and guidance on separability.

Another important missing piece to solve the problem of medium-sized banks is to put in place a European Deposit Insurance Scheme.

Second, MREL needs proper calibration for transfer strategies. In 2022, the SRB will work on MREL policy for the banks that have transfer tools as the preferred resolution strategy. This could, under certain conditions, lower the MREL requirement for banks compared to the status quo. For banks with a credible transfer strategy, there might not be a real need to set MREL at a level that allows the full recapitalisation of the bank. As a result, MREL requirements could be lower, based on the likelihood of transfer strategies being reliably implementable.

Third, access to external funds in resolution, if needed. Currently, banks facing resolution may have access to the SRF and/or the deposit guarantee schemes (DGSs) under certain conditions. However, these conditions severely restrict the use of DGS funds in resolution, potentially jeopardising the success of resolution. This may create incentives for decision-makers to look for ways to circumvent the resolution framework.

Access to the SRF and its combined use with DGS could be further explored, to act as funding to support those resolution tools other than bail-in that ensure the exit of resolved entities from the market through transfer strategies.

To overcome the legal framework's restrictions on the use of DGS in resolution, we recommend replacing DGS-super priority by adopting a general depositor preference. The DGS could then contribute to resolutions in a way comparable to other creditors, in accordance with the creditor hierarchy. While this would likely be a limited contribution, given that the DGS would continue to rank above most creditors, it aligns to the broader responsibilities of the DGS in subrogating to the rights of the covered depositors. This would help to achieve all the resolution objectives; including minimising the use of public funds and avoiding further value destruction.

Notwithstanding the above, given the limited size of national DGSs and the existing uneven playing field, another important missing piece to solve the problem of medium-sized banks is to put in place a European Deposit Insurance Scheme (EDIS). A centralisation of tools and funding at EU level would reduce fragmentation and increase the credibility of the overall Banking Union, thereby further enhancing financial stability.

HELMUT ETTL

Executive Director, Austrian Financial Market Authority

Broader DGS support for failing banks – Yes, but not unconditional!

The current resolution framework is certainly more tailored towards highly concentrated banking sectors with only a few national or even global players than to highly fragmented markets with several hundred banks. The prominent role of MREL in resolution is one indicator in this regard. While for globally active banks with a long track record of bond issuance, issuing MREL eligible debt does certainly not constitute a major obstacle. However, it does so for small, regional banks with either limited or even no capital market access at all. The problems here range from high one-off costs to start an issuance program and the lack of experience in bond issuance to the required minimum ticket size, which smaller bank often fail to reach due to their deposit focused refinancing of their balance sheet.

Of course, there are several other topics in the context of how a failing smaller or medium sized bank can orderly exit the market without any substantial market disruption. These encompass several fundamental aspects, such as whether there is the need for an own regime for small and mid sized banks or not or whether to include those banks in the resolution framework or the national liquidation framework. However, let me return to one of the key elements already mentioned above – loss absorption and financing of the wind-down and exiting process.

It seems to be evident that it is not enough to simply impose full MREL-targets and hope for compliance. Some of those banks would not reach these targets at all, some would require years.

These banks would not be resolvable, they would impose a threat to financial market stability and (resolution) authorities would be accountable. In order to address these challenges, loss absorption requirements will need to be more tailored to the actual business model, the riskiness and the financing conditions of the respective banks, or put differently some form of proportionality will need to be implemented for loss absorption requirements.

This leads me directly to the question how costs in resolution could alternatively be born. In this context, a more flexible usage of DGS funds could open up new possibilities. DGS funds instead of MREL funds could, for example, be used to finance a transfer of viable parts of a bank to another bank. Of course this should not mean to altogether abolish burden sharing arrangements and hence loss absorption requirements for small banks. As mentioned above, mid-sized banks required to hold MREL in particular struggle with the issuance of sufficient MREL eligible liabilities.

DGS could play a relevant role in the winding down smaller banks – but not at no cost.

One potential way forward would thus be to oblige those banks to hold an additional standardized calibrated "MREL buffer" beyond regulatory capital requirements in gone-concern-capital instruments, e.g. Tier-2, but in turn to allow for a usage of DGS funds in the resolution of those banks. Of course, such a usage of DGS funds would need to be conditioned upon several things, most prominently upon the loss bearing of shareholders and other holders of regulatory capital and the market exit of the bank.

Another key condition for such an enhanced usage of DGS funds would be a more harmonized and comprehensive definition of the least cost principle in order to ensure a level playing field nationally and across the EU. Currently, this least cost principle is defined by only one sentence in the DGSD, stating that "the costs of the alternative measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS". How such a specification would look like in more detail remains to be seen, a combination of different cost perspectives and conditions could proof to be a promising way forward.

Furthermore, a least cost principle should not only take into account how much costs arise for the DGS, but also when those costs materialize. Though a DGS might be able to reclaim parts of the paid out covered deposits in the course of the insolvency procedure, these revenues are often realized only many years after the insolvency. Using DGS funds for bridging a liquidity gap in the transfer of business to another bank on the other hand might result in higher one off costs, but those costs might be recovered faster through the sale or transfer of all or parts of the failing bank. Introducing this timing component in the least cost principle can be one potential avenue to improve the measurement of costs in case of an alternative usage of DGS funds.

Summing up, a broader but yet conditional usage of DGS funds can constitute a potential way forward.

At the same time, such an instrument would of course also need to fit within the whole package. This is why I would generally advocate having the discussion on the usage of DGS funds and the least cost test as well as on other specificities only in the context of the whole solution proposed for the revision of the crisis management framework.

EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board, Member of the Steering Committee,
European Central Bank (ECB)

Improving the EU crisis management framework for small and medium-sized banks

The creation of European banking supervision and the Single Resolution Mechanism in the aftermath of the great financial crisis were two crucial milestones on the EU's path to an effective and integrated framework for managing crises. However, in the quest to address too-big-to-fail issues, less attention was paid to managing crises at small and medium-sized banks; it was assumed they would not pose financial stability concerns and could be dealt with under ordinary liquidation procedures at national level.

This assumption has been proven wrong. In some cases, the declaration that a bank was failing or likely to fail at European level did not trigger ordinary insolvency procedures at national level, effectively preventing the authorities from forcing a failed bank to exit the market. Moreover, within the banking union, some Member States rely on administrative bank liquidation regimes with similar instruments to those used in resolution procedures, while others follow the same liquidation procedures that are applied to corporates – often resulting in similar situations being managed differently in different countries depending on the national insolvency procedures. This lack of harmonisation creates an unlevel playing field in the euro area and undermines the potential of the banking union to deliver a truly unified European banking market.

When looking to enhance the consistency and effectiveness of the European crisis management framework, the US model, centred around the Federal Deposit Insurance Corporation, offers valuable insights. Under this model, viable parts of an insolvent bank are matched with a thriving acquirer, often located in another state, thereby allowing small and medium-sized banks to reap the benefits of a large and integrated market while ensuring smooth market exits with minimal impact on depositors.

When considering how the US solution could inspire changes to the banking union, two features stand out. The first is a deposit guarantee scheme, which could support the liquidation of a failed bank's assets, ensuring that the failure of medium-sized banks is handled in an orderly and effective manner that guarantees a smooth market exit and only a small impact on local financial stability. This should be done in the most harmonised manner possible in the euro area, with a view to achieving a fully unified model with the implementation of the third pillar of the banking union. The second feature is enhanced predictability of resolution outcomes, which could encourage market participants to engage in cross-border activity and consolidation, and therefore contribute to a more integrated European banking market.

An effective crisis management framework for smaller banks is key for a unified banking market.

But how can we achieve this in practice? First, as a supervisor I would stress that focusing on actions that can prevent a bank's failure, such as improving recovery plans, remains key. In addition, under the Single Resolution Board's revised approach to the public interest assessment (PIA), the resolution framework can be applied more broadly so as to level the playing field for small and medium-sized banks. However, this would mean that smaller banks would need to meet higher minimum requirements for own funds and eligible liabilities (MREL). As these banks rely predominantly on deposits and have limited access to capital markets, their MREL target would likely be met mostly with equity, which could be depleted at the point of failure, requiring a bail-in of uncovered deposits. And even with a broader PIA, resolution would not be available to all banks. Alternative options need to be explored.

One option would be to ensure, through harmonisation at European level, that national resolution authorities have administrative powers to transfer assets and liabilities in liquidation as an alternative, or complementary, measure to an insured depositors' pay-out, with the support of deposit guarantee scheme (DGS) funds. Although discrepancies across Member States could render this solution sub-optimal, allocating administrative liquidation powers and DGS funds to the European level would be more conducive to orderly wind-ups.

However, the absence of a European deposit insurance scheme remains an obstacle, as an exclusive incentives of decision-making power at European level may be misaligned with the use financing tools at national level. A "two-keys" process could be an intermediate solution: the Single Resolution Board would retain the power to trigger liquidation when resolution is not available and check that the transfer of assets and liabilities ensures an exit from the market, while the national authorities would retain the power to decide whether national DGS funds can be used for this transaction.

Although small and medium-sized banks have so far emerged unscathed from this crisis, we should not be complacent. An effective and consistent framework that caters to crises at these banks is crucial to deepen integration, and therefore ensure financial stability, in the European banking market.

JUAN POSWICK

Head of Recovery and Resolution, BNP Paribas

A way forward in crisis management for small and medium sized banks?

All concerned parties tend to agree that part of the issue stems from the lack of consistency in the implementation of the existing framework and some of its founding principles. Inconsistencies appeared between the European and national levels as well as between different Member States. Besides consistency, at least across the Banking Union, improvements should come in terms of harmonization and predictability.

In this respect, the evolving SRB approach of Public Interest Assessment (PIA) could open an interesting way forward. In our view this could entail that all banks with a minimum balance sheet size, e.g. € 15 to 20 billion, be deemed susceptible of a positive public interest assessment a priori. They should fall under the sole responsibility of the Single Resolution Board (SRB) and not of the National Resolution Authority (NRA) if Failing or Likely to Fail (FOLF).

Accordingly, they would all be subject to MREL requirements, including a recapitalisation amount, and they would all have access to the Single Resolution Fund (SRF) at the same conditions. Similarly, they should fall under the SSM. Consequently, in case of troubles, the possible use of early intervention or preventive measures would be decided at European level in a consistent way, with due coordination between the ECB and the SRB. Although national authorities would remain involved, the decision power for these banks should reside at European level.

The ability of smaller banks in this category to issue Eligible Liabilities in order to meet the MREL targets that belong to the proposed approach is evidenced by empirical analysis of public issuances, which can effectively be complemented by private placement arrangements, available for relatively small tickets. The costs appear quite fair and reasonable compared to that of large banks. Based on the last SRB MREL dashboard, it is worth noting that shortfalls vs. targets concentrate on a limited number of countries, which may be a sign that issuance problems are not linked to size but to local market practices or conditions. We believe that such problems may be overcome by the banks themselves with support from advisers, if necessary, to better represent their strengths and access targeted investor pools.

Besides consistency, improvements should come in terms of harmonization and predictability.

For smaller banks, below the above-mentioned threshold, a way to foster further consistency would be to give the SRB a final say in the PIA. In case of negative PIA, a FOLF situation should entail an effective and rapid exit from the market, a key principle at the basis of the crisis management framework. To that effect, a harmonisation of banking insolvency rules for insolvency triggers following FOLF declaration would help ensuring a level-playing field and avoiding cross-border NCWO issues or limbo situations.

It is also important to address the sometimes controversial use of preventive or alternative measures funded by mutualised or public resources. Here again, we would see benefits in giving a final say to European authorities for the sake of consistency, among other in the way the least cost test is applied and in the logic behind the recommended use of such measures in relation to the PIA. If such measures were to be used for banks with a negative PIA, they might delay but should not prevent an effective market exit. They should neither limit nor eliminate due burden sharing by shareholders and subordinated creditors.

More generally, access to the public or mutualised funds should indeed always remain subordinated to that key condition. To reduce the burden on other banks, minimise moral hazard and avoid competition distortions, adequate burden sharing must be imposed on any failing bank's shareholders and creditors, e.g. through write-down of equity and bail-in of subordinated debts, whenever an authority or a DGS deploys preventive or alternative measures. This should hold whether utilising public funds subject to state aid restrictions, or privately mutualised funds. In addition, each such measure should be subject to the least cost test.

This key principle of burden sharing must also apply to FOLF depositor-funded banks whatever their size. Equity and debt holders of such banks must be clearly informed about the risks attached to their investments, in line with MIFID, and protective rules for retail investors should be reinforced as appropriate, e.g. through relative limits for such investments, in order to prevent socio-political issues upon FOLF event.

Without fundamentally changing the existing framework and by consistently applying key principles initially set by the EU lawmakers we believe that some serious steps forward could be achieved.

JOHANNES REHULKA
Managing Director & Secretary General, Austrian Raiffeisen Association

Do not to throw the baby out with the bathwater

Necessary amendments

When we start to think about improving the CMDI framework we have to keep in mind the current regulatory framework. After long and intensive negotiations, the legislative bodies came to the political decisions to establish a regulatory framework for systemic relevant institutions (BRRD and SRMR) and a regulatory framework for non-systemic institutions (DGSD). These political decisions laid the foundation for the current legal framework in 2014.

We should support all technical necessary improvements of the existing BRRD and the DGSD (see the EBA proposals to improve DGSD) while at the same time we should avoid fundamental structural changes like the establishment of EDIS, higher contributions of the national DGS to the resolution funds or a shift of competences from the national to the European level. Such far reaching changes would rather have a negative impact on the confidence of citizens and market participants in the functioning of the systems.

Also the arguments raised for an implementation of EDIS are still not convincing. For insolvencies of large banks with cross-border implications a resolution mechanism and a highly monetarily endowed resolution funds has been implemented on the basis of the BRRD and SRMR. However we do not believe that such a kind of risk and fund transfer is appropriate in any manner especially for regional active banks, which would be the main target of such an EDIS system. These regional banks (most of them are part of an institutional protections schemes) would never benefit of such a European centralized system but would always be obliged to finance such kind of scheme.

Application framework by authorities

Since 2015 the European resolution authorities have at their disposal far reaching instruments for winding up credit institutions that fulfill the "public interest assessment test". So far some authorities have not applied the resolution framework although the current legislative framework leave the them far reaching discretion (to be clear: the Austrian authority has applied the framework in the past). The current legal framework does not have to be changed in this point rather the resolution authorities would have to change their restrictive application approach.

The same counts for the application of the bail-in tool. In theory the application of the bail-in tool could lead to a higher part of loss absorbency for shareholders and subscribers of bail-in able instruments. The reluctant application of the bail-in tool by resolution authorities with regard to retail investors is problematic in this vein. An exclusion of retail investors by resolution authorities, who were informed in detail about the risks of the bail-in able instruments, does not fulfil the original objective of BRRD.

A big bang with the establishment of EDIS is not required. Necessary Improvements should be adopted.

Small and non-complex institutions

We have to be very cautions to understand and maintain a diversity of different banking models and banking sizes in Europe. As a matter of fact, the vast majority of small and non-complex banks (e.g. cooperative banks) with a traditional business model does not have capital market access and is therefore unable to take up instruments for MREL purposes. In line with the recent adopted exemptions in BRRD II they should be out of scope of the MREL requirements due to their size (balance sheet up to EUR 5 bn) and noncomplex business models. Most of them are operating on a national regional level only and are also part of an institutional protection scheme. A resolution of these banks is not very likely and even in the case a resolution of these institutions would not be of public interest.

Highest ranking for covered deposits

The current priority system according to which deposit guarantee schemes subrogating to the rights and obligations of covered depositors in insolvency have the highest ranking must be preserved as this provision ensures the functioning of DGS-payouts. It is important that deposit guarantee schemes that pay out depositors the full protected amounts shall primarily be reimbursed from the insolvency assets. Otherwise, the consequence would be an unjustified severe disadvantage for DGS and the member-banks financing the DGS.

Preventive measures

Preventive measures of DGS are inherent to banking sectors which are organized in an institutional protection scheme. These IPS have implemented early intervention systems which avoid bank failures at an early stage. Therefore these preventive measures have not only contributed effectively to the avoid bank failures with regard to the DGS-Directive but also do so since decades on a voluntary basis. Therefore they should be maintained under the current conditions.

KARL-PETER SCHACKMANN-FALLIS

Executive Member of the Board, Deutscher Sparkassen- und Giroverband (DSGV)

Improving and not uprooting proven crisis management mechanisms

A key lesson from the Global Financial Crisis was that public authorities must be enabled to resolve financial institutions whose failure could be systemic. With the EU's resolution framework, this premise was translated into practice to limit the overall impact of bank failures on economic activity and to avoid exposing public funds to loss.

In 2021, the European Commission is reviewing this framework, but while emphasising that it will proceed with prudence, far-reaching changes are to be expected.

Of all credit institutions, the review might particularly affect savings banks and cooperative banks in a negative manner. This is despite them not having caused the financial crisis and not having been the target of subsequent reforms on resolution or their underlying reasoning. To be clear, in their vast majority these are small or medium-sized less-significant institutions (LSIs) that do not qualify for resolution.

Looking at the debates accompanying the European Commission's review to date, it becomes clear that there are considerations for a global overhaul of the framework that fail to adequately meet the needs of the EU's diversified banking sector. Particularly problematic in that regard is the intention to closely entangle the review of the resolution framework with the deposit insurance framework. This risks muddling national and European responsibilities as well as the distinction between systemically important banks qualifying for resolution and non-systemically important banks going into national insolvency.

One example are deliberations on further centralisation at EU level and the resulting administrative and financial implications. Neither in terms of proportionality nor from the perspective of financial stability would it be necessary to expand the competence of the Single Resolution Board (SRB) for the use of Deposit Guarantee Schemes (DGSs) or to widen the resolution mechanism beyond those credit institutions of systemic relevance. For the overwhelming majority of small or medium-sized institutions, a regular insolvency proceeding in combination with the responsible national deposit insurance framework has proven to be an adequate solution. These cases display low complexity and entanglement in the financial market as well as a client base that is limited to a region.

EDIS threatens to block any meaningful progress in the Banking Union.

Further complicating the picture, the Commission continues to hold on to its proposal for a European Deposit Insurance Scheme (EDIS). By making it an integral part of the review of the crisis management framework, there is a risk of inhibiting any progress at all. Discussions on EDIS have been in limbo for almost six years. A breakthrough has become even less likely against the background of an ongoing global health crisis whose effects on the real economy have not yet fully materialised. Ongoing increases in public debt and heightened credit risk further complicate the picture, as witnessed at the last Euro Summit.

On top, EDIS would risk undermining financial stability by weakening tried-and-tested institutional protection schemes (IPSs) or even rendering their continued existence economically non-viable. This concerns a significant amount of covered deposits in the Banking Union where currently well over 20% are protected via IPSs.

To overcome the current deadlock, the Commission should consider withdrawing the EDIS proposal. Furthermore, the stabilizing role of IPSs recognized as Deposit Guarantee Schemes (DGSs) must be taken into account and explicitly reflected in future legal texts. A feasible way to do so would be their structural exemption from a centralised deposit protection system. This could avoid that IPSs are limited in their functioning to pure depositor compensation, which they provide merely as a formal last resort.

If the review of the crisis management framework shall advance and bring tangible improvements, it will be crucial that the diversity of the EU banking system is taken into account. For LSIs, the upcoming review could look at ways for a targeted harmonisation of national insolvency rules for banks. Furthermore, a strengthening of the national DGSs and IPSs would allow for improvements, for example by maintaining and encouraging their ability to engage in preventive measures. In this context, the warranted recalibration of state aid rules could ensure that measures in accordance with the Deposit Guarantee Scheme Directive (DGSD) are not limited or prohibited.

The coming months should be used to find ways to increase the efficacy and efficiency of the resolution and deposit protection systems in an evolutionary way, that is, without hampering the functioning of existing structures.

The underlying rationale must be to ensure that the Banking Union can foster the stability of the financial system.

BANK MODEL DIVERSITY IN THE BANKING UNION CONTEXT

HARALD WAIGLEIN

Director General for Economic Policy, Financial Markets and Customs Duties, Federal Ministry of Finance, Austria & Chair, FSC

No credit crunch within sight

Financial markets should be dominated by different business banking models to enable a competitive and effective supply of financial services. Undoubtedly, diversification in the sense of size, complexity, market and consumer focus is fundamental to ensure economic prosperity and to establish and maintain sustainable and viable business models.

This serves the needs of customers and investors, be it in a more traditional or digitalized way. In this respect, the EU banking sector is in a good position to overcome present and future challenges.

Scientific evidence underlines that access to bank loans is closely related with the risk, capital and liquidity position of a bank. A well-capitalized bank with a robust risk management will grant credits if the assumed risk is acceptable and manageable.

In this respect, the financial reforms of the last decades have been proven to be accurate. So far, EU-banks have shown resistance to the negative economic effects of the pandemic, a contagion to the Financial Sector did not happen. Undoubtedly, the fast and targeted responses of banks, Member States and regulators were of high relevance. However, the improved capital base and liquidity position of banks, the more robust and resilient deposit insurance system, the newly established recovery and resolution framework and the comprehensive tool-box for supervisory and resolution authorities helped.

In that vein, the 2021-EBA-stress exercise with its severe adverse scenario, thus also considering the impact of the pandemic, identified room for improvements in the banking sector. According to this exercise, some banks would be considerably more affected than others and some Member States seem to be more vulnerable. However, it also confirms the significantly improved resistance of the EU-banking system as a whole. The information gathered will be used in the SREP as a basis for discussions between regulators and banks. I expect necessary activities to follow which will contribute to solid and stable financial markets thus ensuring that banks remain able to perform their duties.

The EU banking sector is in a good position to overcome present and future challenges.

The ECB's Euro area bank lending survey of Q2 2021 underlines that Euro area banks expect a slight net tightening of credit standards for loans to firms of 2% for Q3 2021 which can be explained by market developments. Besides, a small net tightening impact of the risk perceptions and a net easing impact on banks' overall terms and conditions was noted on balance. The bank lending survey also referred to a moderate increase in firms' demand for loans or credit lines in the second quarter of 2021 while the share of rejected applications for loans to firms remained unchanged.

Overall, the developments of the leading indicator properties used in this survey do not signal a sharp reduction in lending to firms in the coming quarters. This all in all positive outlook for the third and fourth quarter of 2021 is encouraging. The importance of banks for the financing of companies within the EU is undisputed. However, the strengthening of companies with equity and hybrid capital is also of high importance.

I am therefore thoroughly following the Capital Market Unions' progress. In my view, we have to contribute to more financial educated people, should support a better visibility of companies and enforce more effective and efficient Capital Markets.

Legislators, regulators and banks need to closely work together to enable the recovery of the EU-economy by preserving a high and future-proof level of Financial Market stability. We have to closely monitor developments in the real economy as well as the Capital and Financial markets to set the right and appropriate measures if needed in an appropriate and targeted manner. However, in general the EU-banking sector is robust enough to constantly ensure credit supply.

It's diversified structure and the high level of market integration within the EU is of importance and should be preserved.

EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board, Member of the Steering Committee, European Central Bank (ECB)

The diversity of banking business models in Europe

A business model can be seen as the total of systems, mechanisms and methods through which a bank generates earnings and satisfies its owners, clients and other stakeholders in a way that ensures it continues its business. In these terms, European banks are characterised by their different degrees of reliance on lending income (which is by far the most important income type) and range from institutions essentially dependent on lending to banks relying heavily on fee-based activities, such as asset management or investment banking. However, a mixed business model (sometimes called "universal") is also a European characteristic. In addition, there are important differences due to the funding mix (with various degrees of reliance on deposits, which entail different cost patterns), size, and channel of distribution: from small local entities, to very large retail banks present in different national markets, to some purely digital cross-border entities. There can also be very specific specialised entities, like public development banks.

From the point of view of prudential supervision, it should be stressed that, in principle, diversity is most welcome: it not only serves to satisfy different stakeholder needs, but also ensures a degree of resilience that entirely uniform banking structures could not reach. But there is an overarching imperative applying to all, which is the raison d'être of prudential supervision: all banks, whatever their business model, should be managed in a sound and prudent way that ensures their capacity to absorb the potential shocks without negative spillovers to the rest of the economy. This means that all banks have to put aside a margin of income (whether they call it profit or building up of cooperative reserves) over current costs in order to be able to absorb – in a sustainable way – future costs, in particular costs linked to the materialisation of risks.

Here is the main challenge for European banks: net interest income – the euro area banks' main source of income, which accounts for roughly 60% of aggregate income – is under pressure due to margin compression, which persists even when global profitability recovers, as it did in Q1 2021. This presents a challenge to business model sustainability. Even though in Europe the cost of risk is subdued, both for structural reasons and particularly thanks to recent government support, the current levels of interest income would not be able to absorb a marked increase in these costs over the medium term without impairing the global profitability and thus sustainability of a number of European banks.

This is particularly the case for traditional lenders, relying heavily on this margin between interest earned and paid, but it also affects – to different degrees – most of the universal banks and even specialised lenders, as they are also price-takers in a very competitive credit risk market. This heavy reliance on lending sets the European banking system apart from its counterpart in the United States, where capital markets play a larger role in financing, and banks provide more ancillary, fee-generating services. This divergence shows no signs of reversing: we continue to observe a trend of European banks retreating from trading activities in the aftermath of the great financial crisis. Their portfolios also feature less consumer finance than those of their US counterparts – a trend that is not yet abating either.

Another difference is the more diverse nature of the national markets in Europe, which is due to different attitudes toward credit, and legal differences, for instance regarding insolvency or the seizing of collateral; all of that shapes lending and products along internal borders. As a result, even within the euro area, banks have fewer cross-regional credit exposures than US banks.

Action is therefore needed to strengthen business model sustainability of the different banking models in Europe. Banks need to earn a sufficient return on their capital to be sustainable and most banks under European banking supervision currently fail to do so.

Part of the solution could be to reap the benefits of digitalisation. It is not only an opportunity to cut costs or improve the effectiveness of internal processes. More fundamentally, when its risks are properly managed, digitalisation gives banks the opportunity to reshape their processes and services offered to customers, generating new revenue streams.

Digitalisation offers many opportunities to gain a better knowledge of the customer, and it may allow banks to better satisfy the needs of their customers by increasing responsiveness to their particular situation.

Diversity should also be part of the solution: the essence of banking lies in assessing, balancing and managing risks and benefits; since different types of the risk/reward equilibrium are needed to satisfy different types of customer needs, there is place for different types of banks. There is a trade-off between complexity and diversification – banks with leaner business models, specialising more in a specific region or customer group may be able to better align their product offer and operating model to serve that specific purpose; on the other hand, they are less shielded from idiosyncratic developments of that specific activity or market.

Size can yield economies of scale and scope, which can be particularly relevant when rolling out digital platforms, and it can facilitate geographic diversification. At the same time, expansion into new markets and business activities should be accompanied by the acquisition of adequate skills and expertise in the bank's management and appropriate control function and risk management practices. Increased complexity can pose a challenge to management as cost structures, IT infrastructure, etc. become less tractable.

The choice of the specific strategic actions is in the hands of the banks' management.

Our role, which we are determined to play actively, is to ensure that this diversity of busines models develops in a safe and sound way, without being constrained by artificial barriers within the Single Market, including the presence of institutions without a sustainable strategy that are kept afloat in the market at all cost.

KARL-PETER SCHACKMANN-FALLIS

Executive Member of the Board, Deutscher Sparkassen- und Giroverband (DSGV)

Finding a proper regulatory environment for the EU's diversified banking sector

In the EU, there are about 4,300 credit institutions, 9% of which are large, 29% mid-sized, and 62% small and non-complex. Together, they form a banking sector whose diversity increases financial stability and allows meeting the demand of the real economies of the EU Member States. To maintain these benefits, policymakers have to have the entirety of the banking sector in mind when working on any regulation.

Within the EU, the German banking market in particular is marked by a variety of business models, legal forms and the complementarity of large and small institutions. This setup leads to high competition and diversification, benefitting the customer and society as a whole.

The German savings banks provide a good example of how different institutions take on specific economic and social tasks. Their regional focus and decentralised responsibility, covering the entirety of Germany, allow for quick decision-making and close customer proximity that minimizes asymmetric information. This made them a natural partner for Germany's SMEs and helped to create a close relation with private households.

To diversify potential risks, there is an interbank cooperation via the Savings Banks Finance Group bolstering the stability of its autonomous members while enabling them to realize economies of scale, for example regarding shared IT systems and back-office services. This cooperation is best reflected in their joint institutional protection scheme (IPS). During the Global Financial Crisis, these and other regional banks in Germany and Europe provided stable lending to SMEs and self-employed businesses. Again, over the course of the last year marked by the COVID-19 pandemic, they proved to be a reliable partner providing the needed liquidity, advisory services, and forbearances in addition to distributing record volumes of promotional loans.

A diversified banking sector is beneficial for the real economy and enhances financial stability.

There are good reasons to strive for a well-functioning EU single market for financial services, but it should be ensured that this is not done at the expense of a diversified banking sector. Particularly when considering that the resulting concentration would be counterproductive by introducing herd behaviour and placing crucial financial services in the hands of a few at the expense of the European customer.

Considering the challenges ahead, it will be vital that all institutions can make optimal use of their equity to finance the recovery of the real economy and the necessary transitions to come. SMEs will be confronted with the necessity of transforming their business activities in a digital and sustainable fashion, which will require innovation and investment. Given their decentralized setup, the German Savings Banks are well suited to accompany this process. Based on their local presence, they can facilitate an appropriate allocation of credit, including the rural areas. Furthermore, they can provide the tailored financial advice and services necessary, fostering sustainable investments and ecological business models.

Thus, decision-makers should have the entirety of the EU banking sector in mind when shaping the future policy framework. Amongst others, improvements are possible when transposing international capital standards. While these are designed for large, globally active institutions, the EU still largely follows a one-size-fits-all approach in its implementation (Single Rulebook). The resulting fixed costs and complexity affect small or medium-sized banks disproportionately. Due to increased awareness, the principle of proportionality already played an important role in the banking package from 2019. Now, the EU should build on these first achievements when developing its financial markets. Regarding efforts to improve the Banking Union, we see a similar picture. Instead of seeking feasible solutions, specificities of a large share of the banking sector are ignored, particularly regarding questions of deposit insurance, but also considering supervision and crisis management. The interests of small or medium-sized, regionally focussed credit institutions and the special characteristics of their network organisations must not be disregarded.

For all the above, it should be in the EU's interest to have a more holistic view on the desirable way forward for its banking sector. This is not about a preference of certain banks' business models or about lowering prudential requirements. The actual objective should be nothing less than the creation of a real level playing field by introducing measured, proportional approaches allowing for the entire EU banking sector to strive.

PHILIPPE HEIM
Chairman of the Executive Board, La Banque Postale

Diversity of banking models is an asset for the financing of the EU economy

The banking industry has a long history in Europe where various types of banks have emerged over time, shaped by history, culture, public policies and consumer needs. More than others, it has constantly evolved, not only driven by disruptive technologies and regulatory changes but also in a bid to meet growing expectations from all stakeholders, notably in terms of positive impact finance.

Diversity means robustness under economic stress

First, banking models' diversity is key to limit procyclicality, as well as to preserve European financial stability.

As the crisis taught us, European banking models' diversity has allowed economic actors to deal with the sanitary crisis while preserving the robustness of the financial system and limiting any contagion risk. To this end, banks have played a crucial role in supplying more credit state guaranteed to all who needed it.

Yet, it is critical that such diversity does not translate into a burdensome complexity: as evidenced during past episodes, being "too-big-to-manage" often comes with adverse profitability developments. Hence, the debate is on how to strike the right balance between sufficient diversification and profitability.

Diversity means adaptability and innovation

The diversity of banking models also reflects the adaptability of financial services to a fast-changing environment and to customer's needs. Individuals expect ever more simplicity, instant digital interactions while still getting the possibility of tailored human financial advice in local branches. When it comes to savings, customers also expect to benefit from a wide range of services with a growing attention geared towards the social and environmental impacts of their investments.

Diversity of banking models surely does not mean the persistence of archaic banking institutions. Since 2008 in Europe, the total number of credit institutions has decreased by 30% due to the rapid transformation of the banking industry, which has demonstrated its ability to evolve through mergers, investment in new technologies or new partnerships with fintechs.

In this respect, La Banque Postale has been able to build a leading social finance platform gathering leading actors such as KKBB (crowdfunding), Goodeed (fundraising through advertising), Lendopolis (crowdlending) and Microdon (fundraising through micro-donations). In 2019, La Banque Postale also successfully launched Ma French Bank, a fully digital bank, which accounts for more than 350 000 clients to date, while still fulfilling its public service mission of banking inclusion dedicated to more than 1 million clients through the local branches of La Poste.

In that respect, La Banque Postale enjoys a unique and original position on the French market and is now successfully evolving into a large group offering a wide range of financial services including insurance products alongside CNP Assurances.

Diversity also means differentiation

Responsible by design and in line with its imperative of ensuring a "just transition", La Banque Postale will consolidate its international ESG leadership by launching new and differentiating initiatives such as its Global Impact Weighting Factor ("2iG") for financing and investment decision or the rollout of our positive-impact consumer loan offer. Finally, after the unveiling of its company purpose, La Banque Postale will consolidate these long-term commitments by becoming a mission-led company, which is unprecedented at the European level.

Comparability and transparency are necessary

Importantly, preserving banking model diversity goes hand in hand with ensuring comparability and transparency. In the spirit of the single rulebook, common standards are necessary to ensure a consistent and fair supervision, thereby giving true meaning to what a genuine European Banking Union should be.

Striking the right balance between sufficient diversification and profitability is key.

Indeed, the demand for comparability is strongly expressed by consumers and civil society. In Europe, most banks have committed to long term social and sustainable objectives and in the wake of the pandemic the world's long term investors are reexamining their purpose or "raison d'être". In that respect, common standards, labels and measurable impacts are praised by investors and customers to better guide their investment choices.

As a wrap-up, the diversity of banking models is a source of competitiveness and innovation directly benefitting to European customers. As a public domestic bank providing a large physical network, a performing online offer while expanding its international activities, La Banque Postale's competitive edge builds on a differentiating and scalable banking model.

GILLES BRIATTA

Group General Secretary,
Société Générale

Shaping a competitive Banking Union

The French universal banking model has been a source of resilience through the cycle. However, as highlighted by the High-Level Expert Group chaired by E.Liikanen in 2012, rather than their business model, it is the level of risks taken by banks which matters.

In this respect, over the last decade, G-SIBs have made substantial improvements, propelled by regulatory reforms of the single rulebook and the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism.

Large European banks now operate with reinforced capital and liquidity, while enhanced supervisory measures and new resolution regimes are in place. Consequently, banks entered the COVID-19 crisis in a better position, which enabled them to play a pivotal role in supporting the economy.

Ten years into the development of the Banking Union, and despite the progress made on risk-reduction, progress toward completion of the Banking Union is held back by national interests, which could lead to fragmentation and be detrimental to pan-European banks.

Although completing the Banking Union is a commonly agreed goal, there are divergent approaches on what steps should be taken and in what order. Medium and small banks should be incorporated into the framework in order to avoid loopholes in the crisis management framework, which distort competition and hamper efforts at consolidation.

Within the euro area, cross-border banking has not meaningfully progressed since the launch of the Banking Union (as evidenced by M&A figures and cross-border assets in subsidiaries and branches). This is partly because the Banking Union does not fully recognize the EU as a domestic market.

While it is true that large banks have greater operational capacity to implement some measures, the principle must remain "same business, same risks, same rules". Any dilution of the common rules on MREL and the 8% minimum bail-in should be avoided, given that these provisions should be purely risk-based and increase market discipline. The proportionality principle should apply, not only with regards to the size of institutions but also considering the probability to use the schemes: contributions by the French banking industry to the Single Resolution Fund (close to 32%) have become disproportionate. Exemptions and carve-outs limit the predictability of the framework and create different interpretations which are detrimental to cross-border flows and businesses. The Banking Union framework should ensure the market exit of non-viable banks, as is the case in other jurisdictions.

The Banking Union should ensure convergence, competitiveness, and autonomy of the European economy.

The Banking Union is a step towards a Single European Market. It should support recovery and growth with the aim of convergence, especially when national economies and sectors are diversely hit by the crisis.

The objective of the Banking Union should also be to bring efficiency to the banking sector, and not simply increase costs without the potential to generate savings.

Contributions to the second pillar of the Banking Union are significant. As of July 2021, the SRF is pre-funded to the tune of approximately €52 billion. Attention should therefore be paid to the evolution of contributions and their side effects :

a. they should reflect the probability of institutions being covered either by a resolution procedure or by an insolvency procedure, and not create 'zombie' banks ;

b. the impact of COVID-19 State-guaranteed loans should be adjusted to avoid penalizing support of public-sector recovery programs ;

c. the evolution trend of contributions after 2023 should be clarified. At the same time, an incomplete Banking Union weighs on the ability of cross-border banks to make savings and economies of scale, because of ring-fencing when applying certain prudential requirements (solvency, leverage, liquidity, large exposures). The Banking Union framework should enable efficiency gains on these aspects.

Finally, the market share of EU investment banks has been falling over the last 15 years, both globally and in the EU. An EU focused on strategic autonomy should aim to reverse this trend, and this should be a common yardstick for banking union, capital markets union, and the coming reviews of MIFID and CRR.

Strong transnational European banks not only increase the resilience of the system and provide the necessary private investment and jobs but ensure that Europe is sovereign in its choice of economic growth model.

European banks are needed to finance the digital and environmental transitions, by developing European companies (75% of corporate European debt is still dependent on lending, especially SMEs), and by transforming short-term savings into long-term stable financing.

JACQUES BEYSSADE
Secretary General, Groupe BPCE

Preserving banking model diversity in the Banking Union context: benefits and challenges

The EU wants to chart its own course on the global stage, shape its own standards through leadership while preserving its interests and values. It can only do so from a position of economic strength. One of its key strengths is the diversity of its banking sector, notably because different business models increase the overall resilience of the financial system.

BPCE, a non-listed G-SIB with its DNA as a savings and cooperative bank, combines scale and knowledge of local economies, while embracing digitalisation and sustainability. It is ideally placed to illustrate why diversity matters in banking and why European policy and supervision should focus more on sustaining different ownership structures and different banking models.

The closeness of our individual cooperative banks to their local communities provides a long-term perspective and relationships of trust, while keeping us at the pulse of the French economy. As a result we can take a more long-term view on profitability and business orientation. Networks like ours underpin local prosperity beyond the economic and demographic centres. This diversity also particularly fits with the European Renewed Sustainable Strategy as all Europe and not only major hubs should transition.

Yet one challenge we share is that our different models are not well enough understood and taken into account in EU policy-making and even in Euro area supervision. This has important repercussions. For example:

- In EU legislation projects, the diversity of banking models has not been appropriately reflected even in areas where the underlying international standards had actually been neutral. Notably, transposition of Basel IV agreement puts at stake the decentralised model of cooperative banks with a central body;

- This is aggravated by Supervision practice: the ECB as Single Supervisor has benchmarked all banks on the profitability of global listed institutions while robustness, rather than profitability is the main objective of mutual banks. Its horizontal Directorates tend to create a one-size-fits-all approach which undermines models and diversity;

- On governance, there is a fit and proper issue were the technical competence of managers is favoured at the expense of knowledge of local businesses.

Overall, this is counterproductive. First, as a cooperative we do not need to satisfy shareholders looking for pay out ratios (strictly limited by regulations) or share price appreciation (as they are not tradable). Second, many non-listed banks provide highly valued services that correspond to long-term clients' needs and public missions such as financial inclusion, while ensuring trusted relationship with local or regional municipalities and public bodies such as hospitals.

Our different business models are not sufficiently taken into account by EU policymakers and supervisors.

This one-dimensioned "one size first all" approach jeopardises the overarching objective of a sustainable "Economy that works for people".

From a banking perspective, this means that all clients – and not only the most profitable ones – deserve adequate services.

It is now time to let the European diversity in banking finance a bright future for Europe.

SOLVENCY II REVIEW

MARTIN MERLIN

Director, Banking, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Solvency II review: finding the right balance

Since 2016, Solvency II has brought major changes to prudential supervision in the Union, by providing a harmonised and sound prudential regime for insurance companies. Its first pillar set out an entirely new, risk-based framework for the measurement of risks. This was complemented by qualitative and transparency requirements under the second and third pillars. The reform aligned prudential supervision more closely with state-of-the-art risk management practices.

After five years of application, there is broad agreement that Solvency II has overall been working well. The Covid-19 crisis has been a real-life test. Without drawing conclusions too quickly, we can be largely reassured about Solvency II's robustness and the industry's ability to fare through these difficult times.

However, we should not be complacent. Solvency II needs to remain fit for purpose and to tackle the macroeconomic challenges of our times.

The principles of risk-sensitivity and market based valuation on which prudential rules rely, are essential to the success of Solvency II and should therefore be preserved.

Over the recent years, insurers have been facing an unprecedented protracted low – and sometimes even negative – interest rate environment. We have to acknowledge that Solvency II does not reflect this 'new normal'. It is therefore legitimate to assess whether rules on capital requirements and on the valuation of insurers' liabilities need to be updated in order to make them more risk-sensitive. This is a matter of credibility of the framework and of ensuring policyholder protection.

Moreover, insurance stakeholders have raised concerns about the volatility caused by the use of market valuation. When excessive short-term volatility is reflected in quantitative rules, it can indeed hinder long-term investments and the supply of long-term insurance products. Market volatility is expected to be mitigated by the so-called "long-term guarantee measures". However, the developments following the Covid-19 outbreak showed that the measures sometimes have either too little or too much impact. Therefore, they should be reviewed so that they create relief only where insurers' liabilities are truly "long-term", and in such cases, the volatility mitigation should be more effective.

In addition, the Solvency II review cannot only be a technical response to new macroeconomic developments. It should also be a tool to support the Commission's political priorities.

With trillions of assets under management, insurers can play a pivotal role in the financing of the ambitious targets set by the Commission for the economic recovery and the green transition.

As regards the economic recovery, businesses' access to equity financing is one of the top priorities. This is needed to balance out the debt accumulation by European corporates, which increased during the pandemic. Equity investment is an area where insurers have probably been punching below their weight. While Solvency II is not the main driver of insurers' choice for investments, the framework may still provide disincentives to equity investments. The preferential prudential treatment for long-term equity investments introduced in 2019 did not yield the expected results, as the attached conditions proved to be too strict and complex. For this reason, in its new Action Plan on the Capital Markets Union, the Commission committed to improve prudential rules on equity investments.

As regards the green transition, we need to make sure that climate and environmental risks are better taken into account by insurers. We will also have to continue exploring, together with EIOPA, whether it is possible to differentiate prudential rules depending on the green or brown nature of investments, while remaining risk-based.

For our insurance industry to be well equipped to weather risks and committed to support a sustainable recovery, the cumulative impact of regulatory changes should remain balanced.

The Commission does not intend to overhaul Solvency II but to make it fit for purpose. Certain changes, notably on interest rates, will increase capital requirements. Such amendments are needed if we want to maintain a robust framework, which protects consumers and prevents financial stability risks. At the same time, we are mindful that significant overall increases in quantitative rules could have a disruptive effect on insurers' solvency position, impact their ability to provide long-term and sustainable funding to the European economy, and affect their international competitiveness.

Therefore, the review of Solvency II will be a matter of finding the right balance. Balance between the need, on the one hand, to introduce improvements that are technically justified and supported by evidence, and the need, on the other, to recognise that insurers are already and overall well capitalised and that there are high political expectations that the sector ramps up its contribution to the economic recovery and the green transition.

GORAZD CIBEJ

Director,
Insurance Supervision Agency,
Slovenia

Solvency II must recognise the new normal

Solvency II is a complex framework, particularly because of its risk-based approach. This approach implies taking account of all developments, even at a global level, and thinking about what might happen in ways not yet imagined. New risks may emerge from any direction at any time. And even when an emerging risk has been identified, its impact can be difficult to quantify. However, it must be addressed, as it may be significant and can therefore have serious consequences.

Solvency II has proven to be a strong and sound regulatory system where enhanced risk management, reflected in capital requirements and valuation principles, improved governance requirements and extended requirements in public disclosure and supervisory reporting have demonstrated their usefulness.

Nevertheless, it must be recognised that Solvency II was designed under very different market conditions. At least three new circumstances have appeared since Solvency II was introduced: low and even negative interest rates, a global pandemic, and a political decision to accelerate sustainable development.

Low and negative interest rates have affected the whole economy. For the insurance sector, low interest rates, especially of sovereign bonds, create a risk of underperforming guaranteed returns on insurance contracts. COVID-19 has further accelerated the downward trend of sovereign bonds interest rates and has led to an increase in interest rates on corporate bonds, due to higher credit risk premiums. This has significantly increased the already high market risk for the insurance sector.

As a global pandemic, COVID-19 has also introduced other challenges, that critically influence the operational resilience of insurers. The operational difficulties resulting from lockdown measures taken by governments have forced insurers to innovate by moving to more digitalized operations and remote working, thereby increasing operational risk and cyber risk.

The effects of climate change, which have become apparent all over the world, have further strengthened the resolve of governments to move towards a more sustainable environment. The financial sector has an important role to play in this regard. Insurers will have to find ways to support sustainable development using their risk management, underwriting, and investment functions. They need to recognize the impact of climate change in their day-to-day operations and need to improve their internal scenario analyses and stress tests by incorporating environmental and socio-economic data. The availability of such data is essential in order to formulate clear climate action plans and take corresponding investment decisions.

The Solvency II review should adapt the regulatory regime to the new normal.

These three new circumstances have a substantial impact on the business model of insurers. Low interest rates cause bigger problems to life insurers and insurers that are managing pension plans, while property and casualty insurers are more directly affected by climate change. All insurers must take account of the new normal, i.e. a world of market volatility and of increased digitalisation.

If one looks at Solvency II, it is clear that the current approach to interest rate risk in the standard formula underestimates the real interest rate risk in a low and negative yield environment. Furthermore, the evolution of market conditions also requires an adjustment of the long-term guarantee measures, particularly the extrapolation of interest rates and the volatility adjustment. The present approach does not reflect new market conditions, may lead to an underestimation of technical provisions and makes it difficult for insurers to offer long term guarantees. Going forward, it is important for insurers to contribute to the massive investments that are needed in order to achieve the sustainable development goals that have been agreed at political level. However, long term investments will remain difficult as long as insurers refrain from creating products that include long term guarantees.

The Solvency II review should adapt the regulatory regime to the new normal and make those changes that are needed to improve the regime based upon the experience gathered since its introduction in 2016. One of the issues that must be addressed in this context is the imperfect functioning of the proportionality principle.

The Solvency II review should encourage more widespread use of the proportionality principle in the application of the valuation rules, in the calculation of the capital requirements in the standard formula, in the governance structure and in public disclosure and supervisory reporting. The regulatory framework should be clear and offer insurers legal certainty when they can apply a regime that is proportionate to the nature, scale and risks of their operations. Applying proportionate requirements should be automatic and not be subject to prior supervisory authorisation. At the same time, it should be clear when an “upgrade” to normal regular requirements is needed when an insurer engages in more risky operations.

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FRANK GRUND
Chief Executive Director
Insurance and Pension Funds Supervision,
Federal Financial Supervisory Authority, Germany (BaFin)

Insurers stabilise the economic system

The key macro-economic challenges facing the insurance industry in the coming years are the low interest rate environment and climate change. Yield curves are not likely to increase substantially over the next years. This is why BaFin has once again set German life insurers a low interest rate scenario for the annual prognostic survey, and this will also form the basis for BaFin's supervisory measures – for example in the assessment of whether transitional measures granted under Solvency II regarding compliance with the capital requirements for existing contracts of individual companies are still adequate.

Solvency II is risk-based and market-consistent, and therefore involves a certain degree of volatility. Insurers have so far been able to cope with this volatility, in part thanks to the volatility adjustment and the transitional measures. It is to be hoped that the Solvency II review has only a moderate impact here.

Additional capital requirements for insurers do not bring more capital into the system, but instead result in supervisory buffers being dissolved. Such buffers, provided they are correctly and carefully calibrated, are necessary so that insurers can operate on the capital markets with flexibility. Particularly in the acute crisis in March 2020, shortly after the outbreak of the coronavirus pandemic, German insurers with good solvency ratios traded counter-cyclically and rebalanced some of their investments away from bonds with high credit ratings towards riskier investments.

The German insurance sector as a whole proved stable in the crisis and therefore made a substantial contribution to maintaining financial stability in Germany. This ability to stabilise the market must be maintained. The EU Commission and the co-legislators therefore bear a great deal of responsibility in the negotiations regarding the Solvency II review. Solvency II was drafted to follow a risk-based but also retrospective approach, since the capital requirements are based on historical data. It should stay that way. This is because it also requires the creation of risk management tools such as stress tests, for example in the form of scenario analyses, which allows for risks to be assessed and new developments detected ahead of time.

Additional capital requirements for insurers do not bring more capital into the system.

A risk-based system will never be able to address all of the micro- and macroeconomic developments in the years to come. But it will contribute to the stability of the insurance and financial sector – and thus to economic resilience. The insurance industry's stabilising influence will be needed in another area, too: the transition towards a climate-neutral economy and society will not be possible without the insurance industry's active contribution. In this context, we usually think of the investments insurance companies make.

Insurers and Pensionskassen are dependent on investment opportunities that generate high yields in the long term. It is therefore with good reason that European regulators have taken action in this area by introducing transparency and disclosure requirements.

More extensive changes, for example with regard to the capital requirements for green or brown assets, should only be placed on the agenda when there is sufficient and clear evidence for their suitability. Calibration based merely on political motives would threaten the credibility of the risk-based system.

The same is true for the core business of non-life insurers: property and liability risks for private, commercial and industry customers have already changed as a result of climate change. The damage recently caused by the flooding in Germany is a very clear example of this. Insurers are responding to this with better pricing models and adjustments to insurance terms and conditions. It is inconceivable that insurers could cover major risks without adjusting to the challenges posed by climate change.

Insurance companies will need no encouragement to embrace their role in managing the effects of climate change and in bringing about the required transformation in the real economy. They should demand sufficient preventive measures and thus work towards achieving climate change adaptation, both in industry and in society as a whole. Particularly in the industrial and commercial sector, insurers should also decide, with a view to reputational risks alongside strategic considerations, whether to make coverage dependent on the policyholders' commitment towards achieving climate neutrality in their product range. The right approach here can be found in the supervisory expectations set out by BaFin and by EIOPA with regard to companies' consideration of financial and reputational risks in their business organisation and in risk management. Insurers decide themselves which customers they insure and which investments they make. But investors, shareholders and rating agencies, alongside current and future customers and the insurers' own employees, will all be watching to see whether and how insurers deal with the key issue of sustainability.

STÉPHANIE YON-COURTIN
MEP & Vice-Chair, Committee on Economic and Monetary Affairs, European Parliament

A refreshed Solvency II delivering for consumers and businesses

Making a success of the review of the Solvency II Directive is an objective shared widely among EU decision-makers. A refreshed rulebook will ensure that insurers and reinsurers can play a key role in the EU's economic recovery following the COVID-19 pandemic while preserving the integrity and stability of the financial ecosystem in the EU.

With these twin objectives in mind, crucial features of the Solvency II framework may need a revision, as already outlined in the European Parliament's own-initiative report on the Capital Markets Union, adopted with a large majority in October 2020. EIOPA's Opinion on the review of Solvency II published in December 2020 constitutes a strong basis for the forthcoming legislative discussions.

In general, we should ensure that the overall level of capital requirements remains stable, while remaining cautious on the consequences of this approach. A zero sum game on capital requirements, where some European insurers would only win if others European insurers lose, would be detrimental for our strategic autonomy.

When examining crucial features of the Solvency II review in accordance with our twin objectives of economic recovery and integrity and stability of the financial ecosystem, four priorities emerge clearly.

1. Fostering long-term and sustainable investments

Freeing up the financing capacity of insurers and re-insurers can be a game changer in relation to the CMU. EIOPA has already madeadditional suggestions in relation to for long-term equity investments, building on recent changes to the Solvency II delegated act. However, more can and should be done to foster long-term investment in equity and private debt. Alternative approaches are to be explored to this end, including the use ofinternal models, a policy option supported by the European Parliament in its CMU own-initiative report. Similarly, channelling financing from the insurance sector towards sustainable projects will be key to the success of the European Grean Deal.

2. Consolidating the consumer protection rulebook

Protecting insurance policyholders is a core objective of the Solvency II framework, and should remain at the heart of the future review. In recent years, consumers across the EU have faced challenging situations linked to cross-border claims. In this light, the review of the Solvency II Directive should aim to increase supervisory convergence and cooperation between home and host competent authorities, based on a stronger mandate set at regulatory level. Strong regulation and effective supervision should work hand in hand to deliver on the promise of a single market for insurance.

3. Adapting to the current economic situation

Insurers and re-insurers are facing the implications of the current exceptional economic situation with sometimes more acute pressure than other parts of the financial ecosystem. This is particularly the case with the persistence of the low-interest rate environment, a welcome and effective monetary policy response to weather the consequences of the pandemic on the economy. A better management of the perceived risks from this low-interest rate environment will also have to consider possible future rate increases. This forward-looking, future-proof approach will be at the core of the European Parliament's analysis of EIOPA's suggestions, in particular on the volatility adjustment, on the risk margin and on interest rate risk.

4. Simplifying

Further streamlining of reporting requirements, as envisaged by EIOPA, should be strongly supported, provided that reporting to the competent authorities and transparency towards policyholders is not unduly affected. Similarly, the European Parliament has called for a rapid phasing-out of national exemptions and for the reduction of 'gold-plating' in the national implementation of Solvency II. The dueconsideration to proportionality and to a risk-based approach should not be used as a means to weaken the European single rulebook and drive divergences across the European insurance landscape. Such simplification and harmonisation efforts are paramount to ensure the competitiveness of the European insurance sector in a context of fierce international competition.

A zero sum game on capital requirements [...] would be detrimental for our strategic autonomy.

Finally, the short-term focus on the review of Solvency II should also pave the way for a longer-term vision of the role of insurance and re-insurance in the fast-evolving economic context. EIOPA's thought leadership on the coverage of pandemic risks and other non-damage business interruptions risks in insurance contracts should be followed up with concrete actions.

Mechanisms and incentives for better and fair coverage of such risks in insurance contracts are a key demand from the business community. To respond to this demand, the insurance sector can reinvent itself, not out of an instinct of self-preservation, but to continue to deliver on its mission to protect consumers and businesses.

FAUSTO PARENTE

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

Solvency II: a balanced review

In December 2020, the European Insurance and Occupational Pensions Authority (EIOPA) concluded its review of Solvency II. As we wait for the European Commission proposals in response to our Opinion, it is worth recapping the core elements of EIOPA's Opinion.

Since its implementation, Solvency II has been a step change in how insurers approach their relationship to risk. Our approach was therefore one of evolution rather than revolution. Since its implementation, the insurance industry has better aligned capital to risk, uses a risk-based approach to assess and mitigate risks, which means that it can better price them. Insurers have also significantly strengthened their governance models and their risk management capacity.

The coronavirus pandemic underlined this view. The crisis has shown us that Solvency II proved effective in protecting the sector from market turmoil.

Nonetheless, for a regulation to remain effective, it must also remain fit for purpose. Therefore, we have to recognise that the situation today is much different to when Solvency II was conceived.

The realities we had to consider as part of our review included the ongoing low interest rate environment the impact this has had on insurers' business models. We also had to consider climate change which, while not new, has taken on a more urgent dimension; and, of course, the COVID pandemic.

Starting with the low interest rate environment, given the massive intervention measures from central banks as a result of the pandemic, it is clear that the 'low for long' scenario will continue for a long time yet. The framework must therefore take account of the economic situation, notably with respect to the capital requirement for interest rate risk. The current interest rate requirement does not reflect the fall of interest rates experienced during the last years and ignores the existence of negative interest rates. Our Opinion therefore proposes changes to the treatment of interest rate risk, as well as to discount curves used by insurers, in particular regarding extrapolation.

Our opinion does not change the fundamentals of the framework.

Insurers were able to withstand the shocks of the pandemic in part due to the work done during years following the implementation of Solvency II, entering the crisis with a robust capital position.

Looking beyond COVID, the insurance sector has an important role to play in supporting the economic recovery. Long-term investments – the type of investments favoured by insurers – are essential to foster economic growth, develop infrastructure and boost employment and should be encouraged.

In our Opinion, we have taken into account the nature of the long-term insurance business, creating conditions for more long-term investment. We are therefore proposing the changes to the volatility adjustment, the risk margin and equity risk. All of these adjustments should improve risk-sensitivity, facilitate the design of truly long-term illiquid liabilities and incentivise long-term investments.

Looking at about proportionality, which has always been an important element in Solvency II, there is certainly scope to increase its use. Our Opinion recommends a new process for applying and supervising the principle of proportionality. This includes clear risk-based quantitative criteria to identify low risk undertakings eligible for applying proportionality measures. These will capture not only the size but also the nature and complexity of the different risks and will provide legal certainty regarding the application of the proportionality principle. Undertakings complying with such criteria will be able, after a notification, to apply automatically a number of proportionality measures that – in the main – focus on governance and reporting.

Finally, we need to supplement the current micro prudential framework with the macroprudential perspective (including the introduction of specific tools and measures), as well as the need to develop a minimum harmonised recovery and resolution framework and achieve a minimum harmonisation in the field of insurance guarantee schemes.

Our Opinion does not change the fundamentals of the framework. Instead, we are proposing measures that we believe will keep the regime fit for purpose by the introduction of a balanced update of the regulatory framework, reflecting better the economic situation and completing the missing elements from the regulatory toolbox.

At the end of the day, Solvency II is here to protect the consumer. In our review, it was important for us not to lose sight of this fundamental objective. Our balanced approach ensures that policyholders will remain protected in these challenging times.

CLÉMENT MICHAUD
Chief Financial Officer, Crédit Agricole Assurances

Improving the treatment of long-term assets to finance Europe's challenges

For several years, the insurance sector has had to deal with an economic environment of low interest rates. It has also been facing major crises such as pandemics or climate related disasters. With the upcoming revision of its prudential framework, it is therefore legitimate to question its capacity to manage the effects of yet another crisis, but also to adapt its ability to finance structural projects namely the construction of a digital Europe or the transition to a European sustainable economy.

With regard to the resilience of insurers, we have been through an unprecedented crisis with the pandemic, which has generated technical risks, led to volatility in financial markets and weakened the solvency of clients. The intervention of public authorities was obviously essential to preserve the economy. However, the insurance sector has endeavored to rise to the difficulties caused by this crisis and has done well. The insurers played their role in the management of risks by continuing to assist their customers and by supporting European economic activities. They honored their contracts and often went beyond their contractual commitments, even going as far as providing direct assistance to the policyholders most in need..

To play this role, the solvency of the sector was a fundamental element. Moreover, it is obvious that the insurance business model, which aims to mutualize the various risks and to position itself as a long-term investor, is intrinsically built for absorbing shocks. So at a time when the prudential framework is being revised, we should avoid to disrupt a model that proved to be resilient even in a crisis situation.

In this regard, some of the proposals made by EIOPA may seem excessive. For example, even if we have to accept that a negative interest rate shock should be taken into account, it should not go too far and compromise the overall balance of the standard. Indeed, the possibility of investing in equities is counterintuitively closely related to the calibration of the interest rate shock. The direct effect of strengthening the interest rate shock would be to considerably increase the overall capital charge. Moreover, insurers would have an incentive to reduce their share of diversification since the projection of reduced interest flows would no longer sufficiently offset fluctuations in diversified assets. Such a regulatory development, would be particularly counterproductive as it is already difficult for investors to invest in equity due to the high capital charges in the current framework.

We are advocating for a global strategy, taking into account prudential and accounting aspects.

On the contrary, given the business profile of insurers being conducive to long-term investments, improving the prudential treatment of long-term investments should be a priority to finance in particular the transition to a carbon-neutral future and digitalization of the European economy.

In this respect, some Member States have put forward a risk-based constructive solution that introduces a liquidity test to justify a reduction in capital charges and simplifies the framework for long-term investments. In addition, there is a political objective to support European companies in a context of strong international competition.

Nevertheless, such a review of the prudential framework only may not be sufficient to maintain and develop insurers' investment in equities. Indeed, the entry into force of IFRS 17 in January 2023 will put an end to the overlay period of IFRS 9. From 2023 onwards, IFRS 9 will require the recognition at fair value through profit or loss of equities, mutual fund units and debt instruments that do not have the characteristics of simple financing. As a result, the insurers impacted by this rule will experience an increase in the volatility of their results, without benefitting from the neutralization due to the overlay.

This volatility is likely to force the insurers into countermeasures such as substantial de-risking of asset portfolios and a massive reduction of their exposure to the equity market as early as 2022 to anticipate the end of the overlay.

It is therefore urgent to adjust the accounting standards to translate the financial performance of investments under IFRS 9 in a more appropriate way.

In conclusion, we are advocating for a global strategy, taking into account prudential and accounting aspects, in order to remove the obstacles in equity financing for insurers who are by nature long-term institutional investors. Such enhancements would foster the insurance sector's contribution to the political priorities of the European Union while maintaining its economic sovereignty.

MIREILLE AUBRY

Head of Prudential Regulation Standards & Foresight, Covéa

Qualifying market risks for insurers: long-term versus short-term prices

The main macro-economic challenges that have been faced by the insurance industry since the implementation of the Solvency II insurance framework are multi-fold with ever dropping interest rates, low levels of risk premia, abysmal sovereign debts and the ever increasing volatility of shaky financial markets. This is driven by multiple forces such as the new digital economy, climate change issues and the depletion of resources bringing a lot of change, disruptions, uncertainty and unknowns.

In this context, the main lessons that can be learned for the balance and calibration of capital requirements within Solvency II are the excessive bias to short term pricing and to bond investments. There is a lack of adequacy to the resilience of insurers business models and an exaggerated focus on liquidity. This is detrimental to performance and stability. To cut a long story short, the issue at the core of the debate is one of the adequate qualification of market risks for insurance. Are insurance undertakings' exposures to market risks fully determined by market prices despite the "noise", incompleteness and blurs carried by financial markets and their inherent and evergrowing market volatilities ? Or are insurance undertakings' exposures to market risks better depicted in accordance with the actual timing of the invesments and divestments in accordance with insurance undertakings entity specific risk appetite, ALM, investments policies and management actions that forge the reality of the cash in- and out-flows over different time horizons ? What relevant information are market values really conveying about insurers exposures to market risks that is to say to their potential actual and probable future losses and profits ? A major issue with financial inputs based on market prices is their potentially huge volatility not commensurate with the actual risk insurers are exposed to and not providing a complete information. The volatility of financial markets is primarily the result of uncertainty but also the result of the activity of market derivatives and their interest in volatility. Hence financial markets alone are not best placed to convey a complete and insightful information that can be used for true guidance and governance.

The above mentioned limitations inspired the Omnibus II Directive that has complemented Solvency II initial unbalanced framework. Omnibus II has been instrumental in rendering Solvency II applicable in the field of bond instruments and enabling its entry into force. Yet, and also because of the strong concerns about the repeated deferrals of the advent of the new solvency regime, equity instruments have not been under enough scrutiny to help patch the initial framework and sufficiently assess their associated risks in the context of long term business models and investment strategies.

Financial markets alone do not convey a complete information that can be used for true guidance.

We should value more adequately, and also treasure for macro-economic reasons, long term investment strategies in equity based on informed decisions, internal expertise and adequate market timing. This has been the purpose of the adoption in March 2019 by the Commission of an amendment to the Delegated Regulation of a new article (Article 171a) dealing with the treatment of long- term equity investment. Unfortunately, article 171a is hardly used in practice due to overly restrictive criteria. Insurers are awaiting the Solvency II review as a much needed opportunity to review article 171a criteria in order to widespread its application where long term horizons are the driving forces of the equity investment, which includes assets backing own funds.

The results of a recent study by the Louis Bachelier institute show a marked effect of the regulatory constraints on insurers asset allocations. The analysis show that Solvency II constraints lead to a significant decrease in allocations to non-bond assets, for instance more than halved for equities (12% against 27%).

The true essence of insurance is the mutualisation and diversification of risks. A matter of great concern for markets, regulators and supervisors is the building up of systemic risk. Insurance could play a diversifying role. Herd behaviours based on spot prices are a major source of systemic risk in the financial markets. Diverse investments strategies as well as long term strategies are instrumental contributions to the reduction of volatility and hence the risk. Informed strategies based on tangible reality indicators not derived from pure market financial pricing is desperately needed. There is too much automated financial behaviours drifting away from tangible realities and conditions.

GIANCARLO FANCEL

Group Chief Risk Officer, Generali

Insurance industry: a key player for the economic recovery after pandemic

We are living in the midst of a particular historical phase marked by extreme events on a global scale, such as a macroeconomic trend of low-for-long interest rates, a pandemic humanitarian and economic crisis and a global warming which is generating severe weather conditions like floods, heatwaves, droughts and storms.

In addition, the recent concerns about resurgent inflation completes the picture of an evolving macroeconomic context with possible new and unpredictable trends in the near future. However, despite this background, the European insurance industry has shown remarkable resilience, and the Solvency II framework has proven its robustness to a "real" stress test of global scale.

And in this very challenging context, there are, however, also positive signs that can open up new horizons and opportunities for growth if they are addressed in the right way in the years to come.

We must certainly appreciate that the European institutions reacted quite quickly and vigorously to the pandemic health/economic crisis and to the subsequent considerable increase in public and private debt, showing a cohesion that was unthinkable just a few years ago. The Commission's "Next Generation EU" project, which implies the issuance of a substantial amount of common EU debt across global markets, represents an important step which could trigger an acceleration in the development of a more ambitious and integrated European budgetary policy.

Also the European Green Deal has the potential to play a key role not only in ensuring a recovery for economies in the short term but also in addressing long-term Environmental, Social and Governance threats, with a particular focus on climate change.

I believe that Investments in the real economy, infrastructure, private debt and private equity, long-term equity, green and sustainable assets, can boost yields...

But the main point it is worth emphasizing is that insurers are ready to play a key role in exploiting the opportunities that exist even in this adverse environment. In particular, we have repeatedly expressed our strong willingness to support the EU's economic recovery and a sustainable path for Europe, but we need an appropriate prudential regime that does not penalize companies with excessive capital requirements and create opportunities to invest significantly in alternative asset classes.

I believe that Investments in the real economy, infrastructure, private debt and private equity, long-term equity, green and sustainable assets, can boost yields and can also contribute actively to the EU plans of recovery and green deal.

Over the years, the Solvency II regime has already been updated to meet these needs - e.g. infrastructure investments and high-quality private placements - but I do feel that further improvements are needed to make a framework that not only protects policyholders but also actively contributes to the benefit of the economy in order to face future global challenges.

With the current revision of the Solvency II framework, I believe that the discussion can increasingly develop around these issues. This is important also for our business model and strategic asset allocation: the use of "alternative" investments for insurance companies broadens the possibilities for building cutting-edge portfolios, making it possible to diversify into non-traditional instruments and supporting the EU's climate and ESG commitments at the same time. In particular, this is true for green and sustainable assets: the new EU Green Bond Standards recently issued by the European Commission is an example of new investment alternatives in line with the EU green deal.

Hence, the next revision of Solvency II regime is crucial, not only to stimulate investments to non-traditional asset classes, but also to free-up excessive prudential capital. There is no doubt that some parameters are overestimated (I am thinking of the Risk Margin) or need some corrections (Volatility Adjustment) and that some assets are unduly penalized, such as the corporate bonds, which are usually held by companies until maturity to match their liabilities, while under Solvency II there is no recognition of this peculiarity. Freezing unnecessary capital is not economically sustainable and takes resources away from the full capacity of companies to support economic recovery at this difficult time, as well as risking severely penalizing the European industry in the international context.

Furthermore, we must be careful not to introduce new regulatory addendums like capital surcharge for systemic risk or new triggers for preventive measures and dividend controls. They could undermine the Solvency II approach and create pro-cyclical economic imbalances.

The risk-based and market-consistent principles of Solvency II are features that allow high levels of protection in different market situations: adding more capital buffers is unnecessary and would only be detrimental to our global competitiveness. In addition, regulatory uncertainty on our capacity to pay dividends should be absolutely avoided if we want to remain attractive in the financial markets arena.

CARLOS IGNACIO MONTALVO REBUELTA

Partner-Global Insurance Regulatory leader, PricewaterhouseCoopers Auditores, S.L.

Solvency II: a regime fit for macro?

Since 2001, the year when many of us started work on "a regulatory project" called Solvency II, many things have changed. We have gone through at least three crises; we have seen technology blossom; we have witnessed social change; awareness about the need to do "not just something" around climate risk; progress regarding Gender agenda, or consideration regarding vulnerable clients, all steps in the right direction (a shame that we are not being so responsive to the Pensions time-bomb, where Insurance should play -if allowed- a key role). That Solvency II remains, is a testimony to a well-designed core framework; that it is being reviewed, to embed change, is a measure of its adaptability; that we still refer to it as Solvency II (Banking, allow me to be provocative, has seen Basel II, III, IV...) should be seen as well as a signal of recognition: it has worked well, and it remains a global reference for risk based regulation.

Whilst Solvency II was designed as a micro-prudential framework, we have discovered the hard way the need for it to be compatible with macro reality, including especially the challenges of negative interest rates. I recall, meeting Japanese regulators in 2008 to better understand the implications of low rates for the business, more as a notional, "what if?" type of exercise, rather than in expectation it would happen here in Europe, too. With hindsight, had we adopted Solvency II in the shape it had in 2009 - when it was published in the Official Journal- without introducing the so called Long Term Guarantee (LTG) package, a set of rules that deviate from the "pure" market consistent valuation of liabilities, many insurers would likely have been unduly put into liquidation, creating a financial stability problem. It is also fair to acknowledge that, had we continued in a Solvency I (non-risk sensitive) environment, even further problems would have resulted.

If we zoom into the current reality of negative rates, these have a massive impact in the profitability of the financial sector. What brought us here, namely the Big Crisis of 2008 and the need to avoid mass failures from banks, is no longer relevant; what should matter is how this situation is affecting insurers today, in terms of profitability and product offering, and how are they preparing for alternative scenarios, including one of "low for long" followed by a sharp increase of interest rates. Indeed, hope for good (a smooth constant increase of rates) but plan for worse (a sharp increase of rates).

A key lesson learned from 20 years of work on Solvency II is that perfection is the enemy of good.

Staying with the aforementioned negative rates reality, insurers must embed a "search for yield" approach to the asset side of their balance-sheet, taking more risk, in particular liquidity risk, to earn a spread that is currently distorted, inter alia due to QE -monetary policy, again- in terms of risk-return. Whilst insurers need to get even better at assessing underlying risks, there is an urgent requirement for regulators, too, to understand and accept more risk taking on the asset side.

On the liability side, we have seen a trend to put most -if not all- investment risk on policyholders, as offering guaranteed products in the current environment is risky and expensive. This is not in the best interest of policyholders, and Solvency II should ensure that, even in the current environment, insurers can take investment risk from their clients, and offer products with a sound value for money proposition. If this requires adapting existing rules such as the Matching Adjustment, so be it.

A key lesson learned from 20 years of work on Solvency II is that perfection is the enemy of good. The best example has surfaced under today´s negative rates environment: from a pure technical viewpoint, the current design of the extrapolation methodology, with a last liquid point at 20 years, is not backed by data, as proven inter alia by EIOPA. However, the design -technically flawed as it may be - served its purpose well, avoiding mass failures of insurers that would have, under a stricter application of Solvency II, been deemed insolvent.

Let me conclude with two very personal reflections around Solvency II: firstly, one key element that is missing: taxation. With tax impacts sat around 20% of a typical P&L, if not this is not properly understood by regulators, it becomes a dangerous blind-spot. Secondly, if macro affects us all so much, why so much debate around providing regulators with macro tools?

Many things have changed these 20 years, yet one thing remains: Insurance is a business with a unique social dimension, as it takes risk from all of us, manages it and reduces it. Such a business activity demands what Solvency II brought in, namely a risk based regulatory framework to align the rules with the very nature of the activity being managed: *Risk*.

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4

CMU IMPLEMENTATION

ISSUES AT STAKE

CMU is crucial for the EU with the increased funding needed for supporting the post-Covid recovery, the EU Green Deal and digital transformation. The new CMU action plan published in September 2020 completes the previous ones with additional actions for making capital market financing more accessible to EU companies - in particular SMEs, a stronger focus than previous plans on mobilising private capital - notably from retail investors - and measures for further integrating EU capital markets. Among these objectives, highest priority was given by the Council in December 2020 to the two first objectives, which are particularly important for funding the economy and supporting a swift economic recovery from the Covid crisis.

In this perspective work is underway at the EU level on a number of proposals concerning notably the simplification of listing rules, the setting up of a European Single Access Point for corporate information, the review of the ELTIF and securitisation frameworks, of prudential requirements and of the Central Securities Depositories Regulation (CSDR) and also the setting up of an EU consolidated tape.

The CMU project however faces two main types of challenges. Firstly, implementation challenges, due to the breadth of the action plan, the challenge of maintaining strong political momentum on such a project and the fact that many critical actions for the CMU concerning e.g. taxation, pension systems and insolvency regimes are within the sovereignty of member states. Secondly, challenges related to the post-Covid macro-economic and monetary context that tends to favour debt financing and liquidity hoarding.

CMU ACTION PLAN IMPLEMENTATION

SÉBASTIEN RASPILLER

Assistant Secretary, Direction Générale du Trésor
Ministry of the Economy, Finance and the Recovery Plan, France

More "capital markets" is a prerequisite for a successful Capital Markets Union

European capital markets played their role in keeping afloat the economy during the sanitary crisis. Bonds markets, especially, turned out to be the linchpin of our funding scheme to weather the crisis. They functioned well and lent massively to both private businesses and public authorities, thus funding public recovery programs.

Short-term debt markets experienced more difficulties as liquidity suddenly withdrew in March 2020: the ongoing FSB workstream on money market funds has rightly underlined the issue. Deeper short-term debt markets would actually help financial stability in the European Union and the funding of European corporates.

Now that the sanitary background is – hopefully – gradually improving, it is time for equity markets to prove their ability to fund the economic recovery. The relaunch of the Capital Markets Union (CMU) should be seen for what it is now: the second pillar of our recovery strategy together with the Next Generation EU plan. Indeed, this historic European public stimulus package will fully bear its fruits with a symmetrical mobilisation of European equity markets.

Over the longer run, rebooting the Capital Markets Union is also crucial to meet more structural needs while the EU economy remains much dependent on bank lending. Increasing the part of the debt and equity financial markets in the total funding mix will reduce the concentration of systematic risk linked to purely bank-based financial systems. Developing deep and liquid equity markets will turn out to be more suited to fund tomorrow's innovative sectors based on intangible capital. Kick-starting the sustainable finance will prove to be one of our main levers to foster the green economy.

Now we have to maintain a strong political momentum.

Against this backdrop, the publication of the Commission's plan for the Capital Markets Union in September 2020 was much awaited. The plan largely stems from the reports drawn up by the High Level Forum set up by the Commission in 2020 and chaired by Thomas Wieser and by the Next CMU working party set up by the Finance Ministers of the Netherlands, Germany and France in 2019 and chaired by Fabrice Demarigny. It relies thus on a coherent strategy and its priorities are better defined as it sets out a shorter list of well-defined actions.

France has always seen the Capital Markets Union as a strong priority for the European economic and financial agenda and is a strong advocate for an ambitious approach to boost the implementation of the Commission's new plan and for a clear prioritization among the 16 actions the Commission has put forward. Last December's Ecofin conclusions met that goal. Similarly, the Commission has carried out a comprehensive work to define a dashboard of key performance indicators, so as to facilitate a closer monitoring process at the political level.

Now we have to maintain a strong political momentum. The French Presidency of the EU Council, starting next January, will dedicate efforts to foster an ambitious delivering strategy, based on some priorities.

As financing both the economic recovery and the ecological transition will require massive amounts of equity to be raised, priority should be given to actions enabling equity markets to grow further. The review of the Solvency II directive constitutes in this regard an opportunity to direct more of European savings to capital markets, notably equity markets. The current framework – though improved by the 2018 technical review – still disincentives the insurance industry to invest in equity.

It is now time to act decisively to solve the issue, for the benefit of the European economy. Similarly, significant progress in the development of equity markets, notably European private equity markets, should be a priority when reviewing the ELTIF regulation.

Once more, it is only with deeper, more easily accessible and more competitive capital markets that the European Union will be able to fund both the economic recovery and its environmental as well as digital transformation. This will require to pay due attention when reviewing the MIF framework, as well as the Capital Requirements framework for banks, notably for their market activities.

SEBASTIAN THOMASIUS

Head of Unit, Financial Services Unit, Permanent Representation of the Federal Republic of Germany to the EU

Stepping up work to advance the Capital Markets Union further

Enhancing the access to finance and facilitating investments are key elements to achieve a single market for capital across the EU to the benefit of European citizens, businesses and investors. Progress towards a genuine Capital Markets Union (CMU) and well-functioning European capital markets have become more important due to the COVID-19 pandemic and the withdrawal of the United Kingdom which entails that the largest capital market in Europe is located outside the Union. The CMU will also facilitate the ongoing transition towards a digital and sustainable economy. Against this backdrop, work on the Capital Markets Recovery Package and Council Conclusions on the new CMU Action Plan were a key priority of the German Presidency of the Council in the field of financial services.

In December 2020, the Council agreed on conclusion to give political steering for future work and set out its priorities with regard to the measures outlined in the new CMU action plan by the European Commission.

Highest priority was given to measures, that improve the funding of the economy and particularly of SMEs and support a swift economic recovery in the context of COVID-19 pandemic (e.g., facilitating access to financing on capital markets, creating a single access point to company data for investors, supporting long-term investments), and to measures important for mobilising private capital (e.g. enhancing financial literacy and enhancing data availability and transparency). These should be followed by measures that are deemed to be of major importance for progressing towards a more vibrant and globally competitive capital market in the short and medium term (e.g. enhancing the cross-border activities of post-trading infrastructures and settlement and on promoting further supervisory convergence and work towards a more harmonised legal framework).

These individual measures will already significantly contribute to the deepening of the CMU. However, it is evident that other important measures related to withholding tax relief procedures for cross-border investments or the convergence of the outcomes of insolvency procedures are more complex and time-consuming. Thus, the Council has encouraged the Commission to work on these medium-term topics as well.

Deepening the CMU will be an ongoing endeavor - also beyond the current institutional cycle.

The Council has recognized that, despite the measures taken so far, further steps are needed and that making swift and tangible progress has become more urgent than ever.

Also the European Parliament has called for further steps improving the access to capital markets and enabling retail participation with its resolution on the CMU from October 2020.

In light of this, it is welcomed that the Commission – within the next months – will propose a European Single Access Point (ESAP) for financial and non-financial information already publicly disclosed by companies and review the rules for European Long-term Investment Funds (ELTIFs), the securitisation framework, the rules applicable to listed companies as well as the Central Securities Depositories Regulation (CSDR). With regard to the retail investment strategy announced for 2022, it is also very positive that the Commission has already conducted a respective public consultation to gather stakeholder's views on possible improvements that could also contribute to the deepening of the CMU.

The Commission and both co-legislators have intensive and busy months ahead of them. The commitment of both the European Parliament and the Council to advance the CMU will facilitate the implementation of the new CMU action plan.

In any case, the deepening of the CMU has been and will be an ongoing longer-term endeavour beyond the current institutional cycle. It will be key to assess the progress achieved on a regular basis. Although the identification of a causal relationship between individual CMU measures and key progress indicators will be challenging, the toolkit for monitoring progress published by the Commission will be a helpful first starting point.

STÉPHANE BOUJNAH
Chief Executive Officer and Chairman of the Managing Board, Euronext

As any European integration project, CMU needs determination and focus

Euronext has a unique perspective on capital markets in Europe. In 2000, Euronext was formed as a result of a three-way merger of the Amsterdam, Brussels and Paris exchanges. The Portuguese exchange joined Euronext in 2002. In recent years, the ambition of the Euronext founders to bring European markets together has further materialized with the integration of the Irish Stock Exchange in 2018, Oslo Børs VPS in 2019, VP Securities, the CSD of Denmark, in 2020, and the Borsa Italiana Group in 2021. For the first time, market infrastructures in eight countries in Europe, accounting for almost 40% of the EU population and 46% of the EU GDP, are operated within a common pan-European company managed through a federal governance model. Making CMU a reality is core to the Euronext's DNA.

However, more than any other European initiative, CMU suffers from a discrepancy between stated ambitions and results. Policymakers, supervisors and business leaders regularly proclaim their support for greater integration of capital markets in the European Union. Yet, when the time comes for action, many important initiatives have been held back. To really move forward, I would argue for two priorities.

First, the EU should facilitate the consolidation of European integrated companies. Europe needs strong integrated financial players to compete with global financial institutions. Promoting European integrated companies delivers tangible benefits not only in terms of better financing of the real economy in Europe, but also contributes to the European Commission's objective of strengthening the strategic autonomy of the EU. The EU must strive to support the European architects of European finance rather than reinforcing non-European institutions at every turn. This strategic autonomy ambition is not incompatible with the preservation of a transparent, open and competitive environment based on a level playing field. This strategic autonomy ambition in the finance sector must be underpinned by a systematic "competitiveness test" to assess, ex-ante ahead of their tabling, whether proposed rules will strengthen or weaken European financial institutions.

In building the CMU, the EU must avoid the risk of being precisely wrong rather than roughly correct.

For market infrastructure, this ambition must be supported by a strengthening of ESMA's current supervisory powers to foster supervisory convergence. Today, there are still too many differences between Member States in respect of the market models they are prepared to authorise. This is problematic given that investor flows are increasingly cross-border within a CMU context.

The second priority for the EU is to change the way we have added layer upon layer of regulations and reporting obligations. European citizens and companies love Europe when it makes their life simpler, not when it makes it more complicated. Unfortunately, from a regulatory point of view, the EU has been, when it comes to building CMU, quite often precisely wrong rather than roughly correct. We have stacked a large number of measures, sometimes of an excessively technical nature with a multitude of additional obligations, without tackling the key bottlenecks.

Delivering on the simplification ambition of the European Commission is key to making the new CMU a success. Before proposing new rules, there must be a systematic assessment of what works and what does not work in MiFID II, MAR, Prospectus, PRIIPS, Solvency 2, CSDR and other legislations that have transformed markets over the past few years. Improving the legislative process to make it faster and more efficient will also be critical. This is all the more the case if we want to prove that the EU is agile and determined enough to react to competitive changes, especially from the UK in a post-Brexit environment.

We should focus on a couple of big systemic priorities rather than multiplying super complex measures and reporting obligations with less ambition. One of the bottlenecks that should be addressed first is insolvency legislation. The divergences in the balance between creditor and investor rights across EU countries is one of the biggest impediments to the unleashing of the CMU potential. And the differences in the fundamental legal traditions are not insurmountable. In the recent years and months, the EU has overcome much bigger challenges.

To be transformed into another real and substantial European success, the CMU needs more courage and more focus by all stakeholders.

FRANCESCO CECCATO
Chief Executive Officer, Barclays Europe

Time for ambitious reform to deliver enhanced European capital markets

The value of well-functioning capital markets was never more obvious than during the pandemic, not just in Europe, but across the world. Capital market access has been essential to corporates, sovereigns and investors to source liquidity and capital, and manage risks.

The latest CMU action plan, which aims to support the recovery from the pandemic and the transition to a digital and sustainable economy consistent with the Green Deal, has real purpose and can become a major pillar of economic prosperity in future. In addition, an appropriate balance between different sources of finance will help de-risk the European economy in times of stress, supporting financial stability. The objective of furthering sustainable capital markets is a particularly important one for us at Barclays, in addition to supporting the green transition through our own balance sheet.

According to an excellent paper by the Bank of International Settlements[1], capital markets can be enhanced (inter alia) by developing strong investor protections and clear frameworks of regulation, both of which are already within the scope of what existing EU frameworks seek to achieve. In addition, the paper cites the development of a strong institutional investor base, which is also key to holding issuers accountable, and the ability to access relevant derivatives markets as crucial.

For a European capital market to provide the right depth and liquidity to really perform the role intended, more than the incremental changes included in CMU's 33 initiatives will be required. Some areas which could be "quick wins" include:

Securitisation as a specific market needs to be addressed. In 2008, the size of the European securitisation market, including the United Kingdom, was 75% that of the US. In 2020, it was just 6%. While the US market has tripled, the European market is now three times smaller than it was in 2008. I'm pleased to see that the Commission has opened a consultation on the securitisation rules and you will find suggestions elsewhere in this magazine for the types of reforms that could help.

The Commission is due to come forward with proposals to revise both CRR and MiFIR in the coming months, both of which will have a major impact on banks' capital market activities. CRR will determine whether we can put our capital to work supporting economic activity or whether banks will continue to shrink to meet a further increase in requirements. With MiFIR, there is a real opportunity to introduce a consolidated tape to provide meaningful information to investors across a range of venues. Greater procedural flexibility in our rule-making is required, specifically an ability to provide latitude to capital markets operators where this is urgently required.

Rallying Member States around a unifying principle could act as a powerful driver.

At the time of writing, the industry is still faced with an implementation date of February 2022 for the CSDR mandatory buy-in regime, despite an almost universal agreement that the rules need to be revised. There are other examples of this type of situation, and the supervisors need the tools to be able to deal with such scenarios in order to contribute positively to the development of European markets. Despite such positive steps, which themselves will be arduous to achieve given the complexities in consensus building for European initiatives, policymakers should consider whether yet more could be achieved by rallying Member States around a unifying principle which could act as a powerful driver of a truly European capital market. Ideas worth considering include a dominant legal framework for capital markets issuance; promoting asset-based capital markets hubs to improve liquidity within a given asset class; and designating a European instrument as a benchmark for a Euro risk-free rate (e.g. the NGEU bond programme), potentially in conjunction with LIBOR transition.

As a European, I believe that a true Capital Markets Union is worth developing, for all the reasons stated above. While not wanting to dismiss shorter term initiatives, we should guard against this ambition being diluted to an "umbrella term". Rather, we should find a fulcrum on which to concentrate our energies, creating a deep and vibrant source of funding and capital, which will be vital for sustainable economic development.

[1] https://www.bis.org/publ/cgfs62.pdf

CHRISTIAN STAUB

Managing Director Europe, Fidelity International

Consumer advice must go digital for the CMU to succeed

Covid-19 has turned our analogue world into a digital one. Meetings have been swapped for video calls and shop windows have been replaced by iPads. The pandemic has also reshaped our behaviour towards our money. On average, people spent less and saved more in 2020, with some of that excess making its way into capital markets.

Europe now has an opportunity to capitalise on this behavioural shift.

What the numbers say

Last year belonged to the retail investor. Retail investment portfolios, representing 41 per cent of global assets at $42 trillion, grew by 11 per cent in 2020, according to a study by BCG. In Europe, assets grew by 10 per cent, outpacing the 10-year average.

Unusually for a year that experienced a severe market crash, retail investors were the main driver of net new inflows. The BCG report found that they contributed 4.4 per cent in 2020 to the growing asset pile, twice the size of the contribution made by institutional investors, at 2.2 per cent.

As with shopping and office work, the customer experience of the retail investor is going digital. One-third of firms are using digital distribution capabilities with up to 75 per cent of their clients, according to BCG.

As these numbers grow, the EU has a singular and unique opportunity to turn the digitisation of financial services into a force for their democratisation.

Digitising consumer advice

By recasting the concept of 'advice' in MiFID, it will be possible to unlock a range of personalised digital services for retail savers to use as they grow in confidence and financial health.

For example, we know that advised consumers benefit from prompts that highlight the risks associated with investing in only one type of asset or two correlated assets. Or from prompts that draw a consumer's attention to alternative products or to more tax-efficient choices.

These small but significant prompts are easy to deliver online (indeed, they are already part of the online shopping experience outside investments) but are not available to retail investors without triggering the regulatory requirements of full MiFID 'investment advice'.

Updating the concept of 'advice' in MiFID will unlock digital services to engage and empower savers.

For the moment, then, personalised recommendations are the privilege of those who both understand the importance of advice and can afford the time and cost to seek it out in person.

And this has real-world implication: according to an EY survey of around 2,000 middle-income savers, 51 per cent do not feel that paid-for financial support is for them, while just under a third (32 per cent) feel they do need it.

Reducing friction

As the CMU looks to the online world specifically to boost 'retail participation' in capital markets, MiFID needs to keep pace by designing rules of consumer engagement capable of converting digital insight into digital advice. For example, improved data-sharing policies, such as the CMU's pensions tracker and Open Finance initiatives, will be of little use if they help consumers see where they are over- or -under-invested but offer no recommendation by way of a next step.

MiFID review must therefore proceed ambitiously and in line with the CMU's wider aspirations. It must begin by identifying the right tools and services needed to empower digital consumers, and then proceed by enabling these services in legislation. It must not make the mistake of simply tweaking face-to-face advice rules in the hope of giving them digital appeal. To paraphrase Henry T. Ford, MiFID needs to offer EU citizens cars not 'faster horses' as they journey towards better financial health.

Investing in capital markets takes both trust and knowledge: trust that the money foregone today will bring greater security and wealth tomorrow, and knowledge to do so in a way that meets an appropriate risk appetite and need for diversification. However, compared to the relatively low friction decisions of spending money or leaving it in a bank account, making an investment continues to be a high friction experience for too many consumers.

Retail investment policy needs to find a better balance between its existing investor protection mindset and an emerging investor empowerment agenda in general. In the meantime, distribution policy reform should at least seek to remove friction where it can.

We thank the **Slovenian EU Council Presidency** and **the partner institutions** for their support to the organisation of the Eurofi September 2021 Forum

RETAIL INVESTMENT STRATEGY

RODRIGO BUENAVENTURA
Chairman,
Spanish Securities and Exchange Commission (CNMV)

Retail participation in capital markets: a somehow critical perspective

Everybody says that we need more retail investors in EU capital markets, and I agree. In Spain the weight of direct retail participation in equity markets has been historically 25% larger than the rest of the Euro area. However, from that perspective, and given that the general mood is inclined towards the benefits and strengths of increasing retail participation, I will put the focus here towards the risks attached to that process, just to balance the views.

First, we should keep an eye on the rising risks in certain investment choices. In the non-MiFID world, like forex, commodities or cryptocurrencies, controls are simply non-existent. Financial scams are rising, especially around cryptos, due to how easy it is to reach (and apparently to fool) retail investors through social media and the internet. Here, the Fear of Missing Out (FOMO) effect is already taking a heavy toll in the EU in terms of financial losses and financial scams, that we need to tackle collectively. From CNMV we are sponsoring a coordinated response by authorities to financial scams in Spain.

We often speak about the importance of financial literacy to improve the tools with which retail investors access capital markets. Financial literacy is essential, especially to avoid scams and to do financial planning, but it is not a silver bullet for all investment strategies. We can convey to the wider population the difference between the risks in a bond and a share, but it would be naïve to believe that financial education programmes can give an average retail investor all the capabilities to do in-depth research on SME stocks and to pick which one has greater growth prospects.

As some say, most EU retail investors, maybe with the exception of the youngest, do not want a DIY approach, spending hours deciding which stocks are best to buy and when they should be sold. Most citizens do not want to invest time and resources to become financial experts. For them, we simply need a well regulated industry subject to proper supervision.

Most citizens do not want to invest time and resources to become financial experts.

One topic that we need to clarify is what we mean by increasing retail participation in EU capital markets. If we mean direct investment and single-stock picking, there are benefits, but also risks. Collective investment comes at a cost (fees) but brings two benefits: professional research and diversification. Investing and trading on individual SME (and even blue chip) stocks is a legitimate activity and of course everyone should be allowed to do it, but if we want to stimulate long term investment as a complement to national pension plans, we absolutely need to embed the ideas of adequate research and sufficient diversification.

We have observed how the engagement of retail customers has changed in recent years, in a number of dimensions. Retail investors are more interconnected than ever, have immediate access to markets through their phones and receive supposedly low-cost offers. Each of those elements needs regulatory attention.

Connectedness, acting together through social media, can create a false sense of security within the group. And can also give higher leverage to wrongdoing by some if followed by many. Similarly, the “low-cost revolution” comes at a hidden price, which is normally best execution and the preservation of the interest of the investor above the firm’s. ESMA has rightly warned about payment for order flow as a significant source of risk. Likewise, regulators are keeping an eye on gamification, which trivializes the risks of investing by presenting it like a game or a contest. All three phenomena are related and linked with a fourth one: some sectors of young citizens started investing in the crypto world and are now turning their eyes to the equity world, ignoring that it is a highly regulated one, also in conduct rules like market abuse and short selling.

To finish on a positive note, we have to recognize that we have a remarkable level of protection in the EU towards retail investors when they invest in MiFID products. Anyone that has examined (let alone supervised or enforced) obligations of informing retail clients and evaluating their knowledge and experience before they can invest, can ascertain that the check points, the controls, the information requirements are incredibly demanding. Apart from drugs and guns, I know very few industries were so many checks are performed before allowing a citizen to buy something.

We also have an increasingly eco-conscious investor base, which is helping in the transition to a carbon-free economy, and an increasingly social-conscious one too. This trend has brought a great drive too the asset management industry too and will be essential to provide the capital base needed to finance the massive investments attached to the transformation of our economy towards a carbon-neutral one.

MARTIN MERLIN

Director, Banking, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

An EU strategy for retail investment

The 2020 CMU Action Plan announced the Commission's intention to come forward with a strategy for retail investments in the EU aimed at helping retail investors to reap the benefits of the opportunities that capital markets can offer.

The EU has one of the highest individual savings rates in the world, yet levels of participation in higher yielding retail investment markets are low by international standards. That is a concern for policy makers for two important reasons:

1) because capital markets have an important role to play in providing non-bank funding: it is a particularly important consideration in the context of the need to fund the economic recovery post pandemic, and;

2) because we need to ensure a framework that caters efficiently for citizens' long term financial needs.

How can the EU help boost retail investments?

There are many reasons that might explain the comparatively low participation rates in Europe: low financial literacy, lack of an investment culture, the regulatory environment, absence of trust in the market and financial service providers, to name but a few. The Commission is currently gathering more evidence to help it assess which issues might need to be tackled and what would be best way to achieve our goals. In the CMU Action Plan, we have described a number of important principles should underpin the retail investor protection framework:

(i) adequate protection rules tailored to their profile or risk appetite;

(ii) bias-free advice and fair treatment;

(iii) open markets with a variety of competitive and cost-efficient financial services and products, and

(iv) transparent, comparable and understandable product information, available in a digitalised form.

> **The strategy will aim to ensure that the rules work for and empower retail investors.**

What will be the approach in the retail investment strategy ?

Investor protection rules are currently set out in a number of sector specific legislative instruments, including the MiFID II, PRIIPs, UCITS and the Insurance Distribution Directive. By way of example, the rules covering disclosures, payment of inducements to financial intermediaries, or the assessment of whether investment products may be suitable or appropriate for certain investors, can differ from one instrument to another. That means that investors may be afforded different levels of protection depending on their choice of product, and the patchwork of rules may not be conducive to helping them make sound investment decisions that correspond to their needs.

The Commission is currently in an evidence-gathering phase, which will allow us to carefully consider what should be the important next steps.

We have commissioned an extensive study to help us understand how rules on disclosures, advice, inducements and suitability work for retail investors; we have launched a detailed public consultation covering a broad array of issues that are relevant in the context of retail investments; and, at the end of July, we sent three calls for advice to ESMA, EIOPA and the Joint Committee of the European Supervisory Authorities.

At the core of the Commission's thinking is that we need to make sure that retail investors are placed firmly at the heart of the investor protection framework so as to make sure that the EU rules are well conceived and coherent. Our approach is broad ranging: we are considering issues right across the different phases of the "retail investor journey" (awareness, pre-contractual, contractual, post contractual) in order to better understand retail investors' needs and to address any identified shortcomings.

The strategy will aim to ensure that the rules work for retail investors in ways that empower them to take the right financial decisions, providing a framework of trust because they feel sufficiently protected.

Key Milestones

- August-September 2021: end of public consultation and analysis of response
- October 2021: results of the retail investment study
- April 2022: ESAs' advice to be delivered to the Commission
- Q4 2022: retail investment initiative (exact form and content still to be decided)

GUILLAUME PRACHE

Managing Director, Better Finance

EU retail investments strategy: from "Investor Protection" to Value for Money

On 20 April 2021, the European Commission published its consultation on a «Retail Investment Strategy for Europe", recalling the Capital Markets Union (CMU) objective of "*bias-free advice*", and purposefully also specifying "*improved market outcomes*", empowering retail investors and enhancing "*their participation in the capital markets*".

Achieving "*a CMU that works for people*" has been a priority for BETTER FINANCE since its inception in 2015. For the CMU to succeed, European citizens as individual investors and savers, should be at the heart of the project. It goes without saying that inviting EU citizens - the main providers of funding for the EU economy - to participate more directly in capital markets comes with a certain responsibility and the need to amend a number of related EU regulations.

The retail investor protection framework currently in place falls short of achieving these priorities set by the European Commission. Individual investors still have very little access to direct investments in capital markets such as low-cost plain vanilla index funds (ETFs in particular), listed equities and bonds, due primarily to the fact that most EU retail investment intermediaries do not get compensated for informing, promoting, and distributing these products which are on average closer to the funding of the real economy, more cost efficient and more performing over the mid and long term.

In other words, these simpler investment products do not generate recurring sales commissions ("inducements" in the EU jargon), contrary to the more "packaged", complex and fee-laden ones. The scarcity of "*bias-free advice*" is indeed the primary reason for the too often poor value for money of retail investment products and services. For example, European plain vanilla European equity index funds ("ETFs") are on average about 10 times less expensive than European equity "units" sold via life insurance in France (less than 0,30% versus close to 3% of assets per annum). However, unlike the latter, they are almost never promoted and offered to "retail" investors.

It is crucial that the EU indeed achieves its goal of providing "bias-free advice" to pension savers.

And retail investment distributors are the primary providers of investor education for EU adults. In the US, another very powerful and much less biased tool of investor education is provided by employee share ownership (ESO) and corporate savings plans. In particular, ESO is 100 times more developed in US SMEs than in EU ones.

Also, different legal and supervision standards of investor protection across sectors and product categories, combined with the extreme difficulty of obtaining redress for individual investors, leave individual investors vulnerable to malpractice and mis-selling.

This problem is further exacerbated by the inadequate disclosure of key investor information in the non-intelligible, not comparable, and often misleading "Key Information Document "or KID, leaving individual investors in the dark or, once again, dependent on biased advice. This KID does not even disclose the actual full cost and actual returns of investment products.

If the CMU is to stand any chance of succeeding, it will be essential to restore retail investor trust through increased transparency and disclosure of information, coupled with better investment advice. The "*Retail Investment Strategy for the EU*" constitutes the ideal opportunity to do so.

Let's not squander the opportunity to attract EU Households back into capital markets and provide them with the right products and protection. Yet, it is better to prevent than to cure. Whereas ensuring adequate investor protection is essential, it will be a futile exercise if the Retail Investments Strategy does not ensure "value for money" for EU long term and pension savers. It simply means that those should get back at the very least what they saved year after year after all fees paid and in "real" terms - i.e. after inflation: the purchasing power of these lifetime savings.

And this is where we come full circle: it is crucial that the EU indeed achieves its goal of providing "bias-free advice" to pension savers, to ensure they get value for money from their lifetime savings.

The High Level Forum on the CMU, the European Securities and Markets Authority's (ESMA) Stakeholder Group, as well as BETTER FINANCE, recommend as an effective and urgent step forward to:

- extend the existing ban on "inducements" for "independent advice" and for "portfolio management" services to all retail investment products (not only the minority of those covered by MiFID),
- and extend it as well to all "execution only" transactions, which – by definition – do not include any "advice" from intermediaries.

JEAN-PAUL SERVAIS

President,
Financial Services and Markets Authority, Belgium (FSMA)

How to make increased retail investor participation a sustainable trend?

While the COVID-19 pandemic has been a dramatic event with impact on all our lives, it has also, like every crisis, made room for some positive developments. In the financial sector, the observed increased participation of retail investors to equity markets is one of those possible positive externalities. COVID-19 might have played a major role in helping to achieve the objective expressed by the European Commission via the CMU initiative.

In Belgium, both the number of active investors and the number of new investors have been increasing since the beginning of 2020. The number of unique Belgian traders buying and selling BEL20 stocks doubled in 2021 Q1 compared to 2019 Q1. After an enormous increase of new investors finding their way to the market during the first COVID-lockdown (March 2020), an increasing amount of new investors are at the end of 2020 and beginning of 2021 trading on the Belgian equity market.

These figures are promising, as it is in the interest of consumers to diversify their assets, and to take advantage of the higher returns provided by capital markets compared to savings accounts. This also helps channeling funding to the real economy, and by decreasing the reliance on the banking sector, could potentially mitigate some sources of systemic risks – even though other less well-known sources of risk might also appear at the same time. The latter needs to be carefully assessed.

However positive those developments are, it is of utmost importance to make sure that this trend remains sustainable. How to ensure that retail investors do see capital markets as investments, and that they are not using them for pure speculative short-term trading (e.g., as an alternative to gambling)? How to make sure that they understand the risks they are taking, that they can sustain temporary losses? In short, what must be done so that new retail investors stay in the capital markets for the long term?

Renewed efforts in improving the level of financial education is a first key factor. Finance is a complicated field, and some financial instruments will always be too complex for retail investors. Still, some simple rules are a first step to understand the basics of finance: you cannot achieve a high level of return without at the same time taking any form of risk; you should not put all your eggs in the same basket.

An investor armed with those principles, and who has some knowledge of the current level of interest rates, is less likely to fall prey to fraudsters promising 7% guaranteed return. Financial education efforts in Belgium through the Wikifin program launched and managed by the FSMA, the Belgian financial supervisor, are continuously evolving and reached a new milestone with the launch of the Wikifin LAB, a unique interactive digital experience center on financial education, in September 2020.

COVID-19 crisis might have led to a sustainable increased retail investor participation.

The recent increased retail investor participation has also been made possible by the development of new trading platforms that make it easy to trade online, sometimes at zero-commission. While we can only favor sane competition in this area, still we must ensure that all types of retail brokers act in the best interest of their clients. Traditional conduct supervision work is thus key in promoting a safe market for retail trading. Depending on the service that they receive, clients might be subject to a suitability or appropriateness test, and the necessary warnings should be issued before they proceed to transactions.

Brokers must provide all the information to clients so that they understand the decisions they take. However, studies have shown that information per se is no panacea and that too much information could be overwhelming and even detrimental to investor protection. [1] It is thus important to find a right balance, and to ensure that information is standardized as much as possible across different financial areas (banking, insurance, pensions).

The academic literature shows as well that too frequent trading can hurt clients' returns, so clients should not be tempted to fall into a trading frenzy. While it is indeed convenient to be able to trade stocks on a smartphone with a simple swipe, it is also important to avoid that unexperienced traders perceive trading as a game. Promises of « free trading » may appear as a good bargain for retail clients, but it is important they understand that there is no free lunch, and that zero-commission trading probably hides other forms of costs.[2]

During the COVID-19 crisis, retail investors seem to have displayed a welcome new form of risk appetite. Regulators and supervisors should now make sure that this would not result in any form of indigestion.

[1] See for instance, ASIC-AFM, 2019, REP 632 « Disclosure : Why it shouldn't be the default »

[2] See also the recent ESMA statement on this matter : esma35-43-2749_esma_public_statement_pfof_and_zero-commission_brokers.pdf (europa.eu)

STÉPHANIE YON-COURTIN

MEP & Vice-Chair, Committee on Economic and Monetary Affairs, European Parliament

Transparency, accountability & dialogue: the trust recipe for retail investment

Promoting retail investment in EU capital markets is in many aspects a symbol of the ambitious endeavor of the EU single market: reaping the benefits of one of the largest common markets in the world, with almost 500 million consumers, while respecting that the drivers behind investment decisions are strongly rooted in national habits.

The success of the forthcoming retail investment strategy will rely on its ability to knit together common European economic imperatives - unlocking new funding for SMEs and corporates, for the green and the digital transition - and incentives of the level of each consumer. This will not require a one-size-fits-all with full harmonisation of the retail landscape, but a step-by-step approach with a more horizontal approach when needed.

The previous financial and economic crisis has severely damaged citizens' trust that the financial ecosystem can deliver for society as a whole. Numerous episodes of local, national and international mis-selling scandals have eroded consumers' trust that financial intermediaries are acting in their interest. Now is the time to rebuild the two sizes of this trust equation, based on transparency, accountability and dialogue.

1. Transparency

Meaningful transparency is needed more than ever.Consumers should have access to information on financial products in which they intend to invest, free of charge. Suchinformation should be tailored to their needs and their understanding of financial markets, and therefore adaptable to each consumer.

Digitalisation would help in this regard, provided that it does not lead to the exclusion of consumers with limited access to digital solutions. The EU would act as a world-pioneer in proposing interactive digital KIDs, integrating all aspects of risks, costs, performance, sustainability and consumer rights in a user-friendly format.

Such an approach would require a significant overhaul of the PRIIPs Regulation. In the short term, we should focus on finally making the Regulation applicable across the whole investment landscape, after ten years of debate.

The EU would act as a world-pioneer in proposing interactive digital KIDs.

In the medium term, we can update significantly the PRIIPs framework, without going back on its original ambition: PRIIPs 2.0 will cover all financial products and providers. Now and in the future, PRIIPs will continue to focus the attention of distributors and providers on the value provided to end consumers, rather than the value they could derive from selling products.

2. Accountability

Consumers should be confident that financial intermediaries and advisors are acting with the sole interest of the consumer in mind. The principle of alignment of interests across the value chain already features in the distribution rulebook enshrined in both MiFID and IDD frameworks.

However, discrepancies at regulatory and supervisory levels are seemingly leading to divergences in the application of this principle, increasing the risk of arbitrage, where a provider could choose to "change hats" to apply less stringent governance processes for the same product.

A horizontal overhaul of the rules on distribution and product governance would tackle this risk: further harmonisation on the building blocks of the interaction between consumer, distributor and provider is the way forward. Such harmonisation should not do away with the specifics of each distribution landscape, rooted in national particularities.

The increased use of mystery shopping, now an explicit competence of the ESAs, is a powerful tool to detect anomalies and increase accountability at all levels of the distribution chain. From CEO to financial advisor, all actors in the chain should focus on servicing the end-investor.

3. Dialogue

This is the silver bullet to make transparency meaningful and accountability felt. Regular discussions need to happen between consumers and financial intermediaries, in good and bad times.

The financial industry has a key role to play in this change of culture, also ensuring that consumers see them as partners. They can help consumers build saving strategies tailored to their needs, without solely relying on offering ready- made packaged solutions. They should be on the lookout for all products suitable to their clients, not limiting themselves to in-house products.

Financial education at schools and universities can help in this regard. Increasing awareness in the importance of saving and investing is also a life-long learning project. Employers, trade unions, civil society organisations can all contribute to tackling financial literacy in the EU.

Such a dialogue will also address some of the key drivers of retail investment, such as the shape of pension systems and tax incentives. On these topics, the EU can act as a catalyst for potential reforms, but should refrain from overstepping onsuch sensitive national debates.

CHRISTOPH BERGWEILER
Chief Executive Officer, Conducting Officer and Member of the Board of Directors, J.P. Morgan Asset Management

Retail investment strategy: it's time to get investment moving

The biggest risk facing European savers today is not taking risk at all.

A vast majority of European households still do not invest and continue to have high levels of savings in cash. Many households may also be tied to products potentially not best suited to their financial needs. The huge cost of missed investment gains is building rapidly.

According to a recent report by EFAMA, a ten-year investment of €10K in a mixed UCITS portfolio generated a total net performance of 61%, whereas the value of €10K left in a bank account in 2010-2019, after adjusted for inflation, fell by 10%. European citizens have a lot to gain by taking responsibly managed long-term capital markets risk, in turn fulfilling Europe's investment needs and helping to fuel the European economy.

J.P. Morgan supports EU policymakers' work to foster greater retail investment through the Retail Investment Strategy. There is a strong correlation between a healthy retail market and deeper, more liquid capital markets. Helping citizens make the jump from savers to investors will go a long way towards building a successful Capital Markets Union in the region.

The Sustainable Finance agenda is complementary – ESG offers a great catalyst for getting more savers into capital markets. Surveying shows that many Europeans feel investing in companies that were contributing to sustainability increases their confidence. The investment management sector, with its fiduciary compass, coupled with stewardship efforts in support of ESG, is a natural partner for both the savings landscape but also the green economy.

Many people think investment is a high-risk endeavor, or they simply do not know where or how to access investment products. And yet, we have seen greater investment in riskier, less regulated spaces like cryptocurrencies or single stocks.

Gaining a better understanding of investing builds confidence. Addressing a lack of knowledge remains a crucial step in increasing accessibility and engagement, especially for first-time investors. We applaud the Commission for emphasizing the importance of building greater financial literacy.

It's time to, once and for all, empower citizens to become more confident investors.

The past years have seen a cumulative decrease in ongoing charges of UCITS. Measures for enhanced cost disclosure under UCITS and MiFID have helped boost competition and reduce costs. Policymakers have played an instrumental role here. That said, they should also recognize that too much attention on cost can be a disincentive to citizens seeking investment funds.

We must also recognize that there will be different costs associated with different levels of service. Just as passengers should be able to count on a flight to land safely in their destination, retail investors should get an adequate level of service from an investment e.g. a professional CIO view across distribution channels. But some airline passengers may choose to pay more for a ticket that has more legroom or even a first-class ticket. Equally, some investors are prepared to pay a premium in terms of ongoing commissions for receiving ongoing advice, which will evaluate whether a fund's portfolio continues to best meet their specific long-term needs.

A renewed focus on inducements is concerning. Abolishing inducements could incentivize sales of products that produce revenue by other means, like low-yielding bank certificates, structured products, or insurance-based products. This risks reducing investor choice and competition across funds. It also potentially leaves investors with worse growth prospects and works against the goal of the CMU to channel more investment into capital markets. This is concerning given advice is one of the most crucial conditions for spurring broader participation of savers in the capital markets. Policy needs to promote financial advice, investor choice and transparency.

We welcome the work towards improving product disclosure regimes like PRIIPs and enabling greater digital disclosure. Digital delivery is crucial if we are to engage with younger investors, but we must also provide content that the average investor can consume – practical, usable data that has real relevance to the consumer is an imperative.

In essence, we need an ambitious Retail Investment Strategy with a clear, positive vision. If we want broader retail investment to build momentum, we need to focus on empowering citizens. We need to look at each policy measure and ask ourselves whether it contributes to building an investment culture or is detracting from this goal. Policymakers have a duty to emphasize not just what investors stand to lose, but how much they may gain through responsibly managed risk taking.

The biggest problem facing Europe's retail market is not cost, conflict of interest or consumer protection. It is inertia. Albert Einstein put it well when he said: "nothing starts until something moves". It's time to, once and for all, empower citizens to become more confident investors. It's time to get investment moving.

CHRISTIAN HYLDAHL

Managing Director,
Co-Head of Continental Europe
& Head of Nordics, BlackRock

Putting the retail investor at the heart of EU policy making

The EU's Retail Investment Strategy represents a once in a generation opportunity to put the retail investor at the heart of EU policy making. The EU has already established robust foundations for retail investment in Europe with the world's best in class investment product (UCITS), innovative long-term savings products (ELTIF), and a strong framework that focuses on investor protection (conduct, disclosure and transparency). But continued high levels of precautionary savings indicate that the existing investor protection framework is still not delivering for citizens. Increased investor engagement is also key to European citizen involvement in the strategic projects of Capital Markets Union, post-COVID recovery plans and the transition to a sustainable economy.

Putting the needs of the retail investor at the heart of policy initiatives can create truly impactful and positive outcomes for investors and more broadly for the long-term funding of the EU economy. To realise this potential we recommend prioritising three areas of policy actions: 1. Increase empowerment through financial capability and financial health checks; 2. Address the lack of trust and confidence in the advice process by delivering consistent outcomes whatever the sales channel and 3. Increase focus on digital enablement to both simplify and engage more effectively with investors.

1. To empower investors we need to build the infrastructure to support increased levels of financial capability. As much as we prioritise people's individual physical and environmental health, we also need to realise that financial health is for everyone: Every EU citizen needs the tools to manage their financial health and wellbeing just as they need to manage their physical and mental health.

   Financial health checks contribute by filling the gap between generic financial education and the existing regulated advisory and sales process. They aim to empower consumers to develop a lifetime plan to support financial health and resilience. Health is always about maintaining a balance and it is no different when it comes to financial health with a balance between short, medium- and long-term goals.

Every EU citizen needs the tools to manage their financial health and wellbeing.

While financial education remains a national competence, the Commission can contribute to increasing consumer empowerment with a focus on best practises in the design of financial health checks and scaling up Europe's digital infrastructure to boost investors' resilience and capability. This would ensure that every country can offer their citizens access to regular financial health checks throughout their life to set them on the right financial path with actionable recommendations on how to improve their financial resilience, as circumstances change.

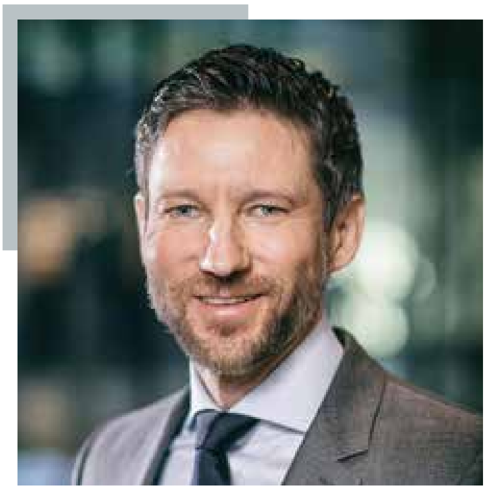
A framework which encourages people to regularly review their finances and builds up confidence in how finance works for them needs both the public and financial service sectors to work together with other core stakeholders such as the social partners. In many member states the workplace would be an ideal venue for delivering health checks, especially if supplemented by workplace access to advice on the benefits of savings and pensions.

2. More can be done to build trust in financial advice by ensuring consistent and transparent outcomes when it comes to incentives and suitability at the point of distribution. Inconsistent outcomes are often the result of the application of different standards by type of product and intermediary. Actions such as certification of advisor training and aligning the incentive regime between different sectoral directives (MiFID and IDD) will give retail investors a clearer picture of what to expect from the financial sector.

   Further steps such encouraging distributors to look at the overall outcome a consumer is trying to achieve will also help the sector connect more effectively with consumers and tackle underlying issues of lack of trust.

3. The use of digital tools is a key part of the broader process of empowerment. Policy actions in this area range from developing more interactive digital disclosure standards and moving away from static disclosure such as the KID (tackling the shortcoming of the current PRIIPs regime) to simplifying client onboarding and providing access to digital dashboards allowing consumers to have easy access to their accounts. The EU proposals for a Digital ID represent a valuable first step in allowing investors to take control of their data and promote more effective decision making.

To summarize: An investor centric policy framework focusing on empowerment and protection will help citizens better engage with the system of investment services and product provision and will help to address longer term strategic challenges such as the transition towards a greener and digital economy.



THOMAS SCHAUFLER
Chief Retail Officer,
Erste Group Bank AG

Improve access to capital markets through digital technology

Why we at Erste Group focus on retail investors

People in our region have dreams. They want to buy a new home, start their own business, desire the best education for their children or prepare for retirement. The standard of living in the CEE region has steadily converged towards Western European levels in the last two decades. But despite having regular income to enjoy life, many people in the region still lack the financial knowledge to take the right financial decisions to make more out of their assets in the long run.

A glance at the composition of household financial assets reveals that people in CEE hold much of their financial wealth in cash and savings accounts. At the same time, households in the more developed markets hold a much smaller fraction of their wealth in cash and savings; they tend to hold their financial assets in typical investment products such as investment funds, bonds, shares or pension insurances. This reveals that households in CEE should and could do much better in terms of building up wealth. Having the prosperity of our region at the core of our statement of purpose, it is our particular interest to put all of our clients into the position to make well-informed investment decisions, to benefit from more profitable investment opportunities and to ultimately improve their financial health.

Based on this situation, what are our current focal points?

1. Digital as key channel to increase customer awareness

With the roll-out of our digital platform "George" in our core markets, we are well on the way to prepare the ground for the democratization of advice via digital channels and to support even more people in CEE with advice on how to prosper financially. This includes the continuous broadening and updating of our product portfolio by integrating asset management and bancassurance solutions into our digital offering. Overall, in combination with personal advice via branches and remote advisory centers, this makes it easier for customers to invest.

Democratise financial knowledge and financial advice by fostering digital channels and improving personal touchpoints

2. Proactive and holistic advice to become our customers' lifelong partner

Our customers' financial situations change depending on their life situation, e.g. through job changes, starting a family or retirement. To help our customers the most, we continue to shift from financial product specific advice to putting clients' needs into the center of our advisory approach and to provide holistic advice over a lifetime. Together with the strong ambition of each and every employee to proactively deliver best advice to the customers in CEE, this will enable us to further boost prosperity in the region.

What needs to be done at the EU level to further promote retail investments?

When it comes to retail investment, a lot of regulatory measures have been taken at EU level in recent years, particularly regarding investor protection and disclosure. On the one hand, this framework has helped to further integrate capital markets and facilitate cross-border investments. On the other hand, it has also sometimes led to overregulation and inconsistencies that are effectively creating new barriers for financial service providers to offer investment solutions to retail clients.

As stated above, digital channels to interact with clients are key to democratize financial knowledge and financial advice. In this respect, harmonization through EU rules often does not go far enough and thus, can lead to goldplating at the national level. For instance, this is the case with MiFID II where complexity and deviating national implementation make it difficult to build standardized digital tools for financial advisory that can be rolled out across multiple markets, leading to extra costs, delays in implementation and further difficulties for financial services providers. More harmonization to foster digital solutions is therefore key to improve citizens' access to capital markets and should be a top priority for the upcoming Retail investment strategy of the European Commission.

Apart from that, we believe that financial literacy and tax incentives are key for a stronger retail investor participation. Financial literacy is an essential basis for every citizen and in combination with tailored financial advice can strongly improve individuals' financial well-being.

When it comes to taxation, suitable incentives such as notional interest rate deduction can have a positive impact by nudging people into making the right investment choices.

ASSET MANAGEMENT TRENDS AND POLICY IMPLICATIONS

GABRIELA FIGUEIREDO DIAS

Chairperson,
Portuguese Securities Market Commission (CMVM)

Asset managers' strategic role in the recovery

While we recover from the pandemic shock, asset managers must face the trends it has fueled, especially in what regards sustainability and technology, while at the same time dealing with policy and regulatory developments in respect to many pressing issues, with financial stability, passive investment, delegation, passport improvements, ESG or investor protection and engagement at the forefront.

Digital transformation, a CMU and EU priority, has been extensively accelerated by the pandemic, involving relevant risks and opportunities. Data analytics, machine learning and artificial intelligence, if properly used, may strongly contribute to foster efficiency at back office, sales and distribution levels – enabling Direct-to-Customer approaches as an alternative to Business-to-Customer; to upgrade customer experience and access to new asset classes; and to support active management decisions. Technology-enabled advice also allows for new and more efficient ways of providing wealth management. As is well known, middle and back office operations have historically been an expensive cost source for asset managers, whose competitiveness depends on their ability to offer value for money to investors.

Digitalization and technology may effectively minimize such costs in the long run, by increasing operational automation and improving the opportunities for outsourced relationships – not only related to the day-to-day operations, but also to key functions as portfolio management and investment advice. Distributed Ledger Technology will also support this movement, enabling more secure, cost effective and fully traceable flows, while opening the way for new processes and products.

Asset managers should avail the transformative times we are experiencing and make the most of it.

All these opportunities should not lead us to ignore the risks posed by digitalization to market integration – namely, excessive concentration and market power on few asset managers – and to investors – who might not be prepared to deal with the new challenges posed by digital illiteracy, behavioral distortions in digital economy and the increasing disintermediation of financial relations. Asset managers, but also policy makers and regulators, are therefore requested to find proper approaches to all these risks, preserving competition and financial stability.

At product level, investment allocation to passive products remains a trend, as investors search for low fees while broadening their market exposure. But the demand profile is changing: along with the continued growth of ETFs, we observe also an increased demand for ESG and long term investment products that meet the current demographic challenges in the advanced economies. Additionally, the inclusion of digital currencies in funds' portfolio should not be neglected as a critical challenge and source of risks to asset managers and regulators.

All in all, the asset management sector, considering all these challenges and opportunities, and being the most democratic and risk diversified savings product for investors, will have a strategic role in supporting the recovery and the transition to a sustainable economy. Its success will depend on its ability to attract retail investors and foster their confidence through fair, robust, and transparent investment options.

Ongoing policy and regulatory initiatives will hence have to acknowledge and support these trends and handle the risks therein. The ongoing AIFMD and ELTIF reviews and the implementation of the CMU proposals are already do it. But the EU retail investment strategy, planned for 2022 will be key. It will have to set up a comprehensive and integrated strategy, more than merely a sum of rules, to give EU citizens the necessary tools and confidence to allocate their savings to investment products and increase retail participation in capital markets. For such purpose, more and better investment advice, improved and consistent financial disclosure, including on PRIPPS, and improved financial literacy (of current and potential investors), alongside with reinforced intervention powers and supervisory convergence, will be paramount.

The most important factors of these initiatives will be to create strong and clear incentives and benefits for retail investors, fostering their confidence in the market through clear and comparable information, diversified products, easiness of access and avoid complex, disproportional and excessive regulation. But, of course, it is also on market participants and not only on regulators to take the responsibility to rise up to the challenge, to avail the transformative times we are experiencing and make the most of it, taking the opportunities to develop new business models, new products and new distribution channels, while putting the investors' interests first as way to build a sustainable and profitable future.

DERVILLE ROWLAND
Director General Financial Conduct, Central Bank of Ireland

Changes to the AIFMD can increase resilience in the non-bank sector

The development of the regulatory framework for the alternative investment sector has been important for the welfare of European investors and the development of European capital markets in general. Since its introduction in 2013, the AIFMD has supported the development of a European market for alternative investment funds, while protecting investors and improving the monitoring of potential risks to the financial system.

It is therefore important that reform of the AIFMD, UCITS and ELTIF frameworks are considered in the context of serving the needs of the European economy and the economic welfare of EU citizens, and that the sector operates fairly and in the interests of investors and consumers. The review of these frameworks has a key role to play in supporting the Capital Markets Union - whereby better facilitating investment across Member States and providing firms with a range of funding options, the non-bank sector can support the economic recovery post Covid-19. The ELTIF review represents an opportunity to enhance the funding of European long-term investments.

Since the introduction of the first UCITS directive in 1985, European capital markets have become increasingly characterised by cross-border activity. The AIFMD, particularly through the marketing passport, has further supported the removal of barriers between jurisdictions. This has helped to provide financing to the European economy and improve outcomes for investors.

The sector is evolving rapidly, however, driven by regulatory changes since the global financial crisis; initiatives such as the CMU to boost direct retail participation in capital markets; and improvements in technology. It is important that the regulatory framework and supervisory architecture keep pace with this changing environment. Continued strengthening of supervisory coordination and consistency is an important part of securing best outcomes for European investors and the EU economy, including in supporting the delivery of the Capital Markets Union, with ESMA continuing to play a key role in this area. Further enhanced coordination and consistency across EU supervision will be important in the context of securing optimal levels of integration between European and international capital markets.

The regulatory framework must keep pace with the changing environment.

When delegation arrangements, for instance, are subject to high standards and robust and consistent supervision by NCAs, investors can avail of substantial benefits. These include reductions in costs, increased operational efficiency, and a wider range of well-managed investment opportunities. To safeguard investor protection, delegation must be performed responsibly with AIFMs maintaining high quality and effective oversight of their delegates. The AIFMD must continue to ensure that fund management companies discharge their obligations in a safe and sound manner and in the best interest of investors, while maintaining the benefits of delegation.

The Covid related financial shock of 2020 brought into focus how collective responses by investors in parts of the investment fund sector-in particular the first-mover dynamic - could potentially amplify financial stress. There is therefore a need to consider how national and European authorities can develop and apply macroprudential powers to limit the build-up of systemic risk. Currently, the EU does not benefit from a complete and operational macroprudential framework for the non-bank sector, so further development is required.

One example of this is the work currently underway on operationalising Article 25 of the AIFMD. The ESMA guidelines, published last year, will help to ensure that NCAs can apply macroprudential leverage limits on AIFs or groups of AIFs in a manner that is consistent, transparent, and effective in reducing risk to the financial system.

However, improvements to the Article 25 mechanism should be considered to make it a more holistic tool for responding to the nature of the systemic risk posed by investment funds. Moving beyond this, there is a need to create a macroprudential framework for liquidity in the investment fund sector, under both AIFMD and UCITS. This would involve considering measures that align the liquidity of funds' portfolios with redemption terms (including pricing), with the objective of mitigating the systemic impacts of investors seeking to gain first mover advantage in redemptions.

Given the success of the AIFMD and UCITS regimes in supporting cross-border activities, macroprudential tools may in some cases need to be applied uniformly across jurisdictions. The current framework could be amended to provide for enhanced reciprocity between NCAs to ensure that measures are not circumvented by re-domiciling.

It is important that the opportunity of the AIFMD review is used to develop the resilience of the European non-bank sector, so that future periods of financial stress do not lead to failings in either investor protection or financial stability and undermine the potential for more effective pan-European capital markets.

JÉRÔME REBOUL

Head of the Regulatory Policy and International Affairs Directorate, Autorité des Marchés Financiers (AMF)

The AMF proposals to strengthen the EU cross-border supervision of funds

AIFMD has been successful in creating an efficient internal market for Alternative Investment Funds ('AIFs') and setting out robust and competitive standards recognised internationally. The AMF does not believe a global overhaul of the directive is needed. Yet, the upcoming review of the directive is an opportunity to consider significant improvements in certain areas, taking stock after almost a decade of application of the AIFMD framework and learning from the vulnerabilities highlighted by the COVID crisis.

The AMF set out detailed proposals in a position paper published in March 2021, highlighting key issues that in our view deserve specific attention in the AIFMD review and should be addressed holistically e.g. with the necessary mirror amendments in the UCITS directive. One area of particular importance, is the supervision of funds cross-border activities: how can we enhance the supervision of funds' cross-border activities within the EU?

The AMF believes a smoother organisation of responsibilities between national competent authorities ('NCAs') would be instrumental to a more efficient supervision of the cross-border activities of alternative investment fund managers ('AIFMs') within the EU. A key challenge is the fragmentation of supervisory responsibilities amongst several NCAs in the case of AIFMs acting under the management passport and the resulting fragmentation of the information required to have a full picture of the cross-border activities of AIFMs.

The partition between rules applicable to fund managers and rules applicable to funds is indeed not always clear-cut and often generates some overlap when a fund and its manager are domiciled in different EU jurisdictions. For instance, according to AIFMD/UCITS, the NCA of the fund manager ('Manager NCA') is responsible for the supervision and enforcement of risk management, liquidity management and valuation requirements that AIFMs have to comply with. In parallel, the NCA of the fund ('Fund NCA') is also responsible for supervising and sanctioning any investment breach or valuation issues within the fund.

How can we enhance the supervision of funds' cross-border activities within the EU?

The current fragmentation in the supervision of cross-border activities means that none of the NCAs involved enjoys a comprehensive picture of the asset manager's activity, which might be detrimental when emergency supervisory actions are needed in times of crisis. For example, the Manager NCA may need access to information related to that manager's funds domiciled in other jurisdictions for the purpose of carrying out its supervisory responsibilities. Although information may be accessed through cooperation arrangements with other NCAs, experience shows that NCAs have different priorities and due to resource and time constraints, they may not be in a position to cooperate at the level and speed required by the circumstances.

In order to remedy the sub-optimal effects of fragmentation and to ensure there are no supervisory gaps, we believe one NCA should be granted a leading role and equipped with appropriate tools to monitor the activities of the asset manager across the EU. In our view this 'Lead Supervisor' role would be best awarded to the Manager NCA, who is already responsible for the supervision of the fund manager and its funds domiciled locally.

Therefore, we propose to enhance the Manager NCA supervisory responsibilities when the manager activates the management passport to operate cross-border, without adjusting downwards the responsibilities of other NCAs.

This would entail granting the Manager NCA direct access to all fund information held at the level of service providers (such as the depositary and auditor), in full transparency with the Fund NCA. This could include for example the breach reports produced by depositaries in the course of their oversight functions.

In addition, NCAs should be required to report to ESMA all notifications they receive regarding the use of the management passport, as well as all instances where portfolio or risk management is fully delegated to third parties. This would serve to complement the information on the marketing passport that will be reported to the future ESMA central database required by Article 12 of Regulation (EU) 2019/1156, thereby centralizing at ESMA level all relevant data on cross-border activities by AIFMs.

Fragmentation of supervision is a challenge for competent authorities but it is inherent to a vibrant EU internal market and we should endeavour to deal with the additional complexity in the most effective manner. It is time to seize the opportunity of the upcoming AIFMD review to fine-tune our rules and design a more effective framework for the future.

SEAN HAGERTY

European Managing Director, Vanguard Asset Management, Ltd

The future of asset management in Europe: shaking up traditional business models

According to the European Central Bank (ECB), household savings in the EU have reached unprecedented levels in response to Covid-19. The effect on individual savers during the Covid crisis has highlighted the opportunity to set policy that encourages long-term financial sustainability for EU citizens. Deposits in banks alone will not be able to address these needs – consumers in all wealth brackets need to have access to high quality, low-cost and broadly diversified long-term investment opportunities in order to help them achieve financial well-being.

In Europe, there is a solid savings culture to build on. But cash savings are typically less effective in the long term as a result of the erosive effect of inflation. Money put aside today is worth less in the future. As a result, going forward, the challenge for both policymakers and the industry is to help savers transition to long-term investments where there is a need for a positive long-term real return.

While the past year has brought sudden shocks and challenges to the marketplace at large, we also believe that the various learnings will accelerate changes in investment markets. At Vanguard, we believe that a long-term investment culture in Europe can be built using an investor-centric approach. The EU's Capital Markets Union (CMU) has an offer that embodies strong investor-centricity, and therefore creates the opportunity to build significant momentum towards an investment culture oriented towards the long-term.

But there are three basic steps that must be taken to boost retail participation in the markets. First, more must be done to encourage people to invest for their long-term future. Second, we need to empower European citizens by reducing barriers to investing, and ensuring rules are consistent across the EU. Finally, once people are saving, they should have access to a fair deal. This means being able to seek out appropriate financial advice, guidance, and investment products, and not being charged unreasonable fees.

Beyond macroeconomic shifts, other changes are afoot that have the potential to improve European citizens' long-term financial futures and their relationship with asset managers.

Europe has built great foundations for retail investment through patient and considered development of the UCITS fund ecosystem. As the total size of the UCITS fund market has grown, so has the opportunity for investors to benefit from economies of scale, lower costs and higher net returns.

A long-term investment culture in Europe can be built using an investor-centric approach.

The European ETF sector continues to grow steadily, helping an increasing number of European investors to benefit from low costs and broad diversification. Developments in financial technology are further helping to increase the public's access to investment opportunities, improve transparency and drive down costs. For us, one of the most exciting uses of technological advances in asset management is how technology is helping to augment human advisors in the provision of investment advice. Innovations in automation and artificial intelligence now offer firms the opportunity to provide low-cost, technology-enabled advice in order to meet the differing wants and needs of the investing public in the EU. In particular, these models appear to have been helpful in ensuring that the younger generation is engaged with their finances and can make better investment decisions.

While there is an opportunity to create an investment culture in Europe, there is also a risk that without the right policy, long-term investment in the capital market could be mistaken for, or substituted by speculation in the capital markets. Policy needs to promote long-term investing by individuals and avoid individuals mistaking investment with speculation.

The rapidly evolving ESG landscape continues to push investment companies to develop new ways by which to deliver value to investors.

However, to positively change investment culture in Europe, we also need to tackle some long-standing challenges. The total cost of investing in Europe remains too high. And potential conflicts of interest in the distribution chain continue to exist through the ongoing dominance of commission-based sales models in many parts of the EU, increasing costs and reducing choice and competition for investors.

The last year has continually shown us that while change is difficult, it is also an irrefutable force.

As policymakers contemplate a CMU to benefit retail investors, we would encourage them to design a regime that is fit for the future and not one that shies away from tackling long-standing challenges and incumbencies.

SIMON REDMAN

Managing Director, Client Portfolio Management, Invesco Real Estate

ELTIF – White knight or a damp squib?

The ELTIF structure was launched in 2015 to satisfy a clear investment need: to facilitate investment in longer-term assets such as transport and social infrastructure projects, property and small and medium-cap companies (SMCs). Additionally, the ELTIF regime was also introduced to fulfil an equally clear investor need: to provide retail investors with the ability to invest in private markets.

The ELTIF concept was, therefore, a good one, but the implementation and subsequent industry take up has not had the desired effect. The European Commission estimates that only around 27 ELTIFs have been launched in the EU, not all of which are being marketed, with total assets under management (AuM) below €2 billion. This represents c0.03% of the €6.8 trillion EU alternative investment fund (AIF) market.

The challenge in practice is that the ELTIF regime, as currently calibrated, seeks to provide access to private markets, but at the same time significantly limits eligible assets in a way that AIFs sold to professional investors are not, for example by effectively constraining managers to invest in infrastructure projects that have a rather loosely-defined social benefit.

Although a laudable aim, in our view, the restrictions mean that it is challenging to launch an ELTIF that can either be invested practically or provide returns that are acceptable to an investor required to lock their capital up for a substantial period of time. The result is that take up of the ELTIF remains limited – the ELTIF has not turned out to be the 'White knight' the industry wanted, but rather a damp squib.

Europe needs a viable long-term investment product for all investors. The continuing decline of defined benefit (DB) pension funds, alongside the steady increase in defined contribution (DC) pension schemes and privately saved capital; combined with an aging European population illustrates the need for all investors to increase their allocations to asset classes with longer term horizons. A recalibrated ELTIF regime has the potential to fulfil this need.

Therefore, the first priority of EU policymakers in reviewing the ELTIF regime should be to substantially reduce the restrictions on eligible assets. For example, under the current regime, investment in real estate is currently restricted to *«commercial property or housing... where they are integral to, or an ancillary element of, a long-term investment project that contributes to the Union objective of smart, sustainable and inclusive growth.»*

Europe needs to improve retail investors' access to investment opportunities in private markets.

This is so restrictive as to make it almost impossible for a manager to be able to invest in this asset class. In our view, there are very few investment opportunities that would meet such criteria, and those that do tend not to provide a return on investment in line with investors' expectations. The EU's objective of smart, sustainable and inclusive growth is, of course, a good one, but placing such restrictions on ELTIFs serves only to undermine this objective, rather than support it.

A better approach would be to allow investors to decide how to encourage smart, sustainable investment. In Europe especially, sustainable investing is at the forefront of many investors' thinking, both institutional and retail, and with the introduction of the EU's Sustainable Finance Disclosure Regulation (SFDR) and taxonomy providing some guidance on how sustainable a fund is, there is a ready-made framework – an ELTIF with the freedom to invest in any real estate opportunity, but which can be classified as an Article 8 or even Article 9 product is likely to be an attractive proposition.

EU policymakers should also focus on recalibrating provisions governing ELTIF redemption policies. Currently, ELTIFs are designed to be long-term investments offering little liquidity to investors and returning capital at a defined point in the future. Here, lessons should be taken from the broader AIF market. Managers of ELTIFs should be able to include the sort of liquidity and valuation mechanisms afforded to professional investors in AIFs. These are tried and tested, and having an ELTIF regime that provides greater liquidity than is currently available would help to facilitate more retail investment in this type of product.

Other areas of the ELTIF regime that require to be made more amenable from the perspective of a retail investor include revising downwards minimum investment requirements and enhancing the proportionality of rules on marketing and suitability.

In summary, the ELTIF concept is a good one, but it needs refining in order to gain popularity and critical mass. Targeted amendments in the areas described above would significantly increase the ability of managers to create well considered and attractive investment propositions while retaining robust investor protections, improve the ability of retail investors to access investment opportunities in private markets and, ultimately, boost investment in longer-term assets such as transport and social infrastructure projects, property and SMCs.

BLED, SLOVENIA

EU CONSOLIDATED TAPE : NEXT STEPS

ROBERT OPHÈLE

Président,

Autorité des Marchés Financiers (AMF)

Key features for an efficient tape: a post-trade real time equity tape

The last two years have seen several commissioned reports on the establishment of a tape, which all recommended moving forward with this project in order to make it a reality. In 2019, ESMA recommended proposing a post-trade real-time tape for equity instruments. The 2020 report undertook by Market Structure Partners for the European Commission, "The Study on the Creation of an EU Consolidated Tape" also recommended inter alia to proceed with the current procurement power (embedded in the texts) and establish a Consolidated Tape (CT) for post-trade data as soon as possible. This study is calling for a CT, which would be "run as a utility and [which] brings data stakeholders together to resolve the current challenges in consolidation".

In very fragmented markets, the principle of the need to establish a CT seems to be largely supported by market participants. However, the question on whether the tape should cover equity instruments, non-equity instruments or both and whether the tape would need to publish pre-trade consolidated data or post-trade data still remain debated. These CT features would be key to ensure an efficient system that embraces most of the market needs and completes the European well-developed markets structure.

In that context, the AMF strongly supports the establishment of a CT, which could meet the following characteristics:

- **A post-trade real-time equity CT**

One could advocate that due to the low proportion of on-venue trading for bonds, a CT for fixed income is more needed than an equity CT. As a first step, a post-trade CT covering equity instruments appears nevertheless easier to develop; but preparatory work for-non-equity instruments such as bonds should not be delayed

In terms of benefits, due to the breadth of geographical locations and latency considerations, we do not recommend the use of the consolidate tape as a way for firms to prove that they have effectively complied with their best execution obligations. However, the overall transparency of where and how trades take place will help market players to determine where liquidity lies. It will provide a useful tool of information for more accurate valuation of certain products and to appropriately monitor trade execution as well as to perform transaction cost analysis.

> **A post-trade equity tape, with an appropriate governance framework, should be set up first.**

As said, although the CT cannot allow market participants to prove they met their best execution requirements, it will nevertheless be instrumental for market participants in defining and applying their best execution policy, in particular for those financial instruments that are dealt on multiple execution venues. It will make it possible for firms to determine the execution venue towards which a specific flow should be directed (based on the price and volumes executed).

The CTP should consolidate post-trade data from all actors except from those that have little market share (i.e. less than 0.5%). This will still allow having a comprehensive view of European markets while not creating an impediment to the entry of small trading venues or new entrants – due to the requirement to be plugged to the CT.

- **An appropriate governance framework would be one of the main feature**

Most of all, to ensure strong commitment to the project and a fit for purpose CTP, its governance framework should ensure representativeness of all providers and users of the consolidated data stream. This does not mean it should be euro-centered and set in stone: should a CTP consolidate data from third-country markets, an appropriately governed CTP could potentially welcome on board third-country entities joining the tape.

- **The success of a CTP finally lies on an appropriate remuneration structure**

First, remuneration of data providers for their data contribution to the tape should not jeopardize the economic interest of building a tape. Indeed, it would be economically non viable for the CTP to purchase data from all data providers. Data providers should nonetheless be entitled to a part of the CTP revenue. As such, though data should be submitted free of charge to the CTP, data contributors should also benefit from remuneration derived from the data consolidation under a pre-defined allocation key.

Second, only data of good quality or participating in the price formation process could entitle data providers to benefit from remuneration. Hence, data of poor quality could be penalized and, transactions which do not contribute to price formation, such as transactions benefiting from a pre-trade transparency waiver (e.g. technical trades), should not be covered by the tape.

HANZO VAN BEUSEKOM

Member of the Executive Board, Dutch Authority for the Financial Markets (AFM)

Why a consolidated tape is an essential element of a real Capital Markets Union

Let's imagine you are an asset manager looking to do a transaction in European government bonds. Before seeking a quote in the market, you want to get a view of possible price bands on your screen. So, you look for information on the latest transactions in the EU. This currently requires you to gather information from a dozen different trading venues, authorised publication mechanism (APAs) and other data providers, only to discover that the data is of inadequate quality, highly fragmented and not competitively priced.

Moreover, much data is not available as the illiquid nature of the EU's bond market allows publication of transaction information to be deferred to up to four weeks. While the asset manager may have the means to compound all this information into something meaningful, less sophisticated investors and issuers looking for EU-wide price information for new investments or issuances are currently facing a highly fragmented and complex environment.

Market fragmentation is not necessarily bad; it leads to a healthy competitive environment and created various centres of expertise evolving around different asset classes in the EU. Furthermore, availability of market data has become the engine that drives financial markets today. It enabled the rapid evolution in electronic trading that revolutionised the way financial instruments are traded. It also led to broader participation, lowered spreads and created better prices for investors. What is currently missing is a broadly available consolidated, standardised and reliable overview of the EU's financial markets.

The establishment of a post-trade consolidated tape (CT) for the European equity, bonds and derivative markets can help tackle this. It can even be considered a condition for the establishment of an actual Capital Markets Union (CMU). The overall aims of a CT within the CMU framework would be to:

- Reduce fragmentation;
- Facilitate price discovery;
- Create EU-wide reference prices across asset classes;
- Improve availability and quality of market data;
- Provide better means to analyse execution quality by banks and brokers;
- Ease access to essential market data for all market participants.

A consolidated tape is needed to provide accessible and reliable overview of EU financial markets.

At a minimum, a CT should provide continuous information streams on transaction prices, instrument types, execution venues and timestamps.

It is important to properly analyse the characteristics and objectives of a CT for different asset classes. It also means that there is no one-size-fits-all solution and that not all CTs have to be established at the same time. A bond CT could be prioritised in comparison to the equity and derivative segments, as these segments already benefit from significantly higher levels of transparency and liquidity.

The EU's secondary bond market remains underdeveloped given its strong primary market model with direct relationship-based interaction between issuers, dealers, agents and investors. Given the high demand for fixed income instruments by buy-and-hold investors and central bank bond purchasing programs, the secondary market (particularly for corporate bonds) is largely limited to newly issued instruments or execution of pre-arranged bilateral OTC transactions. While electronic and multilateral trading models are now widely available, the bond market has generally been slower in adopting electronic trading protocols. It also remains largely closed to non-bank participants. This makes the market highly illiquid and fragmented, exempting it from many of the transparency requirements in the MiFIR framework.

It is important that CTs become part of a competitive setting. CTs should be based on clear industry standards on technology, costs/revenues and governance, ideally through multiple competing consolidators. The level of changes required to the current regulatory framework depend on scope, speed (real-time/delayed) and a mandatory/non-mandatory character of a CT.

There is a strong role for the regulatory community to ensure that the right conditions are in place for the successful establishment of a CT. Focus should be on making sure that necessary data is available through better enforcement of existing rules for trading venues and APAs. Furthermore, changes to MiFIDII/MiFIR are needed to rationalise coverage requirements and other barriers hampering the development of a solid-business case. At this stage, the AFM strongly supports initiatives to develop proof-of-concepts of CTs. This allows the industry to gain experience and establish best practices in order to work towards meaningful and easy to implement solutions.

In order to level the playing field between that large asset manager and small issuer, a CT for the European equities, bond and derivatives market should be an essential part of the European Commission's MiFIR review and CMU agenda.

CARMINE DI NOIA

Commissioner, Commissione Nazionale per le Società e la Borsa (CONSOB)

A Consolidated Tape to lead all the streams back to the river?

At the heart of financial markets there are financial data. In the last decade, financial markets have experienced significant changes in trading strategies, market models, technology advances and regulatory reforms which have considerably improved the value of data. Their relevance in the processes of financial intermediation has become over the years so paramount to impact on even the categorization of market participants. Forget the traditional classification between investors (institutional, professional, retail), issuers (companies, government) and - amid these, as facilitators to channelling financial resources –(stock) exchanges: in a modern financial economy, we can talk of data providers (exchanges, MTFs, systematic internalisers, APAs) and data users (asset managers, traders, and, more generally, investors). As intermediaries, data vendors and aggregators.

At the same time, consolidation of market and corporate data may help both investors and companies to make more effective investment and fund-raising choices, especially for the recovery post Covid-19. Data consolidation implies comparability: i.e. standardization, simplification, digitalization, machine readability, data quality, legal analysis on data property, economic incentives and prohibitions. A rigorous cost benefit analysis is thus needed.

Given that, a Consolidated Tape (CT), though not being the silver bullet, may play an important role for the development of an effective EU Capital Markets Union (CMU). An operating CT stands out, in fact, as the missing piece of the revolution started with the first MiFID directive in late 2004, when Europe chose to pave the way for competition in trading services, removing the concentration rule in place since 1993. CMU needs a centripetal force to overcome the centrifugal trajectories prompted by the evolution and re-organisation of the trading industry. Hopes of a private solution for the setting-up of the CT, foreseen in MiFID II, remained frustrated in face of what can be defined as a typical market failure.

CMU needs a centripetal force to overcome the centrifugal trajectories of the trading industry.

A EU CT could be designed at least on the following pillars.

The scope of consolidation cannot be designed from scratch but should take into account the different market microstructure between equity and fixed income. Considering the compelling need to reduce fragmentation across the EU when it comes to price discovery and formation in this area, it is common sense that equity may come first, but bonds and other non-equity data consolidation is not necessarily less relevant. There, further actions must be implemented to enhance quality, timing, consistency and completeness of data.

If a single start is not politically and technically feasible, then a phase-in approach may be desirable with respect to the type of data to be made available and its timing. Policy makers may follow a two-step approach, initially focusing on post-trade data, given the greater simplicity in relative database aggregation, and only at a later time including pre-trade figures, which still require further considerations about latency, presentation and aggregation of data. In fact, it would be key to strive for a real time availability of the data, which is however still far with regard to consolidation of pre-trade transparency information. Focusing on post-trade would therefore allow to test possible solutions in a first phase.

In addition, the market failure in the establishment of a single CT appears also due to the presence of entities - such as data vendors - which in many cases act as data aggregators, in the absence of a specific regulatory and supervisory framework. The rise of a CT and the sustainability of its business model may be influenced by the regulatory coverage of data vending activities. In this regard, it could be suggested an authorisation regime for data vendors/redistributors, or, at least, specific rules when it comes to transparency duties and data availability, similar to those applicable to APAs and CTPs. In this regard, further analysis is needed to understand the interplay of CT(s) and APA and ARM.

In case a CT framework is envisaged, a single CTP should emerge, at least for each asset class. An important issue is the governance of the CT. The failure of the private initiative so far is mainly attributable to the limited commercial rewards for operating an equity CT which should negotiate market data agreements with hundreds of trading venues and APAs across Europe. Reports issued by ESMA and Market Structure Partners for EC have identified as a possible option the creation of a single CT, supervised by ESMA, with the involvement of stakeholders in the governance. This could be a sensible direction. The desirable success or a new, fatal, failure of the model may depend on how far the legislator would like to address the key point of data licences with market data providers, and eventually propose a mandatory contribution regime, possibly coupled with a revenue-sharing model.

NIELS BRAB
Head of Group Regulatory Strategy & Chief Regulatory Officer, Deutsche Börse Group

A Consolidated Tape for the recovery: start with data quality and transparency

Without doubt, the EU's answer to Covid-19 has been historic and transformational – signalling unity and the next wave of integration at a critical juncture. However, with strained public finances, a banking system at its limits and warning signs of an expansive monetary policy on the horizon, let's not forget about the critical importance of the Capital Markets Union as a key lever to boost the recovery path by tapping the unleashed growth potential of our capital markets.

This is also where the reignited debate around a consolidated tape (CT) comes in. Indeed, more than three years into the game with MiFID II/ MiFIR, a strong fragmentation of the trading landscape is observable with more than 670 trading and execution venues across asset classes, and the proliferation of this trend being particularly pronounced on the equities end. This does not only suggest a clear regulatory imbalance which requires re-adjustment to ensure the broader political objectives are in-sync with the MiFID II/ MiFIR framework (role of primary vs. secondary markets). But clearly, investors could also benefit from a consolidated overview of all trading and execution venues in this complex jungle.

However, before we fall for the easy storyline around the CT again, let us maybe start by realising that the CT is currently already included in the MiFID II/ MiFIR framework. Yet, not a single private sector offer has gone live. Despite the attempts of many, the lack of data quality from the SI, dark pool and OTC segments makes it commercially unviable. By contrast, the data by exchanges stands out in terms of highest quality and availability – and one should not lose sight of the fact that only exchanges gift away their high-quality data to anyone on a 15 minutes post-trade basis. This is probably also one of the main reasons as to why private sector offers on consolidated exchange data already exist.

The key question is therefore: If the European authorities deem public intervention desirable to create a CT that truly covers 100% of the EU's market, should this not lead to assume that the major market failure is being observed around the data quality and unavailability by alternative execution venues?

Quality data as basis for any investor decision should be the starting point for any CT discussion.

Proper data quality is the basis for any investor decision with integrity and should therefore be the starting point for a CT discussion which cannot be left ignored. Indeed, the financial crisis taught us to never compromise on transparency and data quality again. For the EU, this holds true even more so, if we are serious about pushing for a retail strategy and having our citizens endorse the capital markets. Best execution rules and the broader concept of transparency cannot be afforded to remain empty shelve principles.

Yes, creating a consolidated view across European markets can support a successful recovery financing and boost the overall attractiveness for investors. But: Be clear as to your objective and careful what you wish for. There is no need to set up a complicated pre- and post-trade CT in close to real time terms, which even ESMA anticipates to only be fully functional in 5-7 years – way too late for the recovery. But also, because the US case study shows us: Even SEC Chair Gensler questions the national price reference NBBO, since too much trading is happening in the dark.

To put it differently: After almost 50 years of experience, the SEC questions whether the CT is an accurate instrument to determine if brokers are meeting their best execution requirements – given the increasing unreliability of reference prices determined by the public on lit exchanges. But while the US market sees about 60-65% of price formation in the lit – the comparative EU figure is only somewhere between 35-50%.

All we need to succeed is transparency based on reliable data and simplicity. Only if we manage to guarantee 100% coverage without getting yet again side-tracked into overly technical attempts to cushion the truth around the EU's failed MiFID II/ MiFIR market structure with an artificially injected hyper-competition based on a regulatory unlevel playing field, we will be able to establish a system where transparency, best execution policies and compliance checks play an actual role. If we look at the latest developments, such as around payment for order flow practices, this seems more important than ever.

Let us boost the recovery via an effective CMU that sees an efficient consolidate tape concept at its heart – not an overly complex set-up that increases costs of market data structurally while only seeing light once Brussels looks back at the Covid-19 period as it seems to look back these days at the lessons learnt, or not, around transparency and data quality during the global financial crisis.

NICHOLAS BEAN

Chief Executive Officer,
Bloomberg Trading Facility BV

A fixed income CTP is important to the EU in more ways than may be obvious

When writing my first article about a Consolidated Tape (CT) for Eurofi, it was hard to find a relevant proverb that would be internationally familiar. However, a suitable proverb for this article was easier to identify: «necessity is the mother of invention». In essence, the urgency of 'need' has the effect of stimulating creative solutions.

It is natural to focus on the latter 'creativity' element of this proverb, yet it is the former 'need' element which is far more important, given that a failure to understand the real 'need' may result in wasted creativity. Let me explain the relevance of these musings as regards a CT and Consolidated Tape Provider (CTP).

In my previous articles for Eurofi in September 2020 and April 2021, I championed two key themes in respect of bringing about a Fixed Income (FI) CT. Firstly, the need to accommodate the explicit requirements of FI markets when considering regulatory changes. Secondly, an explanation as to why the current legislation prevented the emergence of a commercially viable FI CT as a key lesson when considering future regulatory adjustments.

While many of the concerns I raised are openly shared by other members of the industry, the risk of a suboptimal outcome for a FI CT remains high as focus seems to be on the wrong 'need', hampering the 'creativity' necessary for an effective outcome.

The focus of the EU appears laser-like on solving for an Equities CT, and there seems to be limited appetite to tailor regulation to support the creation of a FI CT. Copy pasting an Equities CT solution onto the FI market would be suboptimal however, as discussed in my first Eurofi article.

What are the drivers behind this focus, i.e. the 'need'?

Equity price transparency benefits from three key elements that FI lacks. Firstly, a significant portion of activity occurs on Trading Venues (TVs). Secondly, the majority of TV activity occurs via an Order Book (OB) protocol. Thirdly, the sum of these two points affords a rapid equilibrium of pricing across access points that provide liquidity (notwithstanding the HFT community leveraging microsecond pricing imbalances).

Is the concern of creating a single provider CTP greater than the fear of delivering none at all?

Conversely FI price transparency is much more limited. FI is often traded off TV, when it is traded on TV it utilises non-OB protocols (with good reason), and the number of instruments is an order of magnitude greater than Equities. Yet the asset class is of equal (I'd argue greater) importance to Equities when looking at the long-term fiscal health of the EU's population - particularly in relation to pensions!

So what 'need' is this focus on Equity markets meant to fulfil? It seems to be less the need to improve transparency but rather the need to address, by proxy, concerns around Equity market data pricing – although the two issues cannot be conflated. The question for the broader community is: «how confident are you that an Equity CT will reduce Equity market data pricing»? My own observation would be 'caveat emptor'.

While such considerations for Equities are ongoing, FI markets, where very real transparency issues for transaction data persist, are seemingly being overlooked. How do we solve for this 'need'? Fortunately, we do not need to look too far as a proven solution has existed since the turn of the century in the form of TRACE - itself an extension of FIPS from 1991.

The lessons we can learn from TRACE were largely identified in my second Eurofi article. That being, i) ensure regulation is tailored for FI markets (no 'cut and paste' of Equities), ii) a single CT provider with appropriate scrutiny by ESMA, iii) mandated contribution and appropriate 'profit share' with data providers, iv) a weaker deferrals regime (work underway), and v) remove the requirement for a CTP to give its product away for free after 15 minutes.

However, the EU does not seem comfortable with designating a single provider solution. But as the multiple provider CTP model of MiFID II has failed, it is not clear why a modified version of the same failed model would succeed. Therefore, the obvious solution to guarantee the successful emergence of a CTP would be to set up a regulated single provider, operating under conditions set by policymakers. It would not be the first time the EU has adopted such an approach to address a key 'need', ANNA DSB being a relevant example. Moreover, any CTP would be subject to effective ESMA oversight.

For anybody tempted to reference SEC Rule 614 (Equities-based tape) it is important to note it is a long way off from being a proven solution, and significant legal challenges still need be to overcome.

In closing, we need to ensure that concerns around mandating a single provider solution for a FI CT do not result in a failure to deliver a functioning FI CT at all. Furthermore, if the EU does not solve for a FI CTP there is a real possibility that the UK could promptly create a solution which could become the de-facto provider within the Union, as there are no limitations preventing EU data sources (TV, APAs) from selling data to UK entities.

ERIC BOESS
Global Head of Trading, Allianz Global Investors

Efficient capital allocation doesn't happen in milliseconds

The focus of any consolidated tape (CT) should be on maximising added value for the overall financial system, not an artificial goal of providing the most complete coverage which will inevitably be very difficult to achieve and questionable in its benefit for the EU capital market union. Ultimately a CT's objective is to maximise price transparency for the largest group of market participants at a reasonable cost without hurting efficient execution for any group of investors. Only when all these factors are met sufficiently can a CT serve a more efficient capital allocation in the EU and make its market more attractive in the global competition for capital which, to a large extent, is driven by regulation.

Efficient capital allocation in an economy is not a matter of milliseconds. What a good market needs is timely information about what traded at what price and, depending on the asset class, how current supply and demand is structured. Additional information about transactions can be helpful (like e.g. venue, packaged deals, off market transactions), but execution price, volume and time remain the essentials.

Price distribution should happen without discrimination and not be dependent on budget. The current reality is that transparency is mainly a function of how much one is willing to spend and invest in systems – in other words, with the right technology and funds available one can have an almost real time view of markets. This puts smaller and retail investors at a disadvantage, so the maximum benefit of a well-designed CT would be to level the playing field, at least for the key asset classes of bonds and equities.

While price transparency seems less of a problem in equities, volume is a major issue for institutional investors. The dispersion of trades between primary exchanges, MTFs, OTFs and SI makes real time monitoring of traded volume almost impossible, a major obstacle for any market impact analysis and best execution efforts.

Fixed income investors face a different challenge, since the absence of a Central Limit Order Book makes price transparency the bigger issue. The majority of bonds are traded infrequently and with reporting requirements left to national regulators, resulting in a patchwork of different deferrals across the EU. A harmonised price emission mechanism with well-balanced deferrals would be a major benefit of a CT and an improvement over the current situation.

Pragmatic consolidated tape implementation is paramount to increase transparency in markets.

On the flipside, too much or poorly designed transparency is potentially harmful, as it makes risk transfer for institutional investors, which usually represent aggregated retail investor savings, more difficult. For bonds, as an inventory-based asset class, a too fast or too detailed publishing of price and volume would most likely lead to pricing for larger trades to deteriorate, which one would consider a negative side effect. Wholesale markets play a vital role in price formation and even in markets like the US where retail participation is much higher than in Europe there are rules that protect larger investors and their trades.

Derivatives, a mainly institutional market, play a vital role in risk transfer for the whole financial system. However, the benefits of tighter regulation around transparency on derivatives trades could be challenged, especially since the broad acceptance of CCP clearing already generates a level of data quality and visibility, which is clearly a huge step forward. Price publication of clearable derivatives with room for the protection of larger trades, seems a practical and balanced solution.

Another open debate is the economic viability of a CT for the provider, as is its governance. Slightly simplified there are two options: (1) an industry owned utility or (2) a private market solution with price controls for the core CT and an option for profit via more elaborated and upscaled data that can be distributed to interested parties. With mandatory contribution to the CT such added value services should be profitable enough to run the CT on a cost recovery basis.

While the utility model works in the US (DTCC clearing system), competition and innovation could very well allow for a private market solution to be efficient too.

A phased roll out of a CT is certainly possible and appears to be the fastest way to improve transparency in market segments where currently desired standards are lacking. CT roll out should ideally start with fixed income. As stated in the beginning, tangible, near term benefits in key asset classes trump potentially hard to achieve goals of super holistic cross market transparency.

KAY SWINBURNE
Vice Chair Financial Services, KPMG LLP

Taking small and simple steps towards a European consolidated tape

MiFID II was one of the key legislative proposals that I was involved in as a member of the European Parliament. I have always believed that a well-constructed consolidated tape (CT) would support fair and efficient capital markets in Europe.

At the time of negotiating the legislation, data costs in the EU were of a different order of magnitude to those in the US. European small asset management funds and pension fund managers could not, in many cases, justify paying for all the data they needed to manage their entire portfolio.

Seven years later the situation is little changed, and a commercial CT has not emerged.

The principal reasons for this, numerous reviews have found, are that: the current structure of the market and legislative framework means that there are no strong commercial incentives for a consolidated tape provider (CTP); data is inconsistent in format and/or quality and therefore hard to consolidate; and there is no effective framework to enforce data standards.

If the EU's goal is to develop integrated capital markets with growing retail participation, a CT will be key. Democratising the data would have broader implications for innovation and research too.

With the UK Wholesale Markets review in train and the European Commission's MiFID II review expected imminently, I have been discussing with market participants what they would like to see addressed. The need for a CT is one of the common responses. Market participants suggest regulators to start small and simple, preferably in fixed income markets. Recent analysis from the Dutch Authority for Financial Markets found the prevailing market sentiment is that MiFID II transparency obligations raised the costs of doing business in fixed income markets while in reality doing little to add meaningful transparency.

Many point to the US Transaction Reporting and Compliance Engine (TRACE) system as a useful model for reporting fixed income transactions. Under this system, all broker-dealers who are FINRA member firms have an obligation to report transactions in TRACE-eligible fixed income securities under a Securities & Exchange Commission approved set of rules, with FINRA being the self-regulatory organisation of the securities industry in the US. It is interesting to note that TRACE was gradually rolled out by sub-asset class.

If the EU wants integrated capital markets with growing retail participation, a CT will be key.

In its report commissioned by the European Commission, the International Capital Market Association (ICMA) also recommended modelling on the TRACE system when developing a CT for bond markets.

It is clear though, that for a CT to work in fixed income markets, and specifically for bonds, the waivers and deferrals regime would need to be simplified and harmonised. The European Securities and Markets Authority's (ESMA) proposals to do this are welcome, more so as ESMA's recent bond liquidity data continues to show that most bonds trading is shielded away from transparency by using waivers and deferrals.

It is difficult to consolidate data if it is in different formats. The legislation needs to be amended so that there is full consistency in the data submitted by trading venues and systematic internalisers. ESMA, in its recent consultation, proposed amendments to MiFID II regulatory technical standards to improve the quality of transparency data which will aid the journey towards consolidation of data.

The market participants I have spoken to have a preference for a public utility CTP model. This is not necessarily a consensus view across the whole market and some regulators back a competitive model. However, given that a CTP has not emerged under the current legislation that envisages multiple competing commercial entities, it could be sensible to pursue other models. The European Commission could exercise its power to request ESMA to use its public procurement process to establish a CTP. Careful consideration of the governance structure would be needed to ensure the interests of all the different market participants were balanced.

The UK Treasury, as part of its Wholesale Markets Review, is supporting the formation of a CT. It would be surprising if the European Commission's review of MiFID, in its third iteration, did not include the consolidated tape. From data users' and providers' points of view – many of whom operate in both jurisdictions – it would make sense to have a common specification across the UK and the EU, although this is politically unlikely.

Away from the politics, I hope that policy makers and regulators will at least be able to start sharing good practice in this area as they develop CTs that better serve customers' needs.

STEPHEN BERGER
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Illuminating the path forward to more robust and resilient EU equity, bond and derivative markets

Consolidated tapes for equities, bonds and derivatives are critical to strengthening EU financial markets. The real-time publication of comprehensive transaction price and volume data will empower investors, advance the Capital Markets Union, enhance the efficiency and resiliency of EU capital markets, and optimize the allocation of capital to both the private and public sector in both calm and challenging economic conditions.

EU consolidated tapes can and should be tailored and phased-in by asset class, but in all cases, must be comprehensive, require mandatory contribution, disseminate information immediately upon receipt (both freely to the public via websites and via real-time data feeds at a reasonable cost), and – if warranted – feature targeted and limited deferral regimes for larger size block trades. There is no reason to prioritize or delay the development of a consolidated tape for one asset class versus another – rather, each can proceed independently and in parallel.

Empirical evidence from North America provides overwhelming evidence of the value and viability of consolidated tapes for both equities and non-equities asset classes. The US capital markets benefit from pre- and post-trade consolidated tapes for each of the equities and options markets, as well as from post-trade consolidated tapes for each of the corporate bond, municipal bond, mortgage-backed security, and OTC derivative markets. In every iteration, models for governance, revenue-sharing, and public versus private ownership have been developed and are continuously fine-tuned. And across the board, market participants' firsthand experience and in-depth academic research have overwhelmingly demonstrated that these consolidated tapes have improved markets, including by driving down transaction costs and enhancing liquidity.

How does the transparency delivered by consolidated tapes benefit markets? First, transparency into the price and size of trades empowers investors to accurately assess execution quality, demand accountability from liquidity providers, and obtain best execution.

Market participants' firsthand experience and in-depth academic research both overwhelmingly demonstrate that consolidated tapes improve markets.

Second, transparency removes information asymmetries and allows all liquidity providers to better manage risk, and in turn, more confidently quote prices, commit capital, and warehouse risk across all market conditions. Finally, transparency makes markets more resilient, especially in times of stress, by ensuring that new information is efficiently assimilated and reflected in current price levels.

Consolidated tapes are of course only as valuable as the quality of the data they collect and disseminate. Therefore, in parallel, it is essential to address the current deficiencies that the European Commission and ESMA have wisely identified with respect to the scarcity, quality, timeliness, and accessibility of post-trade transparency data, particularly for bonds and OTC derivatives. In addition to ensuring that all on-venue and off-venue transactions are covered, rationalizing the current inconsistent and excessive deferral regimes must be a priority. Again, experience in the US across a range of non-equities instruments illustrates both the efficacy of, and widespread market support for, transparency regimes that mask the full notional of large size trades but nevertheless limit their deferred publication to no more than 15 minutes.

To conclude, the myriad benefits of EU consolidated tapes for each of the equity, bond, and derivative markets will far outweigh their implementation costs. Further, the diverse array of beneficiaries will far outnumber any incumbent trading venues, intermediaries or data providers who may cast doubt on the value of consolidated tapes, but nevertheless remain well equipped to compete in a more transparent marketplace.

CLEARING: REMAINING CHALLENGES AND WAY FORWARD

KLAUS LÖBER

Chair, CCP Supervisory Committee, European Securities and Markets Authority (ESMA)

The ESMA CCP Supervisory Committee's view on key CCP risks in 2021/22

In line with its Strategic Orientation, risk-driven assessments are a crucial part of the work of ESMA. Therefore, in performing its supervisory tasks, the ESMA CCP Supervisory Committee (CCP SC) has focused on identifying emerging risks impacting CCPs and their ecosystem to better tailor and adapt its supervisory and convergence actions.

While ESMA was the first authority to conduct jurisdiction-wide CCP stress-testing exercises and continues to closely monitor the development of risks impacting EU and third-country CCPs, real life often provides the most valuable lessons. The global market turmoil in March 2020 following government containment measures against COVID-19 has acted as a live test on the resilience of the financial sector and has helped identify certain unresolved vulnerabilities.

Overall, it is worth reiterating that CCPs have performed well throughout the crisis, despite the surge in clearing activity coupled with a rise in initial and variation margins. In the EU, no default procedures were triggered at CCPs and no waterfall resources needed to be used, showing the overall resilience of the sector, but also of its supervisory and regulatory framework.

However, questions remain as to whether some initial margin increases (beyond those linked to increased volumes and portfolio changes) acted in a procyclical manner, potentially diffusing or even amplifying liquidity stress to other parts of the financial system, and therefore should be mitigated through regulatory or supervisory measures. While EU CCPs, thanks to the EMIR anti-procyclicality measures, mostly appear to have experienced milder margin increases compared to the ones in other jurisdictions in similar asset classes, this does not mean that there is no room for improvement.

ESMA is currently considering whether targeted changes to Regulatory Technical Standards (RTS) and Guidelines are needed and will be contributing to the respective activities of the FSB and the dedicated BCBS-CPMI-IOSCO working group on anti-procyclicality.

Beyond the size of margin increases, the predictability of margin models as well as Clearing Member and client preparedness seemed to have also played a key role in limiting the potentially destabilizing effect of margin calls. Accordingly, the CCP SC has decided to focus its upcoming Peer Reviews on supervisory practices of National Competent Authorities (NCAs) regarding member due diligence checks including for clients and proper monitoring of concentration risks due to member positions.

The COVID-19 lockdowns have also tested the contingency plans of CCPs and their members where, in a matter of days, entire teams were asked to leave office premises and to work from home. ESMA, in coordination with NCAs, has closely monitored the impact of the COVID-19 crisis on EU CCPs, including by conducting a fire drill focusing on teleworking aspects.

While these impressive efforts have enabled markets to continue functioning remotely for months, it has at the same time increased our dependence on the IT sector and especially on certain third-party providers. This trend is likely to continue even as life begins to return to normal.

In this context, operational risks have become of particular concern given the high degree of interconnectedness of CCPs with the rest of the financial sector and require heightened attention of regulators and supervisors. Therefore, ESMA welcomes the proposition by the European Commission to strengthen the digital operational resilience of the financial sector as a whole and hope the co-legislators will come to a speedy agreement.

ESMA has also decided to include operational risk as part of the framework for the 4th CCP stress test. It will focus on operational risk events affecting third-party entities on which CCPs rely to provide their services, assessing the importance of shared service providers in the clearing industry and interconnections of CCPs. In addition, the 4th stress test will use improved methodologies, based on lessons learned from previous exercises, and will also assess the combination of concentration costs and credit losses when liquidating defaulting portfolios. Finally, the 2021 Peer Review will be focusing on how NCAs assess the resilience of CCPs to cyber-risks and their Business Continuity Plans (BCP) in remote working arrangements.

Overall, while the G20-led reforms of the financial regulatory framework have shown their effectiveness, there is no time for complacency. Indeed, market risks remain elevated and may deteriorate even further once public support measures start drying out, especially for Non-Financial Counterparties (NFCs), which may have knock-on insolvability effects. In this context, delivering on the remaining pieces of the financial reforms will remain a key priority, notably with regards to default management auctions, the implementation of recovery and resolution plans and the full rollout of the OTC derivatives reforms.

PAULINA DEJMEK HACK

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Clearing: the status quo is not an option

In the wake of the global financial crisis that unfolded more than a decade ago, and in line with the international consensus at the time, the EU adopted its landmark legislation the European Market Infrastructure Regulation (EMIR) with the aim of making OTC derivatives (OTCDs) markets and central counterparties safer and more transparent.

More recently, these rules have been adjusted and updated in the following ways: In June 2019, a Regulation introducing more proportionate requirements for smaller firms (the so-called "EMIR Refit") entered into force and in January 2020, EMIR 2.2 was published, providing for a more consistent and robust supervision of central counterparties. This was particularly important in light of the growing systemic importance of CCPs and the expected impact that the withdrawal of the United Kingdom from the EU would have on the supervision of central clearing in the EU. Finally, in February this year, the new Regulation on recovery and resolution of CCPs entered into force. In parallel, work is ongoing at the technical level to develop the so-called "level 2" measures, which are necessary to make the framework fully operational.

These legal texts provide a robust framework for EU and third-country CCPs and their users, recognising the global nature and interconnectedness of derivatives markets while mitigating financial stability risks arising from derivatives cleared inside and outside the Union. In particular, the overarching goal of EMIR 2.2 is to mitigate risks in derivatives clearing as its scale and importance continue to grow, while taking into account the role and impact of third-country CCPs in the clearing of financial instruments that are relevant for the stability of the EU financial system. In this respect, EMIR 2.2 introduces a new framework for third-country CCPs.

Those CCPs are subject to a 'sliding scale' of additional supervisory requirements by ESMA and relevant central banks of issue (CBIs), based on objective criteria. While less systemic 'Tier 1' CCPs remain under the primary responsibility of the home supervisor, 'Tier 2' CCPs, which are of a more systemic nature, are subject to direct supervision by ESMA, in close cooperation with the relevant CBIs, making sure that potential contagion risk stemming from these CCPs is appropriately mitigated from an EU perspective. Moreover, such systemic Tier 2 CCPs would only be allowed to offer services in the EU if they applied for authorisation in a Member State of the Union. According to the EMIR framework, the systemic nature – for the Union and its Member States – of CCPs located outside of the EU and wishing to offer clearing services to EU clearing members and trading venues, is being assessed by ESMA and the relevant CBIs.

EU exposure to UK CCPs must be reduced, without creating new risks.

In September 2020, the Commission adopted a conditional and time-limited equivalence decision for UK CCPs in order to avoid cliff-edge effects on 1 January 2021 and the materialisation of risks for the financial stability of the Union and its Member States. Subsequently, ESMA recognised CCPs established in the United Kingdom under the EMIR framework, allowing EU market participants to continue using their services until the equivalence decision expires on 30 June 2022. Out of the three CCPs operating in the UK, ESMA has concluded that two of them should be tiered as Tier 2 CCPs.

As stated in the equivalence decision and in the Commission Communication on Open and Strategic Autonomy of 19 January 2021, the vast amounts of euro-denominated contracts cleared and settled by UK CCPs raises financial-stability concerns, particularly in the case of a crisis. There is therefore a clear expectation that Union clearing participants reduce their exposures to those CCPs, in particular OTCDs exposures that are denominated in euro and other Union currencies. EU CCPs need to build up their clearing capacity in parallel.

In addition to ESMA's work under EMIR 2.2, the Commission, together with the ECB and the European Supervisory Authorities, are in close contact with market participants to assess possible technical issues relating to the transfer of contracts denominated in euro or other EU currencies to central counterparties located in the EU.

In addition to the reduction of exposures, there is also a need to monitor and if needed mitigate the emergence of any new financial stability risks, both for the EU and globally. The overarching objective has always been to approach the issue of risks related to third country clearing and CCPs from the perspective of risks to EU financial stability.

NATHALIE AUFAUVRE

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Financial stability: the compass to guide decisions on clearing

With the 2008 financial crisis and more recently with the Covid crisis, the world (re)discovered that the financial systems' interconnectedness, traditionally considered as a factor of growth, may also lead to a faster and more abrupt transmission of financial shocks.

In both crises CCPs have demonstrated operational and financial robustness, which was extremely valuable in times of market turmoil. Their systemic importance has indeed been rising over the last few years, among others as clearing obligation on certain segments gradually entered into force. Any CCP's even temporary failure would have knock-on effects that could be devastating for financial stability.

To have a deeper dive into CCPs' overall resilience, BCBS, CPMI and IOSCO have launched recent surveys in order to determine whether margin practices and anti-procyclicality tools proved adequate during the Covid crisis, in particular in March and April 2020. Depending on the conclusion of these surveys, and more generally on the lessons learnt during the crisis, recommendations could be issued in order to further improve and harmonize margin calls and anti-procyclicality tools, as well as to reinforce their transparency and foreseeability for clearing members and their clients.

Regulators have constantly adapted to financial systems' increasing interconnectedness. What happens beyond our borders cannot be ignored: stronger cooperation is ever more essential especially for CCPs which concentrate positions of financial actors. Today, enlarged cooperation is necessary, such as global colleges: the Banque de France will hold LCH SA's first global college this year, with attendance by both European and third country authorities.

On top of these cooperative arrangements, in 2020 the EU adopted EMIR2, which introduced a risk-based approach for third country CCPs: when categorized as systemic, on the basis of quantitative indicators, they are subject to closer monitoring, and to certain direct supervisory powers from ESMA. Where such direct powers are not sufficient to guarantee EU's financial stability, offshore CCPs would not be allowed to provide clearing services to EU entities. In this respect, an important decision will be made by the European Union in the coming months.

The aim of all facets of regulatory work is to ensure that economic actors can operate safely.

ESMA, on the basis of a comprehensive methodology it has recently published in this regard, is hence expected to perform an analysis –through both a quantitative and a qualitative prism- of offshore CCPs' substantial importance, and a full cost-benefit analysis. This will support a recommendation to the Commission in the first quarter of 2022, after consultation of the both the ESRB and central banks of issue (including the Eurosystem). By end-June 2022, i.e. before the temporary equivalence decision taken following Brexit expires, the Commission may in turn, against that background, adopt an implementing act to induce relocation of clearing services in the EU.

This process is an important one and all aspects need to be examined very carefully. Concerns voiced by market players on difficulties related to relocation are being heard. Notably, EU regulators are aware of challenges such as the possible directionality of EU members' positions in these CCPs and the need to find new counterparties, which would push liquidity prices up. There is a need to examine how costs can be mitigated, maybe with an appropriate transition period, up to two and a half years. There is also a need for EU CCPs to further strengthen their offers – although much has already been done on certain segments – and for EU market players to orderly migrate their positions.

But on top of these elements, financial stability issues also have to be examined. In particular, one has to think forward, in a potential new crisis situation, while EU entities' risk exposures to third country CCPs remain very significant, which turns out to be a kind of vulnerability especially in a crisis, recovery or resolution situation. In such cases, even for the so-call Tier 2 CCP, EU authorities' powers are de facto very limited: they are fully dependent upon third-country authorities' appetite for information sharing and coordination in an emergency situation. This issue is central, because financial stability is a public good for the economic actors, be they banks, financial institutions, companies, individuals.

All in all financial stability remains the decisive angle when deciding on such a matter. Eventually, an approach proportionate with risks has to be taken, and we should not lose sight that overall, the aim of all facets of regulatory work is to ensure that economic actors can operate safely.

DANIEL MAGUIRE

Group Head, Post Trade Chief Executive Officer, LCH Group, London Stock Exchange Group (LSEG)

Cross-border markets require cross-border supervisory practices

Global financial markets best operate when they can freely balance supply and demand supported by highly capable and resilient infrastructures and participants. This not only makes markets more efficient but also safer. To oversee cross-border markets and the infrastructures they support, cross border cooperation between national supervision plays a key role.

As a financial market infrastructure providing services in 60 jurisdictions and licenced in 11, LCH is a strong advocate of an international approach to the regulation and supervision of internationally active market infrastructures in line with G20 Recommendations.

As a Tier 2 Third Country CCP ("TC CCP"), LCH Ltd is directly subject to the EU EMIR requirements as well as the UK requirements stemming from the on-shored EMIR text. The UK government clearly stated its intention to continue strengthening what is one of the world's most robust regulatory regimes for central counterparties (Chancellor Rishi Sunak MP, Mansion House speech, 1 July 1, 2021). In addition, LCH Ltd is subject to rules of several jurisdictions including the US. We provide our UK, EU, US and Asian members with a highly robust and consistent risk framework applying the highest standards available under the direct supervision of, among others, ESMA, the CFTC, the Reserve Bank of Australia, the Quebec AMF, and the OSC, in addition to our home supervisor, the Bank of England.

During March's 2020 heightened market volatility, LCH's Paris and London entities' risk and margin models performed as designed, with no intervention required and with total margins increasing gradually, and only by single digits. This contributed positively to the markets' resilience and financial stability during extreme market stress. Furthermore, LCH Ltd has been working closely with global regulators over the last few years to ensure the safe and smooth critical transition from IBORs to new reference rates.

In the UK, LCH SA. benefits from the Bank of England's three-year Temporary Permission Regime ("TPR"), and clarity was provided very early on the ability of UK entities to continue accessing EU CCPs.

EMIR 2.2 provides the tools for an effective cross-border supervisory framework.

In the EU, however, LCH Ltd.'s current recognition elapses on 30 June 2022. ESMA is assessing UK CCPs systemic importance in the EU in order to determine if UK CCPs or of some of their services should be denied recognition, taking into account costs, benefits and consequences to EU markets and its participants.

Denial of recognition or regulatory driven reduction of exposures of EU firms to TC CCPs would result in loss of access to a well-established and highly liquid market, increased costs, loss of competitiveness of EU firms and significant financial stability risks for the EU. Mandating EU firms to clear in an EU captive market will reduce choice and competition. In the case of EUR IRS this would leave EU firms captive in a market representing 27% of the EUR IRS notional registered at LCH's SwapClear in 2020, the vast majority of the market (73%) being registered by non-EU firms.

Migration costs would be significant and EU firms' inability to provide products and services at best prices will impair their ability to remain competitive across all currencies, not just Euro. Market fragmentation would lead to fluctuations in CCP basis and heightened bid/offer costs for EU firms in the long run.

From a financial stability perspective, the reduced size and diversity of participants (i.e. EU firms only) in a fragmented market poses substantial financial stability risks particularly with regards to default management. A captive smaller market would have much greater concentration risk and likely to be directional. Ultimately, such market would become riskier and less resilient to market shocks. A diversified clearing services supported by greater liquidity, a wide membership that is subject to different economic dynamics and clearing diversified portfolio, has strong benefits to financial stability. We should ensure EU firms can continue managing their risks by accessing such diversified clearing services.

The newly implemented EMIR 2.2 framework strengthens the supervision of third country CCPs. In addition to the direct supervision by ESMA, it gives EU Central Banks the ability to require CCPs to open deposit accounts in their currency i.e. in the case of the Euro, all Euro payment flows processed through Target 2. LCH Ltd is fully supportive of this requirement.

EMIR 2.2 provides the tools for an effective cross-border supervisory framework based on open and constructive dialog, including on financial stability risks during market stress, while preventing the regionalization of EUR clearing. We must leverage those tools to address any potential remaining financial stability concern as a market, whilst avoiding the increased costs and risk of any form of market fragmentation imposed on EU firms. This would enable EU firms to continue accessing global markets safely.

ERIK TIM MÜLLER

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Setting incentives for a robust, efficient and competitive clearing landscape

With the Covid-19 pandemic and the implications of Brexit we experienced a real-life stress test and major market adaptions. Fortunately, the G20 reforms on central clearing of OTC derivatives and collateralization of non-centrally cleared derivatives have significantly strengthened the resilience of our markets which were far better prepared this time. EU CCPs have managed the market moves well. With EMIR, the EU has laid the foundation for a healthy central clearing ecosystem and set a global benchmark, safeguarding the role of CCPs as independent and neutral risk managers of financial markets. It is also one of the first jurisdictions in the world to have a fully-fledged CCP Recovery and Resolution regime, complementing the existing lines of defense for extreme yet plausible scenarios. Nevertheless, efforts in maintaining financial stability and setting the right incentives for the industry must continue.

Major steps have been taken in relation to strong risk management capacities and oversight of CCPs via the EMIR 2.2. framework, striking the right balance between financial stability imperatives and market access. We now have a toolkit to deal with scenarios in which the EU faces monetary policy and financial stability risks where systemically relevant clearing volume is left in a third country off-shore center. This becomes particularly relevant in light of Brexit. With the end of the transition period, the European financial sector needs to adapt. Major global banks have set-up EU entities to continue servicing EU based clients.

We have seen large parts of equity and derivatives trading activities shifting to the EU (and to the US) in accordance with the respective trading obligations in the EU and the UK. And we could also observe that banks and investors have been moving Euro denominated clearing business to the continent. By granting temporary equivalence for UK CCPs until end June 2022, the European Commission however managed to avoid any market disruption, allowing enough time to thoroughly assess the systemic importance of UK CCPs for the Union under the new EMIR 2.2 regime.

The industry is now closely following the ESMA Supervisory Committee's assessment to provide market participants as well as market infrastructures with certainty as regards the long-term set-up when the temporary equivalence elapses. EU regulators have expressed a clear desire that clearing of systemically important financial instruments denominated in Euro takes place within the Union, calling on the industry to reduce exposures to UK CCPs and increase clearing capacities on the continent. The aim is clear, to reduce the dependency for the risk management around our currency on third countries and foster the Union's global sovereignty.

Supporting an innovative and globally competitive clearing landscape in the EU.

We welcome that the Commission has set up a working group together with the industry to discuss any technical, operational and legal issues in this respect. Whilst fully supporting the EU regulators' objectives, I believe that the development of competitive, efficient and resilient markets is best supported by market-driven solutions rather than public intervention – this is why Eurex Clearing continues its commitment to providing choice to the market and becoming the global home of the euro yield curve.

Besides adjusting to the new realities of the post-Brexit world, the Covid-19 pandemic's social and economic impact is still materializing in the EU with slower economic growth, higher public debt levels, and pressure on bank's balance sheets. In this context, let us not forget that efficient and robust risk management as well as a healthy clearing ecosystem are not only key parts for preserving financial stability during times of market turmoil but also for a sustainable recovery.

Against this background, I welcome the global discussions on risks of procyclicality, where Eurex with its globally leading Prisma methodology is setting the benchmark on anti-procyclicality and industry leading risk standards. We need to continue on our endeavor to strengthen both the efficiency and the stability of our markets via innovative and at the same time prudent risk management. And we shall not lose out of sight that some of margining standards for bilateral markets have still not been phased-in more than a decade after the global financial crisis.

For capital markets to play a central role when it comes to a swift recovery from the recent crisis, policy makers and the industry should continue supporting an innovative and globally competitive clearing landscape in the EU.

At Eurex Clearing, we will remain committed to pushing market-led initiatives that help transition the market into a healthier environment market by fostering true competition, choice, and innovation while simultaneously improving risk management, reducing concentration and increasing overall financial stability with a particular focus on Euro and the European Union.

NEXT EUROFI EVENTS

THE EUROFI HIGH LEVEL SEMINAR 2022

23, 24 & 25 FEBRUARY

PARIS – FRANCE

THE EUROFI FINANCIAL FORUM 2022

7, 8, 9 SEPTEMBER

PRAGUE – CZECH REPUBLIC

POST-TRADING PRIORITIES

DENIS BEAU
First Deputy Governor, Banque de France

Post trading efficiency: halfway through the journey

Europe is still enduring the Covid crisis, which called for exceptional measures in order to cushion its potentially devastating effects on the economy. Contrary to the 2008 financial crisis, not only the ECB reacted vigorously but also both the EU and its Member States. This testing crisis is therefore a unique opportunity to pave the way for further European integration. After emergency measures in 2020, Europe must now build a solid economic union for which a genuine Capital Markets Union (CMU) is a key enabler.

The second CMU action plan published by the Commission in September 2020 was an important step to operationalise progress on issues identified as priorities over the last few years, some of which relate to post-trading and to more fluid capital flows across the EU. Despite significant progress made through the European Post Trade Forum, fragmentation along national borders remains. The need for concrete actions and an active monitoring of their implementation is still acute.

To that end, the Eurosystem has stepped up its contribution in the field of collateral harmonisation. The Eurosystem Collateral Management System (ECMS) project is on track, and will help improve circulation of cash, securities and collateral across Europe as from end 2023 onwards; it will be complemented with the implementation of the Single Collateral Management Rulebook. Nevertheless, a long journey remains ahead of us before achieving full harmonisation, as barriers still exist on accounts of structural constraints and market practices, especially in areas such as tax. Tax processes have been identified as one of the top ten priorities by the Eurosystem AMI-SeCo[1], which could eventually lead to the elaboration of new market standards.

As regards securities settlement, the first review of the Regulation on improving securities settlement in the EU and on central securities depositories (CSDR) will be a cornerstone to support the CMU objectives related to cross-border market integration. Although still under discussion, CSDR Refit is expected to ease passporting. A single supervision would also help remove potential unnecessary barriers.

The need for concrete actions and an active monitoring of their implementation is still acute.

A single supervision does not call for a single supervisor though: national authorities remain indeed vital contributors to effective and efficient European supervisory mechanisms grounded in a deep understanding and close monitoring of markets. A legislative proposal by early 2022 would be welcome, all the more since the review of two fundamental directives, namely the Settlement Finality Directive (SFD) and the Financial Collateral Directive (FCD), closely interplays with CSDR Refit.

In particular, reshuffling the SFD appears necessary in order to update it along recent market and regulatory changes, for instance regarding the extension of participation to payment systems.

The Commission's proposal for a Regulation on a Pilot Regime is also welcome. It will help grasp which requirements of the current regulation will need to be adjusted and how, to safely support technological innovation. In the meantime, it will provide legal certainty for market players to operate a DLT market infrastructure, on an experimental basis, with alleviated regulatory requirements compared with historical players. The pilot regime will also be the opportunity to measure industry's appetite for DLT in general, and for different technologies and segments in particular.

In a fast-moving technological environment, settlement in central bank money remains a critical principle: it avoids introducing counterparty or liquidity risk, and helps contain market fragmentation. If sound guiding principles are forgotten in the frenzy for new technologies, regression rather than progress can be feared in the end. Central banks support technological innovation in a market-neutral way. They can also have a direct role to play: the Banque de France has successfully performed experiments on a central bank digital currency in 2020 and 2021, focused notably on the different ways to "put central bank money on the ledger" for securities settlement[2]. The Eurosystem recently decided to launch the investigation phase of a digital euro project[3]. As technological innovations are dawning on a still fragmented post-trading landscape, it is of utmost importance that all stakeholders strive for market integration.

[1] Advisory Group on Market Infrastructures for Securities and Collateral. See https://www.ecb.europa.eu/paym/integration/collateral/html/index.en.html

[2] As an example: https://www.banque-france.fr/en/communique-de-presse/banque-de-france-conducts-new-central-bank-digital-currency-experiment

[3] https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210714~d99198ea23.en.html

FIONA VAN ECHELPOEL
Deputy Director General, DG Market Infrastructure & Payments, European Central Bank (ECB)

Advancing post-trade services

A well-functioning financial market is essential for the European economy. Since the introduction of the euro, substantive progress towards financial integration has been achieved. TARGET Services have been crucial in standardising the settlement of payments and securities, with essential harmonisation achieved through the T2S project and the Regulation on securities settlement and central securities depositories (CSDR), which provides the legal framework for CSDs operating securities settlement systems across the EU. Nonetheless, national non-harmonised solutions still prevail in parts of the financial market such as the issuance and distribution of debt, and for collateral management-related processes. In this article I will look at how the ECB helps drive forward further financial integration.

One of the basic tasks of the Eurosystem is to ensure the smooth functioning of payment systems. As operator we run three TARGET settlement services – TARGET2, T2S and TIPS – and, as of November 2023, a new service is scheduled to go live, namely the Eurosystem Collateral Management System (ECMS). The service will ensure that a single system based on harmonised procedures and processes will allow counterparties and the Eurosystem to better manage the assets used as collateral in Eurosystem credit operations for all euro area countries. The ECMS will remove the current fragmentation and ensure a level playing field for Eurosystem counterparties.

Coinciding with the ECMS project, the financial industry asked the Eurosystem to initiate work on a Single Collateral Management Rulebook for Europe (SCoRE) including the United Kingdom and Switzerland. The Advisory Group on Market Infrastructures for Securities and Collateral (AMI-SeCO) has led the work which, together with the ECMS project, has brought about substantial harmonisation in the field of collateral management processes. So far, harmonisation standards have been agreed in the areas of billing, corporate action handling and tripartry services, establishing a single tripartry model for Europe. SCoRE will increase efficiency, lower costs and risks and increase interoperability and reach across Europe. Agreed SCoRE standards are now being implemented and compliance is monitored. For more see our interactive map.

The ECB will continue to work for deeper integration of financial markets in Europe.

Despite the extensive progress, fragmentation is still visible in the area of issuance and initial distribution of debt securities in Europe. Access to capital is subject to legacy standards, conditions and market practices at national level. As a result, issuers are unable to reach European investors in a neutral and standardised way. To address this problem, a market consultation was launched in July 2019. The consultation resulted in the set-up of a market contact group with industry professionals involved in euro area primary debt markets. The group's objective is to: 1) identify issues that prevent further improvements in efficiency and integration; and 2) investigate how these issues may be addressed. Work is progressing well, and the group is scheduled to publish its report in autumn 2021.

As mentioned, the post-trade market has advanced extensively over the past decade. However, with a dynamic market that is continuously evolving, there is a need to assess if adjustments are required and the ongoing review of the CSDR launched by the EU Commission in June 2020 offers an opportunity to consider potential adjustments. The Commission recently published a report which identifies areas where further action may be required in order to achieve the objectives of the CSDR in a more effective and efficient manner.

The European System of Central Banks (ESCB) has made several proposals for the review based on the experience gained by central banks acting as relevant authorities under the CSDR. More specifically, the ESCB proposed that the cooperation among authorities is enhanced, for example through establishing cooperative arrangements, in particular for CSDs belonging to the same capital group, that are of substantial importance for other Member States or which outsource core services to other CSDs.

As concerns the provision of banking services, the current rules may impede the expansion of settlement activity in foreign currencies for CSDs without a banking licence. A review of the current threshold under which cash settlement can be conducted via credit institutions could therefore be considered, provided that any increase is accompanied by adequate risk-mitigating requirements.

In its area of direct responsibility, the ECB will continue to work for deeper integration of financial markets in Europe and support various initiatives in the areas of payments, securities settlement and collateral management.

DIRK SCHRADE

Deputy Director General,
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Post-trade harmonisation: status quo and looking beyond

The efficient functioning and resilience of securities markets as an integral part of the financial system is of utmost importance to the EU economy. Harmonising the legal and regulatory framework across Member States as well as avoiding fragmentation on the technical side play a key role in achieving the goal of a truly integrated EU capital market. While much welcome progress has been achieved in recent years, complex issues remain – especially for the Member States. However, tearing down existing barriers is only one side of the coin. The other is not to erect new ones when it comes to challenges such as Distributed Ledger Technology (DLT) and green finance.

Looking back, we can state that, on the regulatory side, the CSDR contributed considerably to shaping European securities markets and enhancing their efficiency and safety. Another cornerstone, the Shareholder Rights Directive II, will add to this. Retail investors, who can now exercise their shareholder rights across borders, will also feel its impact. The ongoing CSDR review is likely to clarify and simplify rules for CSD passporting and further intensify competition in the European post-trading sector.

On the infrastructural side, the Eurosystem platform TARGET2-Securities for the centralised settlement of securities in central bank money drove harmonisation in the past. The Eurosystem's "Vision 2020" projects aim at further safeguarding and deepening the integration of EU financial markets. In this regard, collateral management plays a crucial role as it contributes to the stability and integrity of the financial markets. With the Eurosystem Collateral Management System (ECMS) as one of these projects, the Eurosystem is set to replace the existing 19 different national collateral management systems with a single one for the entire Eurosystem. Of course, such an undertaking goes hand in hand with harmonising underlying processes and national procedures. Thus, ECMS and the related work on the standards of the Single Collateral Management Rulebook for Europe are key for pushing further ahead with harmonisation.

This work covers not only processes, workflows and messages on the NCB side, but diverse market practices. The first step is to harmonise the processing of corporate actions and billing based on ISO 20022 formats and enable a single triparty collateral management model. Further areas of harmonisation will follow. This should benefit not only the Eurosystem, but the whole EU securities market, inter alia by further facilitating cross-CSD market activity.

Further promoting CMU requires harmonising the existing and timely setting standards for the future.

Despite the progress already made, some challenges still stand in the way of a fully harmonised and integrated EU capital market. Some of these are the result of new developments and external factors, others stem from the EU's set-up. Unlike the US, the EU is a political and economic union made up of independent Member States. Diverging national withholding tax procedures as well as varied securities and insolvency laws are still serious obstacles to cross-border investments. However, the EU has limited competence in these fields as they chiefly fall under the responsibility of the Member States, and harmonisation proves to be complex.

The Commission's plan to propose a common EU-wide system for withholding tax relief and to foster convergence of national insolvency laws with an initiative for minimum harmonisation will be important elements for dismantling these barriers. Yet its success will hinge on the willingness of and a strong commitment from the Member States.

Looking to the not too distant future, regulating DLT and encouraging green finance in a harmonised way will help reap their benefits. The Commission made the first steps with a proposal for a pilot regime for market infrastructures based on DLT, providing also new opportunities for smaller-sized issuers, and the Markets in Crypto-assets Regulation on the one hand, and the EU Taxonomy and the European Green Bonds Regulation on the other. Directly applicable regulations instead of directives are the right way to guarantee a level playing field. However, besides the regulatory framework, it is now also important to prevent technological barriers, especially when it comes to DLT.

Standardisation and interoperability on a technical level will be crucial to avoid fragmentation driven by different technologies. Integrated capital markets require both the harmonisation of existing frameworks and keeping pace with new developments and technological progress to set standards right from the beginning.

BARBARA LUPI

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The post-trading sector: turning challenges into opportunities

Since the launch of the first Capital Markets Union (CMU) action plan by the European Commission (EC) in 2015, significant progress has been made in implementing several of the plan's building blocks to support an integrated, safe and efficient EU capital market. A key role has been played by actions targeting the financial market infrastructures (FMIs), including central securities depositories (CSDs). The implementation of the CSD Regulation (CSDR) has ensured the harmonization of regulatory and supervisory requirements across the EU. From an operational perspective, T2S provides significant support for the integration of securities settlement in central bank money. During the recent COVID crisis, CSDs services have proved to be resilient.

Nevertheless, the post-trading landscape in the EU is still characterized by some national features. The EC is aware of this and has identified the main outstanding issues. A targeted revision of the CSDR will play a key role. Among other things, it will include easier access to the CSD passport in the EU and improved supervisory convergence. Further initiatives include revisions of the Settlement Finality Directive and of the Financial Collateral Directive to ensure their effectiveness and consistency across legislative frameworks.

Looking ahead, another major challenge facing the post-trading sector is innovation in technologies and business models. Distributed ledger technologies (DLTs) have the potential to profoundly change the business of post-trading and further enhance the efficiency and integration of EU capital markets. In this respect, the CMU and the EC's digital finance strategy, including a proposed Pilot Regime, are mutually reinforcing.

New technologies have already made inroads into the financial system and the time is ripe to ensure that the post-trading sector can take advantage of the new opportunities. The focus should be on a few key issues, namely (i) whether there are barriers limiting the adoption of technological innovation by CSDs, (ii) what would be the impact on risks if they were removed, and (iii) what measures could be taken to preserve the resilience and stability of the financial system. Nor can it be overlooked that new technologies themselves face considerable challenges. Infrastructures based on new models will have to enter markets served by incumbents, be competitive in their offerings to customers and interact with counterparts whose services and systems are based on traditional technologies.

A major challenge facing the post-trading sector is innovation in technologies and business models.

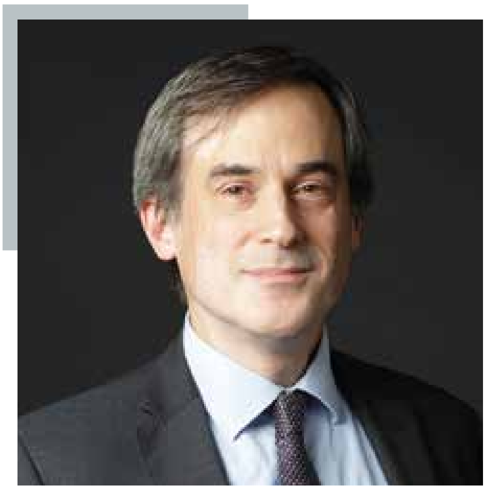
The proposed Pilot Regime establishes the approach to start addressing these points. The Pilot's intrinsic logic is to allow temporary exemptions from existing requirements to facilitate the uptake of new technologies by both CSDs and multilateral trading facilities (MTFs). In doing so, it will make it possible to introduce highly innovative aspects into the traditional value chain of a financial transaction. These aspects include the possible concentration of trading and post-trading services within a single DLT market infrastructure, the potential disintermediation of access to MTFs and CSDs, and the use of so-called 'settlement coins', including e-money tokens (as defined in MiCAR).

Exemption from certain requirements should be counterbalanced with imposing additional conditions on the infrastructure to continue to properly protect against the relevant risks. For regulators and supervisors, the licensing of new initiatives and their ongoing monitoring will be two key tools to allow market infrastructures to exploit the potential of the new technologies while ensuring a level playing field and their safety and resilience.

Moreover, while the Pilot allows different cash assets to be used for securities settlement, which solution will gain traction among DLT infrastructures? For a central bank, it is crucial that the settlement of securities and cash remain safe and efficient. In performing their roles, central banks may contribute to finding solutions supporting resilience in the new context.

Preparing Europe for the digital era is not something accomplished from scratch. EU-wide projects may be supported by complementary initiatives at national level. As an example, in Italy a regulatory sandbox was recently introduced to encourage experimentation with digital technologies in the financial sector. This initiative, undertaken with the support and close involvement of all the relevant Italian authorities, including Banca d'Italia, has the twofold objective of allowing experimentation while preventing and limiting the potential spread of risks.

As with any challenging objective, the construction of a truly integrated post-trading market at European level requires the collaboration of all the actors involved.



JAMES CUNNINGHAM
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Reforming post-trade in Europe – an activist and co-ordinated approach

In July 2021, the European Central Bank published a fascinating book giving an overview of post-trade market infrastructure developments over the past twenty years.

The book conveys two powerful images. One is of Alberto Giovannini, while preparing the reports of the Giovannini Group, carefully deciding whether a specific post-trade barrier should be eliminated in two years, or in two years and three months.

The other is of the comparison, subsequently made by Alberto Giovannini, between work on post-trade barriers, and the construction of the metro in Rome. As soon as you dig and make progress, you make new archeological discoveries and have to stop digging.

The first image tells us very clearly that work on post-trade issues requires both an activist and a co-ordinated approach.

The second image tells us that for an approach to succeed it has to deal with the fundamentals of a problem, and not just the surface layers.

In the twenty years since the first Giovannini report identified 15 barriers to cross-border clearing and settlement in Europe, we have seen some significant progress, but the core problem of unharmonised post-trade processes in Europe remains.

We need an activist, indeed voluntarist, approach because there are many factors – difficulties inherent in trying to modify complex and arcane national fiscal and legal rules - that drive us to passivity.

We need a co-ordinated approach because post-trade processes have three dimensions, fiscal, legal and operational, and changing the rules in one dimension creates risks, as well as the potential for synergies, in the other dimensions.

The European Commission's Capital Markets Union Action Plan includes three major actions relating to post-trade – Action 10 (on withholding tax), Action 12 (on shareholder rights), and Action 13 (on CSDs).

These Actions all have a common feature, in trying to strengthen the custody chain – ensuring that end investors are taxed at the right rate, ensuring that end investors have the ability to exercise the rights associated with ownership of securities, and improving the supervision of cross-border custody chains involving CSDs.

The core problem of unharmonised post-trade processes in Europe remains.

Successful delivery of these Actions will require alignment between fiscal, legal and operational processes, and, in particular, common definitions so as to ensure that the answers to the questions of which entity is entitled to receive the proceeds from a corporate action, which entity should be taxed on those proceeds, which entity should be entitled to vote, and which entity should be identified as the legal owner, are, or can be, the same.

In today's world, a lack of alignment between these processes, and different answers to these questions, have concrete operational impacts. They create cost and risk, and they lead, for example, to investors being incorrectly debited for withholding tax, and to rejected voting instructions.

One very positive outcome of the work on the Giovannini barriers is that Europe has developed world-leading sets of market standards that describe how the end-to-end communication and processing in the custody chain between issuers and investors should take place.

In short, we know how the operational processes should work, and thanks to the work of many stakeholders, including industry associations and the European Central Bank, we have in some areas taken significant steps towards implementing these processes. The key outstanding gaps relate largely to fiscal and legal rules and requirements.

Delivering improved fiscal and legal processes should be based on three core insights.

The first is that the ambition set out in Action 10 of the CMU Action Plan for a common, standardised, EU-wide system for withholding tax relief at source should be based on the OECD's TRACE framework. This is because TRACE has a structure that increases the integrity of the custody chain, while minimising redundant transfers of data and documents, and requirements to maintain duplicative information at different points in the custody chain.

The second is that the introduction of an EU-wide, harmonised definition of 'shareholder' as end investor is a necessary part of Action 12 of the CMU Action Plan. Differences in definition, and any definition in which a party other than the end investor is treated as the legal owner of securities, necessitate complex and idiosyncratic work-arounds to try and ensure that an end investor can exercise the rights associated with its holdings.

The third is that the SRD2 mechanism for shareholder identification – currently handicapped by different national definitions of shareholder – has the potential to be a powerful tool for delivering increased transparency throughout the custody chain for the benefit of fiscal, legal and operational processes.

A famous 19th century journalist once wrote that the tradition of all dead generations weighs like a nightmare on the brains of the living.

Let us take action to reduce this weight.

ILSE PEETERS

Head of Government Relations, Euroclear S.A.

CSDR review – A value-add for CMU?

CSDs have worked intensively over the last years to meet the highest possible standards prescribed in the CSD Regulation ("CSDR") and to adapt to harmonisation efforts linked to T2S, or in the context of ECMS. CSDR is also making CSDs more competitive. For example, it gives issuers choice of which CSD to use for their securities issuance.

How then to deal with the upcoming CSDR review? CSDR is still relatively new, and, an important piece – the Settlement Discipline Regime – is yet to be implemented.

We believe the CSDR policy objectives in terms of financial stability and resilience have largely been achieved. This has been confirmed by the resilience CSDs have demonstrated in the COVID-19 crisis. The financial stability aspects of CSDR need to be protected in any CSDR review.

Yet, the ambition the EU has in frame of its single market objectives - to have greater competition and market integration within the EU - is only partially realised for the moment. Further efforts are needed to address some of the more politically difficult areas of harmonisation as highlighted in the CMU Action Plan. And some targeted changes to CSDR seem warranted.

A detailed and full legislative review of CSDR would come too soon and in our view would need to be conducted in the context of a more fundamental analysis on how the whole securities value chain (trading, clearing and settlement) is evolving following introduction of MiFID, EMIR and CSDR.

For a targeted CSDR review, we see three main priorities. First, to focus on targeted corrections, simplifications or clarifications where there is a disproportionate burden or even potentially new barriers which impact the CSD's and EU's competitiveness. Three examples: the CSDR passporting requirements, the Review and Evaluation process and the Mandatory Buy-In Regime:

- While CSDR has harmonised the conditions for conducting CSD business, amongst others with a view to opening up for competition, the CSDR passporting requirements have - unfortunately and unintentionally - made it more complex, costly and long to accept foreign securities compared to the process before CSDR.
- The Review and Evaluation process: This is a yearly process by which National Competent Authorities (NCA) need to review and evaluate any significant changes which have been made since the initial CSDR filing or the previous Review and Evaluation. We have noted that this process gives rise to different approaches and expectations amongst NCAs, hence creating an important recurrent cost for both CSDs and NCAs as well as unequal level playing field amongst CSDs.
- For the Mandatory Buy-in Regime, there significant market concerns related to impact of the implementation of the regime. While included in CSDR, the effect of this regime will be felt on EU27 capital markets, not only at the post-trade infrastructure layer. We therefore welcome the Commission's and ESMA's openness to look for a suitable solution to the challenges posed by those CSDR rules. We need an urgent steer on the way forward.

Second, we would welcome more supervisory convergence in the practical implementation of CSDR. Settlement and safekeeping of securities remain to a large extent domestic industries, and therefore a homogeneous application and supervision of the new regime is a precondition to the development of cross-border services; services that are efficient and truly competitive (both within the EU and globally).

Third, we believe that clarifications to CSDR are needed to ensure CSDs can use DLT to settle crypto-assets within the existing regulatory framework. CSDs could service crypto-assets considered as MiFID financial instruments by using a permissioned DLT platform with a centralised validation model. Although we believe that there would be no immediate need for level 1 changes in CSDR, certain clarifications seem required to provide legal certainty to the industry and drive market adoption. We are happy to see that the recent ESMA report supports this point. The Pilot Regime for DLT Market Infrastructures that is currently under negotiation between Council and Parliament is a welcome additional route to innovation. We hope that the negotiators on this file will stick to the principle of "same activity, same risk, same rules".

A targeted review of CSDR will benefit the CMU and the EU competitiveness.

A targeted review of CSDR will benefit the CMU and the EU competitiveness as it should remove unintended and detrimental consequences from the CSDR implementation on capital markets, thereby removing rather than creating barriers. At the same time, clarifications to CSDR to make it "fit for digital" which will allow CSDs to provide a safe infrastructure layer for crypto-assets.

SECURITISATION: CALIBRATION ISSUES AND FUTURE STEPS

DOMINIQUE LABOUREIX

Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

The European securitisation framework: some fine tuning still needed

Securitisation is key to further enhance the Capital Markets Union. It allows investors to get different risk/return profiles depending on their appetite and enables banks to reduce their capital needs and obtain liquidity by selling the different tranches of a securitisation. Thus, it helps diversify the financing sources of the economy and should therefore be supported, while learning from past mistakes: in view of its complexity, securitisation requires a robust and prudent regime that limits harmful practices but does not contain undue obstacles to its use by originators and investors, including insurers.

The new European framework, with the introduction of the simple, transparent and standardised (STS) label in particular, aimed at encouraging the creation of a safe, robust and transparent market. However, the recovery of the market has been fairly limited since its inception in early 2019.

Even though progress has been made after a period of slow implementation, the market is still struggling to develop. It is probably due in part to sanitarian conditions, even if securitisation instruments proved robust following the COVID19 crisis, since banks have kept originating transactions in 2020 and 2021 and no material financial losses on STS products have been recorded. But the struggle is also partly due to some elements in the regulation that could likely be improved so that the framework makes securitisation more competitive with comparable products and eases its liquidity while maintaining the necessary transparency.

The High level Forum for Capital Market Union conducted a useful work in 2020 to pave the way for an overall reflection by highlighting the main issues regarding securitisation in the European Union. It provides a strong input for the upcoming review of the European securitisation framework expected in 2021/2022.

Significant developments have already taken place to improve the functioning of certain securitisation segments.

First, the legislative framework has been amended. The publication, in April 2021, of two regulations on securitisation under the Capital Market Recovery Package, introduced a more appropriate treatment for securitisations of Non-Performing Loans based on the new Basel framework. It has now to be closely monitored to assess whether further improvements would be needed. The 2019 EBA proposals, aimed at making the treatment more risk-sensitive and avoiding incentives to arbitrage, could serve as a common reference in this regard, if necessary.

Second, as said, the European legislators have introduced a welcome STS framework for synthetic securitisations that should ease financing of the economy by lowering the capital requirements of originators.

Third, useful clarifications have also been provided to the market. One example is the publication of a recent EBA report the recommendations of which are aimed at harmonising the assessment of the significant risk transfer. It was also clarified that the originator's prudential supervisor should supervise certain requirements of securitisation regulations (such as retention or transparency).

The 2021/2022 reviews should go a step further while ensuring a robust framework.

We value the conservatism that the current framework for securitisation introduces for banks. However, we should stand ready to continue to improve it and would accordingly support a reassessment of the regulatory capital calibration to address certain technical shortcomings; in particular, it might be relevant to revise the range of the non-neutrality factor «p» (which was introduced to create an additional layer through a capital surcharge for securitisations) to make it more risk sensitive.

Depending on an impact assessment, the treatment of securitisations in the LCR might also be improved, for instance through an upgrade of STS securitisations to Level 2A and the recognition of the eligibility of certain non-STS securitisations to Level 2B, along with adequate haircuts to be determined.

To support the Capital Markets Union, the role of insurance companies as investors is also particularly needed. In this regard, the prudential framework for insurers could be made more risk-sensitive. Indeed, Solvency II capital charges encourage insurers to invest in senior STS categories only, putting aside other categories of securitised products. An area of improvement may be, for example, to include a segmentation of the non-STS category into two sub-categories (senior and junior) - as in the banking prudential framework. Such a segmentation would allow these products to benefit from a more risk-adjusted treatment.

The upcoming reviews of Solvency II and of the securitisation framework provide the ideal opportunity to progress on these topics.Taking into account their overall market knowledge, supervisors should extensively contribute to these reviews.

FRANÇOIS-LOUIS MICHAUD

Executive Director, European Banking Authority (EBA)

Careful securitisation can help

As shown by the Great Financial Crisis, securitised products can create new asymmetries of information and systemic risk if they are not used and regulated adequately. On the other hand, careful securitisation offers credit institutions and investors a powerful tool to manage their risks and shape their balance sheets in line with their risk appetites. Getting the balance right so that securitisation can contribute to economic growth has featured high on the EU's agenda over the past decade, including as part of its Capital Markets Union (CMU) strategy. Safer EU securitisation markets are now surfacing but further efforts are needed.

STS securitisation is gathering speed

The EU securitisation regulation has come far since 2007. As a result of the crisis and thanks to a new EU framework for securitisation, opaque structured products have largely vanished. More straightforward and better-priced ones have gradually developed. This has helped to establish securitisation as a viable and safe product for European banks to manage their balance sheets more actively.

Despite a slow start in the first years, issuance under the EU's simple, transparent, and standard ("STS") label is now gathering pace and represents about 40% of all new EU securitisation.

How can securitisation help in the EU at the current juncture? In a (post) COVID environment, STS transactions can definitely help EU banks to further evolve their business models, originate new loans to viable borrowers, and finance important long-term public goods such as the EU Green Deal.

The main contribution of securitisation can evolve over time. In the coming months, it is probably less about funding (other sources are available to banks) than about helping banks manage their balance sheet management, giving them the capacity to originate fresh loans to viable projects or helping them to manage their stocks of non-performing exposures (NPE). On the latter aspect, an EBA Opinion in 2019 highlighted that securitisation can make a difference. Further such efforts may soon be critical again. They would also benefit from the "NPE templates" that the EBA is currently streamlining.

Regulatory adjustments are on the way

Despite encouraging developments, the EU securitisation market has however not reached its full potential yet. In particular, the expected broadening of the investor base has not materialised, and issuance volumes remain subdue. This was sometimes attributed to the complexity of the EU securitisation framework (including for STS) and to other shortcomings. This suggests that further adjustments are needed.

To that purpose, the EBA has been recommending action in three main regards:

i. Clarifying the rules to get the significant risk transfer (SRT) recognition. Uncertainty or lengthy supervisory processes may indeed have deterred banks from using securitisation more pro-actively to manage their balance sheet. In 2020, the EBA has addressed its recommendations to the European Commission to improve the efficiency and predictability of the SRT framework.

ii. Extending the STS label (and its prudential benefits) to synthetic securitisation. This was endorsed by the co-legislators, who introduced a differentiated regulatory treatment for cash and synthetic transactions. The EBA is now developing the related implementing standards. This will provide further clarity on the prudential treatment on key features such as synthetic excess spread.

iii. Removing some regulatory constraints to the securitisation of NPEs. Key legislative amendments taking into account the specificities of NPEs in securitisation retention rules were introduced by the EU Capital Markets Recovery Package, and the EBA is now implementing them into the Single Rule Book.

Is anything else needed?

As more experience is being gained with the implementation of the EU securitisation framework market participants sometimes call for a recalibration of the capital and liquidity treatment of securitised products. The European Commission's review of the securitisation regulation expected by early 2022 might offer an opportunity to investigate the issue.

Securitisation can help EU banks evolve business models, finance viable borrowers and public goods.

This should however be done carefully. While market data on the performance of STS securitisation are becoming available, there may not be sufficient evidence available yet to already substantiate a re-calibration of the prudential treatment. Moreover, the lessons of the 2007/2008 financial crisis should not be forgotten: the specific risks stemming from securitisation transactions and the recent progress in terms of simplicity, transparency, and pricing should be fully acknowledged. This may warrant a fine-tuning rather than a complete overhaul of the current framework. Finally, there should be close coordination with the Basel Committee.

PAULINA DEJMEK HACK

Director for General Affairs, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Securitisation: the upcoming review of the framework

Securitisation, when structured in a sound and transparent way, is an important element of well-functioning capital markets. The EU securitisation framework has been in application since January 2019 and was amended in April 2021 in the context of the efforts to support the economic recovery following the COVID-19 induced recession. The framework addresses the problems identified in parts of the securitisation market in the past by putting in place provisions preventing the re-emergence of harmful market practices, increasing market transparency to facilitate supervision and investor due diligence as well as enhancing legal clarity for all participants in the market.

To help investors identify high-quality securitisation structures, the EU framework identifies conditions for Simple, Transparent and Standardised securitisation (STS). To reflect the simple and streamlined nature of STS positions, banks and insurance companies investing in STS now benefit from a more risk-sensitive prudential treatment in the Capital Requirements Regulation and in Solvency II.

Whilst it is still early days to conclude whether the EU securitisation framework has worked as intended, it is nevertheless useful to examine the preliminary impact of the framework on the market. EU securitisation markets have not yet rebounded as hoped for. The Commission will now analyse developments which will lead to a report which will be submitted to the European Parliament and the Council by January 2022. If the analysis finds that legal amendments are necessary, the report may be followed by a legislative proposal.

The report will cover a number of areas, as set out in the mandate for the review in Article 46 of the STS Regulation.

First, it will assess to what extent the securitisation framework has delivered on its policy objectives and the broader aims of the Capital Markets Union in terms of increasing access to finance, widening the issuer and investor base of securitisation products, enhancing market transparency, enabling investor due diligence, and increasing investor protection.

On 23 July, the European Commission launched a targeted public consultation to gather feedback.

Moreover, the review will assess: (i) the disclosure regime for private securitisations (i.e. transactions that do not have to issue a prospectus), (ii) the need for an equivalence regime for STS securitisations (currently the sell side parties of an STS transaction must all be established in the Union), (iii) the disclosure of information on the environmental performance of the underlying assets, as well as (iv) the case for establishing a system of limited licensed banks performing the functions of securitisation special purpose vehicles. In the area of sustainability, the EC work will benefit from input from the European Banking Authority in the form of a Report on developing a specific sustainable securitisation framework for integrating sustainability-related transparency requirements.

In addition to the mandated topics, the review of the securitisation framework will consider a number of additional issues with a potentially important impact on the market, that have been flagged by the EU supervisory community and the High-Level Forum of the Capital Markets Union. These include the due diligence requirements for institutional investors, the application of the Securitisation Regulation when non-EU entities are involved in the transaction, and supervision. As regards the prudential treatment of holdings of securitisation positions, the report may cover the issue of capital treatment for banks and insurance companies, the liquidity treatment with respect to the Liquidity Coverage Ratio, and the significant risk transfer assessment.

Any potential changes to the legal regime will need to be based on thorough analysis and convincing evidence. On 23 July, the European Commission launched a targeted public consultation in order to gather feedback from stakeholders on the functioning of the framework, which will feed into the mentioned Report under Article 46 of the Securitisation Regulation. This questionnaire will be followed by a Call for Advice to the Joint Committee of the European Supervisory Authorities on the appropriateness of the prudential treatment of securitisations.

The European Commission remains fully committed to reviving EU securitisation on a sustainable basis. The review of the legislation governing that market, work on which has now started, is the next step in this process to ensure that securitisation duly contributes to the Capital Markets Union and provide an efficient channel to managing risk, liquidity and capital.

ALEXANDER BATCHVAROV
International SF Strategist, BofA Global Research

A thriving securitisation market for a thriving capital market in the EU

The size of the EU securitisation market, including the United Kingdom, was 75% that of the US in 2008, and just 6% in 2020, according to the ESM. European insurers held about 10% of their fixed income AUM in structured exposures in 2010, that share today is just 3%. Moody's 12-mo historical average impairment rates for European SF (structured finance) in the period 1993-2020 is 0.1% for CLOs, 0.2% for ABS, 0.3% for RMBS and 1.3% for CMBS with the majority of impairments at the sub-IG securitisation tranches. By comparison, Moody's 12-mo corporate default rate for the period 1985-2020 stands at 0.13% for IG credit and 3.27% for non-IG credit for a total of 1.03% in Europe vs global rates at 0.08%, 4.23% and 1.7%, respectively.

Further, Moody's 10-year downgrade ratio of AAA European ABS/RMBS/CMBS of 5.33% in the period 1993-2020 compares favourably with the average down-grade ratio of 6.5% and 24% for covered bonds in jurisdictions with AAA and non-AAA country ceiling in the period 1997-2019. Academic research demonstrates higher liquidity of HQS (high quality securitisation, aka STS) tranches compared to non-HQS (aka non-STS) tranches, and that ABS and covered bonds do not exhibit radically different levels of liquidity, with some ABS exhibiting higher liquidity than covered bonds.

The EU SF market was rigorously tested during several crises over two decades and its performance was in line with and often above market expectations. These positive facts did not find an adequate reflection in the EU securitisation regulatory framework (EUSR). By contrast, covered bonds were never tested on a stand-alone basis during the above crises, as the bank issuers or their covered bond programmes were bailed out. These negative facts were reflected in a very favourable regulatory treatment.

European SF has performed well on both a stand-alone and a relative-to-corporates basis, be it in terms of default and loss metrics or in terms of market liquidity. But the uninitiated observer would not be able to determine that when comparing their respective divergent regulatory treatments and listening to the public commentary surrounding different fixed income market sectors.

The EU SF market was rigorously tested during several crises over two decades and its performance was in line with and often above market expectations.

As mentioned above, European insurers' presence in the European SF markets is limited, in sharp contrast with their US counterparts who have been active buyers of IG senior and mezzanine tranches of securitisation around the world for decades. What could explain such differences? The comparison across comparable exposures under Solvency II shows that the capital charges for senior STS AAA and AA tranches are 30-40% higher than those for covered bonds, and for non-senior STS AAA and AA tranches – 300% to 400% higher than those for similarly-rated covered bonds. The SF capital differential vs corporate bonds is more or less the same. By comparison, there is no major differential in the US under the NAIC rules, including their recently revamped, more risk-sensitive calibration.

Likewise, the capital cliff of Non-STS Securitisation vs. STS securitisation and corporate exposure is steep: the nominal capital for 5-year BB and B rated leverage loans stands at 22.5% and 37.5%, while such capital for a senior-most AAA CLO tranche backed by a pool of such loans would be 62.5%. The nominal charges for the BB and B tranches of such loans would attract 410% and 500% capital, i.e. 13 – 18 times more than the similarly rated constituent loans. The reason for these discrepancies across different exposures lies in the different methodologies used for the derivation of the capital charges. Some of them appear to be based purely on default risk (e.g. residential mortgage loans), others on both default and spreads risk (e.g. STS senior tranches), and yet others on the latter incorporating additional factors (e.g. liquidity risk, perhaps, for Non-STS Tranches).

In our view, an adequate calibration of securitisation capital charges under Solvency II is long overdue. We think US NAIC, BIS and IAIS ICS can be good starting reference points. We believe that while the different calibration between STS and non-STS should be maintained, the existing steep cliff between the two is not justified. We also question the need for a differentiation between the capital charges for securitisation senior and mezzanine tranches when rated investment grade.

In the EU, securitisation can help boost the post-pandemic recovery and the development of the CMU, free bank capital for more lending, bring SMEs into the capital markets, and help with the greening the EU economy – all that by facilitating bank and new business financing, dispersing risk across markets and geographies, freeing bank capital, creating tradable liquid securities ... if ... the well-known, extensively-debated and long-outstanding issues to create an adequate, risk-sensitive, level-playing-field regulatory framework across securitisation and all other fixed income instruments is at long last resolved.

ALEXANDRE LINDEN

Managing Director in the Securitised Products Group, BNP Paribas

Towards a bigger, broader and deeper EU securitisation market

By turning illiquid credit pools into marketable securities with different risk profiles, securitisation brings huge benefits to both the EU economy and EU objectives through:

- developing EU capital markets in line with the CMU goals
- diversifying funding sources for EU SMEs and corporates that have no direct access to capital markets thus increasing their competitiveness
- broadening the range of green assets available to capital markets investors in the context of the EU Green Deal
- funding the growth of innovative fintechs and digital lending platforms in line with the EU strategy on shaping Europe's digital future

By sharing the risk of bank's credit portfolios with non-banks capital markets investors, securitisation plays a key role for EU banks and the EU financial system:

- enabling banks to continue to lend more to the real economy by achieving capital relief
- facilitating the absorption of upcoming regulatory pressure on bank's capital
- making banks more resilient to an economic downturn
- transferring NPE portfolios from banks to non-bank investors

As noted in the Final Report of the High-Level Forum on CMU (June 2020): « Securitisation can play a key role in addressing the consequences of the Covid-19 crisis, by raising liquidity for banks, helping manage their balance sheet exposures, reducing the link between sovereigns and banks given the large volume of sovereign guaranteed loans, and eventually contributing to setting the post-pandemic EU economy.»

Despite its many benefits, the EU securitisation market remains underdeveloped. The observable public market for placed issuance, which grew to €400bn p.a. pre GFC, has been ranging from €80bn to 130bn since 2008. The implementation of the so-called "Simple, Transparent and Standard" (STS) framework in 2019 has not stimulated the market. Non-STS issuance still outweighs STS, and STS has not led to new issuers or investors entering the market. Overall, the EU securitisation market is 5 to 6 times smaller than the US one, for a similar size of the two economies. The US market is not just bigger but also broader in terms of asset classes and deeper with more investor's participation, especially insurers. Even the more recent Chinese securitisation market is now bigger than the EU one.

The comprehensive review of the securitisation framework is a game-changing opportunity.

The underdevelopment of the EU securitisation market is rooted in harsh regulatory treatment. Due to excessive capital requirements, the capital-adjusted cost for banks through securitisation is often too high. In addition, the STS regulation has created higher hurdles for both originators and investors without sufficient recognition in capital and liquidity rules. As a result, the EU economy continues to rely excessively on banks with 68% of private sector debt financed by banks versus 15% in the US.

Securitisation remains the main gap between the EU and the US financial systems. As long as such a gap exists, every banking regulation will have a disproportionate impact on the funding of the EU economy.

The High Level Forum on the CMU identified securitisation as one of the top priorities. Extensive technical work enabled to identify the key regulatory obstacles constraining the market. The comprehensive review of the securitisation framework is a game-changing opportunity. It is essential that it results in a holistic implementation of HLF securitisation recommendations as all those proposals are jointly necessary to create a viable securitisation ecosystem:

- Capital requirements: recalibrate capital charges and lower the floors applying to senior tranches, in line with their low-risk profile. The impact of the Basel III output floor on securitisation needs addressing, via a recalibration of the "p" factor in the SEC-SA.
- Significant Risk Transfer: provide more clarity and predictability, and ensure a faster SRT assessment process
- Liquidity treatment: upgrade LCR eligibility of senior STS and non-STS tranches, to reduce the current gap with covered bonds
- Disclosure requirements: streamline ESMA templates, currently excessively burdensome for issuers and of little use for investors especially in the private securitisation market
- Insurers' participation: address in Solvency II review the current flaws that make securitisation investment unviable for EU insurers
- Opening to global financial markets: ensure that EU investors can operate on a level playing field in non-EU financial markets by clarifying that the investor's due diligence and associated originator's disclosure obligations under Article 5(1) (e) can be met through a proportionate approach

Finally, for the comprehensive review to deliver meaningful results, a horizontal securitisation policy coordination role is required given the number of different EU institutional bodies involved. This would greatly facilitate a constructive and focused discussion between the authorities and market participants.

GREGOR MCMILLAN
Managing Director and Head of Principal Secured Issuance and Risk Transfer, Barclays

Areas of focus to create a better functioning securitisation market

It is welcome that policymakers both in the EU and UK recognise the benefits of a well-functioning securitisation market. It is an important part of the capital markets ecosystem and a crucial tool in helping the post-pandemic economic recovery, especially for SMEs. As both jurisdictions review their securitisation regimes, there is a unique opportunity to address some areas where the current rules may not have had the intended impact, and also to extend some of the existing benefits further in order to allow the market to reach its full potential.

Both the EU and UK securitisation reviews are fundamentally seeking to understand what impact the Securitisation Regulation has had on the market since it came into force, in order to inform what could be improved. This has been difficult to gauge as the implications of Brexit and central bank liquidity interventions resulting from the pandemic have clouded any direct impact assessment.

In addition, public securitisation supply in the EU and UK has been constrained as a result of cheaper funding provided by central bank lending schemes and simpler regulatory compliance for covered bonds. In addition liquidity has been plentiful and bank deposits have risen, so the need for securitisation as a funding tool has materially reduced.

Whilst it seems clear that the Securitisation Regulation has delivered some harmonisation benefits and has ensured certain minimum standards are met, for banks these benefits need to be weighed against the higher compliance requirements (and associated costs), which do not yet appear to have been matched by significant increased enthusiasm from investors.

A particular area of market concern is in respect of disclosure requirements, which can be costly and extremely time consuming for originators, without appearing to provide significant benefits to investors. This is especially the case for private securitisations. The ESMA template requirements, resulting in increased costs for originators to provide the reports and increased costs for investors to ensure compliance with due diligence requirements, come on top of the reporting requirements which are typically agreed on a case by case basis between originator and investors. These requirements also make securitisation of certain asset classes more challenging, in particular in respect of compliance with confidentiality obligations.

Address prudential bottleneck impediments to create a more dynamic securitisation market.

Partly as a result of the above factors, the EU securitisation market has not seen the desired growth in market size or influx of new investors, but instead it has shrunk: the overall size of the EU securitisation market, (if we include the UK), was 75% that of the US in 2008. In 2020, it was just 6%.

Clearly some of the reasons for these reduced market volumes are outside of policymakers' control, but steps could be taken in the areas set out below to address some of the prudential bottlenecks which are impediments to a more dynamic EU securitisation market, with a deeper investor base.

Firstly, the capital and liquidity treatment of securitisation positions, which is currently very conservative compared to similarly risky instruments, should be re-examined and adjusted. This should include the capital treatment for insurers holding securitisation positions, which currently disincentives their participation in the market.

Secondly, we should recognise that synthetic securitisations are an important element of the market, and they are often used to manage risk and concentration limits, or for efficient capital management, which in turn supports further origination/lending. In our view, policymakers should continue to focus on developing more efficient synthetic securitisation options, in order to bring the capital treatment into line with true sale transactions.

The introduction of the synthetic EU STS regime is therefore encouraging, although there are elements which may need to be refined, in particular the treatment of excess spread. In addition, the disclosure requirements for private securitisations in particular should be reviewed, to determine whether they are adding any real value for investors or improving the safety of the market. If they are not, then a move away from mandatory templates to a reporting approach agreed with investors would likely increase volumes, reduce costs and free up significant resource across the industry.

Finally, the introduction of the Basel IV output floors could be a significant headwind for the market, leading to significantly higher capital requirements for issuers with retained positions, particularly given standardised risk weights. It is important that the industry and policymakers fully engage on this topic, to develop solutions which do not further inhibit the development of the market.

5

DIGITALISATION AND PAYMENTS

ISSUES AT STAKE

Digitalisation and new technologies such as DLT, AI and cloud services are key drivers of innovation, agility and efficiency in the EU financial sector. These innovations also bring many changes in the financial ecosystem that raise new questions in terms of competition, financial stability and consumer protection and also create new challenges for supervisors. The Digital Finance Strategy proposed by the Commission aims to support this transformation by adapting the financial framework to increasing digitalisation, removing potential obstacles to digitalisation and also addressing possible new risks and level playing field issues related to these changes. The DFS is part of a broader Digital Finance Package that includes measures targeting crypto-assets (MiCA), DLT market infrastructures (the DLT pilot regime) and instant retail payments (the retail payments strategy), as well as a framework for digital operational resilience (DORA).

An ever-faster development of internet transactions and payments also challenges traditional payment arrangements and related legal frameworks with new interoperability, integration, cooperation and fair competition issues. There is also a need to adapt the current payment framework to the forthcoming adoption of Central Bank Digital Currencies. All these challenges are true at the global level to swiftly improve low value or large value cross border payments. They are also relevant in EU retail payment markets, which remain fragmented along national borders, while non-EU card schemes are dominant notably for cross border EU transactions, creating dependence concerns in the EU that might be reinforced by the arrival of BigTechs.

DIGITAL TRANSFORMATION AND POLICY IMPLICATIONS

PAULINA DEJMEK HACK
Director for General Affairs, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Shaping the digital future in finance - together

Digitisation is driving fundamental structural changes in the financial system. Banks, investors and other market participants are relying more and more on digital processes. At the same time, new applications, innovative products and entire new asset classes emerge. Consumers increasingly carry out their day-to-day financial transactions with a few clicks on mobile devices.

If used well, this digital shift presents opportunities: It enables the EU to harness innovation as it sustains the recovery and builds a more competitive, inclusive and sustainable economy. Digitisation can also help citizens to make full use of efficient and accessible products and provide new sources of funding for SMEs – in short, it can help us build a modern and resilient Europe post the Covid 19-pandemic.

However, the digital transformation is also creating new risks. The Commission's Digital Finance Strategy, presented in September 2020, aims to make sure that we seize the opportunities created by digitisation while preserving market stability and integrity and protecting consumers and investors.

This involves ambitious legislation, such as our proposal to create a framework for markets in crypto assets. Once adopted, the new rules will safeguard financial stability, bring legal clarity and support innovation, while providing solid rules ensuring consumer and investment protection and preventing abuse, fraud and theft. Member States and the EP have made good progress in their negotiations. The Commission would welcome a swift adoption of this file in the autumn, given the rapid growth of the crypto asset markets.

Only by embracing change can we build inclusive and prosperous societies.

Closely linked to this proposal is a pilot project for market infrastructures based on distributed ledger technology. We are pleased that Member States have found a common approach on this file and hope to conclude negotiations with the European Parliament soon. This would mean that as early as in 2022, market players will be able to test the use of distributed ledger technology on a large scale, in asset classes such as shares or bonds. This is a great opportunity to boost the development of our capital markets, giving smaller firms in particular a chance to attract new business.

A number of cyber attacks over the past months have made painfully clear how vulnerable our economy is to these kinds of threats. The financial sector is no exception. That is why the Commission has proposed rules on digital operational resilience for financial firms. We want all of them to have the necessary safeguards in place to mitigate cyber attacks and other risks to their digital resilience. The scale of the threat shows that we have no time to lose. We are therefore working actively with the European Parliament and Member States to ensure a swift agreement on the new rules.

This is not all.

The digital euro, a digital form of central bank money, would offer greater choice to consumers and businesses, and further support the digitisation of the EU economy. The Commission will continue to work closely with the European Central Bank and other EU institutions to analyse the legal and political implications of introducing a digital euro and to test various design options. We note that this is a global issue and that other jurisdictions are reflecting along similar lines.

We are also working on a common European Financial Data Space to further promote data-driven innovation in finance. The European Single Access Point will be a first important stepping stone towards this goal. We want the EU to have an Open Finance framework in place by 2024. This is in line with the EU Data Strategy, the upcoming Data Act, and the Digital Services Act. Sharing data linked to financial products can bring great benefits to consumers and businesses, such asmore effective and personalised products and services. We intend to propose a balanced framework so as to ensure fair competition and full control for individuals over their data.

We want Europe to be a leader in digital finance. But we need to embrace the digital changes in an inclusive way, to ensure that no parts of society are left behind. To achieve this, we need an inclusive approach, including consumers, businesses, policymakers, regulators and supervisors at European and national level, as well as the financial sector - from incumbent players to start-ups. Let us continue to shape this new world together.

TSVETELINA PENKOVA

MEP, Committee on the Internal Market and Consumer Protection, European Parliament

Transforming the financial sector - a new digital reality

The digital transformation is a fact for few decades now and is our core priority in all policy areas. Customers want faster and more convenient services while innovative companies provide adapted and timely solutions for their needs. The COVID pandemic has caused an increase in the use of financial applications in Europe by 72% in only a week.

Financial companies invest massively in their digital transformation, which on one hand is changing their business models and on the other is bringing a completely new spectrum of processes and services. The use of cloud services and big data, AI, DLT and the internet of things have become viral for the way traditional financial actors adapt to the new reality, as well as for new comers that through combination of different technologies are disrupting the established market.

Outsourcing or developing private cloud infrastructures has proven to be highly beneficial for financial companies. It brings considerable cost reduction with regards to data storage and processing while maintaining an increased level of securty. AI and big data allow for virtual monitoring of transactions and customer behaviour, assembling information for regulatory and compliance purposes or for providing tailor made products.

Blockchain technology, which is often associated with cryptocurrencies, goes way beyond in its fields of application in finance. KYC solutions or real-time payment processing and verification of transactions are a few of them.

Finally, none of these would be possible without increased connectivity. The deployment of 5G and 6G is pivotal in this fast-paced transformation. There are two elements that are essential for the digital transformation - digital identities and cybersecurity.

The Electronic Identification, Authentication and Trust Services (eIDAS) Regulation provides the foundation for cross-border electronic identification and authentication. About 60% of Europeans benefit from the current system, however, usage is still low and the application in the private sector is limited. Our aim is to make the national electronic identification schemes interoperable among the Member States and thus to reduce divergences between countries.

Two elements are essential for the digital transformation - digital identities and cybersecurity.

A new proposal for a Regulation on digital identity was released by the European Commission - it builds upon eIDAS and extends the scope also to the private sector. Member States would offer citizens and businesses digital wallets that will allow them to use the benefits of their national digital identities. They would be able to access services online directly without their sharing personal data and would have full control of the data they share.

Technology companies are getting more and more active in finance, both as service providers, as well as providers of financial services themselves. In the European Parliament, we are working on a 'Digital Operational Resilience Act' (DORA) - a sector-specific legislation aiming to ensure that all actors in the financial system put in place the necessary measures to mitigate cyber-attacks and ICT-related risks. Moreover, the proposal introduces an oversight framework for ICT providers, such as cloud computing service providers.

We are also currently working on updating the European Network and Information Security Directive - NIS2. The Commission proposal extends the scope of this NIS Directive by adding new sectors based on their criticality to the economy and society and by introducing a clear size limit - this means that all medium and large companies in selected sectors will be included in the scope. At the same time, Member States leave some flexibility to identify smaller entities with a high security risk profile.

In the end, in July 2021 The European Central Bank (ECB) already launched the 24 months investigation phase of the digital euro project. And the ECB is not alone. Central banks around the world are running virtual versions of their currencies, as the use of physical money is declining more and more. Financial authorities are determined to enter the digital world of the 21st century, following the development of the private forms of cryptocurrencies, such as Libra.

SÉBASTIEN RASPILLER
Assistant Secretary, Direction Générale du Trésor
Ministry of the Economy, Finance and the Recovery Plan, France

Digitization of financial activities: European cooperation is much needed

In recent years, the financial sector has experienced tremendous transformation, propelled by development in technology. This trend is expected to pick pace in the coming years. The Covid-19 crisis has certainly accelerated this process and underlined the importance of adaptability.

As technologies and business models evolve, consumers and businesses in Europe are increasingly using digital financial services for a range of different purposes. Europe is now home to many thriving financial technology startups. Many European traditional financial companies are in the process of overhauling their own models, through massive investment.

By accelerating cross-border transactions, digital finance also has the potential to enhance financial market integration in the European Union. More broadly, a stronger digital financial sector could support the economic recovery strategy.

Therefore, financial technologies represent a great opportunity for Europe. Disruptive innovations such as blockchain, cloud, quantum computing and artificial intelligence are creating new horizons in terms of efficiency for the financial system as a whole. They are driving the development of new business models for companies and more inclusive services for consumers. Exploiting the opportunities brought by these transformative forces is undeniably a challenge for the public authorities, both at national and European level.

One of the main challenges is to build a responsive financial system adapted to the rapid progress of technologies and to the rapid development of their use cases. Over the last decade, these innovations have contributed to reshape the European financial landscape. New players, whose business model is based on new data uses and innovative methods of delivering financial services, have emerged. Fintechs of course, but also the rise of financial services within “big tech”. The traditional players have therefore had to reinvent themselves considerably to adapt to this changing environment. This movement has accelerated in recent years, as illustrated by the number of partnerships between traditional players and fintechs, as well as by the number of significant fund-raising deals by fintechs and the increased amount of investment by traditional players in technologies.

The European Union must continue to promote financial innovation.

Beyond the final users, society as a whole has to gain from the development of financial technologies, as they can ultimately lead to a more efficient allocation of capital and better risk management. To achieve this requires from public authorities to adopt a balanced approach that supports innovation while promoting fair competition, protecting consumers and preserving the integrity of financial markets.

While each jurisdiction is perfectly legitimate to develop the responses it deems appropriate, the rise of financial technologies necessarily calls for a global European or international framework since they may raise issues that are transnational in nature, such as cybersecurity or financial stability.

The European Commission has therefore adopted a package on digital finance, including strategies on digital finance and retail payments. It has laid down legislative proposals on crypto-assets (MICA) and digital resilience (DORA). One of the remaining challenges during the next months will be to set up appropriate European supervisory regimes, for both MICA and DORA. Two imperatives have there to be taken into account: credibility, with regards to the size of some corporates going under oversight and the sophistication of some business models; and efficiency, with regards to the respective existing competences of the three European supervisory authorities.

The European Union must continue to promote financial innovation and contribute to creating a safe and favorable environment in which ambitious entrepreneurs with promising projects can flourish. This is up to public authorities to offer such a framework, to the benefit of European citizens and businesses.

BERND LEUKERT

Member of the Management Board - Chief Technology, Data and Innovation Officer, Deutsche Bank AG

#EngineerTheFuture of Financial Services

Almost two years of a global pandemic have shown the fragility of cross-border value chains. At the same time international cooperation and technological innovation have proven essential to find an effective response to its challenges: for medical research, remote interaction, granting financial support or effective treatment of Covid-19 patients.

What does this mean for the financial sector? The pandemic has accelerated our digital strategy and that of many of our clients. We are seeing business models being permanently shaped – for example, the demand for asset-as-a-service (AaaS). AaaS allows firms to pay according to the actual use of their production equipment and has become relevant during lockdowns, when companies suffered from having their equipment sitting idle while they were still paying for it. Beyond the pandemic, it can also improve cashflow management, reduce balance sheet size and capital outlays, provide natural insurance against a cyclical business cycle, and avoid incurring depreciation expense.

Also, clients are becoming more interested in digital authentication. Remote identification has been a key enabler for simple, efficient and secure access to financial and other services. All these changes depend on reliable and standardized data.

The political response to those developments has been twofold: we see active support for the development and adoption of innovative solutions, such as digital identities or cloud services.

On the other hand, political and regulatory focus is rightfully on ensuring resilience and autonomy – as in the current debate on Digital Sovereignty. The most prominent development in this regard is the increasing scrutiny on IT providers from outside the EU.

For us as Deutsche Bank, resilience and security are the foundation of our operations, which is why we are following these developments with great interest. At the same time, we're exploring the opportunities offered by modern cloud-based technology to innovate for the benefit of our clients. And we are moving to an engineering-led culture with the ambition to have more than half of our technologists as hands-on practicing engineers by the end of 2022 as a major part of our partnership with Google.

Partnerships are the key to successful transformation.

It is essential to find the right balance between those goals. Digital sovereignty cannot mean erecting barriers to international cooperation or having to build EU-only infrastructures from scratch.

In contrast, digital sovereignty can only be achieved if the industry is empowered to choose the technologies we use, how we use them and who we partner with. As an example, transitioning to the cloud is an important step to increase the stability, security and flexibility of banks' IT systems, while reducing complexity and eliminating the need to operate own physical data centres.

But how can we create a framework that allows innovation to thrive?

- **Enable partnership** via a consistent, innovation-friendly regulatory framework supporting innovation made in Europe as well as collaboration with established players from inside and outside the EU - including clear allocation of accountabilities across the whole value chain. This will increase access to funding, enabling European businesses to compete and grow - both across the EU and globally.
- **Create a single European rulebook,** which is principles-based and focused on the outcome of resilience, rather than specific measures, to allow for flexibility and future-proof regulation. Remove regulatory and supervisory fragmentation in the EU, which increases cost and often creates legal uncertainty.
- **Enable safe and secure data management** to enable companies for the of use data to drive better insights and decision-making. This requires a holistic approach – moving away from sector-specific data siloes towards a real data economy – with a clear focus on empowering the user to take control and actively decide who he wants to share data with and for what purpose.

To be successful, public and private sector must work together to realise the benefits of innovation and deliver solutions that respond to the needs of economy and society. Ongoing initiatives on digital identities, cloud and virtual currencies are encouraging examples of policymakers getting actively involved in developing practical solutions to shape the future of the European economy.

COLIN FITZGERALD

Head of EMEA Distribution, Invesco

Done right, Open Finance can transform Europe's economic fortunes

Even in an era accustomed to the emergence of 'new normals', the transformative potential of Open Finance is highly significant.

By providing consumers with more control over a wider range of their financial data – including on savings, insurance, mortgages, investments, pensions and consumer credit – Open Finance has the potential to significantly improve the financial planning and investment opportunities of the 'under-served' and 'under-invested'.

Put simply, Open Finance represents one of the biggest shake-ups in the history of personal finance.

And the EU cannot afford to get it wrong. With household saving rates in the euro area hitting historic highs over the last year[1], and investment rates languishing at 2011 levels[2], EU citizens have accumulated an additional €540 billion[3] in excess cash savings over the course of the pandemic.

With the EU's post-Covid economic recovery plan still to be funded, there has never been a more important time for policymakers to encourage private citizens to invest in public markets.

Open Finance can contribute towards this objective by making investing easier, safer, cheaper and more efficient for EU citizens.

For example, consumers could benefit from improved access to and switching between an extensive choice of fund platforms, pension plans, investment portfolios, and tax wrappers, as well as sources of expert advice, all via a smart device and facilitated by an authenticated digital identification.

Implemented effectively, Open Finance will boost consumer participation in public markets to the benefit of European citizens and the economy as a whole.

Lessons learned from Open Banking

The development of the Open Banking ecosystem has shown that, where consumers see a genuinely additive open architecture solution, they will use it.

Open Finance represents one of the biggest shake-ups in the history of personal finance.

For example, according to the Open Banking Implementation Entity (OBIE) [4], more than 4 million Open Banking payments were made in the UK in 2020 – up c1,150% from 2018. And banks' servers received almost 6 billion 'calls' from FinTech application programming interfaces (APIs) last year – up c8,620% from 2017.

This shows that where 'openness' can work to the benefit of consumers, there will be uptake – at least in so far as consumers are able to embrace it. Lessons should be learned in this regard from previous experience in opening up access to consumer data in the banking space.

For example, complexities around the standardisation of APIs, as well as differing interpretations of the framework governing Open Banking between domestic regulators, continue to represent a challenge to industry and, ultimately, consumers in realising the full potential of open architecture solutions.

In seeking to extend Open Banking principles to a broader range of financial products and services through Open Finance, policymakers must resolve to overcome such issues.

The way ahead

Open architecture solutions in financial services represent a 'new normal' for consumers in Europe; a new normal that has already delivered tangible benefits in the banking sector.

However, as the EU faces up to the challenge of funding the post-Covid economic recovery, policymakers must not lose sight of the potential of Open Finance in transforming Europe's economic fortunes.

Open Finance can help to liberate billions of euros stockpiled in privately held uninvested cash and put this money to work in public markets to the benefit of European citizens and the economy as a whole.

It can do so by making investing easier, safer, cheaper and more efficient for consumers.

Therefore, as it prepares to legislate for an Open Finance framework, the European Commission must work closely with industry to develop an ecosystem that genuinely delivers additional benefits to citizens by providing the tools to help them truly understand their financial affairs, and to plan and invest for their future.

Done right, Open Finance can help to bridge Europe's growing investment gap and, in doing so, contribute towards securing the EU's post-Covid recovery and economic future.

[1] Eurostat, EuroIndicators, July 2021
[2] Eurostat, EuroIndicators, July 2021
[3] European Central Bank, Eurosystem staff macroeconomic projections for the euro area, June 2021
[4] OBIE, Three years since PSD2 market the start of Open Banking, the UK has built a world-leading ecosystem, January 2021

KRISTINE BRADEN

Managing Director, Citigroup Global Markets Europe AG

User-centred central bank digital currencies

As is often the case with disruptive innovations, digital assets are being forged in times of crisis. Bitcoin was born in the depths of the 2008 financial crisis. In the future, the COVID-19 pandemic will be seen as the crisis that lent digital assets momentum and pushed them closer to the mainstream.

As of mid-August, crypto currencies, a subset of digital assets, were valued at an estimated $1.8 trillion. This is about ten times more than at the beginning of 2020, at the onset of the pandemic, and still nearly 25% below the highs seen in May. During this period, EU and US policymakers have initiated the process of regulating and overseeing crypto currency activity. Meanwhile, the European Central Bank has rolled out a plan to develop their own digital asset - a central bank digital currency (CBDC) - the digital euro.

The question we now face is no longer whether digital assets, crypto currencies and/or CBDC will become a meaningful part of the financial services infrastructure. Instead, it's now where, and how, they will shape and be integrated into financial systems.

Invented 13 years ago, the technology underlying Bitcoin has proved even more popular than Bitcoin itself. Distributed ledger technology, such as blockchain, has been used to create many competing digital coins - there are estimated to be over 6,000 today - and is now being applied to fiat currencies in multiple ways.

The digital asset landscape is diverse, comprising not only coins like Bitcoin, but also coins that are pegged to a fiat currency or the value of other financial assets (stablecoins), and CBDC. Each category is different, confers different rights on holders and needs to be considered separately, with distinct infrastructure and compliance frameworks.

Stablecoins were in fact designed as a response to the volatile nature of Bitcoin-like "currencies". To date though, much ambiguity remains on the "stability" of stablecoins and the appropriate regulatory and compliance frameworks to apply to them. Further, some stablecoins contain characteristics that are like regulated financial instruments such as derivatives or securities. Central banks have also started reflecting on the pros and cons of CBDCs in a bid to capture the benefits of digital assets, stay abreast of changes in payment methods and in reaction to private market initiatives like Facebook's plan to launch a stablecoin.

A wide-ranging discussion on the future of money is in all of our interests as we contemplate the future of the financial system.

CBDCs and distributed ledger technology have much to commend them, though. They could aid financial inclusion by providing excluded groups with access to digital financial products and could make payment systems faster, cheaper and, ultimately, more efficient. The realisation of their potential will only be unlocked when remaining questions surrounding the fundamental design and use are resolved.

As the ECB embarks on its investigative phase for the digital euro, it will have to refine its view on the type of infrastructure and features to be used, for example token or account-based, or a hybrid system, the level of access from wholesale to general use, and the constraints to be imposed so as to prevent illicit activities, reduce the risk of bank runs and protect the mechanism of allocation of credit in the economy.

The choices to be made are more than just technical. Going forward, the debate must include focus on user needs. Choices will have to be dictated by what users - consumers, merchants and entrepreneurs - actually want from the digital payments era. Once the user interface, user experience and user value proposition is right, the other pieces will fall more easily into place.

Three key questions should therefore be addressed:

The first revolves around infrastructure. Do users want a system operated by the Government, the private sector or a hybrid?

The second concerns the interface. Do users want to deal directly with the central bank or through intermediaries, or both, and, should those intermediaries be banks, fintechs, social media, hardware companies or all of the above? The answers to these questions have profound implications, for example for the role of the commercial banking system, the source and amount of available bank capital and the supply of credit to the economy.

Third, to what extent do users want a CBDC to work like cash? There are some trade-offs to consider here. Cash transactions have the advantage of being mostly private, but retaining privacy would limit transparency. A cash-like digital currency would probably mean lower fees, but, at the same time, a lower level of protection, with users exposed to hacks and theft of their wallets.

A wide-ranging discussion on the future of money is in all of our interests as we contemplate the future of the financial system. The way forward is to listen to consumers and companies, finding out what they want in the digital age and responding accordingly. After all, digital assets including crypto currencies and CBDCs can only deliver on their potential if their use is managed and the ecosystem in which they operate is regulated appropriately.

TECH COMPANIES IN FINANCE

FERNANDO RESTOY
Chairman,
Financial Stability Institute (FSI)

The need for more entity-based regulation for big techs

There is a clear need for a determined policy response to the disruption created by the emergence of fintechs and big techs. In addition to traditional policy concerns such as financial risks, consumer protection and operational resilience, the entry of big techs into the financial services sector gives rise to new challenges surrounding the concentration of market power and data governance. These new challenges may not only affect market contestability but may also increase the vulnerability of the economic and financial system.

Therefore, regulatory reforms should aim to uphold primary policy goals such as financial stability, market integrity, consumer protection and fair competition. Unwarranted regulatory and supervisory asymmetries between different market participants should be eliminated, although only in so far as this is compatible with overarching policy priorities.

Contrary to what is often argued, the required reforms should not seek to replace entity-based rules with an activity-based approach to regulation. There are two major reasons for this. Firstly, most fintechs and big techs that are active in financial services are already subject to activity-based rules in the policy areas for which an activity-based approach is warranted (eg consumer protection or AML/CFT). In particular, big techs need specific licences to perform regulated activities such as offering payments or asset management services. Accordingly, they must comply with the rules that apply to all providers of those services. Secondly, replacing entity-based rules with activity-based rules in other areas may severely jeopardise primary policy objectives. An example is prudential regulation where such a change of approach could jeopardise financial stability. In such policy areas, rules need to address the risks stemming from a combination of all the activities that entities perform, regardless of the distribution of those activities across subsidiaries within the same group.

We need more entity-based rules to preserve financial stability and fair competition.

Moreover, there is a strong case in favour of greater reliance on entity-based rules to ensure the proper regulation of big techs. The unique business model of big techs is based on network externalities and is closely associated with the intensive use of data and new technologies. This model requires entity-specific safeguards because most of the risks that big techs generate – and that can potentially become systemic – are caused by interactions between the products and services which they offer (eg e-commerce, payment services and credit underwriting). Those risks cannot properly be addressed by a piecemeal activity-by-activity regulatory approach. Further, in the event that current plans by big techs to sponsor global stablecoins crystallise, the case for entity-based rules would be additionally strengthened.

The entity-based approach is gaining ground in several jurisdictions. This is the case in the United States following the publication last year of a report by the House of Representatives recommending the introduction of specific constraints and obligations on large technology companies. In China, regulators have gone as far as requiring some big techs – which offer several financial services – to become financial holding companies. As such, these big techs will need to satisfy prudential and conduct of business requirements across the entirety of their group. That approach may eventually prove to be helpful in other jurisdictions if big techs continue gaining market shares of a range of financial services.

The European Union's Digital Financial Package contains a number of newly created entity-based rules for big techs. In particular, the European Commission's proposal for a Digital Markets Act has specific requirements to prevent market abuse by firms that are considered to be "gate keepers". Those requirements affect areas such as information obligations, interoperability, access criteria and data sharing. Moreover, the Digital Services Act establishes specific rules and obligations for big tech platforms to protect users' rights and prevent the misuse of their platforms for illegal purposes.

In the area of operational resilience, the proposal for a Digital Operational Resilience Act constitutes an important first step in addressing the increased reliance by all financial institutions on technology and third-party providers. It would also help to regulate some relevant services provided by big techs such as cloud computing. However, in order to minimise the disruption that operational failures could cause to the economic and financial system, specific entity-based requirements affecting the big tech groups as a whole, and not only some of their subsidiaries, could also be warranted. This would help to safeguard primary policy objectives and it would also help to address competitive distortions which are emerging as a result of the paucity of regulation applied to big techs as compared with that applied to banks.

NATASHA CAZENAVE
Executive Director, European Securities and Markets Authority (ESMA)

Tech companies in finance: developments and implications for EU authorities

One of the pandemic's striking consequences has been the acceleration in the digitalisation of our societies. Covid-19 has made us rely more not only on innovative technologies, but also on the companies that provide them. Technology-powered business models that operate across different economic sectors are booming in these times of crisis.

Although their footprint in the financial sector is still limited at global level, with China-based firms offering the widest range of services, BigTechs have the potential to capture significant market share in the EU, including through partnerships with incumbents.

Not only have BigTechs been bolstered by the crisis, they can also bank on solid competitive advantages. Their large customer networks generate huge amounts of data, to which they can apply advanced analytics to understand customer needs. Like FinTech start-ups, they enjoy 'digital proximity' to clients who can use their services at the touch of a button. This reduces the advantage of physical proximity represented by the established branches of incumbent financial providers.

By tailoring their offerings and using the most up to date technologies, BigTechs and FinTechs can integrate different services, increase efficiency, and improve customer experience. Developments such as these are welcome, not least as they may promote financial inclusion. The tools developed by technology companies may have other useful applications, such as helping firms and authorities detect cases of misconduct, thus contributing to the integrity of markets.

Despite these potential benefits, BigTech and FinTech business models also bring some risks. While BigTechs entering the financial sector are likely to boost competition in the short run, they may in the longer term gain a dominant position in the market, putting at risk financial stability in the context of heightened interconnection between financial markets and technology services. Besides, cyberattacks are becoming a growing concern due to their increasing frequency and impact on digital platforms and financial entities. Finally, from the perspective of consumers, threats to privacy, poor sales practices, and price segmentation cannot be excluded.

Innovation can go hand in hand with investor protection and orderly financial markets.

It is our duty to be aware of these possibilities to ensure that the EU regulatory and supervisory framework remains fit for purpose. At ESMA, we believe that innovation can go hand in hand with investor protection and orderly financial markets and welcome the development of a comprehensive framework.

For this reason, ESMA fully supports the Digital Finance Package proposed by the European Commission (EC), which builds on 2019 ESMA Advice. The Regulation on Markets in Crypto- Assets (MiCA) is especially timely given the growing importance of blockchain based offers and recent developments around stablecoins. In addition, the pilot regime for market infrastructures based on Distributed Ledger Technology (DLT) will provide a welcome safe space for market participants, including players from the Tech world, to experiment using the technology. The legislative proposal for a Digital Operational Resilience Act (DORA) is a pivotal initiative to streamline and strengthen rules for entities across the financial sector, helping safeguard the financial system. ESMA actively supports the EU co-legislators as they refine these proposals.

To deepen our knowledge on how technology is shaping financial markets, ESMA launched a call for evidence on digital transformation and the application of innovative technologies in the EU financial sector. This call for evidence will gather information on i) fragmented or non-integrated value chains, ii) digital platforms and bundling of financial services, and iii) groups providing both financial and non-financial services. The feedback received will contribute to ESMA's technical advice to the EC which will outline, where relevant, proposals for changes to the existing legislative framework.

Last but not least, coordination among the three ESAs will be crucial to address the challenges posed by innovative financial technology as the business models are more and more cross sectoral. The work of the European Forum for Innovation Facilitators (EFIF) is a case in point. Established following a Joint ESA report on regulatory sandboxes and innovation hubs, the EFIF provides a platform for supervisors to meet regularly to share experiences from engagement with firms through innovation facilitators, to share technological expertise, and to reach common views on the regulatory treatment of innovative products, services, and business models.

All these initiatives – whether legislative or not – will help us achieve a Capital Markets Union that embraces the digital transition. ESMA, in line with its mandate, is committed to be a key enabler in this journey. To this end, we will continue our work on the convergence of supervisory practices and the development of a sound regulatory environment supporting the scaling up of technological innovation in the financial sector across the EU.

LIE JUNIUS

Director EU Public Policy and Government Relations, Google Cloud

Cloud adoption in digital finance: trends, regulatory hurdles and outlook

The financial services industry is changing at a rapid pace, with shifting consumer expectations, new technologies, and continuously evolving regulatory requirements. Financial services firms need the right technology to help them stay agile and prepare for the future.

The cloud is a key point of leverage for firms looking to improve performance across a broad range of activities. Moving to the public cloud can advance operational resiliency, staff productivity, increase regulatory compliance, and enhance business model innovation.

However, there are a number of financial services companies in Europe and globally that are still hesitant in their cloud journeys. The barriers to adoption vary, from the complexity of the legacy systems, trust and skills gaps, to regulatory uncertainty and fragmentation of supervision and compliance requirements. Although many companies have embraced the benefits of cloud technology, more robust cloud adoption—especially around core back-office functions—will require additional stimulus.

To better understand the challenges and opportunities of cloud adoption in financial services, Google Cloud, together with the Harris Poll, surveyed more than 1,300 leaders from the financial services industry across North America, Europe and APAC. Here are our key findings:

1. **A vast majority of financial services companies are already using some form of public cloud.** Of those using cloud technology, the most popular architecture of choice is hybrid cloud (38%), followed by single cloud (28%), and multicloud (17%). Notably, of respondents without a multicloud deployment, 88% reported they are considering adopting a multicloud strategy in the next 12 months.

2. **Financial services institutions in North America are leading in cloud adoption.** The lowest level of cloud adoption was reported in Japan (42%).

3. **As financial services companies continue to use the cloud, more core functionalities can be migrated.** While many financial services companies have migrated substantial workloads to the cloud, the industry is far from full adoption when it comes to core, back-office workloads. Data and IT security (74%), regulatory reporting (57%), and fraud detection and prevention (57%) rank among the highest workload adoption. Core underwriting activity (40%) and data reconciliation (48%) ranked lowest.

Cloud adoption will advance resilience, productivity and innovation but needs enabling regulation.

4. **Among respondents, there is a high positive perception of the potential for cloud technology to assist in business operations and regulatory compliance.** Nearly all respondents (>88%) agreed that cloud adoption can enhance operational resilience, support the creation of innovative new products and services, and enhance firms' data security capabilities.

5. **Certain regulatory challenges, including complexity of the sectorial compliance frameworks, and fragmentation of the supervisory practices, create hurdles to cloud adoption for financial services companies.** While 88% of respondents had a positive view of current regulatory efforts to provide guidance and clarity for cloud implementation, the results showed that more needs to be done to facilitate adoption. Most respondents (84%) agree that regulatory reviews and approvals take too long because of fragmentation of supervisory practices within the regulatory bodies. And 78% say that regulatory uncertainty over the use of public cloud prevents their organizations from adopting cloud technologies that would otherwise provide benefit to them.

Europe has been leading policy and regulatory agenda when it comes to cloud adoption in financial services. Initially the European Supervisory Authorities Outsourcing Guidelines paved the way for harmonisation of the regulatory requirements to cloud in the European Union, and largely became a benchmark globally. Now with the forthcoming Digital Operational Resilience Act (DORA) EU Financial regulators will have direct oversight over the critical providers introducing regulatory risk monitoring and mitigation processes.

If done right, DORA has a real potential to stimulate innovation and enhance trust and assurances in the new technology. However there are significant risks in national fragmentation with conflicting and overlapping Member State oversight regimes evolving in parallel (eg FISG in Germany). DORA needs to affirmatively remove this fragmentation and in time evolve into a practice of consistent regulatory action that will help guide adoption by the regulated firms - including by superseding the burdensome regulatory reviews and approvals of material outsourcing workloads, and individual customer audits.

At Google Cloud, we're committed to working with financial services customers and regulators to provide them with controls and assurances on risk management, data locality, transparency, and compliance, and have constructively engaged in the DORA discussions.

DANIEL KAPFFER
Chief Financial Officer
& Chief Operating Officer
DekaBank Deutsche Girozentrale

Tech is Tech and Finance is Finance

Three different potential roles of tech companies in finance

As technology becomes more sophisticated, there is a tendency to make things more complicated than they actually are. We also seem to have forgotten the difference between what is technologically feasible and what makes sense from a (macro) economic perspective.

Therefore, I will refer to a very simple three-layer model. At the top is the financial services client, with his needs. This may be for example the desire to finance private housing or to prepare for retirement. Next comes the financial service or product.

It usually requires specific know how and capabilities. In most cases, the provider needs to hold capital and liquidity buffers. Finally, the third layer is the technology used to deliver the service or product to the client.

Tech companies take three different relevant roles in finance: The role as a provider of financial services, an intermediary to financial services providers or a provider of tech services.

It is the nature of the service that matters, not the heritage or main business purpose of the provider

The authority to regulate financial services is in almost all cases dependent on the classification of the company, i.e. it is "entity based". In addition, sometimes in order to drive innovation tech companies may be less subject to regulation. However, financial services provided by these companies need to be regulated in the same way, i.e. "action based". This is also a question of ensuring a level playing field in the financial services market.

Take the example of Wirecard. Part of the failure on the supervisory side was to classify it as a tech company. Even though it offered payment services based on technology. Would the same conclusion have been reached for any incumbent bank that used technology for payment services to the same extent?

> **It is the nature of the service that matters, not the main business purpose of the provider.**

Agent economy with potentially negative impacts

Another notable player in the level playing field of financial services will be the increasing number of cloud-service providers and the role of cloud services. Cloud applications are needed to provide frequent innovations to clients and ultimately remain competitive not only against traditional players but also FinTechs or BigTechs. Actually, it can observed that tech companies do not want to provide financial services because they are fully aware of the complex and expensive regulation. Often, their aim is to position themselves as intermediaries only at the interface to the customer. In the short term, this can have a positive impact as the consumer has access to a wider range of options. However, if they achieve significant distribution power in this role, then there are some undesired consequences.

In terms of consumer protection: the producer of the service loses the connection to the client - the client can no longer judge how reliable the service provider is and the provider does not have detailed knowledge of the client's needs.

In terms of efficiency and competitiveness: there are several providers trying to make a margin out of the same service as before (direct contact customer - provider). This either needs to result in higher cost for the client or will limit the number of products available to him. The intermediary could steer the available products based on financial incentives of the providers.

Sufficient initiatives to regulated tech services when it comes to cloud

While the genuine role in providing tech services is well established, the cloud outsourcing market, and the way the technology is used offers new digital challenges. The cloud is more than flexible hardware capacity. It is becoming the source for running applications and providing banking services over the internet.

Today, cloud services are concentrated in the hands of a few large CSPs, currently based outside the EU. The size and scale of such platforms pose significant risks to operational resilience. In addition the concentration of the CSP market raises questions about the imbalance of market power between CSPs and the individual firms that use them.

While CSPs operate globally, the responsibilities of regulators and supervisors are typically national and increasingly fragmented in their approaches.

In the cloud services sector, authorities also need to decide to what extent the CSP is regulated and how relevant the business itself needs to be supervised. We need to ensure that European financial services providers can use cloud services at least within an adequate framework to ensure their competiveness in the global level playing field.

DIANA PAREDES
Chief Executive Officer
& Co-founder
Suade Labs

The future of technology in financial services

The future of technology in financial services is very bright. Recent policy developments around the world are reflective of governments and regulators' aspirations to foster the growth of the FinTech sector by encouraging investment in digital technology, training talent with digital technology skills, and creating a regulatory environment that is friendly to FinTech companies. As a result, investment in the sector has grown significantly, reaching $44 billion across 3,052 deals in 2020 according to research published by Finextra. Thanks to the significant variety of FinTech players, stakeholders across the financial services industry stand to benefit.

The promise of FinTech

FinTech promises to improve financial inclusion by increasing access to finance for the most disadvantaged in society. A report by the Boston Consulting Group highlights success stories of digital banks in Asia that leverage open APIs to create a digital ecosystem that brings low-interest rate loans to SMEs that are underserved by the traditional banking system.

At the same time, technological developments in regulatory compliance are revolutionising regulatory supervision. The RegTech sector, frequently considered a subsector of FinTech, has made many aspects of regulatory compliance more efficient, including regulatory reporting, anti-money laundering, and know-your-customer requirements. Research published by Suade highlights the potential of applying digital technologies and data standardisation to regulatory reporting processes at financial institutions to improve efficiencies, create cost savings, and increase the accuracy of reports submitted to regulators. The new regulatory regime for investment firms offers an interesting example where Suade has helped investment firms to digitalise their regulatory reporting processes. Investment firms have benefitted from being able to manage regulatory updates and achieve the auditability and granularity required with unparalleled speed and accuracy. In short, deploying technology to the financial services industry creates significant benefits for all stakeholders across the economy.

Existing proportionate and agile approaches to regulation show real promise in creating a FinTech-friendly regulatory ecosystem that fosters innovation, and research and development.

FinTech vs Incumbents

To further solidify these benefits, it is important to consider the position of the FinTech sector in the regulatory system, as it has important policy consequences for regulators and the FinTech sector alike. Regulators face the challenge of ensuring existing regulatory approaches continue to achieve their overarching policy objectives. Meanwhile, the FinTech sector must manoeuvre a regulatory system that was designed with incumbent players in mind. In a speech to the European Parliament in June 2021, Fernando Restoy of the Bank for International Settlements advocated for entity-based regulation designed specifically for the FinTech sector. This would allow regulators to deal with FinTech-specific challenges. At the same time, it would present regulators with an opportunity to create a regulatory system that fosters innovation. The latter is already being achieved with significant success around the world. Regulators are implementing successful programmes of proportionate and agile regulation, whilst providing guidance and support to innovative businesses in the FinTech sector.

Proportionate and agile regulation

For FinTech banks, for instance, proportionality measures in prudential regulation go a long way towards creating a stable ecosystem within which FinTech players can safely bring their products to market without adverse consequences on their operations. The European Union's Capital Requirements Regulation 2 introduces such proportionality measures across capital and liquidity requirements.

In the United Kingdom, the Kalifa Review recommends expanding existing regulatory sandbox programmes to what the review calls a 'scalebox'. The scalebox is designed to make the Financial Conduct Authority's regulatory sandbox available year-round, while offering additional advice and encouraging collaboration between incumbent financial institutions and FinTech and RegTech companies.

The UK's Information Commissioner's Office (ICO) provides detailed guidance on a variety of topics to assist organisations with understanding data protection laws. On the question of anonymisation, the ICO has drafted guidance that should assist FinTech businesses in understanding when personal data is sufficiently anonymised. This will assist developers trying to identify suitable training data, whilst being fully compliant with data protection laws.

Throughout the COVID-19 pandemic, the Monetary Authority of Singapore (MAS) introduced a number of measures designed to support FinTech companies through the economic impact of the pandemic as well as foster growth in the sector post pandemic. The measures include a variety of grants designed to support training and digital acceleration.

These regulatory and policy developments are part of an important trend towards encouraging FinTech growth, innovation, and development. Existing proportionate and agile approaches to regulation show real promise in creating a FinTech-friendly regulatory ecosystem that fosters innovation, and research and development.

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DIGITAL OPERATIONAL AND CYBER-RESILIENCE

JOACHIM WUERMELING
Member of the Executive Board, Deutsche Bundesbank

How to make DORA work – a banking supervisor's perspective

With the Digital Operational Resilience Act (DORA), the EU has begun to forge an effective European oversight framework for banks' ICT[1] risks and for critical ICT third-party providers. In particular, stricter regulation of ICT service providers, including cloud providers, aims to create a level playing field for all financial services providers. Nevertheless, we will need to keep improving supervisory standards further in this rapidly evolving setting.

To me as a banking supervisor, DORA does indeed address today's most important challenges for managing ICT risks. The oversight framework for critical ICT third-party service providers complements the supervisory approaches taken within the Single Supervisory Mechanism (SSM) and at the national level. While the SSM focuses on the risks that financial institutions take when they outsource activities to ICT third-party providers, DORA enables the European Supervisory Authorities (ESAs) to access critical ICT third-party providers directly and sanction them if necessary. The DORA proposal raises some crucial points regarding the interplay between (traditional) banking supervision and the new European oversight framework. First, efficiency of supervision.

If the ESAs increasingly engage in supervising cloud providers, they must ensure that they do so in an efficient manner and without duplicating work. The same issues should be examined only once and by just one authority. This implies that we must clearly define the responsibilities of both banking supervisors and the ESAs in order to avoid a clash of competencies. Under the proposed regulation, the ESAs will perform operational oversight functions for critical ICT service providers. This includes on-site audits, ongoing supervision and recommendations for action. In contrast, banking supervisors are to stick to their mandate of supervising financial institutions. The supervision of critical ICT service providers is therefore at most only indirectly within the scope of banking supervisors.

To make DORA work, clear-cut competencies, close collaboration and consistent rules are key.

Second, closer cooperation among authorities. If the ESAs directly supervise critical ICT third-party providers, this will make the supervisory landscape more complex and will increase the need for cooperation with supervisors. So in the end, it is all about striking a balance between (national) supervision and the new European oversight framework. One example is the "Joint Examination Teams" that the ESAs will set up to conduct on-site inspections at the premises of critical third-party providers: these teams will comprise staff from both the ESAs and the relevant competent authorities.

Moreover, authorities could also cooperate closely when identifying critical ICT third-party providers and evaluating concentration risk – supervisors could contribute valuable information here. Against this backdrop, I strongly support what has been proposed under DORA: in order to prevent future cyber-attacks and reduce ICT threats to the financial system as a whole, we need to strengthen information sharing, and we need to strengthen cooperation between the ESAs, supervisors and other relevant stakeholders such as the European Union Agency for Cybersecurity.

Third, consistency of rules. It is important that the rules set out by DORA are consistent with the existing rules in banking regulation. Otherwise, this would fragment regulatory standards even further and overburden banks that engage in outsourcing arrangements. Europe-wide standardisation of ICT regulation, incident reporting and ICT testing requirements reduce the regulatory burden for the financial sector, especially for cross-border firms. However, standardisation also narrows the scope for implementing rules in a proportionate manner. Here we must ensure that regulation continues to be as principle-oriented and technology-neutral as possible.

To sum up, DORA can be viewed as a milestone towards an effective oversight framework for banks' ICT risks at the European level. In order to make it work, clear-cut competencies, close collaboration among authorities and consistent rules are key. An effective interplay between banking supervision and the new oversight framework has the potential to reduce banks' vulnerability to ICT risks and promote financial stability in Europe.

[1] Information and Communication Technologies.

BILLY KELLEHER
MEP, Committee on Economic and Monetary Affairs, European Parliament

Risky Business: protecting our financial systems from ICT risk

The digitalisation of financial services is nothing new. Wallets are stored on phones; insurance premiums are calculated by algorithms; shares are traded in microseconds; and our data is increasingly stored in clouds. The direction of travel is also only going one way. We must embrace the efficiencies digitalisation brings and continue to innovate to make our markets even more competitive.

As a result of this trend, the financial and digital sectors are increasingly integrated with financial services relying more and more on the ICT sector. This gives rise to operational resilience and concentration risks and, in turn, increased financial stability risks. These evolving risks have been considered at length by supervisory authorities on the global level. In the context of these discussions, in September 2020, the Commission proposed the Regulation on Digital Operation Resilience (DORA) as part of its ambitious Digital Finance Package.

Over the past year, the co-legislators have been negotiating their respective positions before entering into trilogue negotiations. The Portuguese Presidency came close to reaching a general approach towards the end of its term but ultimately could not get it over the line, thereby leaving the Slovenian Presidency to take the reins.

As the European Parliament's appointed rapporteur on DORA, I have the challenge of navigating the Parliament's negotiating team through what is a very technical proposal against the backdrop of a continuously evolving digital landscape. With internal discussions progressing well, we aim to reach agreement on our position in the Autumn.

There is broad support in the European Parliament for the objectives of DORA and general consensus on the priorities the Parliament's position should reflect, yet how these should manifest is still under discussion.

1) Proportionality

The concept of proportionality is imperative and multifaceted. The Regulation must be proportionate in respect of the requirements on the financial entities within the broad scope. These vary in size, complexity and nature yet each may be subject to digital operational risk. Moreover, the DORA framework must strike a balance between proportionality and prescription and must avoid duplication or conflict with existing requirements on the entities in scope. The Parliament negotiating team is aware of the potential overlap between DORA and *Directive (EU) 2016/1148 concerning measures for a high common level of security of network and information systems across the Union* (the NIS Directive), as well as the proposed revision of this Directive (NIS 2.0). Furthermore, the negotiating team are cognisant of the requirements certain sectors have been complying with to date and the procedures and processes already put in place and want to avoid the need for an overhaul of these.

We must proceed with caution to avoid hampering the competitiveness of the Union and its businesses.

Furthermore, the framework must be proportionate in terms of the level of scrutiny and oversight placed on non-financial entities, that is to say the third-party ICT service providers. Finally, the requirements must take account of the available resources and expertise of the supervisors. A deluge of data has little value if it cannot be processed and considered.

2) Future-proof

The co-legislators are acutely aware that they are legislating on a moving target. And, we must not hinder this movement. The Regulation needs to be flexible enough to adapt to innovations rather than be so prescriptive as to limit or steer developments in one particular direction. Furthermore, alongside innovations in the financial and digital sectors, DORA needs to foresee the emergence of new ICT risks and provide financial entities with the space to respond to these.

3) Preservation of competitiveness and innovation

As a liberal, this priority is of particular importance to me. I am a strong advocate for the introduction of regulation in the area of digital operational resilience and welcome the Commission's ambitious approach to including third-party ICT service providers within the DORA framework. However, we must proceed with caution to ensure that it does not in any way hamper the competitiveness of the Union or European businesses vis-a-vis global competitors, nor innovation in the financial or digital sectors.

Both co-legislators have identified DORA as a priority and hope to reach agreement on the file in the coming months. However, we will not compromise on quality and accuracy in pursuit of a quick deal. This is a detailed and technical file with impacts on several sectors, and therefore must be given the necessary attention and consideration.

ANA TERESA MOUTINHO

Head of the Supervisory Processes Department, European Insurance and Occupational Pensions Authority (EIOPA)

Digital operational resilience: addressing risks of the digital transformation

Digital operational resilience is essential for a well-functioning financial services sector. As the digital transformation of the sector accelerates, addressing the risks of digital innovation becomes increasingly important.

The proposal for a Digital Operational Resilience Act – or DORA, as part of the European Commission's digital finance strategy, sets out to establish a comprehensive framework enabling a stronger supervision of the digital dimension of the sector. The proposal builds on work already conducted by the European Insurance and Occupational Authority (EIOPA), the European Banking Authority and the European Securities and Markets Authority (making up the European Supervisory Authorities, or ESAs).

EIOPA welcomes the overarching principles of the proposal. The proliferation of digital technology across the entire insurance value chain increases the exposure of insurers to the risk of a major disruption if technology fails whether through deliberate attack of system flaw. Similar risks can be identified for insurance intermediaries and in the occupational pensions sector. Regulatory requirements are therefore needed to ensure a proper management of such risks and capture the use of different technological solutions used.

The proposal aims to ensure that market participants have sufficient safeguards in place to protect against cyber attacks and other risks.

There are some clear benefits of such a framework, notably in terms of enhanced supervisory convergence across financial sectors and an overall stronger, more resilient financial sector. The implementation of DORA should improve the management of ICT risk by the financial sector, including improving testing of undertakings' ICT systems. It should also increase awareness of threats and risks among supervisors.

Digital operational resilience is essential for a well-functioning financial services sector.

All three ESAs are in firm agreement with the main principles of DORA, in particular as it will help to close the gap in terms of oversight of critical third party providers. Nonetheless, the ESAs believe that, in its current form, the proposal warrants some further reflection. In particular, there is scope for more streamlined and effective governance; a need for more coherence between oversight recommendations and follow-up; and the need for more proportionality considering the wide scope of the Regulation.

One measure of a regulation's success is the effectiveness of implementation. For DORA to work effectively, the ESAs – who will bear the most responsibility for its implementation – must be appropriately empowered – in terms of both resources and regulatory powers. In EIOPA's view, the current proposals have not yet sufficiently considered this point, with regard to both the quantity and quality of resources needed.

An effective framework should bring confidence to the market and act as an enabler of the digital economy.

A sound cyber insurance market is also an enabler of the digital economy. From raising awareness of the risks and losses that can result from cyber attacks to facilitating responses and recovery, a well-developed cyber insurance market can play a valuable role in risk management across the economy.

The European cyber insurance market is growing rapidly. This is in part due to the overall increase in written contracts offered by insurers, but also because of the growing number of insurers providing cyber insurance. In addition, the increasing frequency of cyber attacks, coupled with stricter regulation regarding cyber security as well as continued technological developments are all expected to increase demand for cyber insurance in the near future.

In the context of its cyber underwriting strategy, EIOPA has identified a number of conditions that are essential for a resilient cyber insurance market. These include the presence of appropriate cyber underwriting and risk management practices; adequate assessment and mitigation tools to address potential systemic and extreme risks; a mutual understanding between policyholders and insurers of contractual definitions, conditions and terms; and an adequate level and quality of data on cyber incidents available at European level. This last point has clear synergies with DORA, which also calls for the collection of data on cyber incidents. It is fundamental that a centralised collection of such cyber incidents is considered from the beginning and have in mind a potential wider use in the future. Ultimately, the access to cyber incident data, potentially a European Database, could be seen as a public good and underpin the further development of the European cyber insurance industry and act as an enabler of the digital economy.

As part of its work to support the market supervisory community through the digital transformation, EIOPA will therefore continue to implement its cyber underwriting strategy as well as standing ready to play an active role in the implementation of DORA.

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Regulating and Supervising ICT Risk in the financial sector

In a dynamic financial world, regulation and supervision must be easily adaptable to remain effective. The development of business models which are largely based on technology as well as the digitisation and digitalisation of financial services have created new challenges for financial supervision. The financial system has become more reliant on ICT infrastructures and the confidentiality, integrity and availability of data and systems. Developments in this field are constantly challenging the status quo and, at times, required and still require a quantum leap in the regulatory framework, and the knowledge, tools and systems adopted for financial supervision. In this regard, cyber risk is considered of systemic relevance[1] and must be properly addressed.

The proposal for a Digital Operational Resilience Act (DORA), published in September 2020 by the European Commission, originates from the FinTech Action Plan of 2018. It follows a set of recommendations by the European Supervisory Authorities on: [i] legislative improvements relating to ICT risk management requirements in the EU financial sector; and [ii] an EU wide coherent cyber-resilience testing framework. In view of the: [i] challenges that ICT risks continue to pose on the resilience, performance, and the stability of the EU financial system; and [ii] financial services industry reportedly experiencing more cyber-attacks than any other industry (before and during COVID-19), the proposed Regulation was necessary to ensure a more coherent and harmonised approach to the regulation of cyber risk. Indeed, until the adoption and implementation of DORA, ICT risk will continue to be treated in different ways by national competent authorities. The resulting inconsistencies in approach have brought about a proliferation of individual national regulatory initiatives.

DORA addresses lacunae, as well as the fragmentation and inconsistencies, within the current financial services legal framework that regulates digital operational resilience. It also addresses the lack of incident reporting requirements for some sectors, which impedes the proper calibration and implementation of prudential requirements. The proposal attempts to streamline and simplify the incident reporting process for some sectors with multiple, and sometimes overlapping, reporting regimes. Although the provisions on information sharing arrangements on cyber threat information and intelligence are on a voluntary basis, this is a good starting point towards better participation in, and co-ordination of, the exchange of such information.

Once adopted, DORA will establish a common digital operational resilience testing framework.

Once adopted DORA will establish a common digital operational resilience testing framework. This will potentially build on already established frameworks for advanced testing, with the aim of better homogeneity, with an approach that can be recognised and accepted across Member States. The digital operational resilience framework will address the risk of segmentation in the single market and will strengthen supervision by requiring a more coordinated supervisory approach. A noticeable increase in the use of cloud services providers have resulted in concerns regarding their systemic nature. In this regard, DORA seeks to ensure sound management of ICT third party risk for financial entities and provides for the centralised supervision of designated critical ICT third party service providers by the European Supervisory Authorities.

Notwithstanding these benefits, there are areas that may require further improvement. The proportionality principle is probably one of these areas. It is acknowledged that it is not an easy task to achieve a balance between a cross-sectoral homogeneous approach, and the differences in the risk and level of interconnectedness that the various financial entities and sectors inherently pose on the overall financial system. DORA aims to embrace and support the digital transformation of the European financial system and therefore one may need to further consider its implications on innovation and potential new entrants. The Act will invariably produce a substantial number of Regulatory Technical Standards which may be regarded as a compliance overload especially for small-scale operators. The proposed timelines for the implementation DORA may also be difficult to achieve in practice, particularly when considering the time required for drafting and implementing the necessary proposed Regulatory Technical Standards.

Unless regulation and supervision keep up with change in the financial world, the framework for this purpose will not be in position to address the emerging risks within the financial system effectively. DORA is an excellent example of how Europe is addressing this challenge.

[1] *ESRB, Cyber Systemic Risk, February 2020, available https://www.esrb.europa.eu/pub/pdf/reports/esrb.report200219_systemiccyberrisk~101a09685e.*en.pdf?fdefe8436b-08c6881d492960ffc7f3a9

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Building a more resilient European Infrastructure

The persistent increase in ransomware attacks against critical infrastructure and information technology companies across industries has reinforced the need for resilient business operations. Within the financial services sector, cyber attacks continue to increase in both sophistication and impact, requiring financial entities and authorities to fully assess and understand the resilience of business operations to these threats.

While the financial services industry has performed well throughout the course of the pandemic, it has also highlighted opportunities to further automate and integrate new technology into service offerings. At the same time, the introduction of large technology companies into the financial services sector places pressure on incumbent financial entities to adjust their business models and financial authorities to further examine their oversight frameworks.

In the EU, the European Commission (EC) recognizes the increased digitalization of financial markets; the importance of resilience and innovation to the success of this market; and the potentially significant impact that inadequate cybersecurity or resilience could create.

To increase the resilience of critical infrastructure within the EU and improve the cybersecurity posture across Member States, the EC has introduced three (3) primary texts:

- The Directive on the Resilience of Critical Entities (RCE)
- The Directive on Security of Network and Information Systems (NIS2)
- The Regulation on Digital Operational Resilience for the Financial Sector (DORA)

These texts will provide the foundation for a more resilient European infrastructure and build on lessons learned from prior legislation such as NIS and the European Critical Infrastructure Directive. As these frameworks are instituted and to ensure the best outcomes, it is imperative that the EC and Member States:

- Drive regulatory consistency
- Align with international standards and industry best practices
- Streamline cyber incident reporting

Recognizing these objectives, it is important that the regulatory approach to cybersecurity and resilience by EU Member States be uniform and create a level playing field for financial entities, regardless of the Member State in which they operate.

To build a resilient EU, we must have open dialogue and extensive public/private partnership.

Drive regulatory consistency

The proposed frameworks provide the structure needed for Member States to develop their cybersecurity approaches. While there is a need for flexibility based on each Member State's individual risks, it is important that these strategies are coordinated to avoid fragmentation across the European markets.

Horizontal legislation, such as NIS2, should be aligned with current sector-specific legislation to the extent possible. Lastly, there have been numerous supervisory texts on operational resilience of which cybersecurity is one component. Efforts to align these Directives with the cyber component of operational resilience principles will further limit fragmentation across the EU.

Align with international standards and industry best practices

Operational resilience is forcing financial entities and authorities to review the resilience activities of both the financial entity itself and that of their third parties suppliers and supply chain. Both DORA and NIS2 look to establish frameworks covering third-party oversight, and specifically that of Information and Communication Technology (ICT) providers. It is important that any changes to the current third-party oversight framework consider the current work being conducted by the standards bodies including FSB and IOSCO to prevent conflicting or duplicative effort in this space.

Streamline cyber incident reporting

Cyber incident reporting protects the financial system by making financial authorities aware of incidents impacting the sector, alerting these authorities to potential cross-border impacts, assisting financial authorities with understanding the current threat landscape and providing visibility into areas where guidance may further aid the sector with protecting its systems from emerging threats.

The current regulatory landscape contains numerous and diverse frameworks for incident reporting. While NIS2 and DORA call for the standardization of format and templates for this reporting, other bodies are also aiming to provide guidance in this space. Therefore, it is important that the efforts be coordinated to the maximum extent possible and replace existing national approaches.

Conclusion

While the current proposed frameworks to enhance the resilience of the EU's infrastructure provide a solid foundation to support innovation and security, there remains much work to do to drive consistency across the region. This alignment is beneficial to both the financial authorities as well as the financial entities. To build a resilient EU, we must continue to have open dialogue and extensive public/private partnership to deliver the goals set out for innovation and security across the EU.

LORELIEN HOET

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The NIS2-DORA interplay. A knot untied

The resilience of the financial sector and its increasing reliance on digital services are key issues that require proportionate and harmonised regulation at the EU level. The DORA Proposal for Regulation is a crucial step to accelerate the digital transformation of the financial sector and create a Cloud ecosystem based on security and trust. However, for such a regulatory effort to be truly effective, its provisions should sufficiently reflect the reality of financial and ICT sectors. While we welcome the progress made in the latest Council compromise in June/July 2021, we believe there are outstanding issues that both MEPs in the ECON committee and the Slovenian Presidency will have to address in the months ahead. Among them, the most consequential is the interaction between the horizontal provisions in NIS2 and the sector-specific requirements envisaged by DORA.

Although the DORA proposal foresees a clear hierarchy between DORA and NIS2 for financial entities, it does not do the same for ICT service providers. As a result, under DORA, cloud service providers designated as "Critical ICT third party service provider" (CTPP) will be placed under the oversight of a Lead Overseer at EU level, who can issue concrete resilience recommendations towards them. Under NIS2, the same cloud computing providers (considered essential entities) will be placed under the supervision of the National Competent Authority, who must ensure that those entities take appropriate measures to manage security risks. This situation risks leading to overlapping and potentially inconsistent or conflicting requirements – which the cloud service providers would not be able to comply with without infringing one or the other framework.

From a conceptual perspective, the ideal solution to deal with this complex overlap of horizontal and vertical regulation would have been to first finalize the single and cross-sectoral approach under NIS2, providing a baseline resilience layer, and to complement that layer afterwards with sectoral regulation like DORA that builds on the horizontal framework. Yet, the reality of the EU legislative framework requires that we need to address this interplay by proposing changes to both DORA and NIS2 simultaneously.

Concretely, under DORA, we see a need for targeted amendments to Articles 30-31 of DORA to attribute a clear responsibility for the Lead Overseer to consult the NIS2 competent authorities that have jurisdiction over the critical ICT third party service provider concerned - so as to avoid duplication/inconsistencies of resilience requirements and of investigations.[1] Equally, we recommend to strengthen the co-operation mechanisms foreseen in Article 42 of DORA and plead for a larger role for ENISA under Articled 18 (1) and 23 (4) of DORA, to ensure that the detailed requirements on testing and incident notification for the financial sector will remain sufficiently aligned with general cyber standards and practices that apply beyond the financial sector.

The DORA Proposal for Regulation should sufficiently reflect the reality of financial and ICT sectors.

Under NIS2, the current overlap between the two regulatory frameworks is embodied in the wording of Art 2(6) of NIS2. This article foresees that sector-specific regulation shall prevail over NIS2 to the extent that those sector-specific requirements are at least equivalent to NIS2. According to this principle, the Regulation on digital operational resilience for the financial sector will be considered lex specialis to the NIS Directive once it has entered into force. Yet such an attempt to structurally solve the interplay between different security regulations is no effective solution for cross-sectoral services. Indeed, a sector-specific regulation affects only a part of the services offered by Cloud providers. DORA, for instance, only applies to Cloud services when they are deployed in the financial sector, hence the cross-sector providers will have to comply simultaneously with the provisions enshrined in the horizontal framework for services offered in other sectors[2]. The regulatory landscape would worsen in case the European legislator foresees more vertical regulation in sectors such as energy, health or others. In this case, Cloud providers would be forced to comply with a plethora of sectoral legislation, each with its own specific requirements.

That is why we propose to amend art 2(6) to limit its application to those services and entities which are regulated in their entirety by the sector-specific regulation. This will ensure that the sector-specific cybersecurity risk management measures and notification obligations are consistent with both NIS2 and DORA. Cross-sector services, on the other hand, require ad hoc solutions to ensure the coordination and alignment of the vertical and horizontal frameworks applicable to such services.

[1] In this respect, a number of very constructive amendments have been proposed by MEPs in the ECON Committee list of amendments (am. 693, 694, 701, 702, and 704).

[2] In any event, the provisions in Art 2(6) do not appropriately reflect the existing overlap between DORA and NIS2 for Critical Third-Party Providers (CTPP). Indeed, Article 29(5) of DORA prescribes that the oversight framework foreseen in the Regulation shall apply without prejudice to the application of NIS2, thereby failing to provide clarity regarding the hierarchy between the two legislative frameworks and certainly not endorsing the solution proposed in Article 2 (6) NIS2.

NEW TECHNOLOGIES IN SECURITIES MARKETS

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New technologies in EU securities markets: evolution or smart revolution?

During the last decade, rapid and profound technological developments have reshaped how securities markets work worldwide, especially in the European Union. They have affected the entire breadth of financial markets, from the rise of robo-advisers and pre-trade analytics to trading via all-digital neo-brokers and investing via exchange-traded funds. Similarly, new technologies affect clearing, settlement and other post-trade aspects. The COVID-19 pandemic has only reinforced this trend, causing an increased adoption of digital technologies across the board – spanning from the use of cloud services to a veritable market frenzy over crypto assets. All of these developments affect the Capital Markets Union (CMU) significantly – even crypto assets, if they are predominantly used for financing (initial public coin offerings) and not for payment purposes.

This disruptive change means it is now time to take stock and consider the consequences of new technologies for the further development of EU securities markets. Should we expect evolutionary changes in the near future? Or will we instead see a revolution in how securities markets work in the CMU? If so, how can we make it a smart revolution?

The three main new emerging technologies relevant to the future of EU securities markets are 1) cloud services, 2) artificial intelligence (AI) and 3) distributed ledger technology (DLT) including smart contracts and crypto assets. All three technologies have the potential to increase efficiency across the securities life cycle and the entire transaction value chain. However, these new technologies differ in the degree to which they will disrupt existing securities market infrastructure. Most represent only evolutionary enhancements of existing market architecture while some may bring very profound changes in the long-term to how securities markets function.

CMU will benefit enormously if debt securities turn smart under a harmonised EU DLT issuance scheme.

Cloud services, including the growing segment of 'software as a service' (SaaS), have been expanding rapidly in recent years. The primary way in which they increase efficiency in securities markets is via large economies of scale that the small number of major providers of cloud data centres and their customers enjoy. In addition, firms that use the cloud are becoming more agile as they are able to roll out new features and investment products quicker than before. However, there are existing legitimate concerns about data protection and data availability that need to be addressed.

The use of AI can reduce complexity and costs in processes touching all parts of the post-trade value chain, and can also, for instance, help to facilitate clearing and reconciliation significantly. Similarly, investment via robo-advisers and exchange-traded funds brings down fees, thereby increasing overall market efficiency in an evolutionary manner.

DLT and smart contracts are crucial tools for achieving improvements that go beyond mere evolutionary enhancements. Fixed income could be the ideal segment for harnessing DLT and smart contracts in order to bring about a smart revolution in European securities markets. This is due to the fact that, in contrast to equities (for which stock splits, mergers etc. may occur), all major variables of bonds (maturity, coupon payments) are defined upon issuance. Now imagine that tomorrow you could issue debt securities directly on the blockchain as smart contacts.

Certificates, book-entry-solutions, registrar services or depositary receipts would no longer be necessary. Everything would be on the chain, including the full set of terms and conditions of issuance and all corporate actions during the life cycle of the bond. This could allow for novel, transparent and far-reaching forms of process automation, potentially resulting in a massive reduction in the issuance, process and transaction costs of debt securities.

With its DLT pilot regime for crypto assets the EU has already set the stage for a smart revolution in the securities markets. Under the pilot regime, licensed multilateral trading facilities (MTFs) and central securities depositories (CSDs) can operate and settle markets in DLT securities below certain thresholds. To enhance the pilot regime for the smart revolution this next stage needs support and preparation.

To facilitate and prime the smart revolution in the securities markets, the EU could invite private stakeholders and national authorities to complement the DLT pilot regime with a pilot scheme for issuing debt securities in a DLT-only fashion. Such a pilot DLT issuance scheme would harmonise the way new debt securities are represented on the various ledgers allowing for interoperability and scaling up at a later stage. This is why the CMU will benefit enormously if debt securities start turning smart under a harmonised EU DLT issuance pilot scheme.

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Prudently managed, new technologies may become the EU's competitive advantage

The financial industry is among the sectors most heavily impacted by the megatrend of digitalisation. The use of computer algorithms has massively changed securities trading and paved the way for algorithmic trading. Today, two new technologies are blazing the trail in a similarly disruptive way. One is the distributed ledger technology (DLT) used to create crypto-assets such as Bitcoin; the other is artificial intelligence (AI). Both technologies hold great promise. They can promote financial inclusion and contribute to increasing the efficiency of the European financial system. From a regulatory perspective, however, these technological innovations pose a major challenge, as they were not accounted for when the current European regulatory framework was developed.

To date, specific regulations for crypto-assets only exist as so-called bespoke regimes at national level, while the European Regulation on Markets in Crypto-assets (MiCA) is promising, but still in the works. Consequently, the regulatory treatment of Crypto-assets is challenging and plagued by convergence issues. One of the lessons learned and highlighted by ESMA already in 2019[1] is that the way different supervisory authorities classify Crypto-assets – deciding whether a given Crypto-asset is a financial instrument or not – can vary considerably, as a result of varying national implementation between Member States. This poses significant challenges for supervisory convergence and underlines the importance of a uniform European regulation.

The EU's express objective is to establish itself as a leading location for AI and to develop its own approach to AI ethics which could serve as a global model. In the securities markets, the use of AI is increasing, ranging from investment advice in the form of a robo-advisory to fully automated portfolio management used by leading asset managers. Such models have already accumulated considerable market share.[2]

Strong EU capital markets need future-proof regulation and an empowered supervisory community.

From a supervisor´s point of view such technical solutions entail a plethora of legal, ethical, economic and regulatory challenges. One thing is clear though: The emergence of AI urges us to revisit some of the fundamental principles of the existing regulatory framework, as the application of the regulatory principle of «same business, same risk, same rules» is not trivial. The autonomous decision-making power of AI brings numerous new risks, including hidden bias and accountability for the (decisions of) algorithms. It is therefore paramount to evaluate if and to what extent the existing rules fit AI and which changes are necessary to create a solid legal foundation for strong and digital European capital markets.

Another challenge posed by AI is finding the correct approach to the 'winner takes it all' dilemma observed with AI business models. The more extensive and sophisticated the underlying data of a model, the better the services provided. A better service in turn attracts more business and, crucially, more data, creating a positive feedback loop. This could lead to concentration effects of AI models used in securities business, comparable to the developments already observed in other industries, e.g. platforms and marketplaces for consumer goods. Similar concentration tendencies have also appeared in cloud outsourcing.

Numerous financial institutions use cloud services provided by the largest four service providers (all US-based) who generate around three quarters of global revenues. The Covid- 19 crisis has further exacerbated this trend and increased the high degree of dependency. The European Supervisory Authorities including ESMA have published guidelines[3] providing guidance on outsourcing to cloud service providers, following the European Commission's FinTech Action Plan.[4]

If the EU wants to meet its target of establishing the common market as the worldwide technology leader, it has to intensify and accelerate its current efforts to create a competitive and secure environment for these technologies. This goal rests on two pillars: appropriate, risk-oriented and future-proof regulation in tandem with a strong supervisory community that is equipped with the necessary specialised knowledge and resources to enforce it.

[1] European Securities and Markets Authority (ESMA), Annex 1 Legal qualification of crypto-assets – survey to NCAs, January 2019 | ESMA50-157-1384.

[2] No exact figures are available. The most prominent AI system covered more than USD 20tn in 2017. This figure is equivalent to 10% of the global stocks and bonds market in 2020. Haberly et al, Asset Management as a Digital Platform Industry: A Global Financial Network Perspective, Geoforum 2019/106, 167.

[3] European Securities and Markets Authority (ESMA), ESMA publishes cloud outsourcing guidelines, https://www.esma.europa.eu/press-news/esma-news/esma-publishes-cloud-outsourcing-guidelines.

[4] European Commission, FinTech Action plan: For a more competitive and innovative European financial sector, COM (2018) 109 final.

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An EU framework to encourage the uptake of new technologies in finance

With the development of automation, artificial intelligence (AI), blockchains and the increasing use of the cloud computing, financial services are undergoing structural changes. Further, the global pandemic has dramatically accelerated the pace of digital and lent greater importance in our daily lives. Our role as regulators is to make efforts to accompany the changes to stay in touch with the markets, so as to guarantee investor protection while fostering innovation to remain internationally competitive.

I am pleased that the AMF has made a significant contribution to the European regulatory framework for digital finance. Thanks to its legal analyses, specific regulation and position paper on financial innovation, it contributed to the Digital Finance Package, which was a necessary step:

to enable to test innovative business models that were unduly prohibited, through the Pilot Regime regulation; to fill gaps, through the Markets in Crypto-Assets (MiCA) regulation; and to improve the robustness of our highly interconnected financial markets, through the DORA regulation on cybersecurity.

We particularly welcomed the proposal to set up a pilot regime for market infrastructures based on DLT wishing to trade, deliver and settle transactions in financial instruments in the form of crypto-asset as the potential gains to be expected from DLT can be significant.

Discussions in the Council and Parliament have significantly improved the Commission's proposal by (i) opening up the exemption regime to all types of players, including new entrants, without relaxing the constraints that will weigh on the projects. This will promote healthy competition, giving Europe the maximum chance in the race for technological progress; (ii) by raising the thresholds proposed by the Commission if necessary to ensure the financial equilibrium of projects likely to participate in the experimentation; (iii) by not prohibiting business models based on public DLTs.

I am glad to see that discussions on this Regulation are making good progress, as the Council agreed on a general approach in late June. Some minor adjustments are still needed (such as alleviating the role of ESMA in the registering process) but we do hope that the trilogue could be achieved before the end of the year.

Our role as regulators is to make efforts to accompany the changes to stay in touch with the markets

On the MiCA regulation, a lot of attention has been paid (quite rightly) to the stable coins in the Parliament's ECON Committee and in the Council. However, the treatment of other kind of crypto-assets deserves a further discussion. The Commission's proposal in this area was a very good starting point, but those are the issues that in my view still need improvement:

direct pan-European supervision of activities by the ESMA under MiCA would be a major improvement as national supervision practices might well vary, resulting in unlevel playing field and a risk of forum shopping; investor protection measures need to be better suited to the crypto-asset environment; and there should be transaction reporting requirements for exchanges that have reached a certain size in order to allow supervisor to detect market abuses. On the DORA regulation, the central aspect is the relation with the critical third-party providers. I believe that in practical terms, a single supervisor is more efficient than three sectoral supervisors, with potential endless disputes on their respective remit. If an ESA is to take sole responsibility for the regulation of all critical cloud providers, there is no doubt in my mind that the EBA is best placed, the cloud services being more widely adopted in the banking sector. Thanks to its accumulated expertise, the EBA has been front-runner with its work on Cloud Outsourcing Guidelines.

The development of AI in finance is on-going. However, the AMF has come to the conclusion that it is not mature enough to consider that there exist risks specific to the financial sector. At this stage, existing financial regulation remains sufficient to our viewpoint. I am glad that the Commission released last April a Strategy for AI including an updated coordinated plan and a regulation proposal, which are cross-sectorial and not specific to finance. Following the GDPR, the new regulation is a second step for personal data protection, dedicated to the use of data by an AI.

The requirements contemplated for the financial industry with DORA, MiCA and the Pilot Regime need to be coordinated within the broader framework of the Digital services package. The dividing line between electronic-money tokens and asset-referenced tokens (ART) is thin; likewise the distinction between ART and tokenized financial instruments is vague, considering that there is still no common definition of financial instruments across the EU. The interplay between regulation of instruments and regulation of service providers is complex and the neutrality vis-à-vis technology is tricky to implement. Furthermore, the case of a platform that is at the same time a social media and a trading platform should also be covered.

SWEN WERNER

Managing Director,
State Street Digital,
State Street Bank and Trust

Security tokens: a new market paradigm for Europe

The tokenization of assets promises to deliver enhanced operational efficiencies, a stronger emphasis on peer-to-peer trading and the emergence of new business models due to the programmability of assets and the emergence of decentralized finance constructs. Some studies suggest that the global tokenization market could grow to about 5 trillion USD by 2025. Therefore, in the long run, all financial markets will have to digitize their processes and tokenize their assets to remain relevant. Yet the vast majority of securities market activity in the EU today is still taking place through traditional channels. There are a number of reasons for this:

- The current Central Securities Depository Regulation (CSDR) limits the introduction of publicly listed securities for book entry settlement only to a regulated CSD, making many tokenization platforms unviable or forcing them to shift their focus to private markets.
- There is uncertainty as to how depository duties and the resulting liability under the AIFM and UCITS provisions apply to digital assets and security tokens.

Current measures in the EU Digital Finance Package do not address those issues fully, focusing instead on a number of other important matters such as the regulatory framework for crypto assets and cyber security standards. Resolving the open issues for tokenized assets and allowing the emergence of a more decentralized, distributed market place would help create many opportunities for investors. It would allow the emergence of new digital first, mobile first, self-servicing distribution channels that could appeal to a new generation of emerging tech-savvy investors.

The original vision of digital assets emphasized the concept of censorship-resistant assets providing for the ability to organize economic exchange without a central intermediary. The successful deployment of blockchain technology to securities markets needs to reflect on this principle, while also supporting other secular trends such as;

- The shift in consumer preferences towards service models that operate real time – all the time;
- The growth of private markets whereby tokenization could be used to create liquidity in historically illiquid assets (e.g., private equity); and
- The development of a circular economy, using tokenization to enable broader peer to peer interactions and distribution.

Assets issued in a digital or tokenized format also bring the opportunity to automate financial lifecycle events, such as corporate actions or performance fees, through the use of smart contracts. Additional technical oversight and new governance processes will be needed to ensure that these applications operate as expected and that the data feeds triggering these activities are reliable and accurate. Over time, the market should adopt common standards to determine who bears responsibility for the due diligence processes of different tokenization platforms, and what conditions should be imposed for firms acting as a trusted data provider (so-called data oracle) that drive the 'state' of a smart contract, i.e. the data applied to execute its code.

The EU Digital Finance Package is a welcome and necessary step forward to ensure that EU capital markets can benefit from technological innovation ...

Individual EU member states have started to take the lead in terms of defining a regulatory framework for tokenization. For example, the recent German law on electronic securities defines a number of conditions as to how a tokenized security should be issued, including:

- The applied source code must be made available for relevant stakeholders to allow for due diligence
- The ability to reverse transactions must be in place, if needed
- The ability to migrate tokens to other platforms muse also be available, if needed.

There is an open question as to what extent these efforts should be harmonized, or even be subject to a EU framework, as at the moment national law determines the definitions and requirements to issue securities.

In contrast to security tokens, there are fewer challenges in the use of Artificial Intelligence and Machine Learning (AI/ML) models in market operations, since existing risk management expectations are well-suited to AI/ML and there are fewer regulatory hurdles to overcome. AI/ML is also used in transaction processing and trade settlement, to automatically read and route client inquiries or to support investment fund compliance with prospectus terms, including pre and post-trade obligation.

The EU Digital Finance Package is a welcome and necessary step forward to ensure that EU capital markets can benefit from technological innovation and has the potential to enhance financial market integration in the banking union and the capital markets union. However, more work remains to be done. In particular, asset management regulation and ensuring a level playing field in the ability of firms to tokenize securities remain open challenges.

EMMANUEL AIDOO
Head of Digital Assets, Credit Suisse

Digital asset markets and tokenization

Digital Assets will have a significant impact on finance, but how and why? To best answer this and ensure we deliver on the promises of an efficient, stable, transparent financial services industry, we need to take a step back in history. Settling trades was a more inefficient, lengthy process involving physical paperwork, couriers and lawyers. Institutions built proprietary systems to automate core processing in equities, bonds, FX, etc., which helped accelerate the process. Each institution developed proprietary workflows, yet more complex or illiquid assets never reached full automation. Regulation focused mainly on protecting the public and ensuring stability. As data was shared internally, banks sought to implement and benefit from straight-through processing (STP) efficiency. Technology replaced manual input.

While this made trade processing less manual, it created other problems due to data and timing discrepancies across connected systems. As connectivity became ubiquitous and the industry expanded its STP ambitions to enable processing across counterparties, we learned too well through various crises and bank failures the negative impact a lack of transparency and data mismatch can have on stability, capital efficiency, and resolution recovery. Much of the industry's issues stem from non-standardized data and processing, especially across assets, as some systems communicate via batches while others share in real-time. Our existing processes are burdened with timing and data differences requiring trade breaks and substantial reconciliations; the impact is increased compliance costs and associated operational risk capital.

This leads us to today's opportunity with digital assets or tokens. A digital asset represents in code the behavior of the underlying asset enforcing the rules and regulations that govern it to all investors and issuers. In creating the asset, the legal and regulatory rules are converted into code, allowing the asset to become self-governing. A digital asset can ensure it is legally transferred from one person to another globally at the time of the trade without human input or a third-party intermediary.

Tokens can represent a share in a company, ownership of real estate, or participation in investment funds. The benefits are enormous allowing the industry to develop a more efficient, inclusive financial ecosystem with reduced friction and costs associated with creating, transferring non-exempt public or private securities. These new digital assets will offer greater liquidity, be faster, cheaper, more transparent and make investments in illiquid assets or private companies more accessible.

Digitally enhanced, securities will embed all rules, data standards and regulations.

Digitally enhanced, securities will embed all rules, data standards and regulations consistently on an accessible blockchain. Regardless of where the asset is stored, its behavior, ownership and provenance will be consistent and immutable. Everything from asset origination to its servicing or redemption is managed in code and accessed directly from the blockchain. Wherever the digital asset transfers, the regulations will transfer with it. Meaning, for the first time, more complex, illiquid asset classes can be fully automated compliantly and efficiently.

Asset transfers in private markets are complex and country-specific, making them challenging, costly, and require legal handholding to affect ownership transfer. Self-governing tokens will automate the complexities of private markets, allowing them to be as efficient as the «electronic» public markets. When assets are digital, the KYC, compliance and regulatory checks occur in real-time enforced by the self-governing asset and if permitted, the digital cash and digital asset change owners at the speed of the Internet.

Investors expect to transfer assets in any market globally, instantly, compliantly and consistently, without expensive intermediaries. Through controlled access to digital private markets, frameworks established through the Market in Crypto-Assets legislative proposal (MiCA) could enable greater financial inclusion, help alleviate wealth inequality, and spur growth in a new ESG oriented digital financial economy.

Tokens representing private assets could allow a broader investor base to invest safely in late-stage private companies removing current settlement or liquidity constraints. These tokens would enable the public to invest safely in some of the fastest-growing companies. The advent of blockchain technology presents a unique opportunity to spur growth in line with Capital Markets Union (CMU) goals.

In parallel, MiCA must develop frameworks that recognize and support institutions that demonstrate greater control and transparency through the enablement and implementation of blockchain and digital assets.

BERTA ARES
General Director,
BME Inntech

Financial markets and the imprint of Artificial Intelligence

A few decades ago, the emergence of the Internet shook the world by making information available to all users. Artificial intelligence has kicked off a similar revolution by providing the capability of analysing this information and develop intelligent and evolutive algorithms that allow users to make a smarter use of the information.

Now, our radar is full of machines with the ability to program, to debate, analyse news, generate new content and to play. They can also win at games like poker, by learning how humans lie while using incomplete information, learning on the go, even developing customised lies for each of their opponents.

Financial markets are no exception to the recent blossom of artificial intelligence, where a revolution has been started on a global scale. At this pace, soon, any human broker who does not make use of those tools will inevitably be pushed-out of the market. As well as typewriters have been made obsolete by computers, artificial intelligence is gathering pace in financial markets and has the potential to overcome existing schemes and technology.

There is no doubt that the world ahead of us includes the use of artificial intelligence in a complementary role for the larger part, but also as the main character for many functions related to capital markets and their ancillary activities.

The questions that now arise are related to what the future holds for us, because the horizon of options is infinite, and their evolution is unpredictable.

With markets becoming increasingly crowded by algorithms that improve daily, which will be the share to remain for classic manual trades? How will the new profile of operators change? Future analyst brokers will simply need to cover more and be able to manage the algorithms, control their information input or guarantee the adequacy of data quality; in addition, they will also need to ensure compliance with multiple regulatory requirements and monitoring of operations.

A few years ago, high frequency algorithms (HFT) were installed in proximity servers – located no further than 10 kilometres from the trading centre – or in data processing centres inside the very exchange. Those algorithms were designed to perform simple calculations, and focused fundamentally on speed, aimed at introducing orders to the market to achieve the best possible position in the order book. Their logic was a mere calculation process supported by the shortest possible wire.

The key is no longer infrastructure, knowledge is now the new driver.

This scheme also meant that not all participants could afford the necessary technology infrastructure for placing themselves close to the market; the entry barrier was considerable for a small or medium investor.

In the last few years, the rules of the game have changed, and many financial and also non-financial companies are setting up working groups to develop intelligent algorithms purposed at making investment decisions that leverage on technological advancements. These are based on three essential premises:

- The possibility of accessing free developing environments in a large community;
- The liberation of opensource libraries for advanced artificial intelligence;
- Affordable access to big data infrastructures.

These advancements and accessibility to the necessary conditions have democratised investments, allowing for any small working group – with enough expertise in finance and computing – to develop algorithms focused on "intelligent" investment decision-making, instead of high frequency trading. The key is no longer infrastructure, knowledge is now the new driver.

In the present, any financial process must be technology-focused and includes expertise in one or more fields such as Big Data, Deep Learning, Blockchain or Quantum Computing.

Lines between business and technology functions are starting to blur as new organisations need more cross-functional information and transversal vision to develop efficiencies, improvements, and new market models.

Artificial intelligence has become to financial markets what the Internet became to information a few decades ago. It represents an essential tool that will replace current mechanisms. In the same way the Internet recycled and upgraded encyclopaedias offering much more complete, updated, accessible and verified information – artificial intelligence will allow for a more customised, precise, and targeted way of operating in the financial landscape.

This ability to adapt and integrate artificial intelligence into daily business is the key to step forward and stand out into the new international financial arena.

STÉPHANE JANIN

Head of Global Regulatory Developments and Public Affairs, AXA Investment Managers

New technologies in EU securities markets: a big shift beneficial to AM clients

Digitalization has led to technology innovations which found various fields of application later on. The financial area can now take benefit from them, and notably the Asset Management industry on behalf of its clients.

The advantages offered by such innovations are very well known. First of all, it allows asset management companies to behave more efficiently and in a more secure manner within their own organization. For instance, AI and ML allow us for dealing with huge amounts of data in a faster way and at lower cost, e.g. for scrutinizing legal and marketing documentation, or for detecting anomalies in sizes or prices of trades. Regarding the use of external clouds, it facilitates the reduction of our IT costs while ensuring quicker processes.

Beyond optimizing our internal organization, new technologies are more importantly directly beneficial to our clients. The development of trades through DLT allows for applying decentralized schemes to traditional financial instruments which have been tokenized, thus reducing the central position of CSDs and creating more competition, leading in principle to cost savings and more efficient flows. In addition, tomorrow it can be anticipated that the majority of asset managers will integrate crypto-assets within their whole universe of investments. Last but not least, CBDCs will allow for payment in digital currencies issued by central banks, as critical and secure complements of private companies-led currencies.

However, before taking all these benefits of financial digitalization, we have to make sure that this digitalization develops within a minimum regulatory framework.

Some progress has already been made in the EU on this front.

First regarding the use of external digital service providers by asset managers, the EU Digital Operational Resilience legislation, as well as ESMA's Guidelines on outsourcing to cloud service providers, bring positively more protection to asset managers (and their clients) vis-à-vis those providers when having to perform due diligences on them. Second, regarding DLT, the EU Pilot Regime is introducing a welcomed start of regulatory harmonization between Member States, which will facilitate the inter-operability of DLT schemes across borders – knowing that this supra-national inter-operability of DLT schemes is critical for their success.

Supra-national inter-operability of DLT schemes is critical for their success.

Still, some key challenges remain ahead, for both regulators and asset managers.

As an example, in practice digital assets are now very often directly accessible by retail investors. It leads in some countries to impressive direct investment by uneducated investors in crypto-currencies - including through personal indebtedness. In spite of public consumer warnings by regulators, the popular success is still here and we should be collectively worried by any risk of back-lash on the general image of digital finance in case retail investors become massively "burnt" through such investments. Definitely, MiCA or similar regulations will have to provide for appropriate calibration between investment by retail and non-retail, from an investor protection standpoint.

Even for professional investors such as asset managers, MiCA is key: we consider that crypto-assets are definitely going to be part of all assets we invest in, but we need a minimum regulatory framework to ensure market integrity and avoid systemic risk – we will not jump in the dark on behalf of our clients, as we owe them a fiduciary duty.

On DLT, while cross-border regulatory interoperability might be facilitated in the future through the EU Pilot Regime, it remains still in practice to improve interoperability across players (including at domestic level): we need a fluid secondary market on tokenized financial instruments, which can be guaranteed only if the various players in the value chains are plugged the ones with the others. We know that in practice cooperation is developing among them to set such pluggings, but not always very rapidly – the buy-side must take its part to put pressure on those players.

Last, the ultimate link of the digital finance comprehensive ring will be CBDCs. AXA Investment Managers is fully convinced of it, and has been involved in many successful projects, such as the latest one carried out with the Banque de France in June 2021. That experiment involved the simulation on a private blockchain of the issuance and settlement of unlisted securities and the settlement of listed securities. Settlements of securities were simulated by CBDC issued on the blockchain. This experiment tested the integration of issuance and settlement activities, including exchanges on the secondary market. Those tested settlement processes should contribute to a greater integration of financial markets. In the same vein, we are strongly supportive of ECB's similar initiatives on the digital euro project.

GLOBAL CROSS-BORDER PAYMENTS

DENIS BEAU
First Deputy Governor,
Banque de France

Shaping the future of cross-border payments

The G20 adopted in October 2020 an ambitious roadmap to address the key challenges faced by cross-border payments.

One of the first actions in 2021 is to set quantitative targets for the roadmap, for costs, speed, transparency and access, across wholesale and retail markets as well as for remittances. Under the aegis of the FSB a high level task force finalised last May a proposal for those targets, submitted for public consultation.[1] The initial proposal is currently being refined based on the replies and will be submitted for endorsement by the G20 leaders at the end of October.

As stressed in a previous Eurofi article[2], these targets are critical: they set the level of our joint public-private ambition and will ensure that the implementation of the roadmap building blocks remains tied to that level of ambition over time and that progress will be monitored against this backdrop. Overall, the current proposal foresees that the actions under the roadmap will, by end-2027, jointly: (i) drive down the global average cost of retail payments[3] to no more than 1%, with no corridors having costs higher than 3% (the target for remittances being the one already affirmed by the UN SDG[4]); (ii) allow, for the large majority (75%) of payments in all segments, funds being available for the recipient within one hour from the time the payment is initiated (and within one business day for the remaining payments); (iii) ensure all service providers provide a minimum list of defined information (including e.g. total transaction costs) to payers and payees; (iv) help to ensure that all financial institutions and all end-users (incl. individuals without bank account) have at least one option to send or receive cross-border payments.

For the other actions under the roadmap, the first year of implementation has been devoted to stocktaking, a necessary step to acquire a deeper and more concrete knowledge of the key challenges at stake in the various areas for improvement, paving the way for the following impactful actions.

Expectations are particularly high for the most innovative measures, especially the issuance of CBDC.

Expectations are particularly high for the most innovative measures, especially the issuance of CBDC (Central Bank Digital Currency), given their potential to shape the future of payments, at both retail and wholesale level.

The report on CBDC for cross-border payments to the G20[5] proposes different models based on the establishment of multiple CBDC (mCBDC) arrangements. This creates clear opportunities for improving cross-border and cross-currency payments while safeguarding the anchoring role of central bank money.

In 2020, the Banque de France launched an experimentation program on wholesale CBDC to explore this potential concretely. Overall, several experiments confirm that mCBDC arrangements would improve cross-border payments by:

- Streamlining procedures which currently involve long intermediation chains, reducing the operational burden, counterparty risks and costs while increasing transparency;
- Improving the remittances processes, using wholesale CBDC to speed up payment to the beneficiaries in commercial bank money. This illustrates well the complementarity between central and commercial bank money and how it would be preserved with CBDC;
- Facilitating interoperability both between CBDC systems, and with conventional systems, even when RTGS are not interoperable.

By the end of this year, the Jura Project launched in cooperation with the Swiss National Bank, the BIS Innovation Hub and a private consortium led by Accenture, will achieve a new step in exploring mCBDC arrangements. With this multi-jurisdictional partnership, payment against payment transactions -digital euros against digital Swiss franc- will be carried out in real conditions.

These benefits would not come at the cost of either fragmentation of financial markets or a risk that central banks lose control over their CBDC. Indeed, in all those experimentations, the Banque de France retained control over the issuance and the circulation of CBDC, while ensuring interoperability with conventional systems at the domestic level. The outcome of these experiments is promising. Central banks may indeed through the issuance of CBDC help improve the future of cross-border payments. Further analysis and experimentation should take place to confirm this perspective.

[1] FSB seeks feedback on its proposal for quantitative targets for enhancing cross-border payments.
[2] Taking the cross-border payments roadmap forward, Eurofi (April 2021).
[3] The retail market segment comprises the following payment categories: business to business, person to business and business to person, person to person payments other than remittances.
[4] Global average cost of sending $200 remittance to be no more than 3% by 2030, with no corridors with costs higher than 5%.
[5] Building Block 19, Central bank digital currencies for cross-border payments.

THOMAS LAMMER

Deputy Head of Secretariat, Committee on Payments and Market Infrastructures (CPMI)

Bringing cross-border payments to the next level: towards a global payments area

The payment ecosystem is undergoing fundamental changes, especially in the domestic context, to meet customers' 21st century demands. As a result, many end users are already benefiting from instant, 24/7, contactless and digital payments. However, compared to domestic payments, cross-border payments are often slower, more expensive, less transparent and inaccessible to certain customers.

The ideal cross-border payments solution would address all these four challenges. Several recent proposals promise just that. They often involve radically different technologies and providers from outside the financial sector. However, it is far from certain that they can actually deliver on their promises. In fact, there is no single, one-size-fits-all solution to enhancing cross-border payments, as the challenges affect end users, payment service providers and payment infrastructures in many different ways at different stages in the transaction chain. The problem is complex and multi-dimensional due in large part to these characteristics:

- End users range from large corporates to small enterprises to private individuals with varying technological and socio-economic backgrounds.
- Services are provided by both banks and non-banks. Payment infrastructure providers include payment system operators and messaging service providers.
- Arrangements include correspondent banking, links between domestic systems, multilateral payment platforms and new peer-to-peer models.

Nonetheless, the G20 believes these challenges can be overcome and endorsed a roadmap to enhance cross-border payments at the end of 2020, pushing the issue high up on the political agenda. The roadmap acknowledges that enhancing cross-border payments for all end users requires a comprehensive, cross-sectoral and ambitious approach. The roadmap aims to improve both wholesale and retail payments (including remittances) and contains 19 building blocks that are grouped in five focus areas: (i) public and private sector commitment, (ii) regulatory, supervisory and oversight frameworks, (iii) existing payment infrastructures, (iv) data and market practices, and (v) new developments, such as central bank digital currencies (CBDC) and stablecoins. The Committee on Payments and Market Infrastructures (CPMI) is leading the development of more than half of these building blocks.

Improving cross-border payments requires a shared vision, global cooperation and sustained effort.

Already in the first year of implementation, a number of initial roadmap actions have been completed. These include a joint statement by the Basel Committee on Banking Supervision and the CPMI on the Supervisory Guidance on managing foreign exchange (FX) settlement risk and the Global FX Code, as well as the successful completion of a week-long hackathon by the BIS Innovation Hub and SWIFT, which highlighted the benefits of ISO 20022 and application programming interfaces (APIs) in enhancing cross-border payments.

In July, a stocktake report on CBDC for cross-border payments was published. The report analysed how CBDCs could enhance cross-border payments, and offered practical recommendations on how to do so. Facilitating international payments with CBDCs can be achieved through different degrees of integration and cooperation, ranging from basic compatibility with common standards to the establishment of international payment infrastructures. Later this year the CPMI will publish a report on the application of the Principles for Financial Market Infrastructures to stablecoin arrangements. Other upcoming reports will help advance the planning and potential designs of payment infrastructures (eg multilateral payment platforms, longer and aligned operating hours of, and wider access to, payment systems).

Looking ahead, some roadmap actions can be accomplished quite quickly, others will take several years. The aim is to make progress as fast as feasible and consult stakeholders widely. Improving existing payment infrastructures and aligning regulatory, supervisory and oversight frameworks will also support the more complex, progressive and novel solutions.

It is critical that we maintain the ambition to make real improvements in payments around the globe, while retaining flexibility. A shared vision and a common set of targets will help to hold this complex global programme on course and allow the measurement of its progress. The Financial Stability Board (FSB) is finalising these targets for endorsement by the G20 in October 2021. Irrespective of the final targets, the accomplishments of the first year of implementation have shown that the two most important success factors are, unsurprisingly, close cooperation and strong ambition by both the public and the private sector.

Bringing cross-border payments into the 21st century to support the changes in the way end users transact will require sustained effort over a number of years to come. It is a huge challenge, but if successful, it will result in widespread benefits for citizens across the globe, both directly and by supporting economic growth, international trade and global development.

DIRK SCHRADE
Deputy Director General, Deutsche Bundesbank

Cross-border payments: a strong global approach is key

The ongoing trends of globalisation, digitalisation and migration are leading to rising levels of cross-border trade and services, purchases from merchants across borders and internationally integrated supply chains, resulting in payments that are transmitted across borders. Digitalisation especially has not only boosted a change on the demand side, but also created new instruments on the supply side, such as crypto assets and stablecoins with potential global reach. This not only brings new challenges for incumbent players, but also raises a number of issues concerning, inter alia, the safety and integrity of the payments market as well as financial stability. Compared to domestic payments, cross-border payments have remained relatively slow, costly and opaque. The reasons for this are manifold.

At the infrastructure level, for example, a lack of links between infrastructures creates long transaction chains with multiple players and little transparency. Moreover, the lack of overlap between the opening hours of payment infrastructures in the different countries further increases end-to-end processing times. At the policy and regulatory level, anti-money laundering (AML) measures and know-your-customer (KYC) processes remain a considerable challenge, especially across borders. Different jurisdictions have different standards, impeding automation and requiring manual intervention. This drives up the costs and processing times of payments. Furthermore, growing AML and KYC requirements have led to de-risking, resulting in a decline in correspondent banking relationships. This has reduced competition and prolonged some payment chains. Payments to countries in crisis areas have become significantly harder.

These frictions affect various transaction types, payment instruments and geographical channels differently. While B2B transactions via highly used channels (e.g. between the USA and the UK) as well as credit card payments work relatively well, remittances, consumer and small business payments work less efficiently or have to rely on closed-loop solutions. For example, while the costs for remittances to sub-Saharan Africa continue to slowly decline, reaching 8.2% of the transaction value, they remain significantly above the UN sustainable development goal of 3%. While it is probably unrealistic to expect a uniform user experience across all channels and instruments, the goal should be to reduce the underlying frictions to make all cross-border payments more effective, including to those countries with a relatively low level of financial inclusion. Global coordination is key to addressing many of these frictions. That is why the G20 started work on a roadmap to enhance cross-border payments in 2019 and published the finished roadmap in 2020.

Frictions in cross-border payments require a firm, consistent and timely global response.

At the infrastructure level, one of the goals of the roadmap is to maximise overlap between the opening hours of payment systems, potentially speeding up processing times. Furthermore, it is vital to encourage interlinking between payment platforms across borders, either via bilateral links, or via multilateral platforms that interconnect multiple countries. While the former may seem more feasible at first, the latter may be more effective in addressing the frictions in the backend of cross-border payments.

For both solutions, the emergence of modern and easily accessible instant payment systems in various countries could create an opportunity. However, even payments in modern infrastructures require thorough AML/KYC checks during the process. Harmonising these requirements globally would ease some of the burden on cross-border payment providers. Harmonised KYC standards paired with a standardised payment message based on ISO 20022 could enable automated straight-through processing of cross-border payments, improving speed and potentially reducing the costs of cross-border payments. These common standards could be accompanied by technical solutions that enable data exchange across borders.

Data protection regulations may hinder data sharing between jurisdictions, leading to the idea of a KYC identity scheme, which does not share specific KYC data, but rather shares whether the payer or payee has been KYC checked. New technologies like DLT could help realise ideas such as these. Furthermore, central banks worldwide have started looking into central bank digital currencies (CBDCs). These could be a chance to start with a clean slate. When building the new CBDC infrastructures from scratch, it is therefore important to keep the international dimension in mind. Apart from technical aspects, there might also be the need to develop a framework for CBDCs to ensure global interoperability.

To sum up: there are a number of aspects and opportunities to make cross-border payments more effective – each a challenge to be tackled on a global scale. But it is of utmost importance to use the current political momentum to improve cross-border payments while relying on the trust of official central bank-issued currencies.

MARC BAYLE DE JESSÉ
Chief Executive Officer, CLS Bank International

Settlement risk: addressing the key issue in cross-border payments

Cross-border payments involve the settlement of an FX transaction which requires payment of one currency for receipt of another. One of the main risks in such transactions – settlement risk – is that one party delivers the currency it sold but does not receive the currency it bought, resulting in a loss of principal. Such a loss may be manageable if the amount is small. However, today's global FX market is the largest financial market in the world with an average daily volume of USD6.6 trillion.[1]

FX settlement risk is on the rise and may be reaching levels that threaten global financial stability, following an increase in global trading of currencies that do not have access to payment-versus-payment (PvP) settlement mechanisms. This has resulted in a heightened focus on overall risk management in cross-border payments, with both the public sector and market participants calling for greater adoption of PvP as the optimum solution to mitigate FX settlement risk.

To better understand settlement risk for currencies that are not currently eligible for CLSSettlement and how FX trades are settled in those currencies, CLS is working with its global settlement members to analyze their settlement activity. The results will provide further transparency on settlement behavior and enable CLS to contribute findings towards key policy initiatives. Collaboration between the public and private sectors is essential, and through two public policy initiatives, in consultation with the private sector, the industry is making great strides in this area.

The first is the Committee on Payments and Market Infrastructure's (CPMI) request for input on improvements to existing payment infrastructures and arrangements to enhance cross-border payments. This led to an initiative to encourage PvP adoption in the FX market through the inclusion of building block 9 of the Financial Stability Board's (FSB) "Enhancing Cross-Border Payments Stage 3" roadmap.

The second is the three-year review of the FX Global Code undertaken by the Global Foreign Exchange Committee (GFXC).[2] The updated Code includes amendments to the key principles concerning settlement risk, principles 35 and 50, placing greater emphasis on the use of PvP mechanisms where available, and providing more detailed guidance on the management of settlement risk where PvP settlement is not used.

CLS establishes working group to explore alternative payment-versus-payment solutions.

In response to the need to increase PvP settlement in currencies that are not currently eligible for CLSSettlement, CLS has established a working group to explore alternative PvP solutions. Initial feedback shows a strong interest in a new PvP solution and an industry pilot is underway which will evaluate the liquidity and settlement risk of potential models. While this initiative has considerable industry support and momentum behind it – 12 of CLS's settlement members have formed the working group – any new Financial Market Infrastructure (FMI) solution must prioritize safety, stability and scalability. Hence, an alternative PvP solution will require ample time for appropriate implementation.

For an FMI like CLS to deliver an optimal solution to public policy and industry challenges such as wider settlement risk mitigation, it must continually invest in its products, risk management, controls and underlying technology. This is one of the key drivers behind the completion of a significant phase in CLS's multi-year technology investment program, thereby optimizing the underlying technology platform supporting its settlement services. CLS now has one of the most sophisticated, resilient, scalable and flexible post-trade technology platforms across global FMIs, which will enable the organization to evolve its PvP offering to the requirements of the FX market.

The implementation of best practices related to mitigating settlement risk and efficient post- trade practices is a high priority for market participants, policymakers and regulators. As a systemically important FMI that operates a settlement system for FX transactions (CLSSettlement), CLS supports the industry objectives regarding mitigating settlement risk, and it is committed to raising awareness of PvP adoption more broadly.

In order to develop the optimal model to solve these industry challenges, policymakers and the private sector must engage continually with market participants. This is crucial to ensuring the market's needs are understood and that the preferred solution obtains sufficient industry investment and support. A strong public-private partnership – similar to the one that created CLS in 2002 – is required to build a successful cross-border solution to remove FX settlement risk from global financial markets.

[1] Bank for International Settlements. «Foreign Exchange Turnover in April 2019.» https://www.bis.org/statistics/rpfx19.htm
[2] The Global Foreign Exchange Committee endorsed the outcomes of the Code review on 28 June 2021
FX global code: A set of global principles of good practice in the foreign exchange market (globalfxc.org)

TIM KEANE

Regional Vice President of Operations, Western Union Payment Services Ireland

Cross-border payments - Bordering aspirations with reality

For the last 150 years, Western Union has been at the forefront of delivering fast, secure and efficient cross-border payments across the globe. Drawing on the latest available technology and our network of partners, we ensure customers can transfer and receive funds instantaneously even when there is no other infrastructure in place. At the origins of our company were telegraph poles. Now we have embraced mobile and digital solutions.

In delivering our services, we at all times need to reflect the needs and realities of our customers. Less than a third of the population in developing countries has access to the internet. Only 64% of the inhabitants of least-developed countries own mobile phones. At least 450 million people have no access to a mobile signal. While technology is therefore important, payment solutions need to cater to all their customers, including with cash payments. Any international debate on the future of cross-border payments needs to reflect this diversity of customers and the importance of financial inclusion.

Western Union welcomes the G20 roadmap to enhance cross-border payments. The proposed CPMI building block approach identifies the right set of barriers and opportunities. The challenge will be to implement the recommendations in a way that is consistent with the realities of customers' needs. Rather than a 'one-size-fits-all-approach', the implementation of the recommendations will need to reflect the characteristics of the respective market, such as the remittance market in which Western Union operates.

Let me give you a number of examples:

- The recommendations should recognize the uniqueness of the customers. Payment providers should be in a position to offer the wide range of services to their customers, including those that do not have access to basic infrastructure and rely on cash payments.
- One important criterion is the cost of payments. Other key criteria for determining the effectiveness of cross-border payments should include the customer experience in relation to access, convenience, speed, trust and choice of payment solutions and providers.

Rules and regulations should not restrict innovation, nor should they favour one payment solution over another.

Regulators could take a number of other actions. The increased anti-money laundering requirements (AML) are imposing higher costs on the payment sector. One example of this is bank de-risking. Driven by the lack of regulatory certainty of the AML rules, the decision of banks to de-risk and terminate their relationships with other payment providers reduces competition and imposes additional costs on the non-bank payment sector.

In response, Western Union would support more harmonized AML rules. This would allow payment providers to invest in new compliance solutions, such as e-KYC and e-ID instruments, recognizing AI-powered approaches to AML compliance, as well as streamlining the reporting requirements by introducing common templates and machine-readability. Western Union is excited about the European Commission proposals to turn parts of the current 5th AML Directive into a Regulation and to also increase the day-to-day enforcement capabilities of the EU.

More generally, Western Union welcomes the work by CPMI to align regulatory and supervisory approaches, promote the interoperability of payment infrastructures and contribute to standard setting on data exchange. While recognizing the importance of local rules, regulations and consumer protection requirements, these should not fragment the global payment market and prevent providers from delivering efficient customer solutions. As already mentioned, rules and regulations should not restrict innovation, nor should they favour one payment solution over another.

We thank **the partner institutions**
for their support to the organisation
of the Eurofi September 2021 Forum

NEW EU RETAIL PAYMENT ERA

MADIS MÜLLER

Governor,
National Bank of Estonia
(Eesti Pank)

Instant payments are the future

Today's digitalised world offers numerous new ways to make payments faster, smarter and safer, but at the same time it poses regulatory and technical challenges that we have not had to face before. With that in mind, I would like to highlight three areas where we should focus our attention, and these are the uptake of instant payments, European independence from Big Tech and the global card schemes, and the digital euro.

Instant payments are indisputably a game changer for the payments industry. They provide a building block that the industry can use for building new and more efficient payment solutions in e-commerce, at physical points of sale, or in transactions between individuals. They have enabled solutions like proxy payments and request-to-pay payments that make initiating or requesting payments as easy as everyday messaging on smartphones. This broadly meets the expectations of market participants, but getting the best results from it will need all the euro area countries and their market participants to work together to overcome the two remaining challenges of

- achieving full reachability of instant payments by all payment service providers, and
- making instant payments the new normal for end users and not a premium service.

Overcoming these challenges will take some time, as the transition to instant payments is being made on a voluntary basis. But do we really need legislation that makes instant payments mandatory to make us see the advantages and opportunities they offer? In Estonia, 68 percent of all domestic interbank payments are already made instantly. The question now is whether we should maintain a slower system and the instant payments system in parallel or rather aim for a full upgrade to only one system. Maintaining a single system will surely end up being more efficient, while also offering additional benefits such as a smaller carbon footprint.

Instant payments are indisputably a game changer for the payments industry.

Secondly, we should aim to have more European solutions in our payments market. Card schemes with roots beyond the borders of the European Union hold a monopoly position today, while Big Tech companies are developing solutions that will increasingly strengthen their position in the EU. In response the European Commission and the European Central Bank have come up with their Retail Payment Strategies and the European Payment Initiative (EPI) to work on an EU card scheme solution and broader payment solutions. It is great to see the public sector working together with the private sector, but these are only the first steps and bigger challenges still lie ahead. The eIDAS regulation (The Regulation on electronic identification and trust services) has been revised to promote opportunities for the payments industry, the EPI solution needs to be launched and more widely adopted, and the Payment Service Directive 3 needs to make further progress.

Thirdly, we should always remain open-minded when we look to the future. Today the payments market is already having to deal with crypto assets, programmable or smart money, and the blockchain technology underlying them, and I am certain it will increasingly have to do so in the years ahead. This new technology has been proven to have a lot of potential, as it is highly scalable, faster and secure, and it can be used in many business areas to fuel the digital token economy. The proof can be seen in the private sector, which is developing new solutions like DIEM that are based on blockchain technology. The market capitalisation of crypto assets has already passed 1.3 trillion euros.

This is also one reason why central banks around the world are looking into this kind of technology and analysing and piloting Central Bank Digital Currencies (CBDC). The Eurosystem's digital euro project launched in mid-July is embarking on an investigation phase to identify how best to support the changing payments environment and market needs. It is also significant that the European Commission has made the first steps with the Markets in Crypto-assets Directive and the 5th Anti-Money Laundering Directive in order to protect end users and regulate the crypto assets market.

I welcome these challenges as they hold within them the potential for further improvements in our everyday lives.

ULRICH BINDSEIL

Director General, DG Market Infrastructure & Payments, European Central Bank (ECB)

What are the main challenges facing the European retail payment system?

Digitalisation has paved the way for an array new products and services. For instance, the way we pay is changing, albeit at a slower pace than many other digital developments. This means electronic retail payments are transforming from basic payment services, traditionally provided by domestic banks, to commercialised, global payment solutions.

The coronavirus (COVID-19) pandemic has further accelerated a rise in the use of digital payments that had already been gathering pace in recent years. Payment cards have profited the most from this trend, in particular those attached to international payment schemes. Not only are payment cards widely used at the point of sale, they are also used for back-end processing of most e-commerce payment transactions – for example, when a person pays for something online. At the front end, solutions are increasingly provided by a number of global technology firms – often referred to as "big techs".

To increase choice, resilience and competitiveness, European payments service providers must step up their activities and develop pan-European, innovative payment solutions and technologies. With this in mind, the Eurosystem is promoting a retail payments strategy that prioritises (i) developing a pan-European payment solution for the point of interaction (POI), (ii) helping to fully deploy instant payments and (iii) improving payments that cross borders between EU and non-EU countries. The Eurosystem's strategy is consistent with ongoing efforts to look into using a digital euro for retail payments.

On the development of a European payment solution at POI, the Eurosystem welcomed the launch of the European Payments Initiative (EPI).[1] The EPI aims to develop a payment solution for people and businesses across Europe, including a payment card and digital wallet. EPI objectives meet Eurosystem criteria of pan-European reach and customer experience, convenience and cost efficiency, safety and efficiency, European brand and governance, and global acceptance as a longer-term goal. Other market initiatives are welcome, if they also meet these requirements.

The Eurosystem is promoting a retail payments strategy.

In terms of full deployment of instant payments, people increasingly expect to be able to make instant payments in any situation. They also expect instant payment services to be affordable and transparent. More European payment institutions need to adhere to the instant payment scheme established by the European Payments Council. Full pan-European reach needs to be guaranteed.

The Eurosystem has taken steps to ensure the pan-European reach of instant payments by the end of 2021, using the TARGET Instant Payment Settlement service (TIPS). From the private sector, the Eurosystem would like to see providers push beyond mere scheme adherence, by making instant payments available on all commonly used electronic channels – including at shop checkouts – and offering additional pan-European functionalities such as Request-to-Pay.

Although the Eurosystem's major focus is on payments within Europe, digitalisation should also make payments that cross between EU and non-EU countries more affordable, easier and faster. The Eurosystem contributes to international work on cross-border payments, such as the G20 roadmap[2]. On the operational level, the European Central Bank and Sveriges Riksbank are exploring how TIPS could support cross-currency instant payment transactions.[3]

The advance of digitalisation in the payments sector has also triggered research on possible scenarios that could induce central banks to issue a digital currency. Following its report on a digital euro[4], published for public consultation in 2020, the Eurosystem launched a digital euro investigation phase.[5] It will last 24 months and aims to address functional design, use cases, legal considerations and market impact. A digital euro must meet the needs of Europeans while helping to prevent illicit activities and avoiding any undesirable impact on financial stability and monetary policy. The investigation will not prejudge any future decision on the possible issuance of a digital euro for retail payments. Regardless of the outcome, a digital euro does not imply that cash would be abolished. Cash will remain available to anyone who wants to use it.

[1] European Central Bank (ECB), "ECB welcomes initiative to launch new European payment solution", press release, July 2020.

[2] Financial Stability Board, "Enhancing Cross-border Payments: Stage 3 roadmap", FSB, October 2020.

[3] ECB, "ECB to explore cross-currency instant payments", MIP News, ECB, October 2020.

[4] ECB, "Report on a digital euro", October 2020.

[5] ECB, "Eurosystem launches digital euro project", press release, July 2021.

BURKHARD BALZ

Member of the Executive Board, Deutsche Bundesbank

Reinventing payments: European infrastructure for citizens and businesses

Over the last decade, three different trends have transformed the payments infrastructure: European harmonisation, consolidation and digitalisation. European harmonisation impacted the base layer of payments, among other things, by standardising account-to-account transactions. Moreover, regulatory changes opened up the market for new payment services providers and were intended to enhance payments security. At the same time, the processing industry underwent substantial consolidation. This resulted in an enhanced scale and efficiency of operations.

Digitalisation became most visible at the customer interface. International technology titans started to offer convenient payment solutions built upon existing instruments. These are well-received by users but tend to exploit their data to raise platform value. Moreover, a number of competition authorities are now investigating whether bigtech players may be abusing their prominent market position. European providers are often too small and lacking resources to effectively compete. The coronavirus pandemic has fuelled digitalisation and further strengthened international platforms, while the relative use of cash – as a form of central bank money – has fallen in Europe.

In 2017, instant payments became a reality in Europe. They were introduced to foster direct account-to-account transactions. SEPAinst is harmonised across Europe and can be channelled through a consolidated, efficient infrastructure including the Eurosystem's TIPS. Based on this, European providers can build convenient, safe, data-conscious and efficient payment solutions. Instant payments as rails could be a powerful tool for eluding payers and payees alike, forming the foundation for renewed competition in the digital payment space. In addition, payment processes could be streamlined and therefore potentially better protected against cyber threats. In this sense, instant payments contribute to more safety in payments.

A digital euro would strengthen European autonomy and significantly enhance payments infrastructure.

Yet no European solution based on instant payments has emerged so far. However, the European Payment Initiative, EPI, could become a relevant competitor in this market. It would also meet the criteria laid out in the Eurosystem's retail payments strategy and thus contribute to its realisation. By the end of 2021, the banks and payment processors involved will decide whether the EPI solution will be rolled out. The Eurosystem and the European Commission would welcome such a decision.

On the back of payments digitalisation, including declining cash use, the rise of crypto tokens such as bitcoin or ether has marked a fundamental shift in how payments infrastructure could be organised. Before them, a central, trusted entity was needed to process transactions. With decentralised crypto tokens based on a ledger distributed across a large number of network participants, trust is created by the underlying algorithm. Proponents claim that intermediaries are becoming obsolete. But, crypto tokens in their current design do not sufficiently fulfil the functions of money: a means of payment, store of value and unit of account.

By contrast, private stable coins – such as the planned Diem – might be better positioned, as they are in principle backed by a fiat currency. Central banks and governments around the world are concerned that private stable coins could be rapidly adopted by a large number of users if linked to platform services. This could make effective monetary policy more difficult. Oversight activities need to encompass bigtechs operating worldwide, a challenge not to be underestimated. The financial system as we know it could be at stake.

In response, central banks around the world are analysing the option of issuing central bank digital currency. These are not necessarily based on distributed ledger technology but can also involve account-based solutions. Some are already in place, e.g. in the Bahamas. Most notably, the Chinese central bank has started to distribute e-yuan in pilot regions. In July 2021, the Eurosystem launched an investigation phase to explore different design options for a digital euro. These include data and privacy protection as far as possible. The digital euro would complement cash, not replace it. It should be delivered to payers and payees by regulated payment services providers. They are best positioned to build attractive user interfaces. In my view, the digital euro could be a European solution for retail payments if we succeed in involving banks and other private payment providers properly.

Later on, I can envisage a programmable digital euro that allows smart contracts. This could be linked to a European e-ID scheme to kick-off a digital ecosystem that allows its users fast, secure, seamless, efficient transactions with firms, merchants and government agencies alike. In sum, the digital euro would strengthen European autonomy and significantly enhance the European payments infrastructure, which will also support European citizens and businesses in better navigating digitalisation.

ONDŘEJ KOVAŘÍK

MEP, Committee on Economic and Monetary Affairs, European Parliament

Retail payments have rapidly developed digitally, EU rules must keep up

As the payments sphere has undergone a number of distinct changes in recent years, including the Covid pandemic, and had to adapt. The main challenge to be addressed by retail payment infrastructures going forward is to ensure their relevance. This should be done through ensuring they are modern, flexible, secure, swift and also adaptable to compete and cooperate on an international level.

There are a number of structural changes that we are seeing playing out to determine how best to serve the consumer, but also businesses, from small to large. These include emergence of new projects, such as the Diem or the concept of a central bank digital currency, which the ECB is currently studying, and also instant payment systems, which are speeding up payments to ensure that settlement is performed much more quickly than in the past. We are also seeing some jurisdictions cracking down on crypto-assets and digital currencies such as bitcoin, while other jurisdictions such as the EU try to find the right framing for markets of crypto-assets, which strikes the right balance between allowing for innovation, while reducing risks to consumers and the financial system as a whole.

In devising our new legislation to deal with the future of payments, we should keep in mind a key idea, which is that the same activity with the same risk should be subject to the same rules. The European Parliament has been committed to this approach since the adoption of our report on Digital Finance in 2020.

In practice this is more challenging than it appears, given the conflicting priorities in regulating technology as opposed to regulating financial services, which of course in the past were the main gateway to payments. Now, with technology companies becoming actively involved in the payments sphere, whether through Diem, the Apple Wallet or other such schemes, it's important that when it comes to retail payments, all are subject to the same rules, regardless of the market segment that company hails from.

...the same activity with the same risk should be subject to the same rules.

In the past year and a half, Covid has been an accelerator for the digitalisation of retail payments, with more online and app-based payments, as well as an increase in contactless payments. While these changes may have been somewhat predicted to occur, it would have happened at a slower pace had we not faced the pandemic. Therefore, we also need to ensure that the modernisation of our rules match the pace of the acceleration of digitalisation of payments.

Some problems that we face in Europe include a lack of EU level coordination when it comes to cross-border payments, with different national systems creating hurdles for banks, for example, to jump over. It's therefore important that in the new era of retail payments, there is harmonisation of payments legislation on the EU level. It's positive, and indeed necessary, that the Commission will look at how PSD II has been implemented and whether we will need to make some changes to the legislation. This applies to the front-facing aspect of retail payments as well as the back-end infrastructure.

While the digitalisation of payments has sought to ensure that the consumer is satisfied with services available, the data concerning consumers' transactions is becoming a more valuable and quantifiable commodity to banks, payment service providers and fintechs. In the technology field itself, consumer data and behaviour has become ever more highly valued.

It's important in this respect that the right balance is struck as regards the availability of large scale, anonymised data between those companies which have the big picture and those that may only have a partial picture of consumer behaviour.

In the EU, there is also the potential for better innovation and scale up. In the payments sector, we have some strong EU players, but a number have had to seek investment from elsewhere. We therefore need to ensure that in Europe there is the same prospects in terms of innovation potential, availability of investment and a single rulebook for payments across the EU.

Regarding data, we also have to consider that the EU has very strong personal data protection, while at the same time strong AML rules, which would need better coordination and enforcement. These, together with PSD II are key backbones of the retail payments landscape, and we need to ensure that they are fit for purpose as that landscape continues to evolve in the coming years, as they may have solved some older challenges, but new challenges are emerging from the combination of technology with the payments sphere.

As the legislation evolves to meet the challenges of the digital financial era, so must supervision and enforcement of the rules, with stronger co-operation on a national level, between the national and European level, and finally on the international level. The EU must work together with like-minded allies to ensure the financial infrastructure remains open and easy to use for our consumers.

CHARLOTTE HOGG

Executive Vice President and Chief Executive Officer, Visa Europe

The future of payments is open

Innovation in payments is accelerating to meet changing needs. This is exciting, and it also requires the private and public sectors to ensure that these developments are inclusive, sustainable, and maintain trust and financial stability.

Payments innovation follows the lead of commerce. For payments to be "one size fits all," commerce would have to follow a set pattern—we know it does not. When one considers the innovations in retail, in-app, person-to-person, and government-to-citizen payment flows over the past five years, it becomes clear that change is the only constant. The COVID-19 pandemic accelerated that change.

Central banks and policymakers should promote a diverse and open payment landscape where all players commit to security and resilience, and where consumers and merchants can choose the most suitable payment method depending on their needs.

This brings us to some areas where the public and private sectors can and should work together to improve outcomes for European consumers and businesses.

Instant payments need to be part of a diverse digital payments mix

The market for instant payments is advancing, driven by technological development, consumer and business demand, and support from policymakers. Instant payments are complementary to other payment types and bring unique features and value propositions. But instant payments would not be the preferred method for all use cases.

A diverse payments mix will be needed to allow for continued competition and innovation. Instant settlement is only one feature consumers may care about, and even then, many care more about instant funds availability. That said, instant payments may facilitate a variety of use cases people and businesses care about, and the overlay services, such as request to pay solutions, that they need to be attractive to end users will benefit from private sector innovation. The private sector has much to add in the way of security and fraud know-how as well—in real time payments, fraud can move quickly. If you are going to authorise or settle a transaction in milliseconds, you need to use all the tools and data you can to ensure consumers are protected.

Central banks and policymakers should promote a diverse and open payment landscape...

Open banking holds the potential to spur further innovation

By putting consumers at the heart of the financial ecosystem, open banking should encourage innovation, with more players entering the ecosystem, to create more tailored and relevant financial products and services. Above all, it holds the promise of equipping European consumers and businesses with tools to make their financial lives more simple, reliable and secure.

We recognize that increased data sharing can raise security and privacy concerns if implemented without proper safeguards. A comprehensive security approach is paramount to drive consumer trust in open banking and data sharing more broadly, while interoperability of underlying technical infrastructure, standards and APIs is key. As Visa, we believe that our capabilities in resilience, security and fraud prevention will contribute to the success and scaling up of open banking solutions in Europe.

Private sector involvement in retail CBDCs is essential for innovation and financial stability

We do believe strong support from the private sector is key for the success of a retail CBDC. The private sector is well-situated to help sort out the natural use-cases for instant payment and CBDCs, given its strong knowledge of consumer and business preferences and behaviours. Central banks should continue to focus on the foundational elements - security and certainty of acceptance - while intermediaries are best placed to deliver against these objectives and also to provide the best possible user experience.

CBDC design choices should favour openness and interoperability. We believe that retail CBDCs should be integrated into the existing payments ecosystem as this will, among other things, ensure customers are provided with integrated payments solutions and acceptance is widespread from initial introduction.

In a time of rapid change, the focus on innovation is often at the user experience level. However, innovation in resilience, network availability, fraud prevention and cyber security is just if not more important. We must therefore create the environment for further payment innovation, but never compromise on the security and resilience that makes this all possible and ensures that trust is maintained in the system.

JEAN DIACONO
Vice President and General Manager, Global Merchant Services Continental Europe, American Express

The (eternal) pursuit of the single market

Arguably one of Europe's biggest assets, the Single Market is key for generating sustained economic growth. It is one of the core reasons why overseas firms invest, how domestic firms can scale-up, and fundamental to Europe delivering greater choice and value to its citizens. When designing policy, it should be the Commission's 'North Star'.

This summer, the European Commission launched a revision to the 2008 Consumer Credit Directive. Quite rightly, one of the main objectives of this original legislation was to create a single market for credit. Unfortunately, this has not materialised, and there is a danger that the new proposals do not adequately address the current barriers to a true Single Market in credit. They could even inadvertently exacerbate them, further limiting the potential benefits for the European economy.

As digitalisation continues to drive innovation in payments, we must seize this opportunity to create better conditions for consumers, to allow for more competition, and more products to safely enter the market. A clear step towards creating a true Single Market would be to create a licencing regime that enables the passporting of credit by non-banks and other financial services providers. Lowering barriers for cross-border lending would introduce more choice as well as create the conditions for national fintech champions to emerge as genuine E.U.-based tech unicorns.

The EU should seize this regulatory momentum as an opportunity to build a Single Market for credit.

Equally important is that regulation should focus where there is clear consumer detriment, and allow greater flexibility for products that pose no-consumer risk. A 'one-size-fits-all' approach to regulation – by bringing all payment products into scope and the same regime – may ultimately leave consumers with fewer options, and with it, the potential to increase the cost of credit.

Particularly concerning is the Commission's proposal to introduce mandatory caps on interest rates. This would undermine one of the core principles of the Single Market, namely that of an open and competitive market. We have previously seen that the introduction of caps within the Payments sector has strengthened the position of a few dominant players, whilst diminishing competition and erecting barriers for new players in the market. The proposals go further, allowing 27 Member States individually to determine how a cap on interest should be calculated; this patchwork approach would throw-up significant administrative barriers to firms looking to operate across the EU, and undermine the harmonisation necessary to ensure efficiency.

Payments in the EU are at a critical turning point. EU regulation should protect consumer rights while fostering innovation and competition. The EU should seize this regulatory momentum as an opportunity to build a Single Market for credit that works for citizens and unlocks new avenues of growth for the European economy.

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VI

ESG AND SUSTAINABLE FINANCE

ISSUES AT STAKE

The EU Commission has launched in July 2021 a new "Strategy for financing the transition to a sustainable economy" aiming to increase the level of ambition in the EU in terms of share of private capital flows redirected to green investments, and more generally embed a culture of sustainable governance in the private sector.

Yet this Renewed Strategy comes in the context of the adoption of a first Taxonomy Delegated Act on climate change adaptation and mitigation, and a Corporate Sustainability Reporting Directive (CSRD), which both raise significant implementation challenges.

In addition, the banking and insurance sectors - and their supervisors – face a number of issues regarding sustainability, given the magnitude of anticipated changes. Banks and insurance undertakings must indeed define - and inform on - how ESG considerations are going to be embedded not only in their risk management arrangements, but also in their governance, business model, product and services definition and strategy.

DIVERGENCE OF ESG APPROACHES AT THE GLOBAL LEVEL

JOHN BERRIGAN

Director General, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Toward a comprehensive and coherent EU sustainability reporting framework

Sustainability or Environmental, Social and Governance (ESG) reporting from investors and companies is a key driver of a more sustainable financial system. It allows investors to better manage risks and generate sustainable, long-term returns for investors and for society, by exerting a positive influence on the behaviour of companies.

Transparency about the sustainability performance of companies also allows companies to signal their transition efforts to investors and stakeholders.

For this reason, the EU has put in place a comprehensive disclosure regime throughout the financial value chain. This disclosure regime aims to increase transparency about impacts, risks and opportunities, as well as strengthen market discipline, discourage green-washing and foster innovation in the design of financial products.

Basic information must be provided by non-financial institutions engaged in economic activities that have an impact on sustainability and are exposed to sustainability factors. Therefore, companies will be required to report improved sustainability information under the proposal for a Corporate Sustainability Reporting Directive (CSRD), proposed by the Commission in April 2021 (and revising the Non-Financial Reporting Directive). If adopted, the proposal would ensure that all large companies and all listed companies, including listed SMEs (except listed micro enterprises), disclose relevant, reliable and comparable sustainability information.

> The comprehensiveness and consistency of the EU sustainable finance reporting framework.

Mandatory EU sustainability reporting standards are the centerpiece of the proposal. Commissioner McGuiness recently invited the European Financial Reporting Advisory Group (EFRAG) to begin the technical development of standards in parallel to the negotiation of the CSRD proposal by the European Parliament and EU Member States. The objective is to adopt the first standards by October 2022.

Large non-financial and financial companies must also meet additional disclosure requirements under the Taxonomy Regulation. A delegated act on Article 8 of the Taxonomy Regulation, adopted on 6 July, provides the content, methodology and presentation of the disclosures that large European companies (including financial institutions) will need to make against the EU Taxonomy.

Financial market participants are also required to disclose to their end investors the sustainability impact of their investment products, activities and processes. This obligation is enshrined in the Sustainable Finance Disclosure Regulation (SFDR), which applies from 10 March 2021. The SFDR establishes common rules for institutional investors inform their clients about potential sustainability risks that could affect the value of their investments and how those risks are being managed, the potential adverse impact of investments on the environment or broader society and how sustainable products deliver their green or sustainable objectives. In addition, the SFDR requires products with certain sustainability-related ambition to disclose their degree of Taxonomy-alignment.

As a complement to the sustainability disclosure regime, sustainability preferences are to be included in investment and insurance advice. To this end, the Commission adopted several delegated acts on 21 April 2021 aimed at giving retail investors more information and empowering them to formulate sustainability preferences, if they wish to do so.

The EU sustainable reporting framework provides a comprehensive and consistent set of requirements across the value chain. The Commission is committed to ensure a high level of coherence between the different requirements. Companies' future sustainability reporting standards under the proposed CSRD should be consistent with Europe existing legal framework, in particular the SFDR and the Taxonomy Regulation. The development of EU standards will both build on and contribute to global standardization initiatives. In this respect, future draft EU standards intend to take into account international standard setting initiatives, including the proposed International Sustainability Standards Board (ISSB), or the Global Reporting Initiative. EFRAG is currently in contact with a number of global standard-setting initiatives, including the IFRS Foundation, to discuss the modalities of cooperation and a "co-construction" approach.

BERNARD MENSAH
President of International, Bank of America

The importance of a common data approach in non-financial reporting

The EU continues to act at speed to tackle the shared challenge of climate change, with the European Commission proposing a number of important initiatives in recent months. At Bank of America we also remain strongly committed to taking action to address climate change, and a particular area of focus has been to support the development of consistent metrics in order to measure the impacts of different economic activities.

We supported the work of the WEF's International Business Council, chaired by our CEO Brian Moynihan, to develop a common framework, the Stakeholder Capitalism Metrics. These draw from a range of existing standards and represent a common, core set of metrics and recommended disclosures to align sustainability reporting, reduce fragmentation, encourage the convergence of existing standards toward a single, global common standard, as well as encourage faster progress towards solutions to environmental and social challenges. So far around 80 global companies from every region and across a diverse range of industries have indicated their commitment to reporting under the Metrics.

Harmonisation of reporting and disclosure standards will help ensure that the financial effects of climate change can be more broadly considered by the financial markets and stakeholders can evaluate the progress being made with consistent, transparent, and assurable data.

In July, G20 Finance Ministers and Central Bank Governors highlighted the increasing risks posed to financial stability from climate change, and noted that "quality data and comparable frameworks of disclosure are crucial for addressing climate-related financial risks and mobilising sustainable finance".

We welcome the creation by the International Financial Reporting Standards (IFRS) Foundation of the International Sustainability Standards Board (ISSB) and support the IFRS "climate first" approach to non-financial reporting. This will help create a global harmonised approach to disclosures; standardised disclosures will, in turn lead to improved asset pricing as markets absorb the information based on those standards. The SEC is also working towards consistent standards for ESG disclosure, focusing first on climate change and human capital.

Climate change is a global challenge and one that will require international approaches...

Bank of America is pleased to be a founder member of the Glasgow Financial Alliance for Net Zero (GFANZ) and the Net Zero Banking Alliance (NZBA). GFANZ, chaired by Mark Carney, UN Special Envoy on Climate Action and Finance, brings together over 160 firms responsible for assets in excess of $70 trillion in aggregate to accelerate the transition of the global economy to net zero emissions by 2050 at the latest. Likewise, NZBA members are committed to aligning operational and attributable emissions from their portfolios with pathways to net-zero by 2050 or sooner. Brian Moynihan also co-chairs HRH The Prince of Wales' Sustainable Markets Initiative, which has catalysed cross-industry work in this area.

At Bank of America, we have also formed the EMEA ESG Strategic Council, which I chair and which is led by two of our most senior bankers in the region. This recognises the leading role Europe is playing in addressing the challenges of climate change and bringing green finance into the mainstream. The new Council will help us to assess and manage our climate-related risks as well as support our clients in their low-carbon transition, while providing an important forum for co-ordination of our activities internally.

For financial services firms, gathering and analysing data and understanding and reporting comprehensively on climate risks are a key part of our sector's response to climate change. In all the initiatives described here, we can see the benefits of international co-operation. We would therefore urge policymakers and regulators around the world to maintain a collaborative approach in order to avoid multiple different standards developing – an outcome which risks being costly, time-consuming and resource-intensive for businesses while not helping to deliver the solutions required.

Ultimately, climate change is a global challenge and one that will require international approaches if it is to be successfully addressed.

SIMON HARRIS

Managing Director, Global Financial Institutions, Moody's Investors Service

Consistent, transparent ESG disclosures assist in assessing related credit risk

An assessment of credit implications stemming from ESG risks, or of credit risks more broadly, can be better informed by data. In many areas of analysis quantitative data is plentiful, and in others less so. But in each case Moody's approach to assessing credit risk remains one that relies on analytic judgement, supported by data. Consistent, standardised data assists in comparing credit risk across financial institutions, and development of more uniform ESG disclosures will be valuable in informing our ESG Issuer Profile and Credit Impact Scores.

In establishing ESG Issuer Profile and Credit Impact Scores, Moody's makes a qualitative assessment of the rated entity's ESG profile and the impact of that profile on its credit rating. Our focus is on credit-relevant ESG considerations. In making assessments for individual entities, we have drawn on a number of quantitative inputs to help inform our analysis – as we do for other aspects of assessing credit risk – including selected World Bank and United Nations data for sovereigns. We expect to follow a similar path as we introduce these scores for financial institutions.

The ESG data we are most focussed on are those most relevant to assessing the credit implications of ESG. We look at an issuer's sustainability initiatives through that lens – assessing, for example, if such initiatives support or damage customer, counterparty or regulatory perceptions of an issuer.

Financial institutions face a number of competing, non-converging standards with respect to ESG disclosures, whether for accounting, regulatory or other non-financial purposes. As financial institutions analysts, we regularly deal with such inconsistencies when assessing financial and other risks. A prime example is disparities between accounting systems and reporting and regulatory requirements globally. Nevertheless, this lack of consistency creates complexity and cost as well as opacity around the materiality of ESG issues.

Development of more uniform ESG disclosures will be valuable for financial institutions analysis.

Moody's supports the Task Force on Climate-Related Financial Disclosures (TCFD) principles of transparency with respect to climate-related financial disclosures. The TCFD '4 pillars' approach covering Metrics and Targets, Risk Management, Strategy and Governance particularly aligns with our forward-looking, holistic approach to credit risk assessment. And the insight we gain from interactions with issuers is especially valuable in understanding the likely credit impact of their ESG strategies.

We expect that the TCFD framework will help gradually form consensus on the most informative metrics. In the meantime, we encourage issuers to adopt similar disclosures, where possible, which will improve comparability, reduce transaction costs and start a path toward standardised data metrics. It will also provide a better framework for issuers to explain, and investors to assess, firms' progress on climate-related initiatives such as the route to a 'net-zero' greenhouse gas global economy.

Climate-related risks – such as a bank's loan exposure to carbon emitters or an insurer's exposure to rising sea levels – are an increasingly important focus of Moody's credit analysis. Social and governance risks are also significant considerations – for example in our private-sector rating actions in 2020, 71% mentioned social risk factors, 53% governance issues and 13% environmental issues. And in an analysis made in early 2019, we found that governance issues led to 'corporate behaviour' adjustments for 8% of the banks we rate globally. These findings underscore the importance of a consistent, standardised approach to disclosing and discussing such risks. As a result, Moody's sees considerable upside from the IFRS Foundation proposal to develop a Sustainability Standards Board, with the goal of achieving further consistency and global comparability in sustainability reporting.

DANIEL HANNA

Global Head,
Sustainable Finance,
Standard Chartered Bank

Time is running out: urgent action is needed to scale climate finance

"Code red for humanity". The Intergovernmental Panel on Climate Change's report on climate science, published in early August and around 90 days ahead of COP26, made for sobering reading.

It is encouraging then that the G7 Leaders' Summit and G20 Finance and Environment Ministers' meetings, which took place earlier in the summer, saw greater ambition from the world's largest countries in tackling climate change.

We urgently need to turn this level of ambition into reality.

To stay on track with critical targets outlined in the Paris Agreement, net carbon emissions must fall 45% by 2030 (from 2010 levels). Missing those targets would put the world on course for the worst consequences of climate change.

The private sector is moving. Over 3000 business have now signed the 'Race to Zero'. At Standard Chartered, we have committed to reaching net zero in our operations (Scope 1 and 2) by 2030 and across our financed emissions (Scope 3) by 2050. We will publish a consultation later this year so our stakeholders can input to our roadmap.

To support private action, we need to ensure a standardised policy framework to catalyse climate finance.

Material progress has been made on reporting, with G20 countries (among others) supporting the Taskforce on Climate-related Financial Disclosures (TCFD) framework – something that has been underway for some years within financial services. This is critical. Our Zeronomics report (https://www.sc.com/en/insights/zeronomics/) found that 81% of senior managers believe standardised, globally consistent measurement and reporting standards would help accelerate their net zero journey.

More is needed. Double materiality should be agreed as the foundation of reporting approaches. We not only need to understand the risk that climate poses to us and our clients, but we urgently need to understand, measure and reduce our impact on the world – and this extends beyond climate change to issues such as biodiversity degradation.

We encourage more interoperability. Full harmonisation will take years; years we don't have.

We also need policymakers to implement and extend TCFD reporting across their economies. Smaller companies should face proportionate regimes and transition should not be stifled by burdensome regulation. However, more effort is required to increase, improve and harmonise data and disclosures from all sectors of the economy, in particular from emerging markets which are the most at risk from climate change but also represent the biggest investment opportunities.

Disclosure is a critical tool in unlocking investment in the fight against climate change and the delivery of sustainable development globally. To complement this, we need standardised taxonomies covering both green (Paris-aligned) and transition activity. As these develop across the world, we encourage more interoperability. Full harmonisation will take years; years we don't have. Taxonomies need to be designed with a focus of channelling capital to where it is needed most.

Most of the world's population lives in emerging markets, and if economies with vast populations like India and China do not transition to net zero, efforts in the developed world will have a limited impact. However, 80% of companies and 79% of investors say there is a significant gap between net zero transition investment directed at developed and emerging markets.

Finally, policymakers need to consider and implement regulatory incentives towards sustainable finance. While estimates vary, it is uncontroversial to say that the scale of climate finance required – and sustainable finance more broadly – is staggering. Better data, reporting and risk management, underpinned by common definitions, will create change. While policies put these in place, measures can be introduced to remove distortive pricing effects and create better pricing incentives for climate- or sustainable-aligned finance.

Encouraging progress is underway at the global level and across economies. In turning ambition into reality, we don't have years to create the perfect regulatory framework. We are currently on track for 1% emissions fall by 2030, a long way short of the 45% needed. The time for urgent and pragmatic action is now.

KATSUNORI YOKOMAKU
Deputy Regional Executive for EMEA , MUFG Bank, Ltd.

The path to a net zero banking industry

We are living in extraordinary times; containing a pandemic in the short term while facing a climate crisis in the long-term. It is still too early to assess the real impact of COVID-19 on the economy, however now is a good time to reflect on the way the financial system, in particular, has been an essential support in the current pandemic. Although the nature of the global threats facing us today are different, there may be resemblance in the strength of the financial system to form part of the solution.

The banking reforms following the GFC kept our banks financially robust and resilient during the pandemic. This was an essential component of the economy's ability to transition to the 'new normal' without imposing risks to the financial system. Additionally, the response of public authorities would not have been as efficient without close national and international coordination at all levels. It is now clearer than ever that a global crisis needs a global response.

When it comes to climate change, society's attitude is shifting fast and so are the ESG strategies of private institutions. This is a positive development; the world must move fast if it is to tackle climate change. Since the Paris agreement only five years ago, society has raised its expectations even further. 126 governments, including Japan, have set 2050 targets and are shaping their plans about how the transition to net zero will be achieved. Setting end targets is necessary to understand where we want to be, but it will become increasingly important to set out the detailed plans of how to get there. Decarbonisation pathways of specific industry sectors across the key regions are key in determining whether we are on track.

Over 1500 private institutions committed to TCFD have been making tremendous progress to enhance their disclosure capacities to mitigate the risks associated with climate change. This has provided valuable insights into banks' exposure to carbon intensive sectors. In Japan, the TCFD consortium was established in 2019 and today, it has 428 members. We are pleased to see that the global five standard setters[1] are using TCFD as the basis for a global ESG reporting standard. We need to aim for a single ESG reporting standard for everyone.

Let us not lose sight of what we have already achieved and enable the global financial system to be part of the solution.

More recently, a significant number of large financial institutions, MUFG included, have signed up to institution specific net zero commitments. For banks, this means net zero by 2050, but also 2030 emissions reduction targets with respect to their lending, investment and advisory activities and services. Individual institutions' ambitions will help speed up the transition, but there are many pieces (based on industry specific methodologies for measuring emissions) that need to be considered. And let us remember that bank targets will not only depend on the ability of clients' to transition, but also the decarbonisation pathways of the economies in which they operate.

Mandatory ESG disclosure standards at regional level can cause divergence, making it more difficult to remain aligned with evolving global standards, designed by the IFRS based on TCFD. Therefore, it remains important that third country banks can rely on global voluntary standards for their EU-based entities while we are building a single global standard.

The financial sector is making an unprecedented shift to support the transition to a low carbon economy. We will have to accept a certain extent of geographical fragmentation in the speed of the individual economies to transition. However, what we should not accept is imposing regional divergence and fragmentation that poses burden on exactly those institutions that will be instrumental in helping the world to transition. Let us not lose sight of what we have already achieved and enable the global financial system to be part of the solution.

Let us build climate-risk resilient global financial institutions, strive for strong global supervisory and regulatory coordination and provide the necessary time for the private sector to thrive in the transition.

[1] CDP, the Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI), and the Sustainability Accounting Standards Board (SASB) and the International integrated Reporting Council (IIRC)

HESTER M. PEIRCE
Commissioner,
U.S. Securities and Exchange Commission (SEC)

ESG for Thee, but not for me

As a Commissioner of the United States Securities and Exchange Commission («SEC»), I am charged with regulating, among other entities, investment advisers. Responding to and fueling investor interest in sustainable investing, many investment advisers are offering ESG products and services. ESG offerings, however, require advisers to collect sustainability information about the issuers in whose securities they invest. Collecting such information is difficult because there are many different, sometimes inconsistent, sources for such information. Advisers are, therefore, among the strongest proponents of enhanced ESG disclosure mandates for issuers. Although they have not yet coalesced around any particular set of data points or any one reporting framework, they hope that a regulatory mandate will force uniformity.

As the SEC contemplates whether and how to respond to the advisers' call for issuer ESG disclosure, several points warrant consideration.

Regulators should beware of double materiality ... it cannot translate into a workable regime.

First, lack of uniformity is normal around issues of ambiguous significance to financial value. Advisers' diverse approaches to ESG are helpful in identifying material disclosure items for particular geographical or industrial sectors. The current inconsistency speaks to the fact that investors (as opposed to certain non-investor stakeholders) do not yet know what they want, assuming that they want anything at all, regarding ESG reporting.

Second, consistency is not a good in itself, and imposition of a standard that has not arisen organically would benefit only the companies hired to assist with implementing the standard and companies that have successfully lobbied to receive a "green" ranking in the standard. As Ralph Waldo Emerson said more than a century ago, "A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines." Substitute growing numbers of regulators for statesmen.

Third, over the opposition of many investment advisers, a standardized framework for issuers will likely feed into a standardized framework for asset managers. Here too consistency might not serve investors well as it will limit the types of approaches to sustainable investing from which investors can choose.

Fourth, regulators should beware of double materiality, which threatens to be so vast and shapeless that it cannot translate into a workable disclosure regime.

Finally, as tempting as it is to use the asset managers and other financial firms we regulate to push sustainability throughout the economy, well-intentioned regulatory constraints can impede the ability of the financial services industry to support society's goals for economic, social, and environmental prosperity.

The views I represent are my own views and not necessarily those of the Securities and Exchange Commission or my fellow Commissioners.

RENEWED EU SUSTAINABLE FINANCE STRATEGY

PAULINA DEJMEK HACK
Director for General Affairs, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

The renewed strategy: consolidating the EU sustainable finance policy framework

The impact of climate change and environmental degradation is already very visible to us all, with far-reaching human and economic consequences for our societies. Unprecedented and parallel efforts in a number of areas are needed to mitigate the multiple causes of these risks and to adapt to the new situation as swiftly as possible. To address this, the Commission has recently adopted a package of policies with the aim of reducing net greenhouse gas emissions by at least 55% by 2030.

Besides policy measures, significant public and private investment is needed. The EU will need EUR 470 billion yearly in additional investment to reach its 2030 climate and environmental targets. In addition, to remain sound and stable, financial institutions will need to fully integrate climate and environmental risks and sustainability considerations in their financing decisions. Through this, financial institutions have the potential to accelerate the ecological transition of the real economy.

For this reason, the Commission - with its 2018 Action Plan - laid the foundations of a sustainable finance policy framework[1]. Since then, the EU has put in place three key building blocks: a common classification system, or 'taxonomy' for sustainable activities; a disclosure framework for investors, non-financial and financial companies; and a number of different investment tools, including green benchmarks, standards and labels.

While this is a necessary start, it's clearly not sufficient. The strengthened environmental targets of the European Green Deal need to be translated also in the financial sector. At the same time, the global context is evolving rapidly. The EU's renewed strategy for sustainable finance identifies four main areas where additional actions are needed for the financial system to reach our climate and environmental objectives.

First, the transition pathways of economic actors will vary considerably, with different starting points and different business strategies. Until now, EU efforts have predominantly focused on supporting investment flows towards economic activities that are already sustainable. The Commission will explore additional actions to recognise and support investments in intermediary steps on the pathway towards sustainability. The EU Taxonomy is helpful in this context, as are new labels and standards for financial instruments and products.

Second, to be successful, the transition needs to be inclusive. Citizens, SMEs and public authorities need specific support tools to have access to sustainable finance opportunities. Beyond these specific actors, horizontal policies can improve the inclusiveness of the transition, such as exploring the role of digital sustainable finance, the definition of trustworthy social investments, or a greater protection from climate risks.

Third, the financial sector itself will need to become more resilient to the risks posed by climate change and environmental degradation, and to improve its own contribution to sustainability. The strategy aims to improve the integration of these risks in reporting standards and credit ratings, to ensure that ESG factors are included in the risk management systems and supervision of banks and insurers. The strategy also supports an increased contribution of the financial institutions to sustainability, using for instance financial institutions' target setting or voluntary commitments and the integration of sustainability impact in the strategies and investment decision-making processes of investors. Measuring the progress made by the financial sector as a whole to achieve our climate and environmental goals will also be important.

Finally, global ambitions to address climate and environmental challenges have significantly increased. The EU is at the forefront of global efforts in this area but cannot succeed alone. The Commission will continue to work with its international partners and advocate an ambitious consensus on global sustainable finance standards. The International Platform on Sustainable Finance (IPSF), which the Commission pilots together with 16 other jurisdictions, will deepen its work on taxonomies, labels and disclosures. Finally, the Commission intends to develop a comprehensive strategy to help increase sustainable finance in low- and middle-income countries.

The renewed strategy is an important extra step in our collective endeavour to achieve a more sustainable financial system and builds on the measures already in place. The intention is also to identify new business opportunities and increase the overall resilience of the financial sector. It goes without saying that these once-in-a-generation systemic changes and the limited time available to meaningfully reverse the current climate trends, bring new challenges. But the price of our inaction for future generations would significantly exceed these challenges.

[1] *Communication from the Commission 'Action Plan: Financing Sustainable Growth', COM(2018) 97 final, 8.3.2018.*

SIRPA PIETIKÄINEN

MEP, Committee on Economic and Monetary Affairs, European Parliament

The new EU Sustainable Finance Strategy is a right step in a long journey

Today, we are living through a remarkable period of history. The global cash flows are being gradually channelled in a sustainable direction, and green finance is trending in financial markets. Additionally, the EU Commission introduced its second, renewed Sustainable Finance Strategy for the EU in June 2021. This strategy continues the work of greening the EU financial legislation that started in 2018 and is aligned with the targets set in the EU's newly released 'Fit for 55' climate package. Whereas the main purpose of the 2018's strategy was to present the concept of sustainable finance for the first time to the EU legislators, the new strategy seems to take a major leap forward by proposing a wide set of concrete, polished tools to make the EU financial markets sustainable.

The direction is now right but there is still a long way to go. Firstly, in order to achieve a coherent methodology for measuring sustainability impact across the EU, the EU needs common financial reporting standards. However, when creating these standards, the ambition needs to be set high enough by involving all relevant stakeholders in the standard-setting process, such as companies that report, investors, NGOs, trade unions, as well as bodies including of the UN (UNPRI, UNEP, UNDRR), the European Environment Agency, Eurostat, and so forth. Hence, we could ensure that the standards will follow science-based and futureproof targets, and that those would not perform worse than already existing practices in the markets. Secondly, the company reports that would base on these standards need to be compiled under a common register in a transparent and comparable manner. The most relevant database for that would be the European Single Access Point (ESAP), an initiative introduced by the EU Commission in 2020 as part of the CMU action plan that would gather the financial and non-financial information publicly disclosed by companies.

Not only the private money matters, but also the public sector, including the EU and national budgets need to be involved in non-financial reporting under the same harmonized standards. Additionally, the non-financial reporting does not only limit to environmental issues, as the whole ESG criteria set (environment, social, governance) needs to be visible in those reports. A top-down approach is needed within the company, and both environmental and social due diligence should be included in the list of responses of corporate management and board, for securing adequate levels of meticulousness and responsibility of the business.

From the climate point of view, we cannot afford unsustainable investments any longer.

Finally, the examination and implementation of different risk concepts should be in the core of any EU sustainable finance initiatives. Last year the risk of a global pandemic became reality in the modern world and caused an unprecedented shock to our economies and societies.

The future risks are manifold and even difficult to predict, but I prefer using the concept of 'triple materiality' that gives the most accurate definitions of different types of risks. The first level of triple materiality is financial and technical risks that might have potential impacts on the credit or liquidity of the company.

Secondly, there exists the level of environmental risks including the operational risks, such as potential accidents, and new hazards emerging from climate and environmental changes that have a direct impact on the business.

Lastly, the third and most invisible, though the most important level is the biodiversity risk. It means that if you are increasing and intensifying climate change, biodiversity loss and resource overconsumption yourself, you are both gradually destroying your own business environment and the planet. However, if you are supporting the transition towards climate neutrality, you will also create a sound and successful business environment for yourself. Being thus part of the solution is a win-win.

As a summary, first we need to create a science-based, transparent and harmonized global system for comparable data. Secondly, with this data the sustainability risks need to be assessed thoroughly in system risk analyses, also by credit rating agencies. These assessments, as well as the whole materiality concept should be reflected in banking sector and lending decisions, and capital risk buffers. Thirdly, we need to establish a global sustainable finance framework in both public and private sectors with adequate flexibility, and try to safeguard this framework from political manoeuvring and manipulation.

According to estimates, the climate crisis will cost us $1 quadrillion over the next 80 years if we fail to meet the terms of the Paris Climate Agreement. Moreover, it makes the yearly sum even more than twice per year of what the COVID-19 crisis is hitting us with now. From the climate point of view, we cannot afford unsustainable investments any longer. Sustainable finance is the key to tackle climate change and preserve biodiversity, and we have no time to waste.

NATASHA CAZENAVE

Executive Director, European Securities and Markets Authority (ESMA)

ESMA's views on next steps for Sustainable Finance

Climate change is the challenge of our time. We are already witnessing more extreme weather, as fires and storms increase in frequency and intensity. To limit the global temperature rise to well below 2 degrees Celsius, as outlined in the Paris Agreement, efforts are needed in all economic sectors. The financial sector can provide opportunities for citizens, financial institutions and corporates to have a positive impact on sustainability and must itself manage and reduce risks relating to environmental, social and governance (ESG) factors.

ESMA is eager to contribute to the development and consistent application of a comprehensive sustainable finance framework and supports the Commission's ambitious agenda.

Such a role has been clearly spelled out when the ESAs' Review introduced sustainability as an integral part of ESMA's mandate. In early 2020, ESMA adopted its Strategy for Sustainable Finance which foresees taking ESG factors into account across the activities of rule-making, risk assessment, supervisory convergence and direct supervision.

Since the Commission adopted its first action plan on sustainable finance in 2018, significant progress has been made as policy makers have adopted legislation on classifying sustainable activities, on sustainability disclosures and on climate benchmarks. ESMA and the ESAs, where required, have been preparing related technical requirements and are monitoring the gradual implementation by the market of the new rules. ESMA will also continue its work to ensure that the massive shift towards increased financing of sustainable activities is conducted in a way that does not harm investor protection, orderly markets or financial stability.

In July, the Commission published its updated strategy for financing the transition to a sustainable economy. Going forward, more work is expected in various areas, including on the taxonomy to define activities that can be deemed sustainable. Another key building block of the European sustainable finance framework is the design of appropriate disclosures regarding corporates' activities from a sustainability perspective. The proposal for a Corporate Sustainability Reporting Directive is an essential step to achieve more comparable, relevant and reliable information to be reported at corporate level.

ESMA is eager to contribute to a comprehensive sustainable finance framework.

ESMA considers that further action is needed as the market for ESG ratings and other assessment tools is currently unregulated and unsupervised which presents risks of greenwashing, capital misallocation and products mis-selling. ESMA has therefore advised the Commission to propose minimum standards for ESG ratings including supervision. A common definition of ESG ratings that covers the broad spectrum of possible ESG assessments on offer would help future-proof any regulatory framework. The regulatory regime should be adapted to the current market structure and accommodate both large multi-national providers who may be subject to existing regulatory frameworks, as well as smaller entities.

Effective supervision and enforcement are key to ensure that the financing of the transition happens across the sustainable investment value chain, in full confidence of investors at the different stages. Direct authorisation/supervision at EU level for specific actors, as well as the effective use of the ESAs' supervisory coordination function will contribute to building comprehensive supervision across the EU.

Last but not least, to prevent green-washing, ESMA is planning convergence work to ensure consistent supervision of applicable rules as financial products offered to investors are more and more presented as sustainable or ESG. Labels can also help investors make sustainable choices. The Commission's recently presented EU Green Bonds proposal is welcome and ESMA stands ready to take on board supervisory responsibilities for third party verifiers.

As many initiatives are taking place simultaneously, it is of utmost importance to ensure consistency across pieces of regulation and proportionality in requirements for smaller companies, to ensure they can comply and show how they contribute to a more sustainable future, in a manner that is useful and adapted to their activities.

Finally, while a lot can be achieved at EU level, both financial markets and sustainability challenges are global and require global cooperation and action. In this respect, the International Platform on Sustainable Finance plays an important role to promote international convergence. ESMA participates in and contributes to the work of IOSCO, FSB and the Network for Greening the Financial System (NGFS). In addition, ESMA welcomes the initiative of the IFRS Foundation to consider establishing a board to develop sustainability standards, as international standardisation could facilitate cross-border sustainable investments. While this work would create a common global basis which will promote consistency and international convergence, more ambitious approaches in certain jurisdictions would still be suitable when they are in different stages in their sustainability efforts.

Taken together, the actions at EU and international level will be big steps forward to facilitate and promote sustainable investments to support the transition.

KEIICHIRO NAKAMURA
Chief Executive Officer,
SMBC Bank International plc
(SMBC BI)

Helping the transition towards sustainable banking and finance

Banks and investors are integrating sustainable finance into their business at a quickening speed. Although there are many "drivers" – in particular the regulatory environment in encouraging environmental, social and governance ("ESG") focus – it is increasingly investors' appetites for "green finance" that is key. Financial institutions, including the SMBC group, are reacting to investor demand by providing a range of sustainable offerings, from well-established "green bonds", to newer products such as "green deposits" and sustainability-linked loans. However, there are clear challenges ahead which, if not addressed, threaten to strike at the very heart of governments' green initiatives. Policymakers will be aware of these challenges, but if not addressed they could destabilise the transition path that many financial institutions have embarked upon and have a collective interest to see succeed.

1. Encouraging clear, consistent, and globally comparable standards

The transition towards sustainable finance would undoubtedly be assisted by the existence of similar and, therefore, comparable rules in the key global markets. Although there are signs of collaboration between policymakers on sustainability issues, there is at present no "global ESG standard". Banks and investors therefore face a challenge when trying to understand what "sustainability" means when applied to financial services and the launch of new products. An emerging question is whether there should be a standardisation of sustainability criteria across jurisdictions.

The EU has taken a lead globally by launching:

- A "European Green Bond Standard" as part of its sustainable-finance strategy, setting a voluntary "gold standard" for green bonds;
- A "taxonomy" of sustainability in financial services, under the EU Taxonomy Regulation; and
- Sustainability disclosure requirements under the EU Sustainable Finance Disclosure Regulation.

These initiatives promote sustainability-related disclosure within the EU; however they do not neatly match with disclosure requirements which are emerging in other parts of the world, including in the United States and Asia. Although it is also important to have the necessary frameworks and standards in place that reflect the particular situation relevant to each region, it is difficult to imagine a better issue for broadly consistent global standards than a truly global topic, such as climate change.

An emerging question is whether there should be a standardisation of sustainability standards.

2. Avoiding "too much too soon"

The urgent need to address climate change has led to a mountain of sustainability rules and policy initiatives. These have been published within a reasonably short timeframe, and many of them have imminent compliance dates. It is hoped that policymakers and regulators will continue to bear in mind the need for rules to be published with sufficient time to allow the financial services industry to fully consider, digest, and be able to consider holistically the impacts of sustainability rules on their business.

Together, current EU initiatives require hundreds of data points to be produced. New rules also need to dovetail themselves into an already complex landscape of sustainability requirements. Acknowledging the risk of "too much too soon", the EU has delayed the implementation dates for some aspects of these rules, such as the EU "taxonomy" requirements.

While financial institutions with a strong ESG focus such as SMBC will naturally seek to deploy the relevant resource to address incoming regulation and identify the opportunities in sustainable finance, there is the concern that some actors may seek to "greenwash" their compliance where they cannot meet requirements in time, by over-stating the sustainability of products. This would have negative systemic consequences to the extent that the market is flooded with assets that are marketed as sustainable, but which fall short of the required standards. This would also undermine the trust that is fundamental to sustainable finance.

3. Avoiding reversals in policy

Sustainable investing is a relatively new area of regulation, which builds upon previously understood concepts, such as environmental and social "stewardship", and uses a new array of tools, such as "taxonomies" to ensure that the sustainability rating of investments is measurable.

With all new rules, however, there is the danger that they may be calibrated incorrectly and need to be adjusted. Developments in science may also require rules to be re-considered. It is hoped that, where possible, policymakers and regulators will seek to ensure that any changes to existing initiatives take place in a measured way, with sufficient notice to the market, and that such changes will be relatively infrequent.

The transition towards sustainable banking and finance is far from an easy task, and it will require concerted and consistent effort from policymakers, regulators, and the industry – at a global level – to ensure that we achieve success.

JUDSON BERKEY

Head of External Engagement, Sustainability and Impact, UBS

Finance and broader economy need to align to transition to a sustainable future

The 2018 Action Plan is the EU's ambitious commitment to channel private financial flows towards investments that support the Paris Agreement target of a carbon-neutral economy by 2050, and more broadly the United Nations Sustainable Development Goals.

The plan lays out a comprehensive set of policy objectives to realise that ambition, including reorienting capital flows towards a more sustainable economy by establishing a classification system for sustainable activities – the EU taxonomy - mainstreaming sustainability into risk management, and strengthening sustainability disclosure and accounting rulemaking.

The Renewed Sustainable Finance Strategy doubles down on that ambition, identifying four areas where additional action is needed for the financial system to fully support the transition to a sustainable economy:

1. Tools and policies to finance transition plans and reach climate and other environmental goals
2. Access to sustainable finance for individuals and SMEs
3. Supporting the financial sector in contributing towards meeting the EU's Green Deal targets, becoming resilient, and combating greenwashing
4. The promotion of global collaboration and an ambitious global sustainable finance agenda

And here lies the challenge. Ambition is great but it is imperative that policy actions match the ambition. We must not be bogged down by well-intentioned, but unfit for purpose, regulatory frameworks. We also need to ensure alignment between financial sector and real economy mandates.

While we recognise that a green taxonomy can be the cornerstone of sustainable finance in enabling the financing of the transition, the taxonomy in its current form is too binary and does not adequately support the transition from a negative environmental impact activity to a low impact activity.

Finance and broader economy need to align to transition to a sustainable future.

The taxonomy needs not only to recognise activities classified as 'green', it should also reflect but also activities which are making the transition towards greater sustainability. Helping high-carbon companies shift towards net zero emissions is a vital part of combating climate change and banks, investors and policymakers must step up their support. Thus, we appreciate the recent proposals from the International Platform on Sustainable Finance (IPSF) to extend the Taxonomy framework.

Finance does not stop at EU borders. Thus, a globally aligned and comparable taxonomy is also critical for scaling up the flow of private capital towards environmentally sustainable investments and unlocking transition finance.

Hence it is of paramount importance that EU and global policy makers take due consideration of the work being done by the IPFS highlighting the commonalities between the various taxonomies currently in existence, all of which seek to classify a given economic activity with environmental goals. By so doing, they aim to develop a common ground taxonomy, which in turn will enhance transparency about what is commonly green in member jurisdictions and significantly contribute to the scaling up of cross-border green investments. We also encourage alignment of activities through the Financial Stability Board and G20 roadmaps.

The current alphabet soup of ESG reporting and disclosure standards does not allow for meaningful comparison of companies and thus sustainable finance flows. The proliferation of reporting standards not only increases regulatory obligations, it also adds to investor confusion, potentially jeopardising the reorientation of capital into sustainable investments.

The development of a common sustainability reporting standard is imperative if we are to progress to a situation in which sustainability information has a status comparable with that of financial information.

This is a matter of urgency and so there is no time to waste.

The IFRS Foundation's programme of work to develop a baseline global reporting standard for sustainability, which jurisdictions can then further supplement, is critical to fostering global best practice and accelerating convergence.

Sustainable finance policy is in its infancy. Any framework should allow for flexibility and innovation, leveraging and seeking collaboration through existing structures. This is a multi-year undertaking which requires the appropriate sequencing of regulatory measures. While we recognize that some jurisdictions will push ahead in parallel with the international work it is critical that the efforts speak to each other and align over time.

Finally, the ultimate goal is not only a sustainable financial sector but a sustainable economy. Finance cannot do it all on its own. Real economy companies need policy frameworks and incentives to re-engineer their production processes. Such frameworks also provide the certainly finance needs to make investments. Thus, we welcome the Fit for 55 package and look forward to its rapid implementation to support the transition to the sustainable economy and society that we need.

KATE FOWLER
Senior Responsibility Analyst, The international business of Federated Hermes

Walking the tightrope – what is at stake in the renewed sustainable finance strategy?

The EU's Renewed Sustainable Finance Strategy (RSFS) stands squarely on the shoulders of its predecessor, the 2018 action plan on sustainable finance. It utilises the building blocks already established – in particular the work on the EU Taxonomy and the expanding disclosure regime, including the Sustainable Finance Disclosures Regulation (SFDR). Three years on, much has been achieved but successful implementation of the RSFS is crucial if the EU is to meet its ambitious sustainability goals, including a 55% reduction in greenhouse gas emissions by 2030 from 1990 levels. It comes amid an emerging consensus that, without unprecedented policy intervention to create the right incentives, it is unlikely enough financial flows will be redirected to support the necessary transition to reach global sustainability goals including the Paris Agreement.

For those passionate about financing a sustainable economy, there is a lot to like in the new strategy, from a greater focus on retail investors and small businesses to increased supervision of sustainability risk management processes of banks and insurers.

The need for global cohesion is clearly recognised, answering the calls of those concerned by potential fragmentation in reporting frameworks. The EU has established itself as a leader and can play a key role in keeping ambition high. Global collaboration also offers an opportunity to improve the data that feeds into financial firms' EU-mandated SFDR disclosures.

Perhaps most important is the focus on increasing flows towards financing the transition to a sustainable economy. The EU had previously focused on what is already 'green'. For asset managers such as ourselves, it is particularly encouraging to see that for the first time the Commission recognises the crucial role that investor stewardship has to play in this transition. This is evident in a number of places in the strategy, including the commitment to clarify the fiduciary duties and stewardship rules of investors to reflect the financial sector's contribution to Green Deal targets, and a review of the Shareholder Rights Directive (SRDII). The notion of a transition is also reflected more clearly in the proposed expansion of the Taxonomy framework, such as through recognition of intermediate performance levels. The Taxonomy itself can be a tool for investors to engage systematically with companies on setting targets and transition plans.

The Commission will need to use all the tools at its disposal.

Such an ambitious strategy is naturally not without its challenges, and there are some balancing acts to be performed. If the EU is to reach its sustainability goals, rapid action is needed. Yet equally, care must be taken with sequencing to ensure a coherent regulatory framework.

Lessons can be learned from the last three years, where the parallel development of the Taxonomy and SFDR frameworks created inconsistencies, and detailed SFDR disclosure standards have been delayed twice. The RSFS announces the Commission will be further reviewing aspects of SFDR. This has created uncertainty for investors. The EU must strike a balance between quick action and a clear and coherent framework that incentivises the right behaviour. On the global stage, the need for cohesion may be challenging to balance with the EU's level of ambition and focus on double materiality.

The next challenge will be to maintain the credibility of the Taxonomy as it expands further. This is crucial as it underpins other initiatives including the proposed EU Green Bond Standard. The Taxonomy must be seen to be science-based and led by expert advice, after accusations of politicisation caused some turbulence before the first Delegated Acts were published.

The complementary Climate Delegated Act is likely to become a focus of debate, particularly in relation to the potential inclusion of natural gas. The Commission will need to be able to justify the inclusion of any controversial activities.

And finally, we return to stewardship. Whilst it is promising to see this reflected in the strategy as a key lever to aid the transition, it may ring alarm bells for some. A 'tick-box' disclosure framework could restrict innovation and flexibility to tailor the approach to a fund or firm or encourage boilerplate statements. It is therefore crucial that the EU takes a principles-based approach. The UK Stewardship Code 2020 is a strong example of this. It sets clear standards for disclosure to create comparability and a level playing field, without prescribing a particular approach. Whilst there are opportunities in the revision of the SRDII - including to broaden the scope to cover all asset classes – a principles-based EU Stewardship Code could go above and beyond this, allowing more flexibility and focusing on implementation and outcomes rather than just policies.

The RSFS is a strong statement of intent from the Commission. But it all comes down to the implementation, and the Commission will need to use all the tools at its disposal – not least leveraging investor stewardship – to achieve its aims.

EU TAXONOMY AND CSRD

PAUL TANG
MEP, Committee on Economic and Monetary Affairs, European Parliament

Sustainable transition, but where to?

The EU's sustainable finance agenda has ruffled some feathers. Fearing to miss the boat on a new area in finance, industry groups from utility companies to heavy industry look for ways to include their business in the sustainable finance agenda under the title of 'transitional activities'. Still, the rationale for this is limited. Rather than increasing the risk of stranded assets by stimulating investments in dead-end technologies, industry groups would do better to advocate an expansion of the taxonomy to the full range of sustainability impacts and objectives.

Our transition to a sustainable economy has a clear end-point: a climate neutral economy by 2050. This means that certain economic activities can, and others cannot fit in the economy of the future. The EU taxonomy gives an overview of the 'green' activities that contribute to the future sustainable economy. By creating an index of activities based on this high standard, the taxonomy helps financial markets and businesses understand where, over time, they need to go. Currently, only a small percentage of our economy fits in the green category. According to Eurosif, only 2.5% of investment funds have a taxonomy-aligned share of their portfolio of 5% or higher. Not being part of this elite section of our economy thus shouldn't be a cause of alarm. That is not, however, how many sectors see it.

Utility companies and EU Member States with a big reliance on polluting energy sources fear to be left behind by the EU's sustainable finance agenda. Feeling unable to rapidly replace their coal-powered electricity with sustainable alternatives, they seek to include gas-powered electricity stations in the taxonomy framework as a 'transitional' category. During negotiations a compromise was reached, allowing for gas only under very specific conditions (see article 10(2)). If no technically or economically feasible alternative is available, activities that are consistent with a 1.5C temperature rise can be taxonomy-compliant as long as they don't lead to a lock-in of investments.

The current focus on transition activities is a dead end.

Given the long lifespan of new gas plants and the need for the energy sector to reach carbon neutrality before our entire economy to reach the 1.5C limit, gas-powered plants simply cannot fulfill these conditions. Continued pressure from industry and Member States has made the Commission commit to a change of the regulation to increase space for transitional activities.

But given the rationale behind the green taxonomy, it is difficult to justify a specific transitional category. The necessary transition is the one from polluting towards green activities. Introducing temporary in-between steps only detracts from this. That does not mean we cannot ensure a broader scope of the taxonomy framework. Efforts to broaden the taxonomy should be directed in two prime areas.

The first direction is to clarify which activities, while not contributing to a sustainable future, do not cause harm to sustainability objectives eithers. Many activities in the services sector, for example, are essential for our future economy and should not be thrown on the same pile as activities that harm our environment. By distinguishing between 'neutral' and 'harmful' activities, investors and companies can more easily identify the activities that can be invested without harm and the ones that require additional attention to ensure they reduce their harmful elements.

The second direction is to add a social sustainability element to the taxonomy. The transition to a sustainable economy will disrupt many lives and we need additional efforts to bring along the most vulnerable in our societies. A social taxonomy can ensure that companies making an active contribution to this area are appropriately rewarded. In July this year, the EU's platform on sustainable finance made a proposal for a social taxonomy based on global standards from the OECD and UN and the EU's Pillar of Social Rights. This provides a good way forward to ensure that more sustainable businesses can be included in the EU's sustainable finance framework.

The current focus on transition activities is a dead end. Investments in such activities will frequently lead to stranded assets and distract from the need to invest in an economy that is truly sustainable. It is better to focus at expanding the taxonomy in different ways. With a full scale of sustainability impacts we can include all economic activities, including those that have a neutral impact on sustainability objectives. With a social taxonomy, we can reward business ensuring the transition to a sustainable economy can rely on sufficient social support. This is the prime way of making the taxonomy a tool to achieve the EU's ambition for a socially and environmentally sustainable economy.

EVA WIMMER
Director General,
Federal Ministry of Finance,
Germany

Sustainable Finance, Taxonomy and CSRD – challenges and opportunities

Over the last couple of years, Sustainable Finance has increasingly left its niche and has undoubtedly reached the mainstream of financial markets. Europe is one of the leading drivers of this development. In 2018, the European Commission laid the groundwork for this progress with the launch of the "Action Plan on Financing Sustainable Growth". In this plan, one of the most urgent challenges identified to enhance the role of E, S and G in financial markets was transparency. This transparency comprises two dimensions.

Firstly, the sustainable investor should have transparency on what he or she is investing in, and whether the desire to invest into sustainable projects and assets is met by the investment strategy of the chosen financial product. This part of the transparency challenge aims at preventing greenwashing of financial instruments.

Secondly, it is evident that in order to enable financial market participants to increase their financing to sustainable projects, transparency over sustainability issues in the real economy requires improvements. Two central instruments to tackle these challenges where envisaged as the development of a taxonomy for environmentally sustainable economic activities and a reform of corporate reporting requirements.

The Taxonomy Regulation was adopted in June 2020. With the recent publication of the first delegated acts, which include the technical screening criteria for the first two environmental objectives – climate change mitigation and adaptation – and the transparency requirements for article 8, the Taxonomy will soon become operational. With its definitions of sustainable economic activities, it sets the targets we need to reach our 2050 environmental goals including climate neutrality. Defining these targets is crucial as it clearly shows where we need to arrive in the long term. However, the Taxonomy in its current form does not as clearly tell us *how* to reach these targets.

Building on improved transparency, right incentives and consistent policy framework are requiered.

The challenge for companies and financial institutions remains to work on feasible solutions and credible transition plans. In the coming years, the transformation towards a more sustainable economy will significantly change our industries. Business models that are profitable today may become unsustainable in the true meaning of the word. Financial institutions play a key role in shifting capital to future-oriented, sustainable business models and engaging with their clients to manage the transition at the speed and scale required. The Taxonomy can serve as a central instrument to manage these risks and opportunities both for the financial and real industry because it can help to navigate the transition. To serve that purpose, the Taxonomy must be easily applicable, benefitting not only the still small share of the dark green segment, but supporting less green sectors and companies to embark on the transition path as well.

Moreover, the Taxonomy will not be the only tool for assessing whether a company is fit for the future. Applying the Taxonomy helps understand which activities of a company are aligned with the EU's environmental objectives. However, it does not provide stakeholders the broader picture of a company's environmental and social performance. The proposed Corporate Sustainability Reporting Directive (CSRD) therefore represents an important amendment to the current reporting requirements. The shift in the terminology from "non-financial" to "sustainability" reporting, as well as its integration in the management report, are important signals reflecting the realization that environmental and social factors can affect a company's position and financial health quite significantly.

A common framework for corporate sustainability reporting that produces relevant, reliable and comparable data on all material aspects of a company's performance is therefore a core element for the shift to sustainable economies. It helps financial institutions to better manage financial risks in their portfolios, identify future-fit sustainable investment opportunities and support their clients and investees in managing the transition. In turn, companies themselves benefit from developing a better understanding of their business risks, opportunities and their competitive position.

However, more transparency by itself will remain insufficient. Once relevant information is available, making effective use of it is the critical next step. The European Single Access Point should make that data easily accessible and connectable to other relevant data sources. Effectively integrating the data also requires revising methods and instruments and – perhaps most importantly – developing new competences and a new mindset. Building on the new awareness, the right incentives and consistent policy frameworks are required, fully aligned with the policy objectives for sustainability, to move from commitments to action.

LAURA
VAN GEEST
Chair of the Executive Board, Dutch Authority for the Financial Markets (AFM)

Building on transparency in sustainable finance

A swift and global response is needed to reduce greenhouse gas emissions and to make our economies sustainable. The EU is well placed to take a leadership role in developing and implementing various initiatives, not least when it comes to promoting sustainable finance. The EU Green Deal leads to a better pricing of Co_2 emissions and the Sustainable Finance Strategy – including legislation such as the Taxonomy Regulation, the Sustainable Finance Disclosure Regulation (SFDR) and the proposed Corporate Sustainability Reporting Directive (CSRD) – is a necessary complement. At present, no other major economic block can match the EU's drive towards sustainable finance in terms of ambition and political commitment.

Crucial elements in fostering the transition - investor consciousness and consumers' desire for sustainable products - are fortunately experiencing an upswing. However, a lack of transparency on sustainability risks and impact of corporate activities, as well as the risk of greenwashing, constitute serious barriers. The EU Taxonomy, CSRD and SFDR are designed to tackle these problems. It is crucial that their requirements are appropriately implemented by Europe's corporations and financials.

Together, the Taxonomy, CSRD and SFDR cover much of the sustainability reporting chain – from corporations, to financial market participants, to end investors. While the Taxonomy provides necessary guidance and definitions on what activities count as (ecologically) sustainable, the CSRD will require corporations to report (among other things) to what extent their activities are Taxonomy-aligned, which in turn provides valuable input for the sustainability-related disclosures of financial market participants as required by the SFDR.

While the existing legislation and legislative proposals cover much of the sustainability reporting chain, important challenges remain. Corporations and financial market participants are confronted with the major task of collecting adequate data on sustainability, in an economy based on complex globalised supply chains.

There is an important task ahead for legislators and regulators to facilitate and guide industry efforts to address these challenges, in a way that is consistent across the EU. The AFM, for its part, is actively involved in the development of enforceable standards and works closely together at the EU level with aim of achieving a single rulebook and a level playing field.

The AFM encourages the EU and global standard setters to ensure their initiatives are compatible.

Reliable sustainability benchmarks and reliable provision of ESG data-related services, are key ingredients in overcoming transparency challenges throughout the value chain. For this reason, the AFM and the French AMF have jointly published a position paper advocating a European regulation for the provision of ESG ratings, data and related services[1]. Adequate, reliable and comparable data are essential for companies and investors to be able to make sustainable investment decisions and combat the risks associated with greenwashing.

However, cooperation and coordination in fostering a sustainable economy should not be confined to the European level but needs to extend globally. Investors are working on a global basis. Thus, it is important that issuers apply global standards. Active and ongoing engagement and alignment between European (e.g. EFRAG) and global standard setting bodies (e.g. IFRS Foundation and IOSCO), as well as legislators and regulators is therefore of the utmost importance.

The AFM fully supports the European initiatives in the area of sustainable finance. The EU Taxonomy, CSRD and SFDR are currently the most ambitious and far-reaching efforts on a global scale and therefore are well-placed to serve as inspiration for setting in motion the transition towards a sustainable economy. Aligning European standards with global sustainability standards, for which the European initiatives may serve as inspiration and building blocks, will ensure a level-playing field between European and non-European companies, investors and consumers. This is a necessity in today's global financial markets. Agreeing on global standards will have the added advantage of limiting administrative burdens for cross-border business and financial flows.

Despite important efforts much work is still to be done, and to be done fast given the imminent environmental crisis the world is facing. Formulating ambitious objectives, setting corresponding global sustainability standards and making sure information is accessible, transparent and comparable is crucial for legislators, regulators, industry and investors to join hands in the imperative transition towards a sustainable economy.

[1] *AMF & AFM, Call for a European Regulation for the provision of ESG data, ratings, and related services*, 15 December 2020, French and Dutch financial market authorities call for a European regulation of ESG data, ratings, and related services | AFM.

NATALIE WESTERBARKEY

Director & Head of EU Public Policy, Fidelity International

Disclosure policy will unleash the full potential of sustainable finance

The EU taxonomy and CSRD are key drivers to speed up the transition towards sustainable economic models. The European Union is pioneering policy efforts internationally and other regions are increasing efforts too, most notably China and a re-engaged USA. This is in the interest of European stakeholders, as global regulatory convergence of ESG policies will foster transparency and investor knowledge in sustainable finance. Companies and investors with in-depth knowledge of ESG policies will be able to unleash the full breadth and depth of financial opportunities it presents. Fidelity's Sustainable Investing Report from July 2021 provides a variety of examples and reveals how we are taking specific action on behalf of our clients and society.

The CSRD and the new EU sustainability reporting standards (EU-SRS) will have a substantial impact from an asset management perspective. The fact that the recently extended scope includes large companies and corporates listed on stock exchanges is expected to result in much greater transparency of ESG factors. As a result, asset managers will be better able to integrate these factors into the investment process in a more detailed and comprehensive way. Another improvement is the proposed audit or assurance requirement on the reported information by corporates as it represents an external, independent validation. Consequently, this new requirement will likely lead to greater accuracy and standardisation of the reported information, hence make the ESG data more comparable across investee companies.

Due to enhanced data availability there is furthermore increasing statistical evidence of a positive correlation between financial and non-financial performance. This conviction is now commonly acknowledged within the asset management and investor community. It is furthermore measurable not only for climate related factors, but also for social and governance factors. Consequently, it is a significant step that the CSRD reporting requirement includes not only corporates' climate related data, but ESG data more widely, including social and governance elements too.

Only global standards can ensure a meaningful and comparable disclosure.

Furthermore, the EU policy approach of dual materiality is strongly supported by the asset management industry : the assessment of financial materially with regards to company valuations must include both, the value impact of climate and ESG factors on the company and vice-versa. At the international level, it is therefore important that the TCFD reviews its current single materiality approach with regards to climate-related financial disclosure only, and reconsiders a dual materiality approach as foreseen also within the internationally applicable TNFD, the nature-related financial disclosure.

Hence - as a next urgent step - working towards globally consistent standards is essential for the efficient integration of commonly acknowledged ESG factors into the investment process, as capital markets are global and to prevent potential regulatory arbitrage. Most importantly, global convergence is key to guide the understanding and sustainable finance choices which are ultimately taken by the end investor.

The ESAP - European Single Access Point - is a welcome tool to help asset managers and investors navigate the magnitude and complexity of the ESG data challenge. The ESAP is expected to deliver greater corporate transparency and comparability, which are indispensable to ensure a robust investment process.

Beyond data, Fidelity takes an active asset management approach through stewardship and corporate engagement. Also, through our updated voting policy we directly incentivise investee companies to embrace a transition to net zero and continuously support the improvement of their overall ESG performance. This results in enhanced financial and non-financial performance, making investee companies more robust and consequently meets our fiduciary mandate vis-à-vis our clients' capital that we manage on their behalf. Fidelity's ESG Analyst Survey from June 2021 reveals some key ESG trends that have largely gone under the radar, which analysts discovered through active engagement with corporates.

The key challenge for asset managers is the time sequence of the regulations' entry into force applicable to the finance sector and corporates. The SFDR (Sustainable Finance Disclosure Regulation) requires asset managers to disclose sustainability data is applicable already since March 2021. Whereas the CSRD, which mandates corporate disclosure becomes applicable only from 2024 for the financial year 2023. Active asset managers can overcome this challenge through direct corporate engagement, collecting and validating data from companies directly. However, only common global regulatory standards are essential for corporates and asset managers to ensure a meaningful, comparable disclosure approach, so to unleash the full potential of sustainable finance.

FREDRIK EKSTRÖM

President of Nasdaq Stockholm and Head of European Fixed Income and Commodities, Nasdaq

Inclusion and transition – Let's realize the opportunities

At Nasdaq, we keep taking initiatives and develop offerings in order to support listed companies within ESG. Nasdaq is also in continuous dialogue with investors and other industry stakeholders around us to seek out new ways to support the investment community in its sustainability efforts. Our ESG Guidelines first introduced in the Nordics are now in place on our markets globally, as well as our ESG Data Portal and Sustainable Bond Network. Another example is the recent acquisition of Puro.earth, a global marketplace for carbon removal, a business which we aim to scale in order to address a growing demand for carbon removal around the globe.

Companies are changing behaviors and new business ideas to support the transition are emerging. All this needs financing, and EU regulatory initiatives have great potential to play a central role for transition to a more sustainable society.

Extending the Taxonomy to transitional activities will be very welcome. This will help companies provide clarity towards investors on what transitional activities need to be financed. Bonds are a very suitable instrument for financing transition. In Nasdaq's Nordic markets, the Sustainable bond issuances already represent ~30% of all corporate bond issuances, and they are often significantly oversubscribed. It illustrates the strong demand from the investor side to contribute to financing of sustainability. In this context I want to highlight the not yet realized potential of bond financing in general, and green bond financing in particular, for smaller growth companies and for smaller investors. Today, the wholesale bond markets have developed. Issuers and other stakeholders in the financial ecosystem tend to stay only in the wholesale segment, due to both the structure of the market and due to regulatory incentives in the Prospectus Regulation.

I see an opportunity in revisiting the threshold in the Prospectus Regulation, to facilitate a development of a market for bonds with lower denominations. This would open up opportunities for smaller investors as well as smaller growth companies.

CSRD needs to support more efficient capital allocation to more inclusive and sustainable growth.

Based on the ongoing development of the Taxonomy we are already offering Green Designation of our equity market. Especially in the real estate sector this is developing. In general, I foresee that the Taxonomy will be the key regulatory instrument and I reiterate that the extension to transitional activities should be prioritized.

The expected development of a social taxonomy is also welcome. The social aspects are necessary not only in the longer term but also in the shorter term for the recovery from the effects of the pandemic. Nasdaq's engagement for diversity and inclusion is manifested in many ways in the societies where we operate, in Europe, in the U.S. and beyond.

I also welcome the review of the Non-Financial Reporting Directive, as it responds to a need among both corporates and investors to be better aligned around sustainability reporting. Ultimately, **CSRD needs to support more efficient capital allocation to more inclusive and sustainable growth**.

The biggest opportunity with the CSRD is to provide European companies with one single reporting standard instead of several. This will provide clarity for both companies, investors and any user of sustainability reports. If the EU standard can build on already developed standards, that's most useful, and if there can be convergence beyond the EU, even better.

Another opportunity is to provide a framework appropriately adapted for SMEs, supporting as many companies as possible to get onboard. From my experience working with the many growth companies that opt for public financing across our markets in Europe, I know that every company wants to be part of the transition towards a more sustainable future.

Nasdaq has since long provided support, services and products tailored to growth companies. We know the transition cannot be done exactly the same by every company, but every company is taking steps. In order to maintain as many options as possible open for financing for growth companies, we propose to subject all SMEs to the same rules on sustainability, irrespective of financing mix. Drawing the line as regards the scope of CSRD between companies with equity financing on public markets on the one hand, and companies financed with for instance bank loans or private equity on the other hand, is artificial.

Drawing up an appropriate sustainability reporting standard for SMEs and making them voluntary for all, I believe, is the best way forward for supporting the most companies on the route towards sustainability while at the same time not raising additional barriers to financing on public markets.

RICHARD MATTISON
Chief Executive Officer, S&P Global Trucost

Tackling the data challenges behind the EU sustainable finance agenda

The EU is in the vanguard of mainstreaming sustainable finance. Both the EU Green Deal and the Sustainable Finance agenda have set ambitious objectives to reshape the economy and channel capital towards sustainable investments. However, significant gaps exist in the data needed to inform investment decisions during this transition. Tackling this data challenge in the EU through enhanced corporate disclosure standards, international compatibility, and by leveraging technology can provide momentum for global solutions.

The data on climate change makes for uncomfortable reading. According to S&P Global's latest research, a 72% reduction in emissions is required to achieve the goals of the Paris Agreement. Major companies are currently on track for a >3°C global warming scenario. 80% of major global companies will face moderate physical risk due to climate change by 2050. We estimate that under a strong global policy framework these companies will face $284 billion in carbon pricing costs in 2025, 13% of their earnings, and this cost would rise significantly over time.

This is why disclosure matters: it can expose risks for companies, industries, and markets. By identifying and measuring these risks financial markets and companies can start to address them. Better and more meaningful ESG data from companies will enable issuers and users of corporate disclosure to identify, compare, and act upon emerging risks and opportunities. The EU's approach to disclosure in the CSRD also applies double materiality providing vital insight on how economic activities impact our planet.

The main challenges when trying to evaluate ESG and climate risks for individual corporates are the lack of disclosure generally and – where disclosure does exist – the lack of comparability across peers. The EU Taxonomy, the Sustainable Finance Disclosure Regulation (SFDR), and the Corporate Sustainability Reporting Directive (CSRD) are setting new standards in this space.

However, navigating these new regulations will be a complex endeavour. Ensuring that they remain aligned will be vital. Without an efficient system to produce, channel, and analyse ESG data investors and companies could miss out on critical insights and risks. High quality sustainability reporting should be the goal to enable evidence-based decisions.

S&P Global believes that it is important for corporate disclosure to be comparable, reliable, regular, relevant, and accessible.

As a user, aggregator, and provider of sustainability related information, S&P Global believes that it is important for corporate disclosure to be comparable, reliable, regular, relevant, and accessible. In 2020, S&P Global's Corporate Sustainability Assessment included 7,032 companies, up from 4,200 the previous year. In 2021, we will be collecting ESG disclosure from 10,000 companies globally. On climate we have over 700bn data points and have extensive analysis of climate risks for over 110,000 companies on the physical impacts of climate change. Comparability and standardisation of ESG and climate data remains one of the most important challenges for the financial system if we are to allocate capital to addressing sustainability related risks.

Dialogue and coordination at international level is essential to ensure positive steps on ESG remain aligned with global market practices and regulatory frameworks. As momentum builds behind a global set of internationally recognized sustainability reporting standards connectivity and comparability across jurisdictions will also be key. The work to establish an International Sustainability Standards Board (ISSB) under the IFRS Foundation should be seen as complimentary to the EU's CSRD. The primary focus of both initiatives should be on the integration, enhancement, and alignment of existing sustainability standards rather than the development of completely new ones.

The ability to leverage technology as this new data system is built represents a significant opportunity. The CSRD proposal would represent a significant leap forward in its requirement for disclosure to be provided in digital format. In 2015, S&P Global's Corporate Sustainability Assessment created an XBRL taxonomy in order to align with other taxonomies and company-produced reports. However, the creation of XBRL taxonomies or adoption of this reporting by companies has been slow. More standardized reporting formats coupled with more standardized factors will play a significant role in driving better disclosure by companies and adoption of ESG information by investors.

At S&P Global we have developed data sets, analytics and, solutions to meet the changing regulatory requirements and increasing market demand for high quality sustainability information. We believe that enhanced corporate disclosure standards, international compatibility, and leveraging technology are key components of tackling the data challenge in the EU and globally.

CLIMATE CHALLENGES FOR THE BANKING SECTOR

NEIL ESHO
Deputy Secretary General, Basel Committee on Banking Supervision (BCBS)

The Basel Committee's approach to addressing climate-related financial risks

Climate-related financial risks are of considerable and increasing importance within the financial sector. Financial institutions are building their capacity in risk management to manage such risks and enhancing disclosure. Supervisors and international organisations are also augmenting their oversight frameworks, setting out coordinated plans for addressing such risks, and paving the way for implementation.

Despite the considerable progress that has been made and the work underway, including broadly-used scenario analysis/stress testing and the development of consistent sustainability reporting, significant work remains to tackle climate-related financial risks. There remains a need for broad agreement on fundamental issues such as consistent definitions, taxonomies and risk measurement methodologies. For these reason, the Basel Committee is coordinating with other international bodies and building on the progress that has been made.

The topic of climate-related financial risks is a priority area for the Basel Committee. As the primary global standard setter for banks, the Committee's work: builds on the expertise of its member organisations, is guided by a forward-looking and long-term view of risks, and seeks to develop common minimum international standards that promote the resilience of financial institutions and global financial stability. These are attributes that make the Committee well positioned to address climate-related financial risks. The Committee began its work on climate-related financial risks by first conducting rigorous analyses to better understand the risk features of climate change and its potential implications for individual banks and the broader banking system. On that basis, the Committee published two analytical reports in April 2021 on: *Climate-related Risk Drivers and their Transmission Channels; and Climate-related Financial Risks – Measurement Methodologies.[1]*

The objective is to improve banks' preparedness to address climate-related financial risks.

The reports conclude that climate-related risk drivers can be captured by traditional risk categories used by financial institutions and reflected in the Basel Framework (eg credit risk, market risk, liquidity risk and operational risk). Building off the analytical work, the Basel Committee is examining the extent to which these risks can be addressed within the Basel Framework, identifying potential gaps in the current framework, and considering possible measures to address any gaps.

The Basel Committee is working to address a common set of challenges related to addressing climate-related financial risk, which includes the forward-looking nature of the risk (reliance can't be placed on historical experience), complexity, uncertainty, and incomplete data. Given these challenges and the cross-cutting nature of climate-related financial risks, it is unrealistic to expect that any single measure or tool will be sufficient. The Committee is therefore adopting a holistic approach when considering potential regulation, disclosure, or supervisory approache.

On disclosure, given the various initiatives to develop a globally consistent approach to sustainability reporting and uncertainties related to the measurement of climate-related financial risks, the Basel Committee will consider in the near term an appropriate response to support these initiatives. The Pillar 3 framework is designed in a modular way and can therefore be updated and adapted to reflect additional risks. In the area supervision, both the Basel Core Principles and Pillar 2 framework are flexible to accommodate additional supervisory responses. The Committee is also exploring principles for the effective supervision of climate-related financial risks and banks' risk management practices. In terms of regulation, the Committee is exploring where there might be potential gaps in the existing Basel Framework, but there is no pre-commitment to introduce additional Pillar 1 requirements or propose Pillar 1 solutions.

During this process, the Basel Committee will be led by its mandate to safeguard the resilience of the global banking system and to strengthen global financial stability. That is, the Committee's objective is ensure banks are better prepared to address any material financial risks caused by climate change, rather than using the regulatory and supervisory toolkit to affect climate change or meet broader societal objectives. If the Committee succeeds in its primary objective, it should support the latter.

[1] See Climate-related risk drivers and their transmission channels (bis.org), and *Climate-related financial risks - measurement methodologies (bis.org)*

JOSÉ MANUEL CAMPA

Chairperson, European Banking Authority (EBA)

Enhancing measurement and management of climate related risks

Climate change and the transition to a more sustainable economy is in the top of the EU policy agenda. The financial sector, financial regulators and policymakers are all enhancing their efforts to mitigate risks stemming from climate change and broader environmental degradation.

The EBA recently published its findings from the 2020 Pilot Exercise on Climate Risk. The exercise was run on a sample of 29 volunteer banks and has allowed EBA and participating banks to explore how to best categorise exposures that are potentially vulnerable to risks from changing climate conditions.

The exercise provides evidence on the extent to which the banking sector non-SME exposures are subject to climate-change related risks. High and low carbon obligors each make up roughly 25% of banks' corporate non-SME holdings. However, further aspects need to be considered before reaching any final conclusions on the environmental sustainability of the exposures of the EU banking system. The pilot exercise also showed that there is dispersion across banks in terms of impact on expected credit risk losses due to adverse climate risk scenarios. The results are driven by the impact on exposures to the electricity and manufacturing sectors. Non-SME corporate exposures towards high intensity carbon emission sectors, like mining and agriculture, represents less than 5% of the total exposures covered in the pilot.

Beyond the quantitative evidence, a second key finding is that there are clear data availability challenges and data gaps as well as methodological limitations that supervisors and the banking sector need to address to move forward. Limited data availability in particular affects the comparability of the results. These insights will help support regulators and supervisors in shaping robust methodologies and establishing data requirements going forward. Better disclosure by banks should over time allow for more robust risk assessments - including by allowing for the development of better climate change stress test scenarios.

Active measurement and management of climate risks is needed for a transition towards sustainability.

Next steps

Going forward, institutions need to continue their work to enhance their internal risk measurement, modelling and risk management skills. They also need to enhance their transparency on their sustainability risks. Institutions also need to integrate ESG aspects in business strategies, internal governance and risk management . These efforts in improving data and methodologies will continue to form part of a broader effort to develop regulatory and supervisory frameworks aimed at ensuring the resilience of financial institutions

The EBA will continue to prioritise its policy work on strengthening the institutions governance, and disclosure of related risks. Further and enhanced assessments of the overall resilience of the sector to climate risk. The EBA will publish prudential disclosure requirements for large banks related to ESG risks (Pillar 3 and transparency). The aim is to ensure comparable disclosures on climate-change transition and physical risks as well as actions taken by banks to support their counterparties. The Green Asset Ratio (which provides information on the extent to which banks are financing climate sustainable activities) is one of the tools that will be used to support the monitoring and assessment of developments over time.

The EBA pilot exercise serves as a good starting point for a discussion on how to embed climate risk in the stress testing framework in the coming years. Further interaction with the industry will be also key to exploring possible solutions to key challenges for developing methodologies and ensure availability of data suitable for climate risk assessments.

The EBA welcomes the Commission's Renewed Strategy and will continue to help ensure the resilience and long-term sustainability of the banking sector.

[1] EBA publishes results of EU-wide pilot exercise on climate risk

[2] See the EBA Report on management and supervision of ESG risks for credit institutions and investment firms, EBA/REP/2021/18

EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board, Member of the Steering Committee, European Central Bank (ECB)

Improving the management of climate-related and environmental risk

The European Green Deal aims to make Europe the first climate-neutral continent by 2050. As enshrined in the European Commission's strategy for financing the transition to a sustainable economy, the financial sector is expected to play a key role. Within its field of competence, ECB Banking Supervision has been taking steps to encourage banks under its direct supervision to incorporate climate-related and environmental (C&E) risks into their risk management frameworks and decision-making processes. There are two sides to the picture we have today: on one side, almost all directly supervised banks have already developed implementation plans for C&E risks, and many have started to gradually improve their practices. On the other, all banks still have several blind spots and may already be exposed to material climate risks. The May 2021 edition of the ECB's Financial Stability Review suggests that the latter is the case for around 80% of European banks.

The stance taken by ECB Banking Supervision is clear: further progress needs to be made, and we will see to it that every bank makes headway. In particular, the bottom-up, bank-specific climate stress test will be an important opportunity to assess and further promote this progress. Two areas will be key: the definition of a concrete, comprehensive strategy for C&E risks and progress in the collection and use of data, especially from clients.

Regarding the first area, one preliminary result of the recent ECB survey on banks' self-assessment of their alignment with the ECB's supervisory expectations on C&E risks shows that too many banks have not yet defined a strategy to manage these risks. Moreover, some have not yet begun to define an approach for assessing the impact of these risks on their business model and outlook. Given the growing importance of these issues, this approach clearly cannot be deemed compatible with the sound and prudent management of a credit institution. In fact, those banks that have defined their own systematic approach find that C&E risks are already having, or are about to have, a material impact on their risk profile. ECB Banking Supervision will therefore insist on the need for each bank to develop a strategy tailored to its particular situation. To make this operational from a risk management perspective, banks have to develop measurement and monitoring instruments. Nevertheless, of the banks that deemed C&E risks material in the short term in our survey, only one-quarter had already developed risk indicators to manage them. This shows that we need further progress on the measurement side to make these strategies operational. In relation to this, some banks highlight the real issue of the availability of relevant data, but there are ways in which this can be addressed.

First, banks should enhance their use of available data – public or from third-party providers – which many are still failing to do. Second, and most importantly for the development of their business, banks should collect new data on C&E risks from their clients: these data are key for their business and strategy. Roughly half of euro area banks have already started to integrate climate risks into their client due diligence. They have developed dedicated client questionnaires to better understand the climate risks to which they are exposed, and they use this information when deciding to whom they grant credit. In some cases, a specialised climate-risk function uses this information to advise the bank on higher-risk transactions and customer acceptance. Some banks have also been proactively trying to overcome the scarcity of data on C&E risks by independently developing their own indicators – such as financed carbon emissions, financed technology mix and energy performance certificates – to identify corporate clients with high sensitivity to climate transition risks. They have then set limits at portfolio level to manage those risks. Banks should build upon these best practices, which the ECB will soon publish in a report. In particular, C&E risk aspects should become an integral part of the know-your-customer (KYC) approach: KYC has to integrate C&E risks, as this is the only way for banks to define and integrate a meaningful C&E approach into their business model.

Effective progress in the management of climate-related and environmental risks is essential for European banks.

All these ideas come from practices we are seeing in banks from different countries with different business models and different sizes. What the ECB will be asking banks to develop is thus perfectly possible across the industry, and we expect this progress to accelerate in the coming months: in the case of climate change and environmental degradation, the greater risk for banks is the risk of doing nothing.

EMILIE MAZZACURATI
Global Head of Climate Solutions, Moody's ESG Solutions

Net Zero commitments: implications for the banking sector

As the urgency of climate change rises on corporate agendas, over 50 banks representing more than 25 countries, the equivalent of almost a quarter of global banking assets (over US$37 trillion) have committed to aligning their lending and investment portfolios with net-zero emissions by 2050.

These commitments constitute a momentous challenge for banks, who need to support and finance the decarbonization efforts of their clients across lending portfolios.

Yet the risks are greater if banks and other corporations fail to deliver on their net-zero commitments.

The risks related to the transition to a net-zero economy are generally well understood, though the scale of expected impacts varies widely under different scenarios. In a best-case scenario, where an orderly transition to a net-zero economy takes place supported by rapid technological progress and strong political alignment, banks can expect to see moderate impacts: stranded assets in the fossil fuel industry, increase in reinvestment / replacement costs, could lead to corporate asset devaluation, lower profitability, increased litigation. These impacts may increase the probability of default of some corporate borrowers. Impacts on employment in industries and regions dependent on the fossil fuel industry, coupled with possible increase in energy prices, may lead to a drop in household wealth and an impact on creditworthiness of households.

In a scenario where a disorderly transition takes place, hampered by slow technological progress and lack of political alignment, these same risks grow exponentially: corporations may be ill-prepared, lack the chance to invest in adequate technology or reassess their business model, leading to a larger number of asset devaluations, bankruptcies, greater shocks on the economy and lower wealth across the board.

Risks are greater if banks and other corporations fail to deliver on their net-zero commitments.

The worst-case scenario is a failure to deliver on net-zero targets altogether: economic models provide but a pale image of the economic costs and risks to the financial system that may arise due to the physical impacts of climate change. The risks vectors go well beyond what economic models traditionally capture. A continued increase in temperature rise could drive mass migration, water and food shortages, health impacts, and conflicts, all of which drive disruptions to the economy and create unforeseen risks for banks.

In this context, net-zero commitments emerge as sound risk management policy, and banks are now faced with the collective challenge of understanding whether and how their clients are reducing carbon emissions at a pace aligned with the urgency and scale of climate change. While banks are highly exposed to transition risk by virtue of their business, they also hold important levers to lower this risk for themselves, their clients and society at large.

Proper accounting and disclosure of greenhouse gas emissions is foundational, with regular reporting to track changes in emissions for every borrower. Asking clients as a matter of business to report emissions or key indicators (energy efficiency rating of houses in Europe, auto make and model for retail customers) when they apply or renew their line of credit will help build a much more precise picture of a portfolio's emissions and transition capacity.

Many corporations need help understanding what is expected of them, what technical and market solutions may be available to reduce their emissions – banks may be able to provide simple guidance and pointers for these clients, or offer access to advisory firms through partnerships to support the process.

Where banks' role will be most important, however, is in financing the transition. Corporations may need financing to retrofit their production facilities, decommission high-emitting assets, and invest in energy efficiency or distributed renewable generation. Small and medium enterprises or households may be incentivized with mechanisms like preferential conditions on mortgages for efficient cars, houses, or low interest loans for retrofits. A number of banks have started piloting such mechanisms – now is the time for the industry to share lessons on what financial products are most effective in driving emission reductions and scale these programs so they become embedded into regular banking operations.

Banks can leverage their role as key intermediaries to become a driving force in supporting the decarbonization of the economy, hence lowering their individual and collective exposure, and creating opportunities for new financial products and services.

SHINSUKE TODA

Chief Executive Officer for Europe, Middle East and Africa, Mizuho Financial Group, Inc. / Mizuho Bank, Ltd.

Climate and sustainability risks: implications in the banking sector

Mizuho Financial Group, Inc. views tackling climate change as a key management and strategic priority. We support the objective of the Paris Agreement and will proactively fulfil our role to achieve carbon neutrality by 2050 and have set the following initiatives: (i) direct finance flows towards achievement of the Paris Agreement targets through phased transformation of our finance portfolio, (ii) proactively engage with clients to support their transition pathways and (iii) publish climate-related disclosures aligned with the TCFD recommendations. We published our second TCFD report in June 2021.

Financial institutions play a critical role in supporting clients' transition pathways. A huge amount of investment will be required to implement fundamental changes in the business and operating models of market participants, to ensure that sustainability and mitigating climate change are as much a part of their strategy as generating profit. Banks alone cannot provide the liquidity required for such a monumental shift, and therefore it is vital to attract investors on a cross-regional basis through harmonised disclosure regimes to ensure that the relevant risks and opportunities are uniformly understood.

However, the pace of reform is crucial. Reactive short-term policies issued in response to pleas from activist investors and influential campaigners risk paralysing entire industries and choking transition, which defeats the very purpose. For example, penalising fossil fuel industries too heavily and too early could create irreparable damage, including impairment losses due to premature halting of production and disposition of facilities. The urgent need to transition should be balanced against evaluating the continuing operation of such industries which could provide funding to be reinvested in alternative sources of energy, as well as benefiting market participants and the wider economy through increased economic output. We urge policy makers to holistically consider the broad impact of reforms, to determine their feasibility and ensure there is a sufficient implementation period, in particular for those corporates and sectors that will find it more difficult to transition successfully. To that end, notwithstanding the importance of momentum, mid-to-long-term targets seem more appropriate than subsequently having to remediate unintended and unwanted consequences.

The pace of reform is crucial for effective transition.

In addition to transition risk, physical risk is also important for our clients. For example, recent floods in continental Europe have had a significant impact on global supply chains. In Japan, where there have been incidences of unprecedented torrential rainfall, there is an increasing risk of heavy flooding and the government has created hazard maps to prepare for such significant natural disasters. These help Japanese financial institutions to quantitatively assess physical risk through scenario analysis. EU policy makers may wish to adopt a similar approach to help market participants to quantify their exposure to the physical risks of climate change in a consistent manner. For financial institutions, this will include the consequent impact on credit risk as a result of asset quality deterioration and the increase in credit cost.

Mizuho has and will maintain its engagement with clients to provide appropriate liquidity to facilitate their transition to a carbon neutral environment. A transparent and harmonised global framework with reference to an objective understanding of achieving "transition" will incentivise stakeholders to progress. Currently there is significant fragmentation in the regulatory framework and divergence in market practice, for example there being no uniform standard to quantitatively assess emissions reductions. This is perhaps a consequence of the fast pace of reform, which is paradoxically inhibiting progress. The EU's recent legislative package and the upcoming COP26 will aim to resolve some of these issues, although a material obstacle remains the unavailability of consistent market-wide data.

The implementation of legislative initiatives such as harmonised disclosure requirements for financial institutions and corporates in respect of non-financial information may accelerate transition. These will encourage market participants to consider at a granular level their exposure to sustainability risks and focus their minds on the measures taken to mitigate such risks, as well as enabling them to take into account their wider role in enabling transition. Banks and regulators should work together to facilitate reforms that both achieve the desired policy objectives and are viable from a business perspective.

A clearer globally aligned standard will galvanise the private sector to implement reforms with less fear of being "off market", as well as creating sound and robust markets for sustainable finance. Therefore we encourage EU policymakers to coordinate and accelerate discussions on a global basis in respect of ESG reform.

RICARDO LAISECA

Head of Sustainability Transition for Clients, Banco Bilbao Vizcaya Argentaria (BBVA)

Sustainability Risks: "Beyond the Sea"

I was afraid of swimming in the open sea when I was a child. However, I overcame my fear thanks to a lot of training, perseverance and prudence. Sustainability risks (and opportunities) are the same.

Sustainability risks are new and there is a high level of uncertainty as there is neither enough expertise nor data or long-term modelling techniques. Furthermore, there is growing evidence signaling that climate change-related risks could materialise much faster than previously expected. Therefore, we need to accelerate and adapt our risk models, our strategies, our businesses and our internal processes to progressively integrate them through learning by doing and by trial and error.

Risk understanding and management is a building block to develop sustainable finance. It helps in a smooth transition towards a low-carbon economy, to foster the resilience of the financial system and to better identify and take advantage of the opportunities. However, too much acceleration and leaving prudence behind can bring about two undesirable consequences:

1) An increase in risks for banks and the financial system, in case that due to the excessive speed we cannot manage risks, price formation and assigning investment efficiently. Going faster than what is recommended by prudence can be a risk. For those reasons, a long enough roll-out period is needed.
2) A significant amount of work and resources inefficiently assigned with a high opportunity cost, moreover given the current cost saving environment in the banking sector. There is a risk of doing too many things simultaneously, instead of focusing on the most important and to provide valuable solutions. There seems to be an excess of both private and public initiatives that sometimes are overlapping, inconsistent and have tight timeframes. First things first: to carry out a cost-benefit analysis and focusing on the most important matters is a must. We need to prioritize using a cost benefit analysis.

To prioritize using a cost benefit analysis is needed. Going faster can be a risk.

In that vein, supervisory expectations offer a valuable path to the needed prioritization, and can be a lever for coordination and credibility. For example, in the EU, the ECB Guide on climate-related and environmental risks management and disclosure has helped us to clarify and to prioritise our main challenges: firstly, understanding and measuring them as drivers of the already existing risks (credit, market, liquidity, operational). Secondly, towards quantifying their impacts in our balance sheet and in our P&L (using taxonomies, scenario analysis, stress testing) and, finally, implementing adaptation and mitigation techniques (such as frameworks for the admission, an active engagement with clients and a risk appetite framework). Indeed, portfolio alignment is a useful tool because it allows for i) a comprehensive view (of the whole portfolio), ii) tracking the achievement of the strategic goals and iii) promoting an active asset management.

Having said that, a demanding regulatory and supervisory agenda is accelerating. In EU, the European Commission Renewed Sustainable Finance Strategy proposes some amendments to ensure ESG factors are consistently included in banks' risk management in this year's review of Capital Requirements Regulation and Directive; the first ECB bottom-up climate stress testing will be carried out in 2022, jointly with a the full supervisory review; and the EBA mandate to consider a dedicated prudential treatment of sustainable exposures has been brought forward from 2025 to 2023 to consider a dedicated prudential treatment of sustainable exposures.

Jointly with the regulatory and supervisory agenda, transition will have a leading role in the future. The social component of the ESG will be at the core: there is no sustainability without society. And a huge and complex challenge will emerge: demographics. We need to consider that extra longevity needs to be linked to some years of social engagement and to the creation of some new long-term financial products and value-added solutions. Transforming the longevity liability into an asset for society, subject to the profitability-risk combination will be an elephant in the room.

Achieving all of the aforementioned targets is not easy. Therefore, I would like to emphasize again the relevance of the cost-benefit analysis to focus on the most relevant needed advancements.

SANGHAMITRA KARRA
Global Head of Market Risk Stress Testing, Morgan Stanley

Role of banks in a sustainable transition

Banks have a crucial role of mobilising capital to help aid the EU transition to a low-carbon sustainable economy. The transition to low carbon sustainable economies involves all parts of the economy – from households, corporates to governments. To truly embed the principles of sustainability involves looking at the overall business strategy for a bank including the various stakeholders from clients, customers, employees, shareholders, supervisors and public authorities. At the highest level, this involves having a well-articulated vision such as commitment towards Net Zero pathway or in ensuring Diversity and inclusion.

The vision itself can be translated into asking specific questions regarding how the bank can help support its clients to transition to a low-carbon economy. It also involves have a closer look at the operations of the bank a from corporate sustainability standpoint whether it's around a bank's own footprint, embedding climate and sustainability risks into risk management practices or ensuring adequate disclosures to play its part in improving the transparency agenda.

Political and regulatory stability is key for ensuring the required progress in the ever accelerating transition pathway. As we attempt to solve some of the truly global issues of our times in an interconnected world, the ability to use a common language for expressing the risks, common approaches for testing the risks and a common understanding of what good looks like is crucial. The work by some of the international bodies such as NGFS, FSB and BIS in this space is crucial to develop common principles, scenarios and methodologies. The EU Taxonomy helps with developing the common language for communication and the various disclosure requirements help with improving the transparency around these communication. Some barriers to implementation include accessibility of data, costs associated with implementation and the fast evolving understanding in these areas may require the need for an evolving regulation.

Financing a transition, poses a number of risks to banks and other financial institutions. At the core, this is about supporting innovation in both new and existing companies. Climate risks and sustainability risks more generally have unique features such as deep uncertainties involved in modelling the nexus of climate science and economics, the long duration involved in the projects that aid transition as well as the availability and ability to measure the appropriate data for making decisions. In addition to the financial risks, there are increasing reputational and legal risks in this area.

Banks have a crucial role of mobilising capital to help aid the EU transition.

The speed of change in sentiment in a connected and social-media fuelled world is measured today in a matter of hours and days and this is expected to only grow faster. The legal landscapes are also fast evolving and are quite disparate across countries. Over the last few decades, banks have enhanced their risk management capabilities but the broader sustainability agenda requires more investment in both financial and non-financial risk management frameworks associated with it. An increased transparency over the direction of policy and legal frameworks in this space will be beneficial to manage the transitions.

Data required for assessing climate and sustainability risks needs to be both global (as the issues themselves are global in nature) but granular (as the risks vary materially across entities, sectors and jurisdictions). In considering the transition risk and climate mitigation data, the data is broadly well defined but exposure data is required from both financial and non-financial firms, a number of which is still in nascent journey through the disclosure route, particularly around items such as scope 3 emissions. For financial institutions and banks, it's also important to understand how the risk may be propagated (e.g. through insurance or suppliers) to understand the indirect impacts of climate change risks. The availability of this kind of data is currently sporadic. For physical risks, by definition requires granular local data which often poses a challenge and is more acute in emerging markets where access to such data is sparse but is also more relevant given the propensity for risks. Comparability across third party vendors for ESG data/ratings is also low raising challenges for managing the risks. As highlighted by the recent FSB report on climate related data, it's important to ensure filling these gaps within the data requirements and aiming for better disclosures.

There is momentum in the banking industry to support the transition to a low carbon development pathway. While issues around political and regulatory instability, evolving nature of risks and a need for comprehensive data pose barriers, these are not unsurmountable, particularly with the innovation within the industry as well as the stable policy frameworks provided by supervisors and public authorities.

NEXT EUROFI EVENTS

THE EUROFI HIGH LEVEL SEMINAR 2022

23, 24 & 25 FEBRUARY

PARIS – FRANCE

THE EUROFI FINANCIAL FORUM 2022

7, 8, 9 SEPTEMBER

PRAGUE – CZECH REPUBLIC

CLIMATE CHALLENGES FOR THE INSURANCE SECTOR

VICTORIA SAPORTA

Executive Committee Chair, International Association of Insurance Supervisors (IAIS)

Winds of change: action by the insurance sector to tackle climate risk

This summer's extreme weather events provide a preview of the risks to insurers from climate change. We experienced record temperatures in North America and extreme flooding across Western Europe. Estimates of storm damage insurance claims in Germany already top €5.5 billion and are expected to rise further.[1]

The World Meteorological Organisation estimates that the global temperature is already 1.20c higher than pre-industrial times. Temperatures will continue to rise even with global action, which is currently expected to fall short of the agreed Paris targets.[2] Although establishing a direct causal link between an individual weather event and climate change is still an evolving science, it is clear that climate change in general will lead to more extreme and frequent weather events, increasing the physical risks to which insurers are exposed. This will be coupled with broader economic impacts, which Swiss Re estimates could see an 18% reduction in global GDP in 2050 unless climate action is taken now.[3]

Transition risk is equally important for insurers; with the magnitude of the risk dependent on various factors, including the pace of policy action and future changes in technology. Insurers will need to manage their investment exposures to those assets and sectors that are most vulnerable to transition risks. Earlier implementation of reforms is better for the insurance sector, as unlike many other actors they face both significant transition and physical risks.

So what can insurers and supervisors do to reduce these risks?

Insurers are in the business of identifying, understanding and managing risk; key skills for navigating climate change. It is clear that the risk is systemic and will affect nearly all insurers, regardless of their size or business model. At a minimum, it is essential insurers understand the significant risks that climate change poses to their balance sheets. However, they also have a crucial role to play in helping their clients adapt to these emerging risks, and it is good to see the concerted action that is now being taken in this area.

Insurance supervisors also have an important role to play. Not only as microprudential supervisors, ensuring individual insurers are managing their climate exposure, but also from a macroprudential perspective, in assessing, understanding and mitigating the impact of risks across the insurance sector and financial system more broadly. Lastly, supervisors can create an enabling environment that supports insurers in their role as stewards of the transition to a net zero economy, in line with their key objectives of policyholder protection and maintaining financial stability.

The IAIS is focused on developing new expertise and approaches for understanding and responding to the evolving climate risk landscape. In May, together with the UN-convened Sustainable Insurance Forum (SIF), the IAIS published an Application Paper[4] that guides the actions insurance supervisors can take to better understand and manage climate risk. The paper includes recommendations on supervisory reporting, governance and risk management, investment policies and disclosures and provides various practical examples of our members' experiences to develop effective supervisory responses to climate risk.

In terms of macroprudential assessment and monitoring work, in September the IAIS will publish a deep dive analysis on the potential financial stability implications of insurers' investment exposures to climate-related risks as part of the IAIS' Global Insurance Market Report (GIMAR). This report builds on a data collection from more than 30 IAIS Members and includes a forward-looking scenario analysis, which provides insurers and supervisors with valuable information about insurer climate exposures.

Future work of the IAIS includes a gap analysis of our global standards for insurance supervision to consider whether changes are needed to take account of growing climate risk, or whether further supervisory guidance is needed. Furthermore, as a follow-up to the GIMAR publication, the IAIS will continue to develop its macroprudential data and analytical tools, including by identifying emerging good practices on climate risk scenario analysis.

It is imperative that insurers pick up the pace of their efforts to assess and address the risks from climate change, given the systemic risk it poses to financial and economic stability and social cohesion. As a global community of supervisors, the IAIS is united in its call to act together now to address this risk.

[1] German insurers expect up to $6.5 bln in storm claims | Reuters
[2] https://climateactiontracker.org/global/temperatures/
[3] World economy set to lose up to 18% GDP from climate change if no action taken, reveals Swiss Re Institute's stress-test analysis | Swiss Re
[4] https://www.iaisweb.org/page/supervisory-material/application-papers/file/97146/application-paper-on-the-supervision-of-climate-related-risks-in-the-insurance-sector

DAVID ALTMAIER
Florida Insurance Commissioner and President,
National Association of Insurance Commissioners (NAIC)

Levelling up on climate and resiliency

The insurance sector faces potentially significant impacts from the escalating effects of climate due to its exposure to weather-related property risks, investment volatility, and other issues. Increasing frequency and intensity of natural disasters pose a threat to insurer solvency, especially considering that insurer financial soundness is heavily dependent on its investment portfolio. Financial implications for insurers can impact product availability for consumers, who have their own role to play in mitigating risks they face. Accordingly, communication and collaboration amongst supervisors, industry and consumers is key. For example, having effective climate risk disclosures may help insurance regulators assess and evaluate insurance industry risks along with the potential for insurer actions to mitigate climate risk.

Given the issues facing insurance consumers and the insurance sector, the National Association of Insurance Commissioners (NAIC) and U.S. state insurance regulators continue to work with counterparts both domestically and internationally on the critical work of addressing climate and resiliency.

As the U.S. continues to face increasingly severe weather patterns, natural disasters and repeat losses in many markets, climate and resiliency remains among the top priorities of the NAIC. The NAIC has been studying the growing impact of climate risk since 2005; however, addressing this issue was elevated in July 2020 with the creation of its Climate & Resiliency Task Force. The task force focuses on climate concerns stemming from two pillars: solvency risk from catastrophic losses and market issues regarding availability and affordability of coverage.

Several workstreams have evolved from the task force to focus on: solvency, climate risk disclosure, pre-disaster mitigation, innovation, and technology. Efforts by these workstreams are well underway, for example:

- In 2010, the NAIC adopted the Insurer Climate Risk Disclosure Survey as a way for to identify trends, vulnerabilities, and best practices by collecting information about how companies assess and manage climate risk. Since 2010, the survey has been administered by the California Department of Insurance, and this year with new states participating, the percentage of the market represented will reach 78 percent. Relatedly, last year the states allowed insurers to submit a TCFD report in lieu of the eight-question NAIC survey and the Climate Disclosure Workstream has done a preliminary study to understand how the two frameworks align.

Accordingly, communication and collaboration amongst supervisors, industry and consumers is key.

- The Solvency Workstream has been gathering information from key stakeholders to better understand climate risk factors and plans to provide recommendations by the end of 2021 or early 2022 to enhance the solvency framework to more specifically address climate risk. The workstream has already recommended that more perils be considered in the Risk-Based Capital framework.
- The Pre-Disaster Mitigation Workstream is seeking out information regarding how mitigation can drive down losses. Based on discussions of mitigation measures it will develop consumer messaging on how consumers can take the lead in managing their risk arising from natural disasters.
- The Innovation Workstream is compiling information on parametric insurance and considering regulatory concerns about how these products are designed and whether consumers fully understand how the coverage works.

The NAIC has long been engaged in looking for ways to mitigate environmental risks and recognizes the importance of helping consumers be educated about these risks and to become more resilient. For example, consumer awareness campaigns have been created to address flood, earthquake, wind and other perils. The NAIC and its Center for Insurance Policy Research are undertaking efforts to help ensure state insurance regulators have the information necessary to foster stable insurance markets for their consumers, and maintain a central web-based repository for stakeholders within the industry studying risks, resiliency building codes, and the impact on insurance.

While a variety of activities are taking place at the domestic level, learning from and contributing to efforts at the international level are equally important. Through organizations such as the International Association of Insurance Supervisors and the Sustainable Insurance Forum, jurisdictions can work collectively to address climate-related challenges, risks, and opportunities.

As insurers and consumers will continue to be impacted by climate risk, it will be crucial for insurance supervisors to keep pace with the challenges and work to leverage existing tools as well as create new ones to address this issue as it continues to evolve.

PAUL TANG

MEP, Committee on Economic and Monetary Affairs, European Parliament

Will climate change put insurers underwater?

Floods in Belgium, Germany and the Netherlands and fires in Greece, Turkey and Italy. These events coincide with the publication of the sixth IPCC report that predicts that radical weather events are becoming more intense and more frequent, among other things. As if to say: you ain't seen nothing yet.

There is no doubt that insurers will thoroughly study this IPCC report to see what the future can possibly bring. While insurers do not cover all damages by natural disasters, it seems inevitable that they need to gear up for an increase in future claims. In assessing the future, insurers face the difficulty that human understanding of climate change and its impacts is improving but far from complete. This is further complicated by the fact that the likelihood of different scenarios with wildly different outcomes depends on human action to mitigate climate change. It is indeed the coordinated and non-coordinated efforts for mitigation and adaptation that are most difficult to project into the future, while being crucial for the impact of climate change on ecosystems and economies.

Complicating as the possible financial repercussions of climate change may be, even more daunting are the public expectations of and demands on insurance companies. When it came out, after the floods in the Netherlands, that most insurances didn't cover big floodings of rivers or the sea, there was significant incomprehension. Would really all businesses and individuals in this struggling part of the Netherlands have to cover for the damages themselves? To prevent a public relations scandal, insurers quickly announced they would cover the damages for companies, and to enter into discussions with the government on how to arrange for future coverage of natural disasters. Of course governments have the role of insurer of last resort. But as natural disasters become increasingly frequent, we cannot continue to treat them as "once in a generation" events that merit a last resort intervention.

At the same time, public and political pressure is growing regarding the allocation of the sizable assets of insurance companies. Are investments in fossil fuels really compatible with the mission of insurers to shield customers from risks? Shouldn't insurers take the lead in changing investments towards a carbon-neutral economy ánd help societies to deal with the consequences of climate change? Indeed, investments in mitigation and adaptation is to be expected from insurers, especially since some of them have the scale and capability to be front-runners in impact investment and to develop a full-fledged ESG approach to their investment portfolio. Fortunately, some already have taken on that role. But further work needs to be done. And quickly if I may add.

While the scale of adjustment may be daunting, insurers can harness their pivotal position.

Being impacted by climate change both on their operations and investment side, puts insurers at a central position in our transition to a sustainable economy. This, gives insurers also the opportunity to speer-head a welcome change in (capital) markets. Mark Carney, currently the UN Special Envoy on Climate Action and Finance, emphasizes in his recent book the contradiction between value and values and advocates an approach where people and planet are at an equal footing with profits. Indeed, one could argue that not only financial market participants need a mission, the financial markets need them too: they are to serve people and planet. Environmental and social sustainability is the core theme for the years to come. Greenwashing investments, nice words about corporate responsibility, and other diversions won't do the trick. It requires much more than a change in investment portfolio; it requires a different way of working where stakeholders, broadly defined, have an impact on the insurances companies themselves and on the companies in which they invest. It is only then that markets can live up to the environmental and social challenges that lie ahead. But insurers have every reason to engage in the make-over of markets: they face tough challenges in every aspect of their business, placing them at the heart of the change that is about to come.

Insurers thus face challenges both on their operations and investment side. The coverage (both explicit and implicit) insurers provide to clients suffering from natural disasters will increase the burden on insurers and calls for a re-evaluation of the relationship between governments and insurers. At the same time the sizable investment portfolios of insurers are increasingly under scrutiny and they should be aligned with the mission of insurers to protect their customers. While the scale of the adjustment may be daunting, insurers should seek to harness their pivotal position to re-direct the financial markets as a whole. Only this way, future climate disasters can be kept in check.

JOHN SCOTT
Head of Sustainability Ris,
Zurich Insurance Group

"Inside-out and outside-in" - A double-materiality view of sustainability risks

Almost every industry and their customers are on a sustainability journey as the world strives to tackle major systemic risks. Climate change tops the agenda of environmental societal and governance (ESG) risks – the lens through which the financial sector views sustainability. Insurers, so far mostly in Europe, are taking steps to help manage the climate crisis and wider sustainability risks mainly through the levers of sustainable investing and operational carbon emissions reductions. But, there is increasing recognition that the industry must deploy other levers in areas like sustainable underwriting, risk management and working with policymakers to help clients on their sustainability journey. In particular, managing climate transition and adaptation risks as our customers' risk managers become increasingly involved in developing climate change strategies. But what exactly does this all mean for insurers and their customers?

As an insurance company we cover the risks of millions of consumers as well as commercial customers in almost every industry – which means it's crucial for us to understand, discuss and act on sustainability risks. From a risk perspective this has to happen in two ways; an "inside-out" view of how an insurer can impact sustainability issues and an "outside-in view" of how sustainability risks impact the insurer, especially in its underwriting and investment portfolios.

From an "inside-out" view, insurers' need to lead by example and identify the key sustainability themes that we can influence and find solutions for. At Zurich we have identified three such themes:

- Climate change;
- Confidence in a digital society;
- Work sustainability.

In climate change we have set ambitious sustainability commitments signing up to the UN Business Ambition for 1.5°C Pledge and being co-founder members of the UN-convened Net Zero Alliances for Asset Owners (AOA) and for Insurers (NZIA). To make a real impact we also set ambitious targets to reduce our own operational emissions and emissions financed through our investments. In underwriting the first step is to understand how to calculate the emissions associated with the underwriting portfolios. We are working to develop a methodology to enable this and once we have a widely accepted methodology, analysis needs to be done on the transition pathways of the underwriting book and how we should expect the carbon emissions to develop in line with our path to a 1.5°C Future. As a result, we need to elaborate realistic, actionable steps and targets, working with our customers to facilitate the transition.

Climate change tops the agenda of environmental societal and governance (ESG) risks

From an "outside-in" view we have integrated sustainability risks into our risk management framework for both investments and underwriting. This means not only identifying the sustainability risks, but building and coordinating capabilities across the company to address them. In climate change this is largely about managing the transition and physical risks that either change the underlying risk exposures we underwrite or the values of the assets we invest in.

Today, we are discussing these climate-related risks with our investee companies through the CA100+ and directly with our commercial customers on a regular basis. It's only by working together and balancing the risks against the opportunities with our customers and engaging across the public and private sectors on climate change mitigation and adaptation, that insurers can help implement long term solutions. Zurich is consistently reviewing how our products and services meet the needs of our customers. We are monitoring developments of new technology and emerging risks so that we can develop and design new products or leverage existing ones to meet increasing ESG related opportunities. We are working together across functions and business units in multiple geographies to share customer knowledge and develop a pipeline of innovative products and services focused on supporting our customers' sustainability goals.

Nowadays understanding ESG criteria that impact their organizations the most and having a clear vision how those are being addressed, is a core skill of a risk manager. We are living in an era of stakeholder capitalism, so businesses need to be prepared to answer potentially uncomfortable questions around their ESG strategies and be proactive when they see a need for a change or capture a business opportunity that makes a positive change for society.

ESG is no longer a checkbox factor, our stakeholders are asking us to present on what we are doing on various aspects of sustainability, our culture, our purpose, what we stand for and the products that we are offering in this space. Today these factors have become selection criteria for both retail and commercial clients when choosing their insurer. Future customers will be even more demanding, as will investors, regulators, partners, suppliers and employees, so that ESG integration has become a true business imperative.

ROLAND UMBRICHT
Head of Global P&C, Allianz SE

Sustainability is a global issue and calls for internationally harmonized rules

In 2018, the EU Commission launched an Action Plan on Sustainable Finance with the aim of creating a financial system that supports the EU's climate and sustainable development agenda. The European Green Deal, published in late 2019, raised the ambition aiming to make Europe the first climate neutral continent by 2050. It comprises a Renewed Sustainable Finance Strategy, which has been published in July 2021. The new strategy shall complement ongoing legislative initiatives as well as already announced upcoming legislative proposals. It adds four areas to fully support the transition namely (1) Financing the transition of the real economy; (2) Towards a more inclusive sustainability framework; (3) Improving financial sector resilience and contribution and (4) Fostering global ambition.

The fight against climate change is currently the pre-eminent sustainability challenge and requires the collective efforts of governments, businesses, industries and communities in Europe and around the world. In its triple role as risk manager, insurer and long-term investor, the insurance industry is a natural partner to support the transition to a low-carbon, resource-efficient and sustainable economy.

By integrating sustainability considerations into core business activities, the insurance industry can have a positive impact on the transition and capture related investment opportunities while ensuring a proper management of sustainability-related risks. This requires overarching qualitative and quantitative reporting and controlling processes and relevant corporate rules to foster the integration of sustainability-related considerations across investment and underwriting activities. Rules and standards need to be regularly updated to reflect newest insights and external developments. Sustainability assessment processes need to be integrated into overarching risk management frameworks – including sustainability considerations in the Own Risk and Solvency Assessment and related scenario analysis – which are applied to the insurance business globally.

The EU should ensure consistency in its sustainability regulation and work towards global solutions.

In this context, members of the insurance industry including Allianz have joined forces to form voluntary Net-Zero initiatives. Members of the UN-convened Net-Zero Asset Owner Alliance (NZAOA), launched in 2019, committed to transition their investment portfolios to net-zero greenhouse gas emission by 2050 with first interim targets for 2025. Members of the UN-convened Net-Zero Insurance Alliance (NZIA), launched in 2021, commit to transition their insurance and reinsurance underwriting portfolios accordingly, building on engagement processes and the pioneering work of the NZAOA. Both initiatives underline the importance of cross-industry and international partnerships and cooperation between governments and companies to tackle climate risks.

However, the sustainability challenges we face go beyond climate change and are broader and more complex. If not identified and managed effectively, sustainability related risks can have significant repercussions for insurers, their customers, suppliers, and investments. These span legal and reputational risks, supply chain and business disruption risks, quality and operational risks, and financial risks. In order to steer sustainable investments successfully, and identify and manage sustainability risks correctly, the availability, high quality and comparability of sustainability data is essential. While the ongoing EU initiatives on sustainability reporting are an important step to address the increasing need for sustainability data, a high degree of data comparability can only be achieved via international standardization. The same holds true for risk management requirements – e.g. climate change scenarios – and supervisory expectations where a consistent set of rules is essential. In general, regulators should utilize market mechanisms as far as possible, especially by setting transparent and homogeneous frameworks that make compliance with sustainability criteria a competitive advantage for market participants. At the same time, it is of utmost importance that capital requirements for insurers remain risk-based. The introduction of green supporting/brown penalizing factors for risk capital calculations without a solid data basis are not conducive to policyholder protection.

In principle, the EU should ensure consistency in sustainability regulation to avoid liability risks and work towards global solutions to facilitate international harmonization and to account for the fact that sustainability matters are of global relevance. Europe aims to become the leading continent regarding sustainability regulation and transition towards a carbon-free economy. If the EU successfully tackles the challenges above, this ambition can become a reality to the benefit of environment, society and businesses – a chance that should not be missed.

STEFANIE OTT
Head Group Qalitative RM, Swiss Re Management Ltd

ESG – from acronym to legal requirement

If Environmental, Social and Governance (ESG) factors are not yet part of your risk framework, now is the time to prepare. The EU Taxonomy is bringing ESG from the investment sphere to your annual reporting requirements.

Looking at the ESG performance of companies started with investors who wanted a good return and assurance that people and the environment were not harmed by their investments. Out of this niche, ESG investment has become mainstream today. This was enabled by two factors: the availability of ESG ratings and the fact that ESG investments performed as well or even better than conventional ones.

An example case is Swiss Re which - after a successful trial - switched its investments to an ESG driven portfolio in 2017. Since then, the approach was further refined – also because the positive impact this was having on the insurance side of the business. One example is fossil fuel driven climate change.

No longer investing in fossil fuel industries accelerates the move to renewables and contributes to limiting climate change. The latter is a must if we want to contain the losses of weather-related perils in the years to come. Therefore, Swiss Re now targets its investments to include reaching the goal of net-zero. This will help dampen the negative effects of climate change on underwriting, while at the same time delivering attractive returns.

But ESG did not start there. The «E» was already part of the underwriting side of the business for a long time. The introduction of Environmental Impairment Liability laws in the 1980's triggered the development of insurance policies for these new liabilities – and in turn the necessary risk assessment methodologies. These were looking at the technical aspects of environmental protection.

Still, over time it became clear, that just concentrating on environmental measures was not enough. The risk culture and risk-taking behaviours were proving to be as important as environmental aspects – which made it necessary to look at the Social and Governance factors of risks. At Swiss Re this resulted in the Sustainable Business Risk process in the early 2000s. Since that time, Swiss Re systematically identifies the most critical ESG risks and assesses these risks at transactional level.

Supporting sustainability goals is a key proof point for those stakeholders - now and in the years to come.

All the activities above will become even more important in the EU with the introduction of the EU taxonomy. The taxonomy is a classification system establishing a list of environmentally sustainable economic activities. Related delegated acts have and will be specifying additional new reporting requirements on a quite detailed level. They cover content, methodology and presentation of information and apply to financial and non-financial undertakings. They aim to generate transparency on the proportion of environmentally sustainable economic activities of a business' financial transactions. This is a fundamental change and consequently triggers additional work.

To facilitate this, the development of new indicators is necessary. One key challenge Swiss Re identified in that process is the alignment between ESG and the United Nations Sustainability Goals (SDG).

ESG grew out of the investment world and its prime focus is to help make investment decisions and report on their outcomes. This approach is greatly influencing the current thinking on reporting requirements and stands in contrast to how underwriting focuses on risk.

The broad – and widely varying definitions of ESG – are not well suited to make underwriting decisions relating to sustainability. Here the «crisper» SDGs can be more useful. This is highlighted by the initiative of major insurance companies and the UN who developed the Insurance Sustainability Goals (iSDGs) as indicators for underwriting. Relating iSDGs to ESG to facilitate reporting will be a key task in the near future.

Some of methodologies described here can be founding pieces to address the new challenges attached to future regulatory requirements. But they surely won't be enough. That's why it is important to think ahead. The initiatives of the insurance industry on the UN «Principles for Sustainable Insurance» and the «Principles of Sustainable Investments» are great forums to discuss new industry wide initiatives.

This will not only help us to improve our business but also reinforce our societal «license to operate». In today's world, stakeholders from consumers over NGOs to governments expect the insurance industry to contribute to society. Supporting sustainability goals is a key proof point for those stakeholders - now and in the years to come.

KATANYA MOORE

Vice President, Head of Regulatory Policy Group, Global Government Relations, MetLife, Inc.

Sustainability is what the insurance business is all about

The term "sustainability" covers a broad range of topics. For MetLife, being "sustainable" means living our purpose and making a positive impact for all our stakeholders, including our employees, customers, shareholders, communities, and society as a whole. For over a century and a half, we have provided financial security and driven economic prosperity. Now, we are building on that legacy, adapting to a changing world, and strengthening our commitments to the environment and climate, equity and inclusivity, health and well-being, and economic growth.

MetLife fully recognizes the challenge and seriousness of climate change and we are committed to continuing our work toward development of sound risk management solutions and playing our part to address the impacts of climate risk. We applaud current public and private sector efforts to develop sound policies and frameworks to assist with the monumental task of meeting the goals of the Paris Agreement.

The financial sector has a significant role to play in achieving the transition to a low carbon economy, but it cannot achieve these goals alone. Therefore, we urge our regulators and standard setters to engage with the insurance industry as we seek solutions to the problems we share. Below, we offer three examples of issues shared by many market participants that could benefit from such solution-seeking engagement.

Encouraging capital flows toward sustainable assets to achieve transition goals is important and clear government policies will be essential to provide support to private sector decisions that can further the decarbonization of our economy. However, as insurers and other financial institutions must balance their desire to offer sustainable choices with their duty to meet fiduciary obligations, prudential rule-making should remain risk-driven. To avoid unintended adverse consequences, including market distortions and instability, proposed disclosure frameworks and prudential rules should prioritize decision-useful data, policyholder and investor protection, the safety and soundness of insurance markets, and financial stability. Consumer demand will lead to market-based solutions that in turn will promote sustainable growth.

We urge our regulators and standard setters to engage...as we seek solutions to the problems we share.

The issue of data quality is acknowledged by policymakers, regulators, and industry alike. Quantification of many climate-related risks is a new endeavor, especially when it comes to the future impact on asset value. Evaluating potential impacts over decades introduces additional uncertainty. Regulators should encourage experimentation to improve data quality and avoid drawing conclusions based on the output of current analysis until the metrics are more mature. Decisions premised on current exploration could have long-term adverse consequences for our industry, financial markets, and the real economy.

Fragmentation is another common concern. However, it is difficult to create a consistent approach to disclosing and managing climate-related risks that can also accommodate mainstream local practices, varying business models and disparate strategic goals.

A principles-based framework could achieve an acceptable level of consistency by setting high-level parameters that would apply across jurisdictions and sectors and align with existing financial filings. That framework could be supplemented by additional guidance to:

- emphasize consideration of risk and materiality to a firm's business
- encourage flexibility to allow continued experimentation for data, model and metric improvement and industry-driven agreement on decision-useful information that could be incorporated into required reporting as appropriate over time.

While adjustments may be necessary, throughout all of this, prudential frameworks should remain risk based.

Consensus and full-partner engagement of global authorities will be important to ensure all points of view are reflected in international efforts to streamline approaches to assessment and disclosure.

Addressing what U.S. Treasury Secretary Janet Yellen has suggested is "the greatest challenge that we collectively face" will require a collective effort and we close with a reiterated call for public-private sector engagement on the above and many other climate and sustainability-related issues under discussion.

RENAUD GUIDÉE
Chief Risk Officer, AXA Group and Chair, Net Zero Insurance Alliance (NZIA)

Climate & sustainability from an insurer perspective

The European Union has launched a wave of regulatory changes at unprecedented speed with the objective to make Europe the first climate neutral continent by 2050 and to support the transition towards a more sustainable economy.

The aim of this emerging sustainable finance framework is to drive a real paradigm shift making sustainability a core part of companies' strategy, governance, and risk management.

AXA is fully committed to this aim and is taking action accordingly:

Over the past 10 years, AXA has gained significant experience in managing and integrating ESG within its business and operations. Building on our expertise and our vision, we are committed to continuing serving our clients and bringing our contribution to building a better, greener and more inclusive world and to catering to the new insurance needs of customers and society.

Sustainability is a core part of AXA's strategy, governance, and risk management.

As per our new Strategic Plan "Driving Progress 2023", we have reframed our sustainability strategy and governance by implementing (i) a list of key indicators included in the "AXA for Progress Index" which sets concrete targets to achieve our sustainability ambition along those two priorities as investor, as insurer and as an organization, (ii) a more encompassing governance to effectively steer the delivery of these targets across the AXA Group, (iii) a stronger link between sustainability objectives and leaders' compensation packages. More recently, AXA committed to turning its insurance business into an enabler for climate transition, through the Net-Zero Insurance Alliance (NZIA).

From a Risk Management perspective, AXA started very early on to identify, understand and take action on non-financial risks, with the aim of building a resilient, 'future proof' organization able to operate with a high level of credibility and trust towards its different stakeholders.

We expect new regulatory developments to drive a higher degree of standardization across the EU and hopefully a global convergence. As the scope of regulation continues to expand, it is key to ensure the right operating and regulatory conditions to increase effectiveness and allow us to fully play our role in the economy as a global investor and insurer. We support the following initiatives to foster the paradigm shift being called by society and public policymakers:

- Disclosure of corporate transition pathways to achieve a broad transformation of the economy;
- Access to standardized, robust, and forward-looking data from issuers and borrowers which receive investment flows;
- Analysis of forward-looking scenarios to enable a better understanding of risks, facilitate the risk transfer with appropriate product offerings or public/private partnerships, hence contributing to resilience. Public-Private Partnerships already play and will continue to play an important role to address sustainability impacts, by promoting insurance to protect communities and citizens.

While the ambition still raises some challenges, we are convinced that they can be turned into opportunities and we stand committed to these efforts towards a sustainable economy.

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ABOUT EUROFI

The European think tank dedicated to financial services

- **A platform for exchanges between the financial services industry and the public authorities**
- **Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector**
- **A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors**

OUR OBJECTIVES

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

OUR APPROACH

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two-yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proved over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

OUR EVENTS AND MEETINGS

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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