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FINANCIAL FORUM - SEPTEMBER 2021

Organised in association with the Slovenian EU Council Presidency

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SUMMARY

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The Eurofi Financial Forum 2021 took place in Ljubljana in a hybrid format on the eve of the informal Ecofin meeting and was organised in association with the Slovenian EU Council Presidency. The 30 sessions of this Forum involved 220 speakers from the EU public authorities and the financial industry and were followed by more than 800 participants, among whom 350 were physically present in Ljubljana.

The EU post-Covid recovery measures and the main regulatory and supervisory developments in the financial sector at the European and global levels were discussed during this Forum, as well as the main remaining vulnerabilities in the financial sector and the EU policy initiatives aiming to support the digitalisation of financial services and the development of sustainable finance.

In the following pages you will find the summaries of all the panel discussions that took place during this international Forum and the transcripts of the speeches and exchanges of views. We hope you enjoy reading this report which provides a detailed account of the views expressed by the public and private sector representatives who took part in this event on the different economic and policy topics that were addressed.

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SESSION SUMMARIES

I

POST-COVID RECOVERY AND GROWTH

IMPLEMENTING THE EU RECOVERY PACKAGE

The Recovery and Resilience Facility is the central part of Next Generation EU, the recovery package to revitalise the EU economy after the COVID-19 pandemic while also addressing the main structural challenges of our time - climate transition, digital transformation and improving economic efficiency. To receive support from the facility, Member States have to submit their recovery and resilience plans to the Commission, which then assesses them against the country specific recommendations and the facility's six pillars.

EU financial assistance from the €672.5 billion Recovery and Resilience Facility aims to power the European economic recovery by supporting reforms and investment projects around the six policy areas: green and digital transition; smart, sustainable and inclusive growth; and social and territorial cohesion.

The session assessed if the national resilience plans are fit-for-purpose. The state of play is encouraging but remaining challenges need to be addressed to ensure that this EU financing will effectively contribute to increasing medium term sustainable growth in the EU.

1. Recovery and Resilience plans: an encouraging state of play

1.1 As of 8 September 2021, 18 national recovery and resilience plans were already endorsed by the Council

A policy-maker explained that the European Commission currently has 25 national recovery and resilience plans that have been notified by the member states. 18 plans were already endorsed by the council. 10 member states have already received pre-financing by the Union for amounts totalling almost €50 billion, and the other eight member states are about to receive it very soon. The implementation phase is commencing.

1.2 The national recovery and resilience plans are ambitious

An official stated that progress has been very strong. The member states are delivering and taking ownership. The European Commission is being very strict on those issues. Enforcing the mandate that the Council gave to the Commission in being tough, strict, and clear on the targets is exactly what was decided on.

An official noted that every plan that is going through has significant ideas and creativity on growth-enhancing measures. The first-round effect of public investments is being increased, as well as structural reforms about removing investment bottlenecks. The Commission has been extremely successful in raising the funding required and the demand for the bonds that are being distributed to finance. There is also a substantial volume of highly rated pan-European debt, which is something that will help along with the Capital Markets Union (CMU), the Banking Union (BU) and other big, strategic projects.

1.3 The example of the Italian Recovery and Resilience Plan

An official explained that Italy has the largest plan in Europe in terms of absolute size, but not relative to gross domestic product (GDP). The negotiation with the Commission has been complex, but Italy is happy with the outcome. The implementation stage is upcoming. Many actions will be done before the end of 2021, such as making good progress in shaping coordination and governance for the implementation of the Recovery and Resilience Plans (RRP). One of the chambers has approved legislation for bringing forward a judicial reform package.

An official underlined that in August Italy received the advance payment of almost €25 billion from the Commission. Italy is expected to deliver by the end of 2021 (?) on 51 milestones and targets a total of over 500. The risks are connected to a very complex and lengthy domestic legislative process. Italy has to review the civil service in depth. A dedicated website has been prepared where the government will give full transparency on the whole plan. A five-year plan is in place. The assessment by the Commission and by the Council is a critical step which needs to be done wisely and in an effective and timely manner.

An official stated that the Next Generation EU (NGEU) programme is output-based, and the reform packages are parts of the milestones and targets that have to be met in order to go on with the payments. Performance indicators are connected to the reforms that need to be implemented. Italy is asked to approve new legislative framework on the judicial system to improve the performance but is also expected to reduce the backlog by a certain percentage by the end of the of the plan. There are quantitative indicators that will be assessed by Italy, the Commission and the Council.

An official explained that work is need on the actions that will provide some boost to productivity that has been lagging behind for too long. The civil service is key, and improvements are needed in the way they are organised. The other area is education; human capital is an area that is included in the plan, which will require a lot of effort and a lot of care.

An official summarised that it is important to examine the risks and opportunity from an overall European perspective. The Commission and the Council need to ensure that the overall planning and implementation is coherent and consistent. Some policy areas that are important for some member states can be looked at differently from a European perspective. More can be done on the ways to interconnect the resources at the member state level and on cross-border projects. That is particularly difficult in the implementation stage, but it is worth giving it a try.

1.4 The example of the French recovery and resilience plan

An official stated that the French implementation respected the Commission's deadlines. It has overshot regarding the green transition, so the top priority and about 50% of the investment plans are oriented towards the climate transition. Significant investment has gone into energy retrofitting of buildings, development of green infrastructure, mobility and technologies. France is investing in innovative sectors such as artificial intelligence, cloud, research and development, and digitisation of the economy. The COVID crisis showed that if a business does not have an internet page it is lagging behind. The national plan is 50% for the environment, 25% for digital and 25% for young people. It is likely that there will be important shifts in the economy after the crisis; the incoming workforce need to be able to find a job so that a social crisis does not occur in the long term.

1.5 Delegated acts to support the monitoring of the implementation of the Recovery and Resilience Facility (RRF) should be adopted soon

A public representative explained that the European Parliament is using its scrutiny power to monitor the situation. A working group has been set up. Member states and governments are trying to speed up the process. There is interest in seeing the final versions of the delegated acts that will come from the Commission, which should include the scoreboard indicators that are aiming at seeing how the RRF is implemented. Caution is needed, as it is important to see how long lasting the recovery will be. It is important to keep the support and be careful in not withdrawing too early, because momentum and the positive fiscal stance needs to continue in the countries that are supporting the demand.

1.6 Markets are positive

An industry representative stressed that the market is very positive and has been from the beginning, because it saw a clear discontinuity compared to the past. Europe behaved timely and had a plan that was clearly coming out of a crisis but was not an emergency plan. It is a large, complex plan. Both the Commission in Brussels and single countries are acting fast and with relentless effort. The Commission has done an excellent job in being 11-times oversubscribed. The introduction of a green/brown framework is also important, because it is a huge, important market. The market is fully bought in, but the amount is not that significant.

An industry representative added that the markets are currently positive. For the last 10 years the investment rate in Europe dropped by almost 1% of GDP. COVID has made that worse, so it is hard to see how the growth trend can be changed without going back to compensate for the lack of investment. It is hard to see how growth can be reignited without a well-thought and sizable investment plan. If there is a way to do this for less than €750 billion then it should be explained how the trend in growth is going to be changed with a smaller package. The working assumption is that Europe already has very high leverage in more countries than others. This has an effect on indebtedness. Markets are positive because if the RFF change the growth trend there is no problem in getting the money back.

An official confirmed they are happy with the way things are developing. The Commission has done everything right so far and showed that it can come up with toughness when it comes to the right sort of plans. The area of targets and milestones is now being entered, and countries are curious to find out how they will work in the Council with the proposals from the Commission.

2. Remaining challenges and success factors

2.1 Main challenges and priorities to make the European recovery plan a success and for it to boost potential growth

2.1.1 Timing

A policy-maker stated that the time for spending these amounts is until 2026, which is extremely short when looking at the amount of GDP percentages for some countries and their track record for absorption of the amounts. In many member states there have been very far-reaching measures to try to speed up the absorption, by removing investment bottlenecks and by simplifying the procedures. The European Commission is equipped with technical support and the close help it intends to give member states in that process, but it will be a challenge that should not be underestimated.

An official agreed that impressive work has been done in delivering the European recovery plan, and there are priorities in the coming months to ensure it remains a full success. The first is to ensure swift adoption of the remaining recovery and resilience plans to foster a coordinated rebound among member states, provided that they respect the regulations and requirements. Disbursement should not be delayed for purely administrative or bureaucratic reasons.

2.1.2 Ownership

A policy-maker noted that the plans are member states' plans, which is beneficial. The country-specific recommendations of the European Semester have given an agenda, but the member states have chosen the reforms and the investments that are in those plans. They will have to be delivered, but the ownership will have to be increased because of timing reasons. The Commission needs to have a partnership approach with the member states to ensure those reforms and investments are successful on the ground.

An official pointed out that it is crucial to ensure the measures included in the plan are effectively implemented to keep pressure in the system. There is no doubt that funds will eventually be absorbed. It is a major challenge, but after funds are absorbed, the hope is that they will prove very efficient in enhancing growth opportunities.

2.1.3 The importance of social measures

A public representative stressed that EU Parliament is insisting on the social aspect. There is a lot of interest and a lot of concerns in Parliament, because looking at and investing in something related to education is not just the social aspect as it is presented. When reforms to boost potential growth are discussed, parliament always discusses the reform of the judicial system, especially civil law, bureaucracy, and speeding up the procurement process. It is important to have a business-friendly environment, but the medium to long-term competitiveness of a country is based on the skills and education that Parliament are providing. Achieving the green transition and the digital transformation cannot be done without investment in education and upskilling.

2.1.4 The cross-border dimension of the EU Recovery plan remains challenging

An official noted that they had been hoping to see more cross-border activity in transportation and electricity grids, as a question would be how to deploy and transport the electricity through European grids and several member states. Another question is how to get the planning permissions quicker to generate wind energy, but to also make sure that there is an efficient distribution network to electrify automotive fleets.

A policy-maker added that the cross-border dimension was very difficult for member states to put in their plans, but that does not mean that those plans will not deliver on EU policy and will not contribute together to the single market. That is what is being done in the implementation phase. It has to be done in a consistent manner and will be seen more clearly as the Commission sets out more transparently what the internal market effort has to be accompanying the implementation plan.

2.1.5 Avoiding a stigma around NGEU loans and ensure that member states want to use them

An industry representative stated that the market needs to see that the plan can help Europe become competitive again. A lot has been decentralised at national government level, but reassurance is needed that the entire €750 billion is used. If Europe wants to be competitive again it cannot be just decentralised to single countries. Single countries need to do their structural reform, but competitiveness in Europe is also part of Europe itself. If Europe cannot complete the BU then the credibility of the rest is in question.

A policy-maker explained that the key question is how attractive the loans will be for many member states. When the success of the growth operation is seen, it is expected to get more attractive by the day. For the grants and loans already taken, it is a question of absorption. Everything is being done to ensure the bottlenecks are removed, the reforms are concluded, and the investments are proceeding

2.2 Success factors

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

An official noted that funds will need to be channelled into the productive parts of the economy. Reaching the targets and milestones will create additional growth and productivity. It is unclear whether investing in digital technologies and the green transition will have the beneficial effects that are expected, but on the green transition there is no choice. It is unknown whether green technologies actually create welfare and jobs. It is not enough to just invest in digital, as there needs to be a way to employ all these digital tools and technologies in a way that actually enhances productivity.

An official added that absorption capacity will pose a key challenge in member states with a high allocation. Many member states have passed or committed to pass important enabling reforms to strengthen their administrative capacity and efficiency of the public sector. The Commission shall apply the necessary stringency when it comes to pay out requests, only approving them when all the proposed milestones and targets have been completed.

An industry representative pointed out that the challenge is whether Europe is going to change the growth trend. The market knows it will take years, but it will monitor the situation. A lot of money needs to be well invested. European infrastructure, market infrastructure and digital infrastructure are needed.

2.2.2 The use of proceeds must be done properly and transparency throughout the process is essential

A policy-maker explained that there are packages of milestones and targets for the next five years that will come together once or twice a year to be subject to payment. Member states will have to demonstrate that they have fulfilled the milestones and targets, delivered the reforms that achieve the objectives described in the plan, made progress on the investments that were foreseen, and hit targets on the investment. It is important for the member states, the Commission and the stakeholders on the ground to work together and agree very early on the content of the reforms. There has been a lot of transparency throughout the process.

In response to an official, a public representative stressed that transparency is one of the most important things for parliament and was the reason why it wanted to have scrutiny. It is pushing to have more data and information at the more disaggregated level, as parliament needs to achieve the objectives it gave itself last year. There is also very positive cooperation with the Commission.

2.2.3 Effective mobilisation of member states and relying of International and National Promotional Banks

An IFI representative stated that the European Bank for Reconstruction and Development (EBRD) is an operational institution and will work as much as possible with member states to make that a success. Some elements such as technical assistance have to be embedded in the process of implementation. The quality of project and having the local capacity to bring them to fruition is even more important than the financing. Delegation of funds to institutions which know how to deploy them is important, as is putting the implementation where the expertise is.

A policy-maker noted that delegation is possible and is foreseen on a number of plans towards different types of financial institutions, such as the EBRD, national development plans and the European Investment Bank (EIB). The process should not be delayed and the safeguards within the plan for the quality of the investment delivery need to still be there. Technical assistance is on offer, both by the Commission and by the international organisations that are active in that field.

An IFI representative explained that the original ambition of creation of the European Bank for Reconstruction and Development (EBRD) was about investment in policy and reforms. That is fundamentally country-specific, as coming out of the crisis there is a lot of divergence in different situations across member states. It is sector-specific. The pan-European dimension is very important and is not easy to embed in the plan, because the plans are proposed by member states. Institutions like the EBRD can help connect the actors of these plans.

An IFI representative concluded that it is the role of the Commission to build European public goods, which will be extremely important to create sustainable growth. The EBRD's strategy is based on green, digital and inclusion. The inclusion dimension is an overarching objective that should be there if Europe wants to do the green transition and if it wants to make the digital transition something which is socially acceptable and which brings productivity.

2.2.4 The capacity constraints on a great deal of materials are manageable

An official stated that generally the target of productivity enhancement is the right one, and the right approaches are being intensively discussed. Almost every plan contains measures to improve the carbon efficiency of residential buildings by investing billions, in pretty much every member state, on better insulation and better energy efficiency. If everyone does that at the same time then there will be capacity constraints in an already capacity constrained construction industry in almost every member state. There are already capacity constraints on a lot of materials, so it will be a question of timing and staggering to get the money deployed and not selectively run into capacity constraints in individual industries. That is manageable.

2.2.5 The question of how the mutually guaranteed EU debt will be repaid cannot be left out of sight

An official explained that own resources is part of the deal, and the Commission's proposals are anxiously awaited. There is a lot of discussion, especially on the climate-related proposals. Part of the deal is that a substantial amount of the own resources will be used to pay back the debt, which is very positive, as it could be a way to finally get consensus and unanimity among member states to think about how the own resources can be 'Europeanised' for future Multiannual Financial Frameworks (MFFs).

A policy-maker underlined that own resources are crucial and intensive work is ongoing. The proposals have been slightly postponed, but the Commission is still working on both corporate taxation and on the green side. The Fit for 55 package is already giving good indications of the direction of trave.

EXIT FROM COVID MEASURES: IMPACTS ON THE EU BANKING SECTOR

Following the pandemic, EU Institutions, national governments, Central Banks, and supervisory and resolution authorities took unprecedented action to support the economy. At the same time, there are good reasons to unwind the support measures: the public support measures taken so far have prevented the expected disruption from the pandemic on the European economy from fully materialising, the economic recovery seems grounded on a sound path, and the 2021 stress test exercise has revealed the strong position of EU banking sector.

In such a context, a gradual withdrawal of support measures should in principle avoid cliff effects, but the exit from COVID-19 support measures poses several policy challenges.

1. A gradual withdrawal of support measures to avoid cliff effects

Businesses have been less impacted by the pandemic than anticipated. However, there is no room for complacency, even if the European banking system remains resilient enough to cope with exit from COVID-19 measures.

1.1 The mitigating effect of the support from public authorities

A Central Bank official noted that expectations in the early weeks of the pandemic were pessimistic and quite different from how things turned out. However, that result was because of the actions stakeholders took. The response of macroeconomic and monetary policies to this health and economic shock has been extensive and well-coordinated at EU level. Monetary policy, fiscal policy, microprudential supervision and macroprudential supervision all hang together. The Eurosystem acted early and decisively, and in the spring of 2020 EU member states took a wide range of support measures to dampen the impact of the COVID-19 pandemic on the economy. These mainly took the form of public loan guarantees, direct grants, tax reliefs and loan moratoria.

A Central Bank official stated that the number of bankruptcies has been relatively modest so far, and actually lower in the past year than in normal times. As the measures are withdrawn there will be an increase of non-performing loans (NPL). At the same time, it is very difficult to predict the exact level of the effect and which sectors will be more affected, because there has been a diverse set of government support measures, differing across member states.

An industry representative confirmed that counterparts have generally been less impacted than anticipated. Though there is a deterioration of clients' 2020 balance sheets it is not as severe as initially expected. In countries where measures have been lifted, or where measures were more limited, things continue to be under control. This is largely linked to the strong rebound observed in these countries, but generally there is no wave of defaults. The cash that has actually been dispersed in some cases has been used by companies for buffers and are still in clients' accounts. The supporting measures have been efficient not only in postponing the wave of defaults but also in reducing the number of those defaults with an increased level of gross debt.

With liquidity assured, firms found the financial space required not just to stay afloat but also to invest in adaptations. There is generally limited pickup on equity-based products because of the abundance of liquidity in the market and the debt products still available. Leaders emerging even stronger from the crisis are now engaging in a consolidation spread which will help alleviate the burden of viable but overly indebted firms. The market is regulating itself and new players emerging such as private equity firms.

1.2 There is no room for complacency

1.2.1 Addressing the increasing number of NPLs and loans subject to forbearance

A Central Bank official stated that banks need to take decisive action to address the increasing number of NPLs. When provisioning, banks should take into account the withdrawal of the government support measures. Banks need to recognise payment problems for customers at an early stage and find suitable solutions. Supervisors have seen some deficiencies in the credit risk management practices of eurozone banks. Early warning systems were not sufficiently granular, and some indicators of deteriorating credit quality are mainly backward looking.

A Central Bank official highlighted that there are differences among national financial systems. The initial positions of national banking systems were far from equal. Secondly, the use of pandemic support measures differed enormously from country to country. The deterioration in the asset quality of loans under support schemes is becoming increasingly evident. Loans that still have moratoria or public guarantee schemes are riskier. In the event of extended and repeated business restrictions in activities most affected by the pandemic, an increase in NPLs could still be expected. The recently published stress tests confirm that although there remains robustness in Europe there are differences between financial institutions.

A Central Bank official stated that the speed of exiting COVID measures would matter. The support measures, which are why the situation is better than expected, do not come for free. They have some structural repercussions which are not particularly healthy in the longer term. The historically low NPL recordings is an indication that some of the normal market dynamics have been blocked.

An industry representative highlighted that one area of concern might be the use of forborne loans. With the loan moratoria, many loans have been forborne for good reasons, but it was difficult to identify all of the loans forborne in the systems of the banks back when the asset quality review (AQR) was being conducted. The systems are not very flexible, so it is not always easy to look at the loans forborne because there was a loan moratoria. There may be some loans which were not forborne for a good reason, which will be difficult to identify.

1.2.2 New waves of the pandemic may slow the economic recovery, and emerging financial risks must be addressed

A Central Bank official noted that a new pandemic wave is incoming and ever harsher variants of the virus are developing. The health risks are not yet abolished and nor are the financial and economic risks. A regulator emphasised that if corporate risk is more under control thanks to the policies it is also true that there are new vulnerabilities emerging. There is the risk of sharp asset price corrections, risks on long-term interest rates, inflation risk in the US and more. It is very important to keep an eye on this because, whilst it is good there was not a 'tsunami' of insolvencies, there are not yet completely 'calm waters'.

An industry representative noted that there are many new upcoming risks. Banks and supervisors need to work together to find a way to accelerate the integration of the banking sector, to make sure there are economies of scale. An industry representative stated that one area to specifically draw attention to is the guidance currently in place for leveraged finance. The primary focus of the European Central Bank (ECB) on leveraged transactions, and in particular on highly leveraged transactions, is valid and one area which banks are also very much concerned with. Liquidity is essential. Curtailing financing of highly affected but still viable companies could be very detrimental for them, even though they have high chances of survival.

A regulator remarked that moratoria are de facto at an end. The measures which concern exemptions on the obligation to register insolvencies with courts are also coming to an end. It is important that some public support continues to be there until it is clear that growth is firmly entrenched. There has to be very good use of the growth impact of the Recovery and Resilience Facility (RRF)[1].

An industry representative warned that the crisis has primarily been a sector crisis and measures will need to be retained, and possibly further adjusted, for some sectors. A regulator (Francesco Mazzaferro) added that there is now an opportunity to address the shortcomings in national insolvency frameworks, in order to facilitate the orderly winding-up of non-viable firms. Public support measures will have to change. There will have to be much less focus on liquidity, more selective support and more focus on solvency.

1.3 The European banking system remains resilient enough to cope with exit

The EU banking sector has shown remarkable resilience through the pandemic crisis and is in a strong position overall to absorb losses even in a deteriorated macroeconomic environment.

1.3.1 Banks are part of the solution

An industry representative noted that that there are fundamental differences between the current crisis and other crises faced in the past decades. Usually, the banks were part of the problem, but banks are part of the solution to the COVID crisis. Before the outbreak of the crisis, the banks' clients were globally good and had clean payment recalls. During the crisis, these clients were, and still are, facing a decrease in revenue incomes. The banks' problems are about how to deal with the unlikely to pay (UTP) cases that can cause problems for reimbursing the debt. The public and private sectors have worked together in an efficient manner and the spread of systemic risk was successfully avoided. The banks were able to continue to lend during this period because of the stability there was.

1.3.2 The EU banking sector can deal with the increase of NPLs

An industry representative stated that there was pessimistic forecasting in the summer of 2020 about the number of NPLs in the eurozone. This has not happened as predicted, and currently there is one of the lowest NPL ratios in history. The industry has observed an increase of clients in IFRS 9 stage two. The staging put credit facilities in a less comfortable zone where banks had to take more provisions. However, the banks are better prepared. Thanks to Basel and the last financial crisis, the banks are more capitalised and can better absorb the unexpected credit risk. The peak of the NPLs could occur in 2022, but the banks have more provisions to face this. If NPLs are spread over time, the banking sector will resist. If it is sudden and concentrated, then this could cause a problem to the stability of the sector.

A Central Bank official stated that there is confidence that the eurozone banks will be able to cope with the increase in NPLs. The stress test results confirm that the eurozone banking system is resilient and in an overall strong position to absorb losses in a deteriorated macroeconomic environment.

An industry representative added that the level of provisioning increased significantly in 2020, which means all NPLs have been better provisioned, but as a number of loans have been moved to stage two the level of provision has also increased. When considering where it has increased, generally it is not coming from the usual models because they use historical data and, as defaults were not there, they have less data. The adjustments post-models have been very important and show that the banks are prepared to take into account the increase in risks, which they have already done in 2020.

1.3.3 The EU banking sector has the capacity to lend but needs to improve its profitability

A Central Bank official noted that Danish banks have an incredible capacity to lend, not only given the solvency situation but because banks have introduced negative interest rates on deposits in order to scare away some of the excess liquidity which does not work particularly

1. The EU package has not only been designed to boost aggregate demand in the medium term but also addresses long-term challenges such as greening the economy, Europe's lag in digitalisation, country-specific structural challenges and economic resilience in general.

well. They are quite eager to lend and they can do it under normal conditions. Insolvencies will increase, but that is something which happens in a normal, functioning market economy.

An industry representative emphasised that the capital position of the banking sector has never been as high, thanks to all of the measures taken by all of the banking supervisors after the first crisis. The banking sector as a whole can withstand huge stress tests, albeit with some differences between countries and banks. If they can absorb potential additional losses, then that will also have an impact on the profitability of the banks. It is necessary to have new measures to accelerate the integration of the banking sector to improve the profitability of the banks.

2. The necessity of the withdrawal of support measures and the policy challenges

There are good reasons for exiting the support measures. The timing and sequence of withdrawal of support measures need to be well calibrated in order to avoid a cliff-edge effect that can jeopardise all the efforts accomplished. Exiting is happening now. Most moratoria are expiring and, in any case, will be expired by the end of the year. Public guarantees are also expiring. Some sectors or activities, such as hotels and restaurants, remain affected and could require further support or face widespread restructuring. Looking ahead, an optimal allocation of resources towards innovative and sustainable uses must be ensured and the heterogeneity of fiscal performance across Member states also needs to be addressed.

2.1 Good reasons for exiting the support measures

An industry representative stated that there are good reasons for exiting the measures. There has to be consideration of returning to economic fundamentals. The question is whether this current period of stability is artificial or strong stability. Everything is also based on gross domestic product (GDP) growth, natural growth and firm growth. There is also the trust and confidence of the population. These are the key fundamentals of the economies. The exiting is happening because the measures are expensive and because the indicators are brighter. The lifting of the measures should consider the industries that are still very fragile. There are industries that have been over-performing during the crisis which should be lifted from the measures. The US and China have already largely recovered from the crisis. There is optimism about the ECB response to the pandemic and the ambitious NextGenerationEU programme.

2.2 The sequence of withdrawal has to be well calibrated

A Central Bank official stated that there is additional risk from exiting support measures too soon or not doing so prudently. The support measures have been timely and well-coordinated, and that should also be the case for exiting them. They should be lifted gradually and in a balanced way. The immediate withdrawal of all support measures could lead to adverse pro-cyclical effects. However, being too slow to remove the measures could lead to additional financial stability risk. To avoid unwanted negative effects the exit measures should be communicated clearly and in a timely manner and supported by other measures such as the Capital Markets Union (CMU) and bankruptcy legislation.

An industry representative emphasised the extraordinary nature of the current crisis, with its unprecedented sector heterogeneity and likely permanent changes to consumer and business behaviours. Some of the particularly impacted sectors will need more measures to remain in place for a longer time.

The tools have already been well identified and have proved to be performing. Ultimately, it is about supporting the economy, ensuring the positive dynamics of the market and supporting banks. Looking at the monitoring tools, there is the targeted longer-term refinancing operations (TLTRO), the conducive rates at the moment, budgetary and investment stimulus, which is already on the cards in the EU, and also facilitation of the digital, green, new ways of living and working conditions, which have been accelerated by the crisis and are absolutely fundamental to continue to attract investors' interests.

For banks, the results of the stress testing again demonstrated the resilience of the industry and the provisioning steps that have been made in terms of stage two buffers.

2.3 Three issues to tackle

A Central Bank official highlighted first that government liquidity support measures could end by them expiring and possibly being replaced by bank lending, but some incentives to exit government liquidity support could be considered by introducing interest rates or making credit assessments to transfer some of these measures to the banking sector. Secondly, transparency has to be brought back to the accounting and reporting of bank exposures. Thirdly, there has to be preparation for the other side. That could be the other side of a housing boom, which is prevalent in quite a few countries, pressure in the goods and labour markets and maybe somewhat higher inflation and interest rates. It is not obvious that there is readiness for higher interest rates.

Denmark had an early and strong rebound, and widespread pressures in quite a few markets. In terms of government support, Denmark relied more on postponing tax deadlines and government lending. Without credit assistance and interest rates it is possible to lend compared to what is normally reported for tax revenues. There is now much better micro data compared to only a few months ago. Those companies that took up the measures are less liquid, more indebted and have a lower credit quality for their exposure to the banks.

2.4 Exiting is already happening

A regulator stated that most moratoria and public guarantees are expiring. Any deterioration of asset quality should be appropriately reflected in bank balance sheets. Banks have to be stronger for when the public support is withdrawn. There should be consideration of instruments like tax incentives and other possible public support measures through which banks could be encouraged to actively engage in the restructuring of viable debt. Restructuring will probably be the most important instrument of recapitalisation of the non-financial corporations. The Commission's NPL action plan has to be implemented and Basel III must be fully implemented.

A Central Bank official suggested that in some cases the exit could be sped up, but if there is a credible strategy in place and it is well communicated then it should run its course. Many banks are eager to return to normality. They have the capacity to lend and have, to some extent, interpreted government support measures as a substitute for their own lending. There will be losses to bear, and not only in the banking sector. If the government has issued lending with no credit assessment and no interest payments then they will also bear losses. By waiting longer, these losses will rise and distortions of some market conditions grow.

Government support measures may ensure that labour continues to have an attachment to companies during a lockdown with a low level of activity. But this becomes structurally unhealthy during the recovery where labour shortages are becoming more and more prevalent in other parts of the economy. However, it might be relevant, for vulnerable sectors, to maintain the attachment of labour to these industries since it might become difficult to regain that labour afterwards.

2.5 Returning to market dynamics

A Central Bank official emphasised the importance of realising that the economy is moving in a structurally different way. The way people shop, spend their free time and work will be different from pre-COVID times. Moreover, the virus may be present for years still. Removal of government support measures should proceed, but there are also productivity impacts for the economies in Europe the longer that is delayed. Air travel will not get to pre-COVID levels for a long time and more people are needed in the health sector. The longer government support measures continue the longer these inefficiencies and lower productivity will exist within the economies.

It is important to return to market dynamics. To some extent this has already happened. The second and third waves have been coped with better than the first wave. However, there is a cost in prolonging the government support measures, so there should be a proper pace to moving ahead, because it is also hampering dynamics such that it is delaying the adjustments in economies. Policy support should not hamper structural adjustment as this could undermine productivity growth.

Regarding the specific measures for the banking sector and the relief measures, there is also a need to move ahead. By the end of this month there will be an end to the dividend restrictions. Single Supervisory Mechanism (SSM) guidance must be given on the ending of the relief measures related to leverage and Pillar 2 Guidance (P2G).

There have also been some stories about trying to connect the Basel reforms and their implementation to this recovery. There is no such connection. There will be a longer implementation, and the Basel reforms should be proceeded with while making sure that is done in a consistent, timely and full way in the EU.

2.6 The ongoing role of regulators and supervisors

An industry representative stated that many would agree that the sectors and assets most affected by the crisis differ from previous crises. In Spain, recent evidence suggests that the non-financial corporate sector is proceeding fairly well with the crisis. This is down to the public measures but also the better initial conditions of the sector in comparison to the last financial crisis. In 2020, the consolidated debt on non-financial corporates grew 12%, reaching 85% of GDP, which is far from the 120% peak that Spain reached in 2009/2010.

However, the full face of the crisis remains to be seen. There is a wide range of corporates to consider, and small and medium-sized enterprises (SMEs) could be particularly affected. Many SMEs were able to navigate the crisis, supported by fresh credit from banks, but their future may be compromised because of the level of debt they reached during the pandemic.

An industry representative noted that to help viable companies have access to the finance they need, or to even structure their financial obligations, three types of measures could be taken. The first is on the fiscal side. That was mentioned before with the opportunity for some public support. That will be necessary to accelerate some additional public supporting measures to viable but highly impacted SMEs. This could be in the form of direct fiscal stimulus.

The second type of policy is regulation. The regulatory rules should provide enough flexibility for banks to be able to differentiate between viable and non-viable companies, avoiding something like an 'automatism bias' in the regulation applicable to exposures classification, especially to SMEs. In particular, provisions should be allocated to exposure to non-viable companies, while re-financing of viable projects should be encouraged by avoiding undue costs for banks.

Finally, there is supervision, which should go hand in hand with regulation. The flow of finance to viable SMEs could also be supported by avoiding something like an 'inertia bias', where some supervisory approaches aimed to address legacy issues from previous crises, or which would be more suitable for normal times, are applied to times like the present. These three kinds of policies could help to sustain credit.

2.7 Addressing the heterogeneity of fiscal performance across member states

The Chair noted that there was a question from the audience on whether small and medium-sized banks, in this very low interest rate environment, will be able to lend, given the restrictions and constraints the low interest rate environment put on profitability.

An industry representative remarked that it is a difficult question. A gradual, balanced removal of any support measures should be welcomed, and this is happening right now, with measures being exited, but there has also been an extension of the measures. The stability of the measures is something that countries and authorities are well aware of. On monetary policy, economic and financial indications and the outlook should remain central for the final withdrawal of the stimulus.

An industry representative highlighted that, in Spain, economic indicators have improved markedly over the summer. Economic activity is expected to reach pre-COVID levels during 2022. Despite the impact of COVID on tourism, employment in August reached the level of February 2020 and less than 2% of employees remain on furlough schemes.

Domestic tourism has performed extraordinarily well and has partly offset the continued weakness in international tourism. Some sectors may lag behind and it may take time for some companies to fully recover, so in this sense they will avoid ill effects and err on the side of caution when deciding on the final withdrawal of the stimulus measures.

Regarding monetary policy, there is stimulus on the monetary side in the context of a low interest rate environment, which puts pressure on banks, for example compressing their net interest margins. The monetary policy might be usefully complemented with fiscal policies. These fiscal policies could focus on supporting viable companies with good growth prospects. Also, structural reforms in countries should be supported.

An industry representative highlighted the heterogeneity of fiscal policies across member states. A significant part of the policy responses has pivoted on countries' own fiscal capacity, but this fiscal capacity is quite heterogeneous across the EU. This heterogeneity could be a source of fragmentation, and cross-border negatives could spill over to other countries. As a result, further efforts might be necessary to avoid differences in the levels of public support provided to the private sector and it turning into gain for some countries at the expense of others. That is something that should be addressed.

The Chair thanked the panellists for the discussion. Two good messages came from the discussion, which would be good starting points for the conference. There was confirmation about what was achieved with the measures in keeping the banking sector healthy, and there has been good news and a good message on the capability of lending. At the same time, there is a call for caution in removing the support measures. That concerns the current learning experience all are going through. The Chair noted that this is not a one-way street and thanked Eurofi in that regard. Public policymakers will have to move on this.

NORMALISING MONETARY POLICY: WHEN AND HOW?

An industry representative stated that this is an appropriate time to think about the monetary policy mix and the present stance of monetary policies. Fiscal and monetary policies have played a major role in Europe to help to overcome the crisis. The pandemic is not over, but Europe is slowly getting out of it and confidence in the recovery is growing. The eurozone may not be 'out of the woods' yet, but it is very much on its way.

An industry representative added that inflation is back, as increased demand and supply bottlenecks have raised food, commodity and shipping costs. There are also risks of much more persistent pressures on inflation in the future.

The session discussed views of when the pandemic will be over, if the return of inflation is a temporary or lasting phenomenon, and what consequences for monetary policy this will have. An expert explained that central banks should move towards a monetary normalisation event if inflation remains low, in order to avoid a possible financial crisis.

1. Consequences of the end of the pandemic and the return of inflation on the normalisation of monetary policy

The panel began by discussing views of when the pandemic will be over and what consequences it should have on the policy mix in the euro area. The most important question is whether the current higher inflation rate is temporary or something that should be worried about over the longer term.

1.1 When the pandemic is over is a medical, economic, social, and political issue

An industry representative stated that the question around the pandemic ending is three questions rolled into one. It is a medical question, and it cannot be answered. Throughout the world and in the EU there are different patterns and waves in different countries, which are not synchronised. COVID may never end entirely, but could instead turn into something endemic, like Middle East Respiratory Syndrome (MERS). A second question is a public economic question. The pandemic ends when it cannot be seen in the economy. When looking at job creation, gross national product (GDP) and the Purchasing Managers' Index (PMI), if the effect of the pandemic cannot be seen except for the rebound then it is economically over. For society, the pandemic stops when society says it does.

In the first year of the pandemic, without vaccines or masks, France had 100,000 deaths from COVID-19. There are 600,000 deaths per year in France, and roughly 100,000 of those are due to air pollution, 100,000 are due to smoking, and 100,000 are due to alcohol consumption. From now on there will be 20,000 to 50,000 deaths from COVID every year and it will be a new normal.

1.2 Economically, it is time to exit from urgent COVID measures

A Central Bank official explained that there may be a fourth or fifth COVID-19 wave, but Europe has made a good progress with respect to vaccinations that only little impact on the economy is expected. The virus will be with Europe for years to come, but the economic implications have become very small. The latest projections which have just been published at the European Central Bank (ECB) show that the outlook for 2021 and 2022 is better than expected. By the end of this quarter Europe will have jointly reached the GDP level of 2019. Inflation is projected at well over 2%, and at 3% in some countries, although perhaps beginning to decline in 2022. It is important to think about moving out of the current urgency mechanism.

1.3 The return of inflation is not a surprise, but is it a lasting or transitory phenomenon?

An industry representative noted that a range of factors are currently pushing up inflation. The most important question is whether the current higher inflation rate is temporary or will be more persistent and therefore something that central banks should be worried about over the longer term.

1.3.1 Arguments for the temporary nature of inflation

An industry representative listed several arguments that supported the notion that higher inflation was transitory. There were base effects related to the decline in activity and prices in Q2 2020. A year later, the year-on-year numbers look very high, but it is partly a statistical artifact. Second, idiosyncratic factors such as used car prices and auto rental rates are having disproportionate effects. Those prices have moved, but they impact a relatively small number of people. Third, there are supply chain disruptions and shipping delays, which have prevented goods from getting from A to B. Those matters are expected to work themselves out as the pandemic recedes if it ends quickly. Finally, since the 2008 crisis, there have been many warnings that there would be higher inflation and all the money printing was going to result in inflation, or even hyperinflation. Those have all been proved wrong. Many view the current warnings as similarly overdone.

A Central Bank official stated that the euro area has learnt from the past decade that it should not move too early. It should move when it is sure that inflation is where the target is. Raising rates will have some repercussions, but it is no excuse not to move when inflation is close to its target. It is extremely important to point to the difference as to the ECB's monetary policy strategy and the Fed's strategy – ECB is not to compensate for past inflation shortfalls. Regarding the recent inflation dynamics, overall macro news is very good. There is growth, recovery has strengthened, and inflationary expectations are increasing. The current inflation dynamics forecast is 'hump shaped' and the current increase in inflation is largely transitory, i.e., it is not a binary thing that is either fully transitory or fully permanent. The ECB's latest inflation forecast for 2022 and 2023 is significantly lower than 2%, but it has been pushed up to 1.7% and 1.5% respectively.

A Central Bank official added that he is optimistic that inflation is going to be somewhat higher than the current forecast. It will not yet be at 2%, but it will be significantly above the current forecast. There are a number of factors possibly pushing up the forecast. The new strategy and guidance is very clear and much stronger than in the past, removing the past asymmetry due to "close to but below 2%". Supply chain bottleneck problems are likely to last longer, which will provide more time for these pressures to be built up and priced in. Wage negotiations is – there is some anecdotal evidence of growing pressures but has not yet been seen in data. Another important factor that might increase inflation by increasing demand is household savings behaviour. There has been a recent decrease in savings rates, but surveys show that households do not plan to tap into the savings that they have accumulated during the crisis. If the risk of COVID can be removed it is quite likely that people will start dipping into their accumulated savings as well. That is going to increase demand.

A Central Bank official summarised that inflation going forward is likely to be 'hump shaped'. Inflationary expectations are climbing up, with a very clear target of 2%. When these higher inflationary expectations will start to be priced into the wage negotiation, second round effects will root in and there will be a much more robust story for the inflation outlook.

1.3.2 Arguments in favour of a lasting phenomenon

An industry representative stressed that there are arguments against the transitory nature of the higher inflation rate. During the pandemic there has been a massive fiscal stimulus in the United States and elsewhere that increased income. That increase in income has increased demand so that the aggregate demand curve has increased at a time while the aggregate supply curve has stayed flat, or even decreased, because of the supply chain limitations. Demand for housing in the US is very strong, but there is a shortage of skilled labour and materials to build these houses to meet that demand. There is also a migration of inflationary forces into wages and compensation. In both skilled and unskilled labour there is a bidding up of compensation rates.

An industry representative summarised that the risk is that we observe a migration of one-off factors in prices into compensation, which then becomes a self-reinforcing process. The Fed is not in a hurry to dial back the amount of stimulus that it is putting into the system. In the past few years warnings of inflation have not materialized and that seems to have made the Fed hesitant to act pre-emptively. Over the last five years the worry has been that inflation has been too low rather than too high. The new approach, which it calls flexible average inflation targeting, is about getting the inflation rate above target to compensate for previous undershooting.   Whereas previously central banks wanted to act before inflation began to rise, now they want to wait until after it has risen. This framework has a new set of risks,

1.3.3 Inflation is likely to stay elevated

An industry representative concluded by noting that in the near term it seems that inflation is likely to stay elevated. Measures of compensation are rising, suggesting that inflation pressures are not only a "goods" phenomenon. Markets will hope the Fed's outlook is correct, because there are a lot of long-duration assets that the market is holding, whether they are bonds or equities. If the Fed and other central banks have to tighten then these assets will be at risk. The risk is that the inflation process takes hold, and the central banks have to move much more aggressively later on.

1.4 The moment to wind down approaches

A Central Bank official underlined the importance of inflation estimates. At the moment, the increase in inflation looks like transitory. The macro models show that inflation will most likely go back below 2% in 2022 or 2023. The financial markets also show that inflation is not expected to increase. A recent poll in Austria amongst 1,000 individuals showed that inflation expectations are increasing from below 2% to above 2%.

Besides the macro modelling it is important to stay alert and to follow a cautious approach.

An industry representative agreed with much of what has been said, as nobody knows if the 'inflation genie' is out of the bottle or not. There are a lot of accumulated savings. Their company's life insurance business premium volume has increased by close to 50% this year, which has come from all the accumulated savings. There is a lot of 'dry powder' that can go into life insurance, but it can also go into consumption. One of the main markets to look at is the labour market. Labour costs are growing, and both unskilled and skilled wages are growing. Younger people hired to replace people going into retirement are better paid. If the collective choice is to address climate change and move towards more expensive energy sources such as renewables, that will feed inflation.

An industry representative concluded that the ECB needs to remember history, as it had one episode where it moved too early. However, to go back in history before the creation of the ECB, it is clear that US monetary authorities in the 1970s took a very long time to accept that inflation was here to stay, was taking hold and was entrenched. Inflation can be missed for quite a long time before a mandatory authority acts.

2. Central Banks should move towards a monetary normalisation event if inflation remains low to avoid a possible financial crisis

2.1 There must be awareness of the dangers of two low interest rates, on financial stability and on the accumulation of purely liquid savings, that deter from long-term, productive investment

An expert explained that 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, which pushed global debt to 355% of world GDP. 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 intensify already negative consequences for growth and employment. A huge boost in monetary policy has been enacted in order to address the COVID problems. Since the pandemic is reducing in Europe and elsewhere, it would seem logical to normalise monetary policy and significantly reduce the pandemic-related emergency purchase programme.

As far as inflation is concerned, the structural dampening factors at play over recent decades related to demography and globalisation could potentially keep inflation relatively moderate in the longer-term after the immediate bubble and inflationary forces. However, that does not mean that monetary policy should continue its accommodative stance. Care should be taken not to push leverage beyond its boundaries, and there must be awareness of the dangers of two low interest rates, on financial stability and on the accumulation of purely liquid savings, that deter from long-term, productive investment.

He added that structural causes of low inflation cannot be adequately addressed by conjunctural creation of liquidity. Structural deficiencies call for structural measures, not for systematic money creation. House prices are increasing because of a strong demand for houses and because very low interest rates are now granted for people who want to buy a house on credit. More monetary policy facilities will not solve the housing supply problem; they will only increase house prices, which is what is currently happening.

He concluded that it is important to realise the dangers of continuing the present monetary stance without looking at the conditions of supply. Society is living in a world of extremely high leverage, which is always a cause of future financial crisis. Lasting low or negative interest rates are deterring long-term investment, which has declined over the last 20 years in a dramatic fashion.

2.2 The normalisation process should be sufficiently gradual to avoid motor market tensions

An expert stated that the normalisation process should be sufficiently gradual to avoid market tensions. It should be firm enough and its orientation should be understood by the markets. This normalisation must be as a result of collaboration between central banks. To avoid exchange rate 'beggar thy neighbour' practices as well as trade and currency war and protectionism, there needs to be a common understanding of what monetary policy should be. A common misconception is that fiscal policy should be privileged and should take the lead while monetary policy is normalising and abating. Fiscal policies have been slipping in the most advanced countries for the last three or four decades to a point that is indescribable. A normalisation of both monetary and fiscal policy is needed.

He noted that continuing to live under the illusion that fiscal stimulus can replace monetary stimulus will lead to two negative results. The first will be fiscal dominance. If more fiscal stimulus is done it cannot be done with high interest rates, so the central bank needs to keep interest rates low. Secondly, a fiscal crisis will come onto the horizon because that is what excessive leverage always leads to. Extremely extended debt calls for low interest rates because, if interest rates are high, the indebted parties cannot pay, but low interest rates are not compatible with monetary normalisation. The world needs more public and private productive investment in order to improve productivity and potential growth on the supply side.

2.3 Ultra-loose monetary policy and a delayed withdrawal of monetary policy accommodation carry risks

A Central Bank official stated that it is necessary to make sure that monetary policy does not interfere with the issues that an expert has outlined before. It is important not to misuse instruments in order to make sure that inflation stays in place. Central banks will have difficulties to normalise monetary policy if the equilibrium interest rate stays as low as it is now. Central banks could promote an economic situation – with their monetary policy and responsibility for financial stability – with a new wave of social entrepreneurism and new enterprises entering the market, which could drive productivity in areas such as climate and digitalisation.

2.4 Structural problems need to be addressed by structural policies

A Central Bank official agreed with many points that an expert made. Normalisation will happen, inflation permitting. One must distinguish between (i) pandemic emergency support and (ii) monetary stance vis-à-vis medium to longer-term inflation. The pandemic emergency purchase programme (PEPP) is a measure designed specifically to deal with COVID-19. PEPP should end with pandemic fading. ECB's quantitative easing (QE) will not end with the end of the PEPP, which is why it is very important to draw the difference between the discussions at the Fed and the ECB.

A Central Bank official added that the strategy review that has just been published clearly states 2% symmetric inflation over the medium term, as well as taking forceful and persistent action when necessary. Every decision will be taken while considering proportionality. Negative side effects will also be assessed. The monetary policy mix and set of instruments can only be effective if monetary policy is politically independent of fiscal policy. That is one of the reasons why fiscal dominance should not be allowed. The ECB will do everything necessary to avoid fiscal dominance. Normalisation will be done, and it will be done very cautiously. Clear and timely communication is very important. Monetary policy should not be overstretched, as it cannot solve structural problems.

An industry representative summarised that recovery from the pandemic is well underway. It is unclear how inflation will play out, so central banks have to be vigilant, careful, and not act too early or too late. Regarding normalisation, everybody wants to keep flexible. Everybody has the clear goal of avoiding fiscal dominance. Normalisation is needed, and strategies that may force excessive monetary reactions somewhere down the road should be avoided.

OVER-INDEBTEDNESS: WAY FORWARD

A Central Bank official compared the discussion of over public indebtedness to when people want to lose weight and try to find the 'magic diet'. In reality, it is about effort and eating less. There was an awareness 10 years ago that the EU fiscal rules may be too complex and consideration of which independent body could enforce states' commitments.

The following three points emerged from this session. First, fiscal discipline is essential in the Economic and Monetary Union (EMU), but the fiscal rules of the Stability and Growth Pact (SGP) have not been obeyed and growth is the only way to repay the debt. Second, the reform of the SGP must focus on simplicity and enforcement and should improve the composition of public finances. Third, a tailor-made system and better internalising of the European framework in domestic systems is essential to achieve an effective EU fiscal framework.

1. Fiscal discipline is essential in the Economic and Monetary Union, but the fiscal rules of the Stability and Growth Pact have not been obeyed; growth is the only way to repay the debt

All speakers agreed that fiscal discipline is essential in the EU monetary union, that the SGP failed to prevent the build-up of excessive debt levels in many Member States and that growth is the only way to repay debt.

1.1 Why do we need fiscal discipline in the Economic and Monetary Union?

An expert stated that there is in Europe a monetary union without a fiscal responsibility at the helm of the system, so some form of fiscal cooperation is needed. If each member does exactly what it wants, the big danger is anarchy, moral hazard and smart spending ones taking advantage of the virtuous economising others. Basing a fiscal framework on the assumption of indefinite low interest rates and monetisation of public debt is not realistic nor consistent with the functioning of the monetary union.

An industry representative emphasised the importance of strong fiscal discipline. Market discipline is slightly forgotten in this discussion. When there is European-level debt, there might not be so much market discipline in relation to the national sovereign debt. But credible debt restructuring might be needed.

1.2 Public debt has increased at the EU level between 2007 and 2019, at a time when the level of public debt was already worrying

An expert commented that the SGP has not been enforced for the majority of the time over the last two decades. The aggregate government debt ratio between 2007 and 2019 rose from 65.0% to 85.9%, one third more debt compared to the pre-crisis level. Eurofi's macroeconomics scoreboard demonstrates that over-indebtedness in several countries over 20 years has led to a reduction in competitiveness and a slowdown in productivity. Governor Knot also demonstrated this during his earlier speech. In addition, the economic and social consequences of the pandemic are increasing the heterogeneity of fiscal performance across euro area member states. if this heterogeneity is not corrected, the existence of the euro would be called into question.

1.3 Growth will be the only way to repay the debt, but the liquidity trap, which is a consequence of persistent very low interest rates, is an obstacle for relaunching sustainable investment

An expert stated that improvements in growth are needed to address this exceptional debt and avoid economic consequences. Growth will be the only way to repay the debt, over a gradual and planned period. The focus on growth and productivity is all the more important given the risk of inflation. When inflation starts, it is very difficult to stop. In the meantime, greenwashing bias is very widespread in the market. Promotion of the green economy relies on public spending and private actors. If low interest rates and too-accommodative policies persist for too long, savers and corporates will fall into the liquidity trap, where savers are encouraged to keep their savings in liquid and non-risky assets and sustainable investment is not relaunched. Persistent low interest rates do not incentivise entrepreneurs and private investors to launch productive investment despite the needs of the climate and digital transition.

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

The key will be achieving a combination of these outcomes ahead of the next economic and financial shock, which will inevitably come. An industry representative stated that governance capacity should be discussed in the context of the next shock. Considering plausible expectations for inflation, interest rates, and fiscal stance, as well as growth, most governments will have a higher debt burden than pre-pandemic by the middle of the decade. Which options are likely to be more successful or politically palatable in the face of the next shock should be considered. Higher inflation would help. There does not seem to be a consensus across Europe to move towards higher inflation as a steady state, in particular because it would harm savers or voters.

An industry representative (Marie Diron) stated that the political economy is not yet tackling expenditure or revenue, instead addressing the health and economic impact of the pandemic, which falls back onto growth. It is surprising how much growth has been put on the EU agenda, combining objectives of creating or reinforcing a green, digitised economy with structural reforms. Reforms in Finland or in other countries in Europe have managed to increase growth on a state-to-state basis. The credit differentiation is likely to come in governments' capacity to channel these resources towards higher growth state to state.

1.5 The Recovery and Resilience Facility: a potential game changer

A policy-maker emphasised the importance of the Recovery and Resilience Facility as the first instrument of macroeconomic scale to combine reforms and investments. Many reforms included in the national recovery and resilience plans can make direct contributions to fiscal sustainability. These include making tax administration and collection more efficient, making public procurement more centralised and professionalised, and reforms to public financial management, particularly in local and regional government.

1.6 A permanent EU fiscal policy would contribute to closing the investment gap with the US

An industry representative emphasised the necessity of sustainable growth to address public debt. Normalisation of inflation is also needed. The EU should be congratulated for its very good handling of the COVID crisis on all policy fronts and the issuance of the joint public debt and the NextGenerationEU (NGEU) programme. The strong EU industrial policy dimension ensures that the money is used for productive, transformational investment in climate topics and digitalisation. The use of the funds in productive investments supporting sustainable growth is the key.

An industry representative commented that it is important to have Nordic buy-in for this EU angle in fiscal policies. More fiscal capacity may be needed at the EU level to ensure the money is used for these productive, transformational investments. A more centralised European fiscal capacity, focused on research and development, closing the gap with the US, and maybe larger EU budgets and common taxes, would be appropriate. Gert Jan Koopman noted that the EU bonds have been very well received and coexist with national bonds. Mutual debt could be used to finance EU-level public goods and investments.

1.7 There is a strong case to maintain a supportive fiscal policy stance in 2022

A Central Bank official advised that, when countries return to a path of sustainable growth, fiscal policies should aim to achieve prudent fiscal positions in the long term. Currently, fiscal and monetary policies are working together to deliver a strong, consistent economic response to the ongoing crisis. When a monetary policy is at its low effective bound, fiscal multipliers play a greater role. Fiscal stimuluses should be spent in a focused, prudent and efficient manner to reduce the indebtedness level.

2. The reform of the Stability and Growth Pact (SGP) must focus on simplicity and enforcement

Presently, the SGP is excessively complex and suffers from poor enforcement. The reform of the fiscal rules must address these two issues.

2.1 Simplicity

An official commented that the rules are complex because they govern a difficult conceptual issue. Fiscal rules in general are difficult in a euro-area context and more so in an EU context. Simplification is necessary and overdue. There are problems around enforcement and governance. The International Monetary Fund (IMF) is in favour of a single debt rule and a single operational rule, favouring an expenditure rule and a single debt anchor. The IMF has not given an opinion on what the debt anchor is, how it relates to the Maastricht or the 60% debt, and whether the 3% deficit is still appropriate or not. if we can move in the direction of simplification with these two rules or two criteria, that would be very substantial progress.

A Central Bank official commented that, in relation to the Chair’s metaphor of a diet, there is no perfect form of diet. The problem is probably that the individual is overweight and has an issue. The current European fiscal rules are too complex and rigid. The reason for this is often forgotten and the situation is considered as it is.

2.2 Enforcement

2.2.1 A perennial issue for Europe

An official stated that, despite its imperfections and complexity, the SGP has been beneficial in the context of fiscal outcomes. Not every country has abided each year by the exact criteria of the rules, but the situation would have been worse in the absence of rules. There was excessive austerity at times. A collective judgment of what debt levels are sustainable was not advisable. Going forward, a move to simplicity is vital because it is challenging to understand the rules in their entirety.

2.2.2 Understanding the main shortcomings of the poor enforcement of the SGP

An expert stated that a minimum amount of fiscal normality in the system is critical. Otherwise, the negative externalities will kill the whole exercise. In the past, the fiscal rules of the SGP have not been observed by the large or smaller powers. It is possible that the norms were too simplified and that member countries did not believe in the legitimacy of those norms, perceiving them as artificial, global, and too arithmetic, and therefore did not perceive that they belonged to the system and the rules.

2.2.3 It will not be possible to improve enforcement without a simpler, less complex system

A policy-maker stated that a much simpler fiscal framework is needed to improve enforcement. Whatever fiscal framework emerges in the future must be applied and implemented by all member states all of the time. An agreement on a new and better economic governance framework is needed. The full and proper implementation of the Recovery and Resilience Facility will be crucial. Currently, member states, particularly the member states with the most economic difficulties, have significant funds and transfers to finance the necessary reforms and investments. If these reforms and investments do not proceed now, it is uncertain when they will and how confidence can be built in this area.

2.3 Regarding debt sustainability issue, the sovereign bank loop must still be addressed and a common EU approach for macroprudential policy is required

An industry representative noted that banks hold a great deal of their own sovereign debt. The link between the sovereigns and the banks has still not been addressed, for instance by putting some restrictions on holdings of national debt. The Banking Union aimed to break this link between the banks and the sovereigns. Now that there is also the EU-level debt, breaking this link can be explored. The perception of central bankers is that asset price inflation or the indebtedness issues cannot be addressed through monetary policy, but there are the macroprudential instruments. As Andrea Enria noted, European integration or harmonisation in that field is lacking.

3. The reform of the SGP should improve the composition of public finances

The revised common framework should ensure a composition of public finance that is both growth friendly and sustainable. More importance should be placed on the quality of public spending, rather than its quantity. The question of a special treatment for growth-enhancing public expenditure was also discussed.

3.1 The quality of public spending should be a criterion for assessing fiscal policies

An expert noted that public spending is very important in many economies, and it therefore must be treated with care. It is one of the future rules of the Commission's economic and financial package. 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 a degree of homogeneity in budgetary performance is the aim. Public support is needed for some very-long-term investments in the green economy. The lack of a real EU energy policy or common strategy is regrettable. In such a challenging context, 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.

3.2 Encouraging public investment in all Member States

A Central Bank official noted a Eurofi article for the panel that underlined that investment is only 4% of public spending. There is a margin of improvement to invest more and better, with the quality of investment being key. A huge amount of money is spent for consumption or not growth-enhancing debt.

A policy-maker commented that the previous crisis demonstrated that the first source of fiscal consolidation is public investment. The level of public investment in virtually all Member States is below what is needed to sustain the level of the public capital stock. The level of the public capital stock is being decreased at the time that it should be increased. The fiscal rules are not the source of the problem; they are a choice to be made.

3.3 Certain types of investment could be exempted from the fiscal deficit rule

An official suggested that certain types of investment could, in principle be exempted from the fiscal deficit limit, given the European agenda on climate change and the need for more green investment. But this will not over come fiscal space constraints in some countries. So, in practice governments will need to acknowledge a trade-off between more public investment and current expenditure and prioritize public investment in line with national needs.

A Central Bank official commented that the rules are difficult to understand for the wider public and policy-makers. Growth-enhancing public investments should not be undermined by over-fixation on debt level. A reformed SGP should ensure sufficient flexibility on public investment linked to long-term growth and employment. If this is connected to an important topic such as fighting climate change, digitalisation, or transformation of economies, a green clause could be included. Safeguards would be needed to avoid abuses. The SGP should better fit the macro-stabilisation function of fiscal policy during downturns, especially when the monetary policy is near its effective lower bound. The current framework of fiscal policy tends to be too procyclical. More countercyclicality should be introduced. An appropriately designed expenditure rule could assist in this.

An industry representative commented that whether the reform of the fiscal rules will be effective is not yet known. An alternative would be to try to move towards a more principles based approach, with a common agreement on the principles to apply to a fiscal policy.

4. A tailor-made system and better internalising the European framework in domestic systems is essential to achieve an effective EU fiscal framework

The revised framework should define, on a state-by-state basis and from a medium-term perspective, the budgetary guidelines that best reflect the specific national and Community interests. Finding ways for countries to better internalise the revised fiscal framework in their domestic systems is essential. From this perspective, building a constructive fiscal dialogue between member states and an EU fiscal independent authority that is also in charge of surveillance makes sense. Political difficulties could interfere there, but, if political factors make comprehensive fiscal action at the level of the Union impossible, the problem is a lack of belief in a true European Union.

4.1 An adapted framework for a common discipline

An expert commented that a tailor-made system is needed. This will be more complex than a one-size-fits-all system because the reality of the economic challenges of each country must be understood and accommodated. Each Member State should define a specific path for reducing its public debt and a politically independent EU institution should discuss and validate these plans. A dialogue will be needed between the economists of this impartial EU institution and the national authorities. If the country understands that the measures are reasonable, enacting those prescriptions becomes easier. Increased confidence and trust between the economists in charge of this supervision and the national authorities will improve enactment and application of the system. A fiscal authority, comprised of economists of good economic and academic backgrounds, would add credibility.

A Central Bank official suggested that this independent, honest, trustful body could be the European Commission.

4.2 Domestic fiscal choices are domestic and political issues, which complicates action at the EU level in this area

A policy-maker commented that an independent fiscal board can play an important role in critical elements of a fiscal survey for ensuring fiscal sustainability. However, the critical choices around the composition of public expenditure, the designed tax system and distribution are fundamentally political. There is a role for independent fiscal authorities in certain aspects of the fiscal surveillance, but, ultimately, many of these choices are political. Consensus and trust in bodies like the European Commission and the European Fiscal Board (EFB) is very important. Member states need to have confidence that their counterparts are going to adhere to the commitments that they entered into.

An official emphasised the importance of the political aspect. The IMF's record in Europe, or elsewhere, of persuading countries to pursue structural reforms for growth, sustainability and such is not stellar. The IMF works very closely with the Commission on its country-specific reform recommendations, and its experience is similar. The issues are largely political. Debt levels have been very high in many industrial countries across the world from the 1950s onwards. Debt came down from these high levels because of growth, not because of austerity, fiscal consolidation, belt tightening, or extreme diets. And higher growth requires countries to pursue reforms more consistently.

An industry representative suggested that an economic reform board might also be needed. This body would dispassionately outline the conflicts of interest, namely on reforms, and demonstrate with examples what could be done, considering the political constraints. The board would aim to be transparent about the social and political hurdles to reforms.

An industry representative agreed with other speakers that there is a very bad track record in public spending expenditure and not generating productive investments. A European fiscal authority might be too ambitious an approach at the present time. Instead, industrial policy could be coordinated, while retaining the national debt and coexisting policies.

4.3 If it is stated that political factors make a comprehensive fiscal action at the level of the Union impossible, there is a lack of belief in a true European Union

An expert commented that, if political factors are blamed and considered as impossible for making a comprehensive fiscal action at the level of the Union, there is a lack of belief in a true European Union. The reactions of the panel to the very modest proposals around a fiscal board and an adapted framework are disappointing.

GROWTH CHALLENGES IN THE CEE REGION

1. Structural growth challenges in the CEE region

The panellists highlighted the main structural challenges that impede economic growth in the CEE region: labour and skills shortages, over-reliance on bank financing, regulatory fragmentation and the effectiveness of public finances.

1.1 Labour and skills shortages

An industry representative described the lack of qualified labour within the CEE region. Although situations differ across countries there is generally a challenge around increasing worker participation, especially in the context of the digital transformation.

An IFI representative stressed that the availability of skills is a major concern in the region. For many firms, the issue of skills is one of the main impediments to investment. This is partly due to way skills are taught in the region, with insufficient emphasis on innovation. Before COVID there was substantial outward migration of workers. With post-COVID growth objectives there is now an opportunity to attract people back to the region.

An official agreed that there are concerns about the labour market in several CEE countries. The shortages in the workforce are exacerbated by demographic changes and particularly an ageing population. In some CEE countries such as certain Balkan countries, this is further compounded by the so called 'brain drain'. These evolutions lead to a potential middle income trap, i.e. an economic situation in which a country attains a certain income level but then cannot exceed that level, which is a threat to sustainable growth. The data suggest that the CEE region is currently reaching the limit of its economic potential for growth. Convergence is a key indicator here because when there is increased economic convergence across countries, there is a slowdown in economic growth. This is also valid for so called sigma convergence (i.e. reduction in the dispersion of levels of income across economies).

1.2. An over reliance on bank financing

An official explained that many CEE countries are over reliant on bank financing and that access to more diversified sources of finance remains a major challenge. There is no developed capital market in these countries and therefore no real alternative to bank financing. In many CEE countries, this is also underpinned by an excessive concentration of the banking sector with a few banking groups controlling the majority of the market, which potentially restricts financing options of smaller companies in particular. In Slovakia, for example, more than 60% of banking activities are controlled by three banking groups. A policy-maker agreed with the need to increase the diversification of financing and make capital markets more accessible and noted that this objective is being pursued with the Capital Markets Union initiative (CMU).

Another official agreed that the CMU strategy is an appropriate solution for supporting the financing of growth and that many of the measures needed to develop capital markets have been identified in the Commission's action plans, however the implementation of the project is challenging and requires further work.

An industry representative agreed that further diversification of funding sources would be welcome but emphasised that the current financial industry was nevertheless able to act as a buffer against the shock of the COVID crisis.

1.3. The effectiveness of public finances and regulatory fragmentation

An official considered that the effectiveness of public finances is a further challenge in the CEE region. This is evident in the fiscal multiplier in CEE countries (i.e. the effect that increases in fiscal spending will have on GDP), which needs to be improved, as well as in the use of European funds. There is public money available, but its impact on closing the investment gap is still too limited. This requires in particular strengthening the governance of public institutions in the CEE region. The official also explained how the weaknesses of CEE countries had been exposed in the COVID pandemic. The huge investment gaps in many areas, especially in education and health, should be the region's first priority.

An industry representative added that regulatory fragmentation and heterogeneity across CEE economies are issues that also need to be considered. This is evident in the insurance sector in particular, which is naturally more domestic driven than any other part of the financial industry, because its risk-mitigating social function for individuals, families and companies needs to be adapted to the specificities of each country.

2. Opportunities and challenges associated with the digital and green transitions in the CEE region

An industry representative considered that Europe must exit its current 'COVID recession doom' and progressively move into a mood of structural adjustment in which new priorities can be set around the challenges and opportunities presented by the digital and green transitions in particular.

An IFI representative suggested that the COVID crisis is an opportunity for the CEE region to 'rebuild better' and that this has already started. The long term structural growth challenge induced by COVID has amplified pre existing structural challenges for the region, such as the digital transition, the climate transition and the issues around skills which are particularly relevant given the role of the region in global value chains. The COVID crisis is therefore an opportunity to rebuild competitiveness taking into account the digital and green transition needs In addition the IFI representative explained that every year the European Investment Bank (EIB) surveys 12,500 European firms about their long-term economic expectations and this year and last, COVID implications were taken into consideration. In the CEE region, 70% of firms expect COVID to bring structural transformation. 50%, particularly the larger firms, expect to increase digitalisation in the long term. Interestingly, 30% of firms expect that the structural transformations resulting from COVID will cause transformations in the global value chain. 30% expect that they will require more innovation in their products. 20% expect a reduction in permanent employment in the long term.

The IFI representative also explained how firms reacted immediately at the outset of the COVID pandemic and the challenges they face. In terms of digitalisation, the CEE region already had a reasonable level of digitalisation at firm level and CEE companies have an appropriate access to digital infrastructure. The COVID crisis offered an opportunity to accelerate digitalisation in the short term due to the need to move to remote working, and was also a trigger for individual firms to launch more advanced digitalisation efforts subsequently. There are also several positive examples of advanced digitalisation in public administration. For example, more than 50% of municipalities state that they have digital capacities in the region.

The climate transition is a bigger challenge for the region, the IFI representative emphasized. There is a large investment gap at a local level. Over 70% of municipalities say they have underinvested in the mitigation of and adaptation to climate change. They lack technical capacity and do not know what needs to be done to support the climate transition, which is a barrier to investment. The same is true for private firms. While they tend to be aware of physical climate risk, they are less aware of transition objectives and do not invest in them in the same way. 35% of firms are investing in climate change, and their main concern is the potential uncertainty around regulation and taxation, which means that the goal at the European level should be to create a coherent regulatory framework to guide the climate transition that is then transposed in a consistent way at a national level in order to avoid fragmentation in the market and possible protectionary measures.

The IFI representative also emphasized the importance of skills in this context and the need to change the way people are trained in order to enable them to seize the opportunities presented by the digital and green transitions. The COVID crisis is an opportunity to attract talent back to the region, but this will require a more flexible job market and a more welcoming economic environment that is capable of attracting people with different skills. This is especially relevant for the CEE region due to concerns around cohesion and inclusion. The digital and climate transitions are an opportunity to transform the job market, but inclusion needs to be increased at the same time, given the region's heavy dependence on the integration of the global value chain.

An official agreed that the digitalisation of economies is an opportunity for CEE countries and that the main issue is how to increase productivity in the region in an inclusive way.

An industry representative described how the COVID crisis has homogenised the use of digital tools across the EU. A McKinsey study shows that the gap between the new and old Europe on mobile and data penetration for example has narrowed dramatically. The crisis forced CEE countries to narrow the digitalisation gap simply because there was no other way to do business.

3. Public policy responses to the pandemic and related implementation challenges

3.1. Public policy responses to the pandemic

A policy-maker stated that the COVID crisis has produced a massive response from the public authorities starting with measures concerning labour which are essential for economic rebound. It has also changed to a certain extent the way that public authorities seek to do policy.

An IFI representative emphasized the opportunities associated with the post-Covid rebuilding for the CEE region. This crisis happened at a time when the Multiannual Financial Framework (MFF) was being designed which meant that there was an opportunity to adapt the way money and resources were allocated and deployed. Additionally, the very strong policy response, including the Recovery and Resilience Facility (RRF), provides substantial ammunition to push for and drive a transformation in the CEE region in order to help it to catch up with other parts of Europe.

There is a huge amount of resources coming to the region with the RRF. The IFI representative outlined several features of the RRF. Over six years, the RRF will finance 40% of gross fixed capital formation and 8% of GDP in the region. This is a huge resource that will kickstart the transformation. Plans are very different across countries, but there is a significant shifting of resource, around 65%, towards public investment. 10% will go to current investment and 25% to incentives for investment, the impact of which needs maximising. This shift is designed to boost infrastructure, which is understandable because the region is still building its capital stock.

3.2. Implementation challenges and factors for success

An IFI representative outlined several of the implementation challenges associated with EU investment initiatives. First, is exploiting the potential of the single market over time, which requires full market integration including for public infrastructure in order to ensure that these plans have appropriate cross border spillover effects. Secondly, reforms are needed in order to ensure that the regulatory environment does not create an impediment to future investment. Additionally, there is a question around implementation capacity and whether the efforts made at the design level will 'trickle down' to the project level. This is particularly important for the climate transition, because the relevant skills do not exist in the region and the regulatory environment is evolving. Finally, although financial instruments can act as incentives for private sector investment, the EIB's survey of firms suggests that only 5% of CEE firms received an incentive for accelerating their digital or green transitions in the last three years. The equivalent number in the rest of Europe is 15%, which is a significant difference. Firms in the region are having to do this alone; some support or a guided incentive would be useful here.

A policy-maker agreed with the importance of implementation capacity in relation to the recovery plans. Technical support is available for supporting the implementation of recovery plans in each country as part of the RRF. The single market also plays an important role in this context. After some fragmentation at the onset of the pandemic the European countries implemented common approaches for fighting against COVID, and now Europe is outperforming most other regions in this regard.

An official emphasized that reforms are the key to success in the CEE region and that CEE countries have demonstrated their ability to adapt when their economies were transformed from centrally planned models to market economies three decades ago. NGEU is a huge opportunity for the region, and it contains a good combination of 'stick' and 'carrot' actions. The biggest challenge for the CEE region is around implementation, the official stressed, but the Commission is helping CEE countries not only to monitor, audit and control recovery plans but also to implement them with the Technical Support Instrument (TSI) mentioned by the previous speaker. The official emphasised two other important aspects of governance, which are necessary to consider in addition to reforms: a focus on value for money and the strengthening of public institutions.

An industry representative noted that financing will be more challenging in the future because inflationary pressures will increase more than hoped, which means the interest rate and the cost of financing will rise.

An industry representative stated that NGEU along with its redesign of existing instruments such as the Stability and Growth Pact (SGP) provides an appropriate policy environment for supporting the recovery. From an implementation perspective, the main challenge now is reconciling the objectives and approaches of the public authorities and of the private sector in the implementation of the recovery plans. The private sectors in most European countries reacted well during the pandemic and are now on their way towards more sustained growth and the public sectors of many EU countries provided huge financial resources to assist this reaction. The challenge is now to transform these evolutions into more structural adjustments. From the private sector perspective, there are clear gaps in the labour market, construction and the accumulation of human capital that need addressing in many CEE countries. This requires in many cases upgrading national legislation and harmonising it at the European level, especially in relation to labour market policies.

The industry representative suggested that the private sector should also consider how to translate the opportunities around the digital and green transformations into new investment flows. The activation of private investment in these areas requires the right direct and indirect incentives. Direct incentives are created when public money is spent through initiatives such as the game changing NGEU. Indirect incentives emerge from changes in the regulatory and legislative environment, where there are still many obstacles to growth caused by the lack of legislative harmonisation. This applies to labour market legislation, as well as to tax legislation and the legal instruments that facilitate private sector investment.

The industry representative emphasised the strong link between structural reforms and investment. Investments are the vehicles through which the impact of structural reforms is diffused in the economy. New legislation is useful, but it must be implemented. For the private sector, implementation means more investment. The European economy needs investment both because investment is good but also because investment is how structural reforms are diffused in the system. This is where the financial industry in Europe can play a facilitation role. Banks and financial companies exist to intermediate between savings and investment, but in a post pandemic, digital and green environment, incentives must be directed towards creating green and digital investment rather than simply investment, while avoiding green-washing.

4. Policy responses in the areas of digitalisation and capital market financing

4.1. Digitalisation

An official stressed the need for structural change in the CEE economies rather than just 'showering the economy with money'. There are several interesting initiatives around data at the European level, including several new directives that could be taken advantage of for example concerning Artificial Intelligence (AI). There is an opportunity to explore what the data market in Europe will look like as well, the free movement of data and how this will be achieved. It is important to understand what will be needed here. For example, there is a proposition to use sandboxes to test new and innovative concepts around data and some CEE countries will be creating data sandboxes as part of their recovery plan. The official added that the EU's digital finance strategy, which discusses open finance and how to accelerate the digitalisation of finance, could improve financing from the private sector.

An industry representative supported the remarks made on digitalisation. Any common European digital framework e.g. for contracting with third-parties will increase the transferability of solutions and enable firms to benefit from innovation, because at present Europe is not a unified market.

4.2. Capital Markets Union (CMU)

An official explained that developing capital markets in the EU with the CMU initiative is essential to overcome the growth challenges that the CEE region is facing, but emphasized the importance of focusing on the game changers rather than the low-hanging fruit for the success of the CMU. First, a Europeanisation of the insolvency framework is needed, as well as an EU wide system for withholding tax relief in order to lower the cost of cross border business and prevent tax fraud. Secondly, there should be a stronger focus on supervisory coordination, because the full potential of the internal market is not being utilised with the current set up and it is necessary to eliminate the non prudential obstacles faced by the CEE region. Thirdly, consumer protection is particularly important for the

CEE region. There is a need to improve the level of financial literacy and education of most citizens and also of many managers of smaller firms, whose awareness about alternative sources of funding is insufficient. The objective proposed in the CMU action plan to introduce a requirement that already exists in the UK, for banks to direct SMEs whose credit applications have been refused, to providers of alternative funding seems appropriate in this perspective. Fourthly, digitalisation is vital and it is important to consider the AML framework in this context, because there is huge reputational risk here.

An industry representative highlighted the role of insurance as a source of liquidity. In addition to helping policy holders face risks of loss of assets or accidents and managing and pooling risk, insurance companies are also a significant potential source of funds for long term projects with safe returns. The Solvency II framework should allow for more investment here. There is a need for long term investments, and these will be even more necessary in a world where there are higher yields on safe assets, which will happen.

Another industry representative agreed with the need to seek game changers and not merely the low-hanging fruit, although the low-hanging fruit was very useful in helping to manage the pandemic shock. The European economy is entering a new phase now where more growth is needed, which requires policies that can be game changers. Policies must however be designed carefully to ensure they produce the appropriate response from the private sector and allow putting idle liquidity in the system to the benefit of unexploited investment opportunities. Policy-makers and industry players need to determine what to do together. If there is a new spirit here, it could deliver strong results in terms of growth, convergence and employment.

4.3. The green transition

An industry representative suggested that there would be a benefit to having greater clarity on the green transition as soon as possible, especially for the CEE region. Manufacturing is a very important value creator in CEE countries still, with the most industrialised economies within the EU being the Czech Republic and Slovakia, and therefore clarity is required in terms of green transition for the region. Additionally, it is necessary to focus on 'greening the economy' as opposed to just investing in 'green', because resources need to be used to green activities that are currently brown or black.

OPTIMISING THE FINANCING OF EU CORPORATES

1. Current structure of corporate financing in the EU

1.1 A strong debt and bank financing bias

A Central Bank official stated that data from the Bank for International Settlements (BIS) shows that the funding mix of European corporates is 55% bank-based compared to 33% in the US. Europe is still a bank-centric financial system where larger corporates go to the capital markets, but most small corporates are dependent on banks. In times of crisis this could make the economy more pro-cyclical as banks may cut credit flows. Increasing market funding would allow the provision of alternative financing in the event of a financial crisis and also the funding of immaterial assets that cannot be easily financed by banks.

There is also a debt bias in the financing of EU corporates, the Central Bank official observed. Most European countries have a favourable tax treatment for debt vis-à-vis equity financing, which incentivises firms to take on more debt than is economically optimal, leaving them vulnerable to shocks. Corporate indebtedness was already high in the euro area before COVID and has increased post-COVID, as have, for example, debt-to-earnings ratios. This may lead to a rising proportion of low productive 'zombie firms,' dependent on loose financial conditions and to a misallocation of capital to such firms, which could be put to better use. However this is not only a European challenge and is not the only productivity challenge facing Europe since ageing population and low productivity growth issues pre-date COVID. Another issue associated with debt is that highly leveraged firms invest less in research and development (R&D), which is vital for long-term high productivity growth, as shown in the OECD corporate governance study published in June 2021. Therefore too much leverage and too little equity and market funding are not positive for the economy's long-term potential. in addition market-based financing increases market resilience on an aggregate level and at the company level. Indeed, unlike bank-financing, market-financing focuses on the higher-risk share of firm financing associated with more productivity and innovation.

The Central Bank official added that there are fundamental ratios to consider for assessing the funding structure of enterprises and how equity is provided, which show that Europe does not have the same equity culture as the US. In the US private investors, including friends and family, provide 33% of US SME financing, but only 9% in Europe. Angel investment amounts to €20 billion in US SMEs, but €6 billion per year in Europe. Pension funds provide €15 trillion in the US, corresponding to 53% of equity, and €4.3 trillion in the EU, or around 30% of equity. The consequences of this equity shortfall in Europe are two-fold. First, SMEs are more fragile in times of difficulty or shock, even if the fundamentals are good. Secondly the pandemic would have been a disaster, and worse than in the US, without strong government support.

A market expert agreed that the current financial structure between equity and debt of European small and medium-sized enterprises (SMEs) is a major weakness. As a consequence these companies are less able to invest, in particular in R&D, as previously mentioned. A 2018 European Central Bank (ECB) study of the 2008-12 crisis found that firms with more equity were more resilient in terms of investment and development. Firms with less equity tend to cut investment more strongly. This is particularly an issue for start-ups which need equity at the beginning in order to develop and cannot correctly service debt because of limited cash flows. As a result it is easier to start a business in the US than in the EU and innovation potential is lost in the EU due to an insufficient culture of equity financing. The Chair added that a further issue in some countries is the difficulty to attract large investors to invest in SMEs notably, because of the limited liquidity and volume of issuance.

1.2 Impact of the COVID crisis on the financing structure of EU SMEs

A market expert highlighted the evolution of the financing of corporates, especially SMEs, during the COVID crisis based on figures for France, which can be considered to be representative of the rest of the EU, because the government support schemes put in place were similar. SMEs saw little change in retained profits on an aggregated level, thanks to government support. It was just below 7% of turnover in 2020, close to the pre-pandemic level.

Net investments dropped slightly in 2020, but were not hugely different compared to the pre-crisis level. Net borrowing increased significantly by +16% compared to +2% in 2019, including a +37% increase in net cash. The cash was probably needed for a period of time before government support programmes came into effect and the liquidity was then kept on balance sheets by firms for precautionary reasons. Considering the liability side, net and gross debt have both increased significantly in volume: gross debt increased by €224 billion and the cash balance by €215 billion. Looking at other ratios, gross debt compared to own funds for SMEs was 67% in 2019 and 74% in 2020, but net debt to own funds went from 30% to 26%. This shows that the crisis did not weaken company balance sheets significantly, thanks to government support programmes and the provision of state-guaranteed loans by the banking sector. The prime objective of these fiscal interventions was to restore turnover and business, maintain firm profitability and their capacity to develop and invest when the government programmes would stop. In addition, the financial structure of SMEs improved significantly over the past decade, as the gross debt to own fund ratio decreased from 90% in 2011 to 67% in 2019.

An IFI representative commented that, despite massive public intervention via guarantees and debt support, SMEs were hit harder than bigger EU companies, and the performance gap between them widened, partly because SMEs started out with a smaller buffer and had limited access to credit. An IMF report stated that public policies have mitigated only half of the rise in liquidity shortfall. Public support has addressed liquidity needs to an extent but only covered about 30% of the rise in equity gaps. Even with such public support, it is worrying that the share of insolvent firms could further increase by 6% across Europe and put at risk the jobs of around 8% of the workforce, the IFI representative believed, which shows that the crisis is not yet over.

1.3 Capital markets worked well through the COVID crisis in the EU

An industry representative stated that during the COVID crisis the equity market at the European and global levels worked well. Markets remained liquid so it was easy for investors to get in and out, spreads were tight, and listed companies were able to access capital to strengthen balance sheets or conduct M&As.

Access to initial public offering (IPO) capital also remained open for SMEs. When looking at the Nordic and Baltic region, markets worked very well for SME IPOs and an effective mix of bank lending and market financing has remained available, although statistics differ from market to market and some markets still have improvement areas. From January to the end of August 2021, the Nordics welcomed a record-number of 121 IPOs, among which around 100 concerned SMEs. Most of the IPOs occurred in Sweden, where market access works well and where there is a focus on supporting the access to capital of SMEs over the long-term thanks notably to a well-developed equity culture among private investors. The bond market also worked well during this period, as many larger listed companies issued debt securities, with sustainable bonds making up around 15% of those listed so far in 2021. Improving the financing of EU corporates is about getting the right setup and structure in each relevant market the industry representative concluded.

2. Main solutions for optimising the financing of EU corporates

2.1 Further adapting funding instruments to the needs of SMEs

An industry representative stated that companies want competition and choice for accessing capital and are agnostic about whether capital comes from private or public markets. Domestic market structures vary however in their capacity to support investment effectively across Europe. The CMU action plan is addressing some frictions that need to be removed concerning capital markets, but a major challenge for SMEs in the EU is deploying at scale. This is a key area that policymakers should focus on with the objective of encouraging the development of local markets adapted to the needs of different investors i.e. domestic and international ones, insurance companies, banks and retail savers.

An IFI representative observed that more quasi-equity and subordinated debt instruments are needed. SMEs also need more flexible, tailor-made financing solutions which can be in the form of loan funds, fintech financing or venture capital. It is also important that the private and public sectors collaborate in this area. As shown in a recent AFME study, many SMEs and family-led companies value the notion of control and are reluctant to give it up when using equity financing. They are ready to pay for less invasive solutions, which could be quasi-equity and subordinated debt. This is also supported by European Investment Bank (EIB) analysis showing a readiness for paying an interest premium for that. Subordinated financing is not a standalone solution, but a way to diversify SME financing sources taking into account the need to further provide SMEs with standardised, scalable, easily deployable and non-invasive forms of funding. This type of financing exists at national level in some countries, and others have launched recently such instruments, like France's 'prêts participatifs', but a pan-EU product is still missing and is needed. Such products and solutions were envisaged at EU level through a solvency instrument but did not materialise.

An industry representative suggested that more can also be done in terms of product innovation, in areas such as venture debt, digital lending and equity-light financing, which are more suitable for companies with intangible assets and are harder to cover with traditional forms of financing. There is no pan-European vehicle at present to cover these needs. The actions put in place by the US Small Business Administration for supporting the funding of SMEs could be interesting to replicate in the EU. A Central Bank official added that there is a need to create incentives for equity funding. An industry representative agreed that incentives could have an impact over time but warned that effects cannot be created overnight.

2.2 Supporting SMEs throughout the funding escalator

An IFI representative stated that financing solutions should also be adapted to the various development stages of SMEs. The traditional focus in Europe has been on early-stage finance, where there was a market failure and still is, particularly outside Western Europe. However, there is also a need for growth finance to keep well-performing, venture capital-nurtured companies in Europe because value creation does not stay sufficiently in Europe. 44% of unicorns supported by the EIF for example and for which the earlier, high risk financing stages were achieved in the EU, have exited European financial markets and are now either listed in the US or Asia or have been acquired by US or Asian firms. There is awareness about the need to support growth finance at EU level and some measures have been implemented for scale ups such as the European Scale-up Action for Risk capital (ESCALAR) instrument. The Commission is also working on the pre and post-IPO stages, but it will require sizeable interventions, coordination with national players, and solutions to attract private money, as public money alone cannot do the job.

An industry representative stated that the EU IPO fund which has already been decided needs to be activated. Another industry representative added that a more precise definition of SMEs is needed from a policy perspective because growth SMEs, which create job innovation and boost productivity do not have the same characteristics and needs as other SMEs. An issue that needs considering is that a company going through different stages has to re-market itself to different providers of capital. This is part of the 'funding escalator' concept whereby SMEs go through various stages of specialist venture and growth financing before ending with an IPO. But there is in Europe a recognition that some steps are missing in the escalator and must be filled.

2.3 Leveraging the complementarities of banks and capital markets

An industry representative considered that the COVID crisis has shown that the perception of the juxtaposition of Banking Union (BU) and Capital Markets Union (CMU) as a zero-sum game i.e. with capital market financing potentially replacing bank financing is a false dichotomy. There is instead a 'mutualistic symbiosis' between the BU and CMU, which complement each other, ensuring a greater investor base heterogeneity and the availability of more diversified sources of funding and also allowing the progressive strengthening of Europe's corporate funding ecosystem. During the COVID crisis, firm sales went to zero in many cases and corporate balance sheets became illiquid, which accentuated short-term liquidity needs. Banks, which were in good shape thanks to the post-Global Financial Crisis (GFC) reforms and policy changes, were the immediate provider of short-term liquidity to allow firms to keep their business running and pay their employees. Corporates drew on revolving credit facilities (RCFs) and short-term lending facilities, and then turned those maturities out in the capital markets. Liquidity returned to the banks, who extended it to other companies that needed it for potentially a longer period of time.

An example of the synergies between bank and capital markets financing are minibonds which are used in Italy, the Chair mentioned. A 2020 paper on the Italian minibond market shows that after the issuance of minibonds, the access of companies to normal debt financing by banks is improved, because the issuance of mini-bonds is a sign of quality. A market expert agreed that the example of the Italian minibond market illustrates the complementarity between bank and capital market financing. An ECB study on ex-post results shows that shortly after the issuance of minibonds, there is a reduction in lending rates by 40 basis points on average for long-term loans and 28 basis points for advances for the companies issuing them. Minibonds also reduce the amount of used bank credit by 35%, keep credit in the balance sheet, and, importantly, reduce the ratio of used credit compared to credit created significantly, giving companies the possibility to augment their total external funding capacity by 40% and to seize additional investment opportunities.

Another example of complementarity between banks and capital markets, the market expert mentioned, is the key role that banks play in the introduction of equity into the market and in the sales of securities to institutional and retail investors, mostly via investment funds. Maintaining this role however requires a review of banking regulation in order to ensure that banks continue to have the capacity to provide liquidity for market making activities. Banking regulations were rightfully strengthened after the 2008 financial crisis, but it is necessary to ensure that this does not prevent banks from playing their role in the development of capital markets. It is also essential not to introduce more severe regulation in finalising Basel III plus than what exists in the US.

2.4 Developing retail participation in equity markets

An industry representative stated that the increased retail participation in capital markets observed during the COVID crisis is encouraging. Many online brokers in Europe saw significant increases in the number of retail clients, as in the US. Going forward there should be a strong focus on developing retail investment in Europe, after the time previously spent on developing professional investment. The First North Growth Market in Stockholm for SMEs shows that 60% of trades and more than 40% of turnover are performed by retail investors, which is a high level of participation. In Sweden 80% of citizens have equities, directly or indirectly and part of these are SME equity, which means that retail investors are helping to fund SMEs in their growth period.

Attempts have been made to copy the Swedish model into other markets, with some success, but with some gaps also. An equity culture for retail investors cannot be built overnight, the industry representative believed. Sweden has focused on this objective for more than 30 years, starting with education and creating the right tax incentives for investing in SMEs with the introduction of a low-tax investment saving account where banks or brokers report taxation on behalf of retail investors, which encourages them to invest in small-upside growth companies. Stock exchanges have also been involved in the development of equity markets in Sweden, along with advisors, anchor institutional investors and pension funds. This has been a long journey, but as a result the Swedish market for SME growth companies and new listings is probably the most dynamic in Europe. This also requires political will and the backing of the industry as shown by other Nordic markets which are still struggling to develop their capital markets.

A Central Bank official added that Dutch pension funds, which act as an indirect investor in financial markets and then supply retirement benefits, are another positive example of retail participation in capital markets in Europe. Pension holders are indirect investors, but on aggregate represent a significant share of the market. Increasing savings in capital-based pension funds would contribute to develop and deepen EU capital markets.

An industry representative agreed on the need to develop Europe's equity culture, an objective which is often overlooked when considering possible policy levers. Europe is too reliant on debt funding. Reversing that balance notably requires increasing financial literacy and the understanding of citizens about retirement savings, and especially the role that equity can play in this perspective.

2.5 The prospects of SPACs

The Chair emphasized that there is an on-going debate among regulators about the role that Special Purpose Acquisition Companies (SPACs) could play in facilitating SME financing and retail investment and the regulatory approach needed for such vehicles. An industry representative explained that the US market has had more than 400 SPAC listings in 2021. In the EU Nordic market 7 SPACs, have been listed so far in Sweden and Finland. SPACs are an interesting concept, are part of the market structure and are there to stay, the industry speaker believed, however, US stats show that not all SPACs are performing well. SPACs offer many opportunities, but investors must conduct the necessary due diligence before investing in them in the same way as for traditional IPO companies, assessing the prospectus and IPO materials. Currently they are regulated on a local level, which means that rules differ across the EU. The EU could consider a broader regulation at EU level.

A market expert agreed that SPACs are an interesting instrument for developing capital markets alongside equity, crowdfunding, private equity or venture capital, especially when there is a difficulty with price discovery. For an innovative company where intangible assets are dominant or represent almost exclusively the value of the company, it is difficult to embark on a classical IPO. Using a SPAC allows for price discovery and establishing a basis for a price to then go to the market as a result of de-SPAC-ing. The European approach concentrated on real business objectives seems more appropriate than what is happening in the US where the development of SPACs seems excessive.

2.6 Reviewing EU legislations impacting capital market financing

A market expert noted that a number of EU legislations must be reviewed to improve the financing of EU corporates and particularly SMEs and suggested three priorities: (i) reviewing Solvency II prudential requirements, which are calculated based on a risk at one year for a multi-year investment and so disadvantage investment in the most volatile securities, especially equity; (ii) reviewing the ELTIF regulation: the European Long term Investment Fund (ELTIF) is a pan-European vehicle in private equity, attractive for savers, but regulations have led to negligible amounts of investment and this requires greater focus; (iii) reviewing the securitisation regulation, as it is an important way for markets to develop: with securitisation, the initial financing is done by banks, who have limits in their balance sheets for regulatory reasons, but are able to assess the quality of the risk, so securitising is an appropriate way to develop market financing and provide the EU economy with more financing.

EU-UK RELATIONS: WHAT FUTURE PERSPECTIVES AND IMPACTS ON THEIR FINANCIAL SECTORS?

1. Current status of the EU-UK cooperation in the financial sector and risks of regulatory divergence

1.1 Current status of EU-UK cooperation

A regulator considered that the Brexit transition went smoothly thanks to the important preparation done by the UK, the European authorities and financial market participants. Despite several minor issues of concern, the post Brexit landscape seems relatively stable in the area of capital markets in particular. In terms of day-to-day cooperation, there is effective supervisory cooperation between the EU and UK. There are regular exchanges and ongoing dialogue between ESMA and the UK authorities, which are important to maintain, given the high degree of interconnectedness between EU and UK markets. Ultimately, the two public authorities still have the same goals: to ensure investor protection and to maintain stable financial markets. There are memoranda of understanding (MOUs) which form a framework for cooperation between the EU and UK capital market supervisors: one MOU which enables dialogue between ESMA and the UK Financial Conduct Authority (FCA) and a multilateral MOU that facilitates dialogue between national competent authorities (NCAs) and the UK FCA.

An official agreed that the stable exit from the transition period reflected the good work done by officials on both sides and by the financial sector and that there is strong on-going cooperation between the EU and UK authorities. The transition of supervisory responsibility from the EU to the FCA for credit rating agencies (CRAs) and trade repositories, for example, was managed very effectively. The exchanges during the pandemic were also effective in terms of managing both the particular issues around money market funds for example and the general turbulence which occurred throughout the crisis. A regulator added that even during the COVID crisis the EU and UK regulators had had effective dialogue and discussion on new trends such as gamification.

1.2 Risk of regulatory divergence between the EU and UK

Answering a question from the Chair about the risk of regulatory divergence between the EU and UK, a policy-maker stated that divergence is inevitable because the EU and UK are two different markets and jurisdictions. Legislation will evolve on the EU side as well. This will be based on reviews and analyses conducted by the Commission and public consultations will be organized to inform all stakeholders of potential changes.

A regulator described how regulatory divergence between the EU and UK was announced and expected, stressing that it is a natural process. Divergence is becoming clearer following a number of announcements, publications and consultations by the UK authorities concerning financial regulations. The European authorities did not expect the UK authorities simply to copy EU rules, so these changes will need to be carefully monitored and assessed to understand the potential impacts. This review process is only starting but it covers a wide range of topics, which means there are many potential areas of divergence. These include listing rules, prospectuses, packaged retail investment and insurance products (PRIIPs), open access and a Wholesale Markets Review. Equally, the Commission and the European authorities have an ambitious regulatory agenda and their own priorities, which may lead to further divergence. The question therefore is not whether there will be divergence but how it will be managed. ESMA will support the Commission in monitoring those developments, understanding their origins, assessing the impact on the industry, and offering advice on potential changes. There is also the need for an institutional framework to enable dialogue between the EU and UK and allow the EU authorities to understand the changes that are happening and their potential scope and consequences.

The regulator added that there are different views on how the European industry should adjust. There is no proper answer to this question. Some people view Brexit as a huge opportunity for the European industry to make the most of both regions and possibly benefit from arbitrage, meaning that ESMA will need to monitor such possibilities. Others feel there is a need for alignment because the industry's business models were created when the UK was part of the EU.

An official agreed that divergence is neither side's fault. The UK authorities have published a set of proposals for reforming certain financial frameworks, which are more incremental than fundamental. These proposals aim at making these frameworks inherited from the EU better adapted to UK markets. In the UK, the review process is managed in a stable, orderly and predictable way. The UK will conduct consultations, reflect on the results and then engage with industry and with international counterparts, including the Commission.

A policy-maker emphasized that while the review process may be incremental at the technical level, the rhetoric put forward at the top level of the discussion is quite different, with regular statements about 'big bangs'. Since it is this top level that matters in the end, the 'big bang' rhetoric tends to cloud the discussion and make things more complicated.

2. Progress made on the setting up of a new EU UK cooperation framework

2.1 Progress made on the proposed EU UK MOU

A policy-maker described the technical agreement achieved on the MOU. The language has been agreed between the Commission and the UK and the MOU is 'ready to go'. Once the MOU is endorsed by the member states, adopted by the Commission and eventually signed this will establish the framework for regulatory dialogue between the EU and the UK, which will enable both sides to understand where divergence will inevitably arise and the extent to which it can be tolerated. As Commissioner McGuinness said on several occasions, the financial sector cannot be isolated from the broader political context. Ultimately, there is only one relationship between the EU and the UK. Noting the geographical proximity of the EU and UK and the inevitable degree of future interconnectedness between them, the policy maker explained how there is a desire to create an EU-UK forum in order to establish a regular, ongoing and structured dialogue. Cooperation should be based on trust, and the way to build trust is through dialogues such as this one. The intention is to build on the model that is used for discussions between the EU and the United States. There is a framework to this dialogue, and trust can be built up within that framework. Eventually, it should be possible to have fairly frank exchanges and 'get the job done'.

An official considered the establishment of a technical agreement on the future MOU to be very positive. It will be essential to make this forum operational and facilitate these kinds of conversations.

2.2 The prospects for future EU UK equivalence of financial rules

A policy-maker stated that equivalence assessments could be addressed once the MOU is formally concluded. These assessments would be conducted on a case by case basis. Equivalence does not require complete consistency, but there are limits to the amount of divergence that is tolerable and trust is essential.

Answering a question from the Chair about the possibility of minimizing any differences in rules via legislative or regulatory and supervisory means in order to ensure the freest flow of capital and financial services from the UK to the EU and vice versa, a regulator suggested that ESMA will certainly seek to maintain and strengthen cooperation here. The deep interconnection between the EU and UK creates a need for the public authorities to monitor the situation closely. The Derivatives Trading Obligation (DTO) and the Share Trading Obligation (STO) for example demonstrated how activities can sometimes move very quickly. As a supervisor, ESMA's objective is to strengthen its cooperation with the UK authorities and to create a stable situation in which dialogue can occur. The two sides will not agree on everything, but it is important to ensure there is a forum in which views can be exchanged. Many regulatory priorities are global in nature, which will require EU regulators to have a different engagement with their UK colleagues within international fora. In addition there are several areas such as sustainable and digital finance where the goals are shared between the EU and UK and significant progress should be possible within this forum.

The regulator also stated that ESMA will seek to provide objective evidence to support conversations about equivalence. Taking CCPs as an example, ESMA will provide evidence to the Commission and to wider stakeholders around key indicators, appropriate risks, and the consequences of changes in normal and stressed times from a market perspective, an orderly functioning perspective and a supervisory perspective.

Answering a question of the Chair about the future role of ESMA in equivalence determinations, the regulator suggested that the EU authorities would 'learn by doing'. ESMA's teams will focus on providing input to the Commission on the basis of their technical expertise and analyses of the impacts of specific measures from a consumer protection and access perspective in line with ESMA's new mandate to support the Commission on equivalence assessments. As part of ESMA's new equivalence monitoring responsibility, ESMA's focus will be on scrutinising regulatory, supervisory and enforcement developments in relation to equivalence decisions that currently exist, for example, STO and DTO decisions with the US – meaning that the UK does not generally fall within the scope of this exercise for the time being. It is important for ESMA to ensure that it has a good understanding of any potential implications for the European markets for areas and jurisdictions where equivalence is currently in place.

3. Future EU and UK strategies for the financial sector and implications for EU-UK relations

3.1 The EU open strategic autonomy agenda

Answering a question from the Chair about whether strategic autonomy is fundamentally about financial stability, a policy-maker agreed, highlighting the fact that, while the context of Brexit is inescapable, the strategic autonomy discussion was 'bubbling under the surface' before the UK's exit from the EU. It was simply made more acute by this democratic decision and its political consequences. The concept of 'strategic autonomy' is tricky, because the term is borrowed from foreign affairs and does not translate perfectly into economics. Secondly, the word 'autonomy' has often been misunderstood. Ultimately, 'autonomy' is about choice. It is not about doing anything per se; it is about the choice to do something rather than being forced to do it. The mention of 'autonomy' does not presuppose any particular outcome.

The policy-maker explained how the EU is an outlier in terms of developed economic and financial blocs, because it has a relatively small financial sector due to its historical evolution. The European Union quite sensibly put its domestic financial system next to the global financial centre that was available to it, namely London. London could grow further as a financial hub thanks to its membership of the single market. Due to the jurisdictional changes of Brexit, a large part of the EU financial system is still outside its jurisdiction and therefore outside its accountability framework.

Although the question of strategic autonomy goes beyond finance, it is particular acute for finance and is a vital question for the EU public authorities. While this type of arrangement functions relatively well when the situation is normal, history proves that it is not optimum in periods of stress, even within the EU. A jurisdiction will not necessarily take decisions to the disadvantage of the other, but each jurisdiction may well have a different definition of what is best for financial stability and it is impossible to presume how third-country relations will work. What the EU does to maintain financial stability may be different for legitimate reasons to what action is taken in the UK or elsewhere.

The policy-maker suggested that this position is sometimes seen as the EU 'responding' to Brexit or seeking to 'take back' markets, but this is not the case. It is simply stating the fact that there are supply chain issues in finance and considering whether or not this situation makes sense over the long term. The EU recognised even before Brexit that there are vulnerabilities here, and these vulnerabilities have become more acute because of Brexit. It is often said that the US has a greater amount of risk in the UK than the EU does, because there is a larger absolute amount of dollar exposure than euro exposure. Proportionately, however, the amount of euro exposure is much higher. In addition, the US can use Chicago as an alternative. As the discussion about the DTO makes clear, transactions can migrate from London to the US relatively easily, but this is currently impossible for Europe. Autonomy, however, is not about changing things per se; it is about having the option to change things and therefore being more comfortable with a decision in the first place. The Commission remains fully committed to integration and multilateralism and will continue to have a close relationship with the UK going forward. If that relationship is more balanced, however, it will be more sustainable and more robust.

Responding to a question from the Chair's about the possible relocation of euro denominated clearing to the EU, the policy-maker noted that the present situation is not comfortable for the EU in the long term. From the Commission's perspective, the EU UK relationship is unbalanced. This does not mean that clearing should happen entirely in Europe, but there should be more balance. The Commission established a working group to discuss these issues with market participants from the buy and sell sides. The public authorities, including ESMA, participated in a discussion of the risks. The question is whether the EU can live with this risk. The Commission is currently assessing the pros and cons of making any changes.

3.2 The UK vision for financial services

An official described the UK's general vision on financial services, which is grounded in the desire to build on the success of the UK as a financial centre. This success is founded on adherence to robust standards. International standards are important, but in many cases the UK is looking to go far beyond them. The UK will succeed in the future by playing a leading role internationally and having the highest standards possible, because this will mean the UK is a place where people want to do business.

Mentioning several important examples of areas of international collaboration, such as digital regulation and sustainable finance, the Chair queried the UK's ambitions in terms of bilateral and international agreements, highlighting the mutual recognition agreement currently being negotiated with Switzerland. The official explained that the UK considers that global markets are good for the UK and good for those who participate in them. Complicated and technical rules can obstruct the provision of services in any highly regulated sector. The UK is focused on talking to partner jurisdictions about ways to support the cross border flow of capital and tackle global issues such as green finance and technology. The UK's philosophy on participating in these markets is to acknowledge that there will be inter reliance and interdependence. The UK relies on the provision of services and infrastructures in the EU and in the US for the proper functioning of its markets. The question for the UK is around finding an arrangement that will make all parties comfortable that this arrangement will work in good times and times of stress.

The official noted that these were the kinds of conversations that the UK is having with the Swiss, for example. The UK and Switzerland are two sophisticated and well-regulated developed markets. The discussion is about what is possible in terms of any mutual recognition agreement. The work with Switzerland is focused on activity in the wholesale markets. It will genuinely set a standard for what is possible in sophisticated and advanced jurisdictions; it is up for other jurisdictions to determine whether that model is also interesting for them.

In terms of the possibility for financial services to be part of future trade agreements, while the GATT (General Agreement on Tariffs and Trade) does not substantially affect financial services, prudential and conduct supervisors must be involved in anything that affects the cross border provision of financial services due to the impact this can have on the economy, which makes it complicated to include any substantive changes in a trade deal. The UK approach has therefore been to establish the kind of dialogue that is taking place, for example, with Japan or Australia based on the GATT framework. This will allow finance ministries and regulators to explore improvements to the cross border functioning of markets for the benefit of both sides.

4. Possible improvement to the EU equivalence determination process

4.1 Specific issues raised by the UK

A policy-maker described the issues around equivalence in relation to the UK. Typically, equivalence decisions happen between jurisdictions that are already relatively close and expect to move closer to each other based on multilateral discussions. There are international standards with which all jurisdictions conform, but the idea is that the jurisdictions will stay where they are or converge rather than diverging. The problem is that the EU and the UK started from almost total alignment and the discussion is now about moving apart. This makes it more necessary to consider how far the two sides will go. Nobody wants an unstable equivalence process in which equivalence is granted, revoked and then granted again. When equivalence is granted, it should be stable and there should be an expectation that the degree of convergence will not deteriorate substantially, if at all. However, currently, both sides are discussing potential divergence from this very close alignment. There must be a qualitative discussion of what this will mean, because it cannot be done quantitatively. It will not be possible to predict perfectly, but there must be an understanding that neither side will 'tear up' the rulebook.

Responding to the Chair's query on whether equivalence has become politicised, the policy-maker disagreed. Ultimately, equivalence is a prudential tool which in some cases can grant access to the single market. In Switzerland's case for example, there were problems around two fundamental elements of the single market: the Court of Justice and state aid rules. This decision was not a political decision per se; it was to do with the single market itself. If a country agrees to adopt the EU framework while maintaining that it will not accept any judgements the EU makes about the single market, the EU cannot grant equivalence. This is not politicisation; but the decision simply cannot be removed from the political context.

4.2 The challenge of monitoring equivalence agreements

A policy-maker described how equivalence was already a topic of discussion before Brexit. In a communication before Brexit, the Commission discussed some of the shortcomings around equivalence. One obvious disadvantage is that the Commission has limited resources to perform checks over time to determine whether the conditions under which an equivalence decision was granted remain still valid. There is a tendency to give equivalence once and for all. There could be periodic assessments of equivalence with a view to ensuring that a decision continues to be appropriate over time. Even before Brexit, the Commission was considering the possibility of introducing a more structured monitoring process. The policy-maker stated that there are between 250 and 300 equivalence determinations, depending on what counts as equivalence. It would be an 'operational nightmare' to monitor every single equivalence decision continuously, which means that EU authorities will have to define priorities depending on the relevance for the market. Tiny countries or tiny elements of the market will not be prioritised; more significant exposures will be the main priorities. The idea is not to monitor everything on a day to day basis, however, but to check that something equivalent in year one will be equivalent by year 20.

An official expressed sympathy with the comments expressed by the policy-maker. The UK has inherited the same 300 or so equivalence decisions, and it is faced with exactly the same set of questions. The UK wants to adhere to the notion of outcomes based equivalence. While the UK is very close to the EU, the underlying legal structures in almost all EU jurisdictions are very different, which means there is often no choice but to consider equivalence on the basis of economic and financial policy outcomes. This is a judgement basis, but it is certainly not a line by line piece of work. It is resource intensive, and it will require a considerable amount of focus.

SESSION SUMMARIES

II

FINANCIAL RISKS AND STABILITY CHALLENGES

ADDRESSING FUND LIQUIDITY RISKS
(MMFS, OPEN-ENDED FUNDS)

1. Addressing Money Market Fund (MMF) liquidity risks

1.1. Liquidity risks observed at the outset of the COVID crisis (March-April 2020)

An industry representative explained that MMFs are securities that invest in a wide range of short term assets thus offering diversification and transparency. Unlike cash placed in a bank, investors own the investments made by the MMF on their behalf, which means that they are preserved from the potential failure of the intermediary or asset manager. MMFs can also be considered as a first step towards longer-term investments and are therefore an important component of the Capital Markets Union (CMU). Reducing the use of MMFs would therefore reduce the diversity of saving instruments and of funding sources, hindering the proper functioning of securities markets and their potential benefits for the economy.

The industry representative stated that MMFs did not cause any significant liquidity problems in March 2020 and that the regulations put in place following the 2008 financial crisis helped to ensure that MMFs continued to perform adequately. They were however affected by the underlying short-term funding markets, which ceased to work as efficiently as normal. No MMFs were unable to meet their redemption requests and none needed to impose any fees or gates in March 2020, showing that tinkering with the MMF framework would not help to improve financial stability. In many instances, MMFs held significant liquidity that they were unable to use because their clients were concerned by the link that regulations establish between liquidity levels and the possible imposition of fees and gates.

A second industry representative added that the liquidity issues observed in March-April 2020 concerning MMFs were mainly triggered by a 'dash for cash' by corporates and were therefore not comparable to what happened during the 2008 financial crisis. Generally, MMFs remained resilient and this is in part due to the new money market fund regulation (MMFR).

A third industry representative stressed that not all funds experienced the same levels of stress in March 2020, which illustrates the need for potential reforms to the fund sector to be facts and data based, in order to avoid impacting the overall sector. In addition, despite the volatility experienced in March-April 2020, particularly in the underlying commercial paper (CP) market, Central Bank intervention tools to provide liquidity for such notes were actually used by very few in the industry. However, the existence of a potential backstop did enhance market stability.

The Chair observed that there being no failure of any MMFs in March 2020 could be argued to be due to the central banks stepping in to support the underlying short term market or MMFs directly. The key issue is defining how to ensure that in the future MMFs can continue to work properly in time of stress without relying on the systematic support of central banks.

A Central Bank official considered that the events of March 2020 exposed the frailties in the MMF market at a time of extreme stress in the financial system, which would have caused potentially very serious vulnerabilities had central banks not intervened very significantly. These vulnerabilities need to be tackled. At the core of this issue is liquidity mismatch, which has to be resolved because otherwise those frailties will be further embedded in the system. A regulator agreed that although MMFs did not contribute to triggering the crisis they would have run into severe difficulties had central banks not stepped in and there may have been a spill-over to other sectors as well.

The first industry representative however believed that in times of sudden episodes of stress it is up to governments and their treasuries or central banks to help calm the situation and to provide a regime in which the public can see that their savings are safe and available.

1.2. Regulatory proposals made for addressing pending MMF liquidity risks

The Chair suggested that the March 2020 events demonstrate the need to examine options for enhancing the robustness of the MMF sector and noted that three public consultations on policy options for reforming MMFs have been completed at the international level. These were led by the SEC in the US, ESMA for the EU and the FSB at the global level and the time has now come to deliver a 'meaningful regulatory response'. The policy options presented in these three consultations are relatively similar and there was also a broad consensus in the answers received to the consultations. One option on which there is a wide agreement is the need to suppress thresholds in the regulation which trigger potential cliff effects and runs. Some other options considered concerning both liquidity management and the way to absorb losses could more profoundly affect the way the MMF industry is working. There was general disagreement in the responses to the consultations about loss absorption tools such as capital buffers and there were diverse views on how liquidity should be managed inside MMFs.

A Central Bank official agreed that the time has come to decide on a package of reforms for MMFs. On the asset side, there is a need to ensure sufficient liquidity as a buffer, which can be done by imposing liquidity requirements and public debt holdings. However liquidity buffers need to be of a sufficient scale and to be usable, avoiding cliff effects.

A regulator pointed out three problems associated with MMFs that need to be tackled. The first is that they are more exposed to run risks than other investment funds. The second is that a solution needs to be found with sufficient impact but without requiring reform of the entire MMF market, which would take several years to achieve. The third is that central banks cannot be the only market makers of last resort of MMFs, which would go against their mandate. Regarding run risk, it is probably easiest to address the question of whether there should be a Constant Net Asset Value (CNAV) component in MMFs. The second and third issues can be solved with liquidity management tools (LMT), which exist in the EU but have only been used rarely so far. This reveals a ‘bias to inaction’ at the investment fund manager level that has obliged central banks to take action in the past. Proposals concerning asset quality also need to be considered, including the possibility of daily or weekly liquidity requirements and also having part of the assets invested in public debt. While increasing disclosure and data provision is a further option to consider, the data from other sectors of the financial industry shows that this cannot be the only solution because of its poor quality.

An industry representative suggested that a complete review of MMFR is not needed. There could be targeted amendments for anti-dilution levies, for instance, but there is firstly a need for relevant data in order to evaluate the potential impact of different solutions. In addition, without a proper functioning of the short-term financing market there cannot be reliance on the data being accurate and transparent. The industry representative also emphasized one concerning question in the FSB consultation document relating to reforms targeting the asset side and eligible assets of MMFs and which does not appear in the ESMA consultation. This is not the correct route to follow because the liquidity crisis of last March had little to do with the quality of the underlying assets. MMFR has already defined a list of eligible assets, which enabled MMFs to enter the COVID crisis in a very good shape. Further changes to eligible assets should be considered with caution, because this may lead to a shortening of the funding horizon for issuers and may amplify the risk of overlapping positions across the different MMFs. The industry representative also suggested that Article 27 of MMFR on know your customer (KYC) policy[1] could be improved. There could be more detailed measures at Level 2 or 3, and possibly through an additional liquidity buffer depending on the result of the stress test or the KYC policy. The industry representative however opposed any minimum balance or any risk or capital buffer requirements, which may lead to the end of MMFs if they are fixed at an excessive level.

Another industry representative agreed that building up an additional buffer in MMFs seems both unnecessary and impractical, especially at a time of ultra-low interest rates. Reducing liquidity transformation, especially in short-term MMFs, also seems unnecessary. MMFs already follow strict rules in the EU that ensure that CNAV and Low Volatility NAV (LVNAV) MMFs have to maintain minimum balances of 10% of their assets on a daily basis and 30% on a weekly basis. There are also strict regulations and minimum levels in place regarding Variable NAV (VNAV) MMFs, which worked well in March 2020. Strict weighted average maturity and average life also have to be maintained. Realistically, the only amounts that the funds invest over 90 days tend to be about 20%. Even that is capped at 13 months, so very little transformation takes place there. Medium-term assets are not held, nor are mortgages or equity positions, because MMFs invest in short-term debt.

1.3. Role of Liquidity Management Tools (LMTs)

An industry representative noted that when the MMFR was negotiated there was a request by a part of the industry to have LMTs at their disposal, such as fees and gates, rather than a capital buffer. These LMT mechanisms were at the time specifically introduced to compensate the derogatory pricing methodology that is granted in MMFR for CNAV and LVNAV MMFs. Reviewing this would mean amending the Level 1 text, which should be avoided. One aspect that needs to be changed in MMFR is de-linking the imposition of fees and gates from the liquidity ratio. The cliff effect issues also needs tackling. Concerning LMTs the industry representative was open to adjustable exit fees if further measures are needed in this area, which should be presented in the legal documentation.

Another industry representative agreed that suppressing the link between liquidity levels and the possible imposition of fees and gates is a priority. When someone places money with a bank on a fixed deposit but wants their money back early, the bank will charge them for breaking the initial engagement. If, on the other hand, someone invests the cash in an MMF and asks for the money back, in normal times the fund will have sufficient liquidity to settle the redemption. If redemptions are higher than normal, MMFs already have, thanks to MMFR, methodologies for dealing with that situation. They can put a gate on the fund or charge the redeeming investor a fee equivalent to the cost of providing the extra funds. However that has yet to happen for EU MMFs, which have never had insufficient cash or been exposed to excessive price movements for CNAVs or LVNAVs.

A Central Bank official stated that redemption pricing mechanisms, such as swing pricing or anti-dilution levies that allow to get the liquidity premia priced in, need to be considered. Cliff effect thresholds have to be removed also since the buffer is actually acting as an enhanced trigger.

The Chair suggested that the tools aiming at suppressing first-mover advantage are important because they address both the issue of investor protection and also alleviate the risk of runs. Avoiding runs is essential from a macroprudential perspective because they amplify financial stability risks.

1.4. Responsibility for implementing liquidity measures

An industry representative suggested that LMTs should not be at the sole hand of the manager because there could be a stigma effect. Involving the

1. According to Article 27, the manager of an MMF shall establish, implement and apply procedures and exercise all due diligence with a view to anticipating the effect of concurrent redemptions by several investors, taking into account at least the type of investor, the number of units or shares in the fund owned by a single investor and the evolution of inflows and outflows.

macroprudential authority does not seem appropriate but it should be considered whether the national competent authorities (NCAs) can play a role, taking into account the fact that accurate data e.g. on the short term funding market is necessary to evaluate whether the conditions are met for using this type of instrument.

A second industry representative stated that fund managers, through their board of directors, have a duty of care to the regulators and also to redeeming and remaining shareholders for implementing such tools and the regulations dictate the conditions for putting them in place. Fund managers are also best placed to react quickly and fairly to ensure the best outcome for all clients. Regulators should be informed promptly of any such action being taken, but to ensure that timely decisions are made based on an in-depth knowledge of both the fund and its clients, that decision must be made by the fund manager. Additional KYC requirements could also be beneficial.

A third industry speaker felt that portfolio managers are best-placed to assess the situation in connection with the regulators, taking into account the specific characteristics of the portfolios in terms of liquidity profile and of the underlying investors. It is also essential that regulators ensure that an appropriate and operational toolkit is at the disposal of portfolio managers for managing liquidity risks.

A Central Bank official noted that there needs to be a move from a view of the market mainly focused on investor protection on a fund-by-fund basis to a more collective approach that incudes financial stability considerations. The macroprudential authorities have to be fully involved in this approach because fund managers cannot, by definition, see the full implications of decisions or actions at market level. As demonstrated in the previous crisis, while individual actions may be adequate for a particular fund or management company, this may not be the case for the overall market. The relevant levers and triggers therefore have to be in the hands of public authorities with the macroprudential authorities at the heart of the decisions.

2. Improving the liquidity of underlying short-term paper markets

The Chair noted that the liquidity of commercial paper (CP) and certificates of deposit (CD) markets in which MMFs invest is very poor, as well as the liquidity of many short-dated treasuries especially in stressed times. The question to address is whether significantly improving the functioning and liquidity of these short-term paper markets is feasible and to what extent that could contribute to improving MMF liquidity. The characteristics of the short-term paper market also need to be taken into account. It is a buy and hold market much of the time with a secondary market less active than the bond market for example. In addition Basel III requirements will continue to restrict the capacity of market makers to increase their books.

An industry representative suggested that improving the trading and the functioning of the short-term paper market would contribute to mitigating the risks that may reside upstream in the investment process of MMFs. This requires first a better understanding of the liquidity on those markets, based on robust data. One issue to note regarding the volatility of the short-term notes in particular is that the key concern the previous year was less about the quality of the securities, or a fear that investors would not be paid back, and more an issue with banks' or brokers' balance sheets not having enough room to buy those securities from the funds, largely due to capital liquidity requirements imposed on them after the financial crisis. The same dynamic was observed in the more liquid US treasury market. In this context it is important to define the right balance of safeguards needed to ensure the robust operation of the short-term paper markets and the potential constraints that may act as an impediment to buying high-quality assets, which could further deteriorate the liquidity conditions.

A second industry representative considered that improvements can be made to the short-term financing market and that this should be done before considering targeted amendments to MMFR. Improving the short-term financing market should also be a priority for the CMU. One recommendation is to have more transparency and standardisation of money market instruments and reduce fragmentation through the launch of a pan-European money market. Secondly, the development of a repurchase agreement (repo) market of CPs should be facilitated. Thirdly, best practices existing at the national level should be considered, such as the Negotiable European Commercial Paper (NEU CP) initiative put in place by the Banque de France supporting the financing of corporates. Fourthly, there should be facilitation of the use of money market instruments as a means to access central bank liquidity and therefore broader eligibility of CPs to central banks.

A third industry representative emphasised that improving the functioning of securities markets should be focused on, rather than 'punishing' market makers and intermediaries with high capital requirements or considering closing markets when volatility rises too much. Improving the functioning and liquidity of short-term funding markets must be the priority in this regard. At the same time there needs to be a significant increase in transparency in these short-term markets for all market players, both buy-side and sell-side, particularly in times of stress. There should notably be more transparency on programmes and outstanding volumes, as this would improve the asset valuation and risk management processes. Like the Federal Reserve in the United States, the ECB should also consider the creation of a permanent, standing repo facility that would be a market-based solution to support a smoother functioning of short-term funding markets.

Concerning the idea of reforming the underlying short term paper market, a Central Bank official stated that the regulatory community has to deal with the market as it is now. The priority is to put in place a framework that addresses vulnerabilities at the heart of the MMF market. However, in doing that, thought should be given to how the underlying market can be improved in order to ensure resilient liquidity.

3. Addressing open-ended fund (OEF) liquidity risks

The Chair explained that the regulatory work in terms of financial stability is less advanced for other OEFs than for MMFs due to the heterogeneity of their profiles, and probably also because they are perceived as less risky in terms of financial stability. Nevertheless, the work is progressing.

An industry representative observed that the previous year's market turmoil, which affected the whole of financial markets and not just funds, was a real-time stress test for the asset management sector. ESMA highlighted in a report in November 2020 that only a limited number of OEFs (around 0.2%), suspended subscriptions and redemptions in March-April 2020, while the vast majority were able to meet redemption requests and maintain their portfolio structure, which demonstrated the level of resilience of the sector. Specific segments of the funds industry were however faced with either valuation constraints or large-scale redemption requests and investor outflows.

Regarding the response of the OEF fund sector as a whole, the industry representative considered that the agility and efficiency demonstrated in the EU is largely due to two factors. One is readiness and the other is the existing robust liquidity toolkit derived from the regulatory framework. Readiness is linked to the fact that under UCITS and AIFMD requirements the fund industry, in close coordination with the regulatory authorities, regularly scrutinises how portfolios can operate under stressed market conditions, in particular in relation to liquidity risks. This regular liquidity stress testing exercise is very valuable, as has been the dialogue with regulators. In addition the high-level guidance from ESMA, in combination with the specific approach and supervision of the local authorities, the latter having proximity to the local markets and liquidity conditions, remain a key point in this context and can also help to provide aggregated information for regulators across Europe. The existing liquidity management frameworks of the UCITS and AIFMD Directives also played primary roles in the resilience shown by the fund sector in Europe. In particular, the process and wide range of LMTs at the disposal of fund managers to deal with different conditions have been key lines of defence, allowing for a calibrated approach that focuses on the portfolio composition and the underlying securities of the liquidity profiles. This demonstrates how important it is to ensure that a full toolkit is operational for use at the discretion of the portfolio manager.

In relation to the next regulatory steps concerning OEFs, the industry representative suggested that the focus should be kept on those areas where gaps and inefficiencies have been demonstrated. Firstly, that means ensuring that the wide range of liquidity tools listed in the asset management legislation are available and operational in every national jurisdiction. Secondly, ensuring that appropriate information is available during periods of stress is critical, not only from the industry to supervisors but also between NCAs and towards the European regulators. Thirdly, a cautious approach should be taken when considering further additions to prudential tools that go beyond fund-based liquidity processes. Trying to impose a one-size-fits-all approach as additional layers of regulations for all OEFs, with no distinction for their specific segments, in order to address the specific conditions and rules caused by particular actors in specific market segments could lead to ineffectiveness and unintended pro-cyclical risks.

REDESIGNING EU AML POLICY
(ENHANCED SUPERVISORY COOPERATION, TECHNOLOGY ENABLERS)

A supervisor outlined the four main elements of the Commission's recent proposal: a new regulation on customer due diligence (CDD) and beneficial ownership; a new regulation to create an Anti-Money Laundering Authority (AMLA); a sixth directive, improving some elements of the framework a revision of the regulation for crypto assets to address the so-called travel rule. The roundtable would focus on three main elements: the current main trends in anti-money laundering (AML) and whether the COVID-19 crisis has created new challenges; technological challenges; and the proposed new authority. The creation of a new authority within the European Union is not frequent and so should be discussed in detail.

1. AML challenges as seen by the European Court of Auditors

A regulator noted that a previous panel suggested that AML is one of six important aspects of the Capital Markets Union (CMU). AML is a race against a clever and fast counterpart. There are two sides to the coin: national and European. The recent audit by the European Court of Auditors considered whether EU-level action is implemented appropriately, efficiently, and effectively. The audit focused primarily on the banking sector, but the conclusions are valid for the entire financial sector. There are three aspects: legal, organisation set-up and real functioning.

1.1 Implementing complex aspects of EU law is a challenge

A regulator stated that the third and fourth AML directives were difficult to create. AML 4 is now in existence, with the improvements of AML 5 expected, but full implementation in the member states is still lacking. There is complexity of the directive itself and complexity of transposition. A significant amount of national law must be changed to implement this directive. The European Court of Auditors advised the Commission to utilise a regulation instead. An advantage of the legal developments is the factoring in of AML risks in the prudential supervision in the European Central Bank (ECB).

1.2 Institutional fragmentation and poor coordination in the EU

A regulator commented that quality of information from national authorities is often poor and the breach of union law procedure has almost never been invoked. The European Court of Auditors found institutional fragmentation and poor coordination between institutions. Supervision remains at the national level and effective enforcement powers over any of the institutions are lacking.

1.3 Real functioning is still unsatisfactory

A regulator stated that it is difficult to assess the riskiness around organisations from a European perspective. The Council transposed the Financial Action Task Force (FATF)[1] list that is applied in the United States into European legislation. Risk assessment should be the primary tool. The Commission carries out a risk assessment every two years. The European court of Auditors criticised the Commission for not being up to date and not learning lessons from previous assessments. The fight against money laundering is driven by reports in the media. Difficulties with the AML directive stem from issues of coherence and level playing field.

A policymaker stated that, while it is true that the media sometimes influences policymakers, it is not the primary driver of policy. Well-substantiated complaints are necessary in order to activate enforcement tools. The European Commission did not "copy and paste" the FATF list of high-risk countries. Autonomous assessments take place, following the methodology of the European Commission.

1.4 Although cash is still king, the pandemic has caused a shift toward digital transactions, compounding the challenges

An official commented that there has been a shift from cash to more digital transactions. Regarding predicate offences[2], in addition to the misuse of state aid programs, there was scamming and cyberattacks through ransomware. This often involves crypto transactions.

A regulator noted that digitalisation enables tracking and many activities that were previously hidden will be more transparent. However, new types of risks that are not yet fully appreciated might develop.

2. Against this context the EU, in addition to its usual tasks, is awakening all the stakeholders, fostering harmonisation and transparency, and leveraging digital tools

An official stated that there are four major trends in AML in the EU: awakening, harmonisation, campaign for transparency and use of digital tools.

2.1 Awakening

An official explained that awakening refers to the process of recognising how important AML is. There is a move from a formalistic application of legal rules to a more risk based approach.

2.2 Harmonisation in Europe

A regulator stated that harmonisation started globally 30 years ago, with the FATF standards and the assessment

1. The Financial Action Task Force (FATF) is the global money laundering and terrorist financing watchdog. The inter-governmental body sets international standards that aim to prevent these illegal activities and the harm they cause to society. As a policy-making body, the FATF works to generate the necessary political will to bring about national legislative and regulatory reforms in these areas.

2. A «predicate offence» is an offence whose proceeds may become the subject of any of the money-laundering offences established.

of 205 jurisdictions. At the European level, there is much closer harmonisation through the directives. The AMLA proposal is a new evolutionary step.

2.3 Transparency

An official commented that the campaign against anonymity will lead to stricter cash controls and new regulation on crypto transactions. There is a trend towards stricter requirements when it comes to beneficial ownership. The European Union can play an important role here for the global community.

2.4 Use of Digital Tools

An official stated that digital tools can make the AML fight much more effective and efficient. However, more data is needed, and this poses a regulatory challenge. Data protection must be reconciled with AML issues.

3. Very substantial and sustained efforts on the ground have been made by both the public and private sectors

A regulator commented that the AML/combating the financing of terrorism (CFT) situation has changed dramatically in recent years, thanks to the efforts from the public sector and financial firms. The European Supervisory Authorities (ESA) review was the first key step. The formal mandates of this ESA review have been expanded and consolidated within the EBA since 2020. This has enabled the acceleration of change and provided a bridge until AMLA is created.

3.1 There have been remarkable achievements in recent years regarding risk-based AML approaches, further cooperation and capacity building

A regulator stated that there is now a common risk-based approach to AML/CFT. Cooperation has increased significantly. This involved joint work to strengthen cooperation between AML, prudential authorities, and financial intelligence units (FIUs), AML/CFT colleges[3] and an AML/CFT database, which will be available from 2022. The European Banking Authority (EBA) supports competent authorities through training and bilateral advice.

4. Additional progress is expected

4.1 AMLA will be an essential step forward that should not become an excuse to reduce current efforts, while legislating on the form of regulations will finally deepen harmonisation and efficiency

A regulator stated that recent momentum on AML must be maintained. AMLA is a positive development but will take up to 2026 to implement and should not serve as an excuse for inaction. The monitoring of AML/CFT risk in the EU already suggests that most competent authorities have engaged in significant referrals, but also that this is not easy. AML requires non-negligible adjustments on the part of existing competent authorities. When preparing AMLA, regulation is crucial. Minimum harmonisation was at the root of the difficulties in the past.

4.2 Carefully defining the governance of the AMLA and precisely articulating prudential and AML/CFT are key success factors for making steep progress in the whole financial sector

A regulator emphasised the importance of convergence on AML/CFT. Effective and efficient governance for AMLA will be critical. Prudential and AML/CFT objectives need to be clearly articulated throughout the entire life cycle of a financial firm. A common regulatory referential should be used, serving both prudential and AML. AML/CFT risks are not restricted to banks. A common approach across all financial sectors and beyond is needed.

5. A better use of technology is the single biggest initiative that can be taken in relation to fighting money laundering and terrorist financing

5.1 Money laundering and terrorism financing represent a deep threat to financial institutions and their managers, which requires tools up to the challenge

A regulator stated that most mainstream banks are now very aware of the need to avoid money laundering or terrorist financing. This change is due to the joint pursuit of those who facilitated money laundering and terrorist financing. There is not a country or major bank in Europe that has not faced these issues. The problem is not that banks are not willing to apply the rules, but that banks do not have the tools and technologies.

5.2 Effective KYC processes and PEP and RBO databases should help to address the fast increasing volume of suspicious transactions, provided that privacy challenges are overcome

A regulator stated that the main issue is technology around know your customer (KYC) processes. FIUs are presently being overwhelmed by suspicious activity reports (SARs). The Danish Financial Supervisory Authority has recently published a report considering how KYC processes could be improved. Countries that have electronic ID should be capable of using the electronic IDs for the verification of the identity of the customers. Most countries have registers that identify Politically Exposed Persons (PEPs)[4] and their Relatives and Close Associates (RCAs). Banks should be able to request that public authorities share this information. The quality of the Registers of Beneficial Ownership (RBO)[5] has improved, but they need to be better certified. There is a trade-off between fighting money

3. These colleges gather prudential and AML/CFT competent authorities for the purposes of AML/CFT supervision of credit and financial institutions both domestically and on a cross-border basis.

4. T0he FATF defines a politically exposed person (PEP) as "an individual entrusted with a prominent public function". The requirements set in the FATF Recommendations apply to PEPs, as well as to their family members and close associates.

5. Article 30(1) of the EU's Fourth Anti-Money Laundering Directive (4AMLD) requires all EU Member States to put into national law provisions requiring corporate and legal entities to obtain and hold adequate, accurate and current information on their beneficial owner(s) in their own internal beneficial ownership register.

laundering/terrorist financing and privacy. Europe must lead a public discussion, involving civil society, to develop views on these issues.

5.3 AI-enabled AML approaches are promising and should replace rule-based ones

An industry representative stated that technology should afford faster and more accurate AML capabilities, at least partly through applied artificial intelligence. AI enabled approaches are less brittle and will lead to a reduction in false positive alerts. AI can incorporate more contextual signals and generate targeted flags for investigators.

5.4 The explainability of alerts should help to address the AI black-box stigma

An industry representative advised that, in order for technology to improve AML performance, the how or the why behind any alert must be elucidated. This is referred to as explainability. The algorithms involved in AI are often perceived as black boxes. In the context of AML, AI explainability can be defined as how this type of AI approach uses the inputs to produce outputs, which are the alerts. It could also include whether insights are effectively communicated to the people that receive them.

5.5 However, making AI successful requires enabling banks' and banking systems' data capabilities and organisation

An industry representative emphasised the importance of focusing on data. The availability of data in a near-time fashion is critical. The socio-technical challenges around how companies self-organise to look after data are an issue. From an intra-FSI perspective, data should be shared across financial institutions, lines of businesses and geographical regions. From an inter-FSI perspective, standard data schema across financial institutions is advised. Technology can assist in this.

5.6 Improving the financial sector's agility, mobilising sufficient investments and data protection, and customers' rights, are key challenges still on the road to reap the benefits from technology

A regulator stated that banks and supervisors are underutilising technology, in particular artificial intelligence. There are three key impediments. One is that technology develops very quickly, and it is difficult for organisations to keep pace. Secondly, there are data protection and access to financial services issues. Thirdly, the expectations from regulators and supervisors are not completely stabilised. A review of the use of fintech solutions at the EBA demonstrated that the use of innovative solutions is most frequently observed for AML/CFT, so there is some progress.

An official suggested that technology can be the solution to the conflict between AML and data protection. Techniques like migrating algorithms or encryption technology mean that there is no need to give up on the high standard of data protection or be inefficient with AML.

An industry representative agreed that technology can help to reconcile the conflict between AML and data protection.

6. The AMLA, encompassing a supervisory arm and an FIU arm, is a masterpiece for the whole EU AML/CFT framework still in the making

A policymaker stated that the creation of AMLA is a central element of the legislative package tabled in July 2021. Following the major AML scandals that occurred in the EU, the consultation process, the impact assessment process, and discussions with the co-legislators, it was concluded that there would be added value in having an EU decentralised agency responsible for AML matters. AMLA will not replace national authorities but aims to ensure that national supervisors and national FIUs cooperate better. AMLA will have a supervisory arm and an FIU arm. AMLA should be able to conduct joint cross-border analysis of suspicious transactions. AMLA will host and manage a number of tools and platforms for this purpose, starting with FIU.net.

In respect of governance, a policymaker explained that two general boards are proposed, where all national authorities and all national FIUs will be represented. These general boards will be responsible for developing both the non binding and the binding elements of the single European rulebook. An executive board will follow the model of the Single Resolution Board (SRB). For supervisory decisions, a fully independent board that is not composed of national authorities is needed. Operations of AMLA are planned to begin in 2024, with supervisory activities starting in 2026. The AMLA proposal addresses the deficiencies found by the European Court of Auditors report. AMLA will have three fundamental functions: coordination for better information exchange, standard setting and uniform application of the rules.

6.1 Certain financial institutions operating on a cross-border basis may be supervised at the EU level, while the non-financial sector will not be left aside

A policymaker commented that a single supervisor could be fully in charge of a few very large cross-border entities, rather than having 20 national supervisors looking at the institution. Oversight and indirect supervision of the non-financial sector is also needed. Tools such as peer reviews or breach of union law procedures can be utilised to ensure that the national public authorities supervise the non financial sector in an appropriate way.

6.2 Improving the efficiency of FIUs is also necessary

A policymaker stated that new tools are needed to increase the effectiveness of the work of EU FIUs. Common standards are necessary to achieve sufficient harmonisation and ensure high standards.

6.3 A detailed and accurate understanding of the issues to address is necessary to work out the appropriate arrangements regarding direct supervision, the articulation of prudential and AML supervision, access to information, enforcement powers and staffing

A regulator advised that supervisors should act according to facts and what the law suggests. Instead, the European Court of Auditors rode a political wave. Breach of union law should be used to correct deficiencies, not to look back in time. The Commission has a great greenfield opportunity to set standards around use of technology. Difficult questions are being raised, including in terms of direct supervision. The distinction between governance supervision as a prudential supervisor and governance supervision as an AML supervisor must be treated with caution to avoid two sets of recommendations that cannot be reconciled with one another. ESAs should be collaborative places where issues can be discussed. Cooperation in the EBA is good, partly due to the management there.

A regulator emphasised the seriousness of the decision-making in this area. The AMLA proposal is a real response to the European Court of Auditors' recommendations and a shift to centralisation, but it does not go into the details. There are some risks. Right of access to information has been a problem for supervisory authorities around Europe. Efficient exchange of information will be difficult with the FIUs in particular. Enforcement powers are necessary. The SRB may be a positive example in this respect. Effective everyday functioning requires appropriate levels of staffing. The Commission should take part in the initial establishment of the authority.

An industry representative stated that their organisation welcomes the Commission's proposal. Greater harmonisation in the EU AML framework is an important step forward. The new authority should have sufficient resources and capabilities to understand the use of new technology and fintech in the market.

A policymaker noted that there is up to two years to discuss the proposal in the Council, in the Parliament and with all stakeholders to ensure it is successful.

SESSION SUMMARIES

III

BANKING AND INSURANCE REGULATION

IMPLEMENTING BASEL III IN THE EU: REMAINING CHALLENGES AND TIMING

1. Completing the work undertaken under the aegis of the international standard setter for bank prudential regulation to address modelling practices and trading book risk assessment challenges revealed by the international financial crisis required difficult compromises at the international level

An international public decision maker commented that while it is significant for Eurofi to discuss Basel III, it might be time to stop discussing and start implementing. The international public decision maker pointed to a recent letter by a majority of EU central banks and supervisory authorities which made a similar point. During the Global Financial Crisis (GFC), everyone, not only regulators, knew that the banking system's fault lines had to be solved, so an ambitious reform agenda was initiated. Basel III is an important part of that and not inconsistent or in addition to it. It aims to restore credibility in the risk-weighted capital framework, as that was obviously at stake in the GFC, by reducing excessive variability in banks' model capital requirements and developing a robust, risk-sensitive, and standardised approach, to serve as the basis of the output floor. A recent European Central Bank (ECB) paper models the reform's implications on Europe's economy. The net benefits are positive only if Basel III is fully implemented. If it is diluted, the benefits disappear.

Basel III reforms do not aim to increase overall global capital requirements. Outlier banks with aggressive modelling practices will face higher capital requirements but will have a transitory period to adjust. The crisis has not proven that this reform is not needed. The pandemic was an exogenous shock, and banks remained resilient due to public support for households and non-financial corporates. The standards are already a compromise. The Basel Committee follows a consultative process, and more than 10 papers were published after consultation and more than 33 adjustments made, many due to comments by European stakeholders. Financial stability is a global public good, and so the Committee designed and calibrated Basel III at the global level and incorporated flexibility via national discretions within the framework. Giving undue attention to the impact on individual banks, jurisdictions or regions risks 'missing the forest for the trees.'

A Central Bank official noted that international banking standards used to be unsatisfactory before the GFC, banks were one of the weak links during the GFC, and there were issues with quantity of capital, quality of capital, the treatment of risk, especially trading book risks, and excessively aggressive modelling under Basel II. These were tackled by the Basel Committee. The decision process was long; the implementation was longer and has not ended. The project should be completed. Since then, banks' capital has significantly increased. This is good and proved to be so during the last crisis.

1.1 The anticipated evolution of banks' business models throughout the transition period is an intended consequence of the reform, which should alleviate its actual burden on banks

A Central Bank official believed the significance of 10% is a terminology issue but the European Banking Authority's (EBA) estimates of the required capital increase for European banks have been decreasing over time. The reason is that each wave is premised on existing balance sheets and business models, but banks adapt to changes in regulation. Discouraging investment in certain activities is an intended effect of regulation. Risk treatment in the pre-GFC framework was lopsided, with disfavour for credit risk and favour for financial market risk. This had to be corrected, it has been, and banks are adapting. The time available before Basel III implementation is finalised will allow banks to do more and the gap will continue to shrink. Some banks are more impacted by the new rules and others less so, which was also intended. An additional capital requirement is an average concept, but the more impacted banks have the strongest incentive to adapt asset composition and business models and have room to do so. The governors' recommendation to the Commission about a timely and faithful implementation of the final Basel III rules is supported.

1.2 Public and central bank interventions helped the banking sector to weather the COVID shock. This stresses the need to implement the trading book framework reform featured in Basel III

A Central Bank official underlined the importance of not being complacent about the banking system's resilience during the last crisis. Public intervention, including substantial central bank intervention, was vital to prevent serious long-term turmoil in financial markets. Non-banking financial intermediation, with issues of open-ended or money market funds, should be aimed at making NBFIs capable of withstanding market turmoil without massive central bank intervention, which constitutes an obvious risk of moral hazard. This is true also for banks. The crucial trading book treatment reform in Basel III, which is to be completed, should be consistent.

An industry representative commented that, on attributing banking sector resilience to the massive intervention of public authorities, the EBA stress test included the hypothesis that public support will stop. The stress test measures banking sector resilience without this strong public support.

2. Heavy implementation of Basel III in the EU risks penalising decentralised banks and reducing the availability of bank financing needed for growth as EU banks are vital to address SMEs' needs

An industry representative stated that consistent Basel implementation should respect the principle in the Basel Accords' introduction not to significantly increase overall capital requirements. It is not only a political mandate; it is in the Basel agreement. For consistency, the output floor must be designed as a backstop, as in the Accords, and should not rewrite the European banking solvency regulatory framework but complete it. A backstop means that the output floor does not change existing requirements or the calculation of existing solvency ratios but adds a minimum capital requirement as with the leverage ratio. The parallel stack is Basel's stack. The output floor must apply at consolidated level as the Basel Committee provides international standards at that level. Applying at consolidated level ensures business model neutrality. If it applies at solo level, more decentralised banks will be penalised by the output floor.

The industry representative stated that growth matters. More bank capitalisation does not always lead to more loans and long-term economic growth. If it did, capital requirements could be set at 100% and Europe would lead for growth globally. A balance must be found between financial stability and growth, which is based on bank financing in Europe. Supervisors have affirmed that European banks are adequately capitalised, as confirmed by recent stress tests. Basel III's implementation provoked a major deleveraging, which only ceased with measures taken in 2020 to stimulate lending. An ECB graph on outstanding loans to corporates shows a sharp increase from 2003 until the GFC, and the deleveraging effect ceased in 2020. Deleveraging must not be triggered, especially when Europe needs financial and banking power to finance a strong recovery through the Green Deal and digitalisation of the economy. A significant increase in capital requirements should be avoided.

An industry representative agreed that significantly increasing capital requirements for European banks will detrimentally impact European growth and competitiveness when uncertainty remains high, and financing is needed for the green and digital transitions. Higher capital requirements force banks to increase client´s funding costs and deleverage balance sheets. With the prominent role of bank funding in Europe's SMEs and households, this will negatively impact investment and growth capacity. If not adjusted, Basel III implementation will result in a significant, permanent drop in gross domestic product (GDP) of 0.5%. The assessment shows that the impact on other regions will be negligible or negative, so affecting the competitiveness of European banks. US banks' equity return is more than double that of Europe's, and Basel III could widen the gap. The benefits for financial stability do not offset the costs for growth.

Banks are well capitalised as proven in the recent crisis and as the stress test results show. Recognising that it was not a financial crisis and that public support helped, it is also true that banks supported and contributed to the recovery. This has not been for free. During the last years, banks have strengthened their balance sheets, so capital levels more than doubled, capital quality was enhanced, leverage and liquidity frameworks implemented and have put in place the comprehensive crisis management framework, that doubled bank's loss absorption capacity and implies new contributions to resolution funds, this effort should not be underestimated. Banks have committed to strength and to financial stability.

The last piece of regulation should not be about further increasing overall capital levels but ironing out unjustified outliers. Europe should make use of the flexibility embedded in the framework, for instance in the discretion allowed for implementing the new operational risk framework, to reduce the impact on banks' profitability and competitiveness. Strong banks are needed in Europe more than ever to finance the recovery and the green and digital transitions.

A sound and well capitalised EU banking sector suggests adherence to the 'no significant increase' principle. Banks' profitability will further deteriorate whatever transition period is proposed

An industry representative commented that supervisors and regulators agree that banks have high capital and liquidity buffers, which helped in the COVID crisis. The recent stress-test scenario was extremely severe and based on post-COVID balance sheets inflated by increased crisis loans. After simulation this harsh and unrealistic scenario, the average common equity tier 1 ratio of banks was 10%, which is too much. The tests check that in a crisis buffers are used or partly used and that banks remain above 4.5%. At more than 10%, 3-4% is wasted for the economy. A satisfactory result is 6% or 7%, so banks' capital should be considered satisfactory. Market participants also consider large EU banks to be over-capitalised. Taking the credit default spread (CDS) market as reflecting the credit quality appraisal by the market, the CDS spread for Santander and BNP Paribas is 31, with 43 for JPMorgan and 44 for Wells Fargo. The market believes that Europe's big banks are better capitalised and more solid than US banks, but the return on equity is lower, which means a lower price to book. On one day, the price to tangible book value was 0.8 for Santander and 0.7 for BNP Paribas versus 2.4 for JPMorgan and 1.4 for Wells Fargo. Above 1 is normal for US banks, and below 1 for European banks, because of this excess capital.

This overcapitalization explains why respecting the no significant increase mandate as crucial for Basel III implementation is a view shared by many and comments from key member states representatives in the panel are welcome. This approach should drive the Commission's forthcoming initial text. If the proposal does not include key adaptation elements and technical adjustments for limiting capital requirements increases, and if this proposition translates into a significant capital increase, it will create a negative effect in the market, as banks must commit to an adjustment plan without waiting for the final vote. The final vote of the initial Basel 3 package occurred in 2012, but as soon as 2010 banks adjusted and deleveraged due to pressure from shareholders, lenders, and clients. If deleveraging is needed to meet the regulation, it has to be done soon. Any significant inflation of risk-weighted assets endorsed by the Commission in its legislative proposition would be sanctioned by an immediate share price hit, particularly affecting the lowest-risk banks.

'No significant capital requirement increase' means a low single-digit figure and 10% is not low or insignificant. Central banks' representatives are too humble in estimating their actions' efficacy over the last 10 years. The capitalisation level demonstrates that European banking supervision does not lack credibility. The thought remains that the models are tricked, while the targeted review of internal models (TRIM) happened and flaws that were maybe existing at the beginning in 2010 are now adjusted by the supervisor himself. The process took time but some of the purpose of Basel IV has now lost importance. Balancing financial stability and growth must consider the law of diminishing returns. In 2010, financial stability reforms were needed. Now, the impact on the economy is potentially more negative than the small benefit expected on the financial stability side.

An international public decision maker stated that the commitment not to increase overall capital requirements was at the global level, not for individual banks or jurisdictions. The Basel Committee agreement was at the end of 2017 and the G20 in 2018. Knowing the substance, content, and details of the agreement, its statement asked for a full, timely and consistent implementation. That is the political background of this technical exercise.

3. Complying with the international agreement requires a faithful implementation of the agreed framework, should avoid a significant increase in capital requirements and should preserve a level playing field between banks. EU implementation should target similar outcomes to other regions

An official commented that the Basel agreement is an important milestone for consistent prudential requirements and must be transposed faithfully and consistently in Europe. The G20 gave the Basel Committee a political mandate, as a multilateral political authority, for no significant increase in capital requirements and preserving a level playing field. That does not contradict the goal to improve comparability and soundness of risk-weighted assets but, at macro level, the political mandate is valid and more acute than ever. The time to get such standards is long, while the world goes faster. That does not mean giving up on Basel standards, it means considering the world as it is. For Europe, whatever the technicalities, the end result should be no significant capital requirement. If it is an average, it must be weighted to assets, to preserve a level playing field. There will be discussions about technicalities to achieve that, but it means being faithful to what was agreed and respecting the political mandate.

With the Basel agreement, as with any text, there is room for interpretation and discussion. The spirit might be discussed, but there is also the letter, which was heavily discussed and negotiated. The text was written carefully and being faithful to what is written is vital. Basel III's standards show the parallel stack is Basel's stack. A single stack in the European framework would be an over-transposition of the Basel agreement. The political mandate must be respected as giving credibility to Basel, and not doing so would question the trust placed in such multilateral exercises. Since these are valued, respecting the political mandate must be balanced with the best means to achieve it, being fully open but having this discussion in a trustful, faithful manner.

An official stated that it is vital to commit to a consistent and timely implementation of the final Basel III reform package, particularly for internationally active banks in Europe who must meet international standards. The balance must be struck between increasing banks' resilience, complying with international standards and preserving the ability to finance the real economy. It will soon be the 13th anniversary of the Lehman Brothers bankruptcy, and many remember those days. It was agreed that banks should have more capital, so a reliable and resilient framework for banks is crucial. Thanks to the Basel III reform agenda, the sector entered the COVID pandemic much better prepared. Banks have more capital, more liquidity and are far less leveraged than in 2008. Supervisors used the flexibility embedded in the regulatory framework during the COVID crisis, and the banking system has weathered the pandemic and shown resilience.

While increasing banks' resilience, the final Basel package must be in line with and not endanger real economy financing. The G20 expects that overall capital requirements will not significantly increase due to the final package, and colleagues in the Council and the Parliament have reiterated this commitment. Dealing with unrated corporates will be important for real economy financing. Most European companies and medium-sized corporates have no rating, and capital markets are underdeveloped to finance them, so a flat risk rate for unrated companies is a risk for the European bank-based lending model. The proposal made with France in 2020 is to apply adequate risk rates for financially sound companies. It is hoped that this can be agreed in the negotiations, to apply Basel consistently and support the needs of the European economy.

An industry representative commented that it is reassuring that speakers respect the political mandate to implement the Basel package without a significant capital requirement increase, which is in the Basel Accords. This decision was taken as, when Basel IV and the finalisation of Basel III was discussed in 2016 and due to the massive capital increase implemented in the post-crisis reforms, the level of bank capital was deemed adequate as an average and, although it may differ from one bank to another which is another topic to be addressed by supervision, not regulation. The capital market business is global beyond Europe and needs full alignment with US rules. In the past, Europe has been caught out by the US as ultimately US rules are becoming market practice not EU ones, so European players are penalised. An example is the day one profit accounting role for capital market activities, which the US considered implementing. Europe rushed to implement it first and then the US decided not to. This penalises European banks by several hundreds of millions per year. Another example is the minimum requirements for own funds and eligible liabilities (MREL) compared to total loss-absorbing capacity (TLAC). There is value in waiting until the US is clear about what to do and then to align, in content and timing, European implementation to the US. That is not to ask for any help or subsidy, but for a perfect level playing field.

An industry representative did not agree that parallel stacks are not compliant. The EBA states this, but without an argument. Legal analysis shows that they are fully compliant. Indeed, parallel stacking is the right Basel stacking as Basel doesn't impose any Pillar 2.

3.1 Key success factors are consensus building on the rationale for the Accords and settling debates raised by the proposed framework. Addressing EU-specific challenges on Banking Union and SME financing requires defining adequate regulatory approaches for the EU to comply with Basel III

An international public decision maker highlighted comments on the trade-off between financial stability and growth. In the short term, growth may be higher, but at the cost of financial stability, which must be avoided. The ECB Governing Council's statement on the monetary policy strategy review from July is key in affirming that financial stability is a prerequisite for price stability and growth. Technical papers from the crisis show that banks with higher capital lent more. A Basel Committee exercise asked banks to model credit risk capital requirements for the same hypothetical portfolio. The resulting reported capital ratios varied by 400 basis points. This is a lot and is what created much of the non-confidence during the last crisis, so Basel III implementation is key.

A public representative welcomed the recent supervisors' letter, as the Commission proposal is expected and governors will be able to speak to the proposal. There are many European specificities, and perhaps not all of them are Basel compliant, but the Commission must present to the Parliament and the Council a fully Basel-compliant proposal as there will be other opinions from the Council and the Parliament. At least two European specificities can be differentiated, some of them completely Basel compliant in theory. The Basel Committee introduced these options to regulators, but other European specificities are not in the scope of Basel. The parallel stack is not Basel compliant. This is not only personal opinion; it is also the opinion of the EBA, so it is clearly not Basel compliant, although there will be another option to analyse the output floor. Evaluating or calibrating the capital requirement at consolidated level could be a good option to improve Banking Union consolidation.

Unrated corporations are a clear specificity, as Europe does not have the same capital market as the US. Another instrument that is not the same but similar is the SME-supporting factor. Improving the Capital Markets Union (CMU) is also key. Introducing incentives or elements to help the unrated corporation may not set the incentive to improve the CMU, but is also on the table, and is only a first idea. In the current crisis, the European banking system did better than before. The private sector supported SMEs, the real economy and households, but although the banking sector did better, an increase of capital requirement may be needed. This is an element for debate. Another is if financial regulation can advance the green transition. There are elements to increase disclosures and facilitate market discipline, but there should be discussion around a green supporting factor at the ECOFIN, as Finance Ministers must think about adapting fiscal rules to invest more. There is a clear commitment in the medium and short term, and market discipline or non-discretional measures could be needed, if useful and enough to comply with international commitments.

An official stated that there should be a balance between financial stability and financing the real economy. Putting financial stability first is key. An industry representative stated that there is no aggressive modelling in Europe, as after 15 years of implementation of the models, approved by supervisors, there were two EBA repair exercises and a five-year TRIM by the Single Supervisory Mechanism (SSM). The EBA reports showed no excessive variability of European models and that the model's variability is not higher than the one of the standards. Excessive variability or excessive aggressive modelling may exist in the US or globally, but not in Europe. Increasing the capital requirement is a strong incentive to adapt business models. The most impacted banks are those with the lowest risks, especially on mortgage and real estate business. If the new situation prompts an increase in risks in that field, or abandoning real estate financing for more risky businesses, it is not right for financial stability.

An official commented that the ECB studies compare 'pears and apples.' It is not a trade-off between financial stability and the impact on the economy; both must be considered. The ECB states that the impact is recessive for the first eight years, with aggressive assumptions that it is not recessive after that. In the first eight years, France has minus 250 billions of lending capacities - twice and half more than the domestic recovery plan - and the EU minus 800 billion, so of an order of magnitude compared to NextGenEU. This relies on an assumption that should be discussed based on facts. The ECB is thanked for its study, but it is not the end. It should be the starting point for discussions. Sticking to a level of capital requirements in a static way may not be best for financial stability. The ability to generate buffers for banks is also key, and that means profitability. This is a huge issue for the EU banking sector, and it requires a dynamic view. It is disappointing to see in the letter from national supervisors that many of them want a solo application of the output floor, as that frontaly denies the spirit of Banking Union and is against enabling EU banks to invest to manage their capital and liquidity. It is worrying as, if the ECB study is considered, what Europe does may not be in favour of financial stability.

A Central Bank official stated that, in the long run, there is no real alternative between stability and growth, as stability is conducive to growth. In the short run there may be trade-offs, but credit growth, beyond certain limits, is not always a good thing: there was an excessive increase in lending before the crisis, which was not sound; too much leverage can be a problem. Balanced growth can come with financial stability. Financial stability and growth go together. A public representative stated that not only is there no trade-off between financial stability and growth in the medium term, but there is also no trade-off between lending capacity and capital requirements. Perhaps there is in a partial equilibrium model, but not in a global equilibrium model. Banks with more capital requirements can issue more debt or can finance, and other non-banking financial entities in the market can provide finance to the real economy. The trade-off is not useful in the debate.

An international public decision maker noted that these arguments were made during Basel Committee discussions, and the outcome is already a compromise. This is an important moment internationally and the EU must demonstrate its commitment to multilateralism and to adopting a globally agreed message to address global challenges.

3.2 An essential effort to provide is on the proportionality of the framework

An official considered that Europe has good reasons to apply Basel to all banks, but rules must apply proportionately. The last banking package defined small and non-complex institutions, which was key to reducing administrative requirements on smaller banks. The new package should build on this and mitigate administrative burdens as proposed in the recent EBA study on the cost of compliance with supervision. For smaller banks, Basel leaves enough room for manoeuvre, for example, that due diligence requirements for external ratings should be appropriate to the size and complexity of banks' activities, but there is an expectation that a proportionate package will be discussed, as with the last banking package.

A Central Bank official commented that proportionality is one field where European specificities exist. EU regulation should take account of small banks' reality, with the aim not to make the requirements weaker, but to make them simpler. The solo or consolidated application has pros and cons. It must be considered in a reasoned way.

3.3 A cautious implementation of the operational risk part of the framework also deserves attention

An industry representative stated that an element of the Basel agreement that is one of the most challenging to implement but has been less discussed is the operational risk framework. It is the second biggest impact after the output floor and, according to the Basel impact assessment, it could imply an increase on capital requirements of 5%. A discretion used by Europe that does not link capital requirements to past losses could reduce the impact by half. Europe should make use of this flexibility to reduce the impact, but also because operational events are more uncertain than credit or market events, and extrapolation rules are not good predictors of future losses.

Even applying this discretion, the impact of the new standard model for operational risk will be significant for large and diversified banks through two other changes in the reform. The business indicator calculation at consolidated level does not allow diversified banks to take advantage of the "requirements cap" for operations in countries with high interest margins, and the progressive factor on the business indicator penalises large banks. Given the uncertainty of operational events, it would be better to focus on assessing key aspects, such as good governance, forward-looking scenarios and contingency plans, instead of increasing the Pillar 1 requirement.

BANK FRAGMENTATION AND CONSOLIDATION: ARE PROSPECTS IMPROVING IN THE EU?

The Banking Union was a response to the EU sovereign debt crisis, but it is failing to provide the expected degree of financial integration. Indeed, despite the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), the banking sector remains in Europe too fragmented and oversized, and market concentration has only progressed at domestic level. During this session, there was an overall perception that there is a lack of trust between home/host authorities, a lack of trust in the business models of many banks and a lack of trust for investors in returns on the banking sector. Actually, the Banking Union has come to a complete standstill. Different pathways to reignite this project were discussed.

1. The Banking Union has come to a complete standstill

A great deal has been achieved during the past decade on the supervisory side. However, the existence of the SSM and the SRM has not had any marked impact on the banking industry's structure in Europe and the COVID-19 crisis has increased fragmentation across the Banking Union. Member states have ring-fenced their banking sectors and various barriers impede cross-border consolidation.

1.1 The European institutional landscape has improved compared to what it was 10 years ago

An international official commented that, from a broader historical perspective, an enormous amount has been achieved in the euro area on the supervisory side in a short span of time. The SSM and the European Central Bank (ECB) played critical roles in this. The huge economic crisis of the pandemic has not translated into a banking crisis. One consequence of this success is that the policy impetus for Banking Union has diminished.

A Central Bank official agreed that the situation has changed completely since the crises of 2008 and 2011, when every supervisor tried to protect its own banking system by erecting barriers within the European Union, which made the global financial crisis and the European sovereign debt crisis more difficult to treat globally. There has been great progress made in the supervisory architecture in Europe since that time, but there is much further to go.

1.2 The existence of the SSM and the SRM has not had any marked impact on the banking industry's structure in Europe and the COVID-19 crisis has increased fragmentation across the Banking Union

A public representative stated that the factors leading to the doom loop and the factors leading to fragmentation were the two key drivers of starting the Banking Union. These factors have not reduced. In countries like Spain and Italy, the amount of sovereign debt in the hands of the domestic banking sector is still very high. There have been no improvements in cross-border lending and fragmentation.

An industry representative suggested that there would likely be general agreement that no progress has been made on market integration. Instead, there have been symptoms of market fragmentation. More market fragmentation leads to more doom loop risks and therefore a move away from integration towards more national approaches to integration. This must be addressed.

A public representative noted that the Council has developed a roadmap. However, there is a German-Italian conflict, where Italy is not willing to reduce the sovereign exposures and Germany is not willing to introduce deposit insurance. As such, the roadmap is not progressing.

An industry representative emphasised that the issue in Europe cannot be reduced to an Italian versus German conflict. A Central Bank official stated that it is not the case that all progress in the regulatory framework is currently impossible and agreed that the idea of an Italy-Germany conflict is an oversimplification.

1.3 Member states have ring fenced their banking sectors

1.3.1 There are no host supervisors anymore, but there are still host authorities

A Central Bank official stated that mutual trust among regulators and supervisors has increased in recent years. There are no more host and home supervisors within the Banking Union, in the context of the supervisors themselves, because they cooperate and exchange information.

An international official agreed that there are no host supervisors, but there are still host authorities, or host jurisdictions in the broadest sense. It is not just about who pays the bill when a bank fails. It is about the economic disruption that bank failure can create for economies, which is why the supervisory side should be emphasised. Reducing the probability of bank failure should be the first line of defence.

A public representative added that home/host issues are still very important, with the host authorities unwilling to concede any movement or liquidity or capital from one place to the next in a cross border banking group. Host authorities fear that, in time of a crisis, parent companies will protect their own interest, and home authorities will prioritise their fulfilment of their national aims.

1.3.2 The excessive flexibility in the macroprudential framework encourages ring fencing measures

A Central Bank official agreed with previous remarks by Andrea Enria that there is currently an excessive national leeway in the macroprudential framework. The ECB can only intervene in the case of EU harmonised measures and many national macroprudential powers are delinked from EU legislation. Moreover, most of the macroprudential requirements are enshrined in the Capital Requirements Directive (CRD), while most relevant macroprudential provisions in the CRD relate to options for member states. The lack of harmonisation and a sufficiently strong European framework for macroprudential intervention has led to the possibility of those instruments being used as a way of ringfencing.

1.4 Various impediments to cross border consolidation in Europe

1.4.1 Lasting zero interest rates, new entrants and political obstacles

An industry representative stated that coming together across large national champions is difficult currently because of the persistent low rates environment. New entrants are taking market share away from the national champions. Bank CEOs in Europe question how-to take-out cost when bringing two large organisations together. There are obstacles and political sensitivities when reducing overheads. Sector consolidation requires an EU environment fostering the circulation of capital and liquidity within European cross-border banking groups

1.4.2 A strategic hurdle to European mergers

An industry representative commented that banking integration is possible from a pure technology perspective. Technology issues are much more at the front end. European 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.

An industry representative stated that, if the banking system in Europe is not profitable enough to invest in innovation, that innovation will instead go to fintech. If the consolidation does not happen, long-term innovation will suffer, and other regions will take over from Europe.

A regulator commented that the endemic challenge for investors is the lack of profitability of the industry and the lack of credibility of sustainable business models. This is part of what the banking union aims to solve.

1.4.3 The lack of EDIS leads to a costly burden that makes it difficult for banks to combine across borders

An industry representative commented that, without EDIS, banks are replicating costly operating models across countries.

2. Avenues to progress in the integration of the euro area banking sector

Different ways of making progress were discussed during this session, including the effective implementation of cross-border liquidity waivers within the Union, a system of contractual guarantees between the parent company and its subsidiaries, backed by the SSM, and the use of branches.

2.1 The ECB is exploring all the possible avenues offered by the existing framework to increase integration in the Banking Union

2.1.1 The aftermath of the crisis offers an opportunity to pursue pragmatic avenues to increase integration in the Banking Union

A Central Bank official agreed with other speakers that there is limited progress at the regulatory level. The crisis offers development opportunities for European banks. More revenue is needed to increase the return on equity from 4%. The only realistic approach to this is to develop cross-border banking. The ECB is in favour of regulatory changes and more European integration. Even if the framework does not change, the ECB will encourage the development of cross-border business. The ECB is prepared to explore all options available to it, including organic growth by restructuring, the use of the freedoms of the treaty, the freedom to provide services, the freedom to branchify subsidiaries and outsourcing projects.

The ECB will use the present framework, recovery plans and the possibility of intra-group guarantees to build confidence. Specific treatments for significant subsidiaries have already been developed in the SSM. In the EU Banking Union there is no longer a host or a home supervisor. The former host now has access to all the information of the SSM. The ECB is ready to commit the whole SSM to increase trust so that parents will support subsidiaries. The point at which it is possible to re-establish trust and help to relaunch the regulatory challenges is when issues are manageable by supervision.

A regulator commented that, since the last crisis, there is a tendency to consider what happens in the worst case, at the end of the stage. This is like asking banks to walk around with their coffin throughout their lives, just to make sure they are ready to die when they die.

2.1.2 The ECB has published appropriate initiatives to address banking fragmentation

An industry representative stated that the ECB has made a step forward in addressing market fragmentation from an M&A perspective. The ECB also presented an interesting proposal to increase incentives to enter into so-called group support agreements, which would link cross-border liquidity waivers to the existence of adequate intra-group financial support. What investors believe they will get out of the value of a consolidation in the banking sector is an important consideration. Investors do not believe that they will get better returns in Europe in the current environment.

2.2 Contractual arrangements within cross border banking groups backed by the common supervisor (SSM) could reassure host authorities and eliminate national ring-fencing practices

A regulator noted that there are not only concerns about the host country in the case of a bank failing. If there is cross-border integration, there could be employment loss, loss of economic activity and loss of control over financial stability.

A Central Bank official commented that arrangements such as guarantees between the parent company and its subsidiaries can make a great deal of difference by demonstrating that the support begins at an early stage, because host authorities are concerned that promises will not be kept in a failure or likely to fail situation.

A regulator noted Andrea Enria's previous proposal on the potential move from subsidiarisation to branches. One of the arguments that has been made for subsidiarisation is the ability to have better earlier information from the host authorities and to generate trust in the day-to-day operations.

2.3 Regulation should foster capital and liquidity movement within European banking groups

An industry representative stated that a calibration of total loss-absorbing capacity (TLAC) requirements at the low end of the Basel range would potentially bring down cost, because there is also more effective cross border regulatory cooperation. Consistency in regulatory judgment, application and outcomes will make comparability of global banks viable. The final implementation of Basel III will increase the credibility of the European banking landscape. The EU should use the opportunity to reduce excessive room for national discretion. The European Union could also play a role in reducing the cost and clean-ups of non-performing loans (NPLs), fostering a faster circulation of capital and liquidity in a crisis.

An international official stated that the home/host issue is a trust issue. The host jurisdictions have legitimate concerns, where new supervisory protocols and mandates could help build trust. The SSM has significant institutions and less significant institutions (LSIs). The introduction of a third category, the significant subsidiary institution – SSI - with new protocols and more of a focus on solo supervision, could assist in information sharing and building trust.

2.4 The upcoming regulatory files (Basel 3, CRD, review of the EU crisis management framework) could allow some progress

A public representative noted that the Basel III regulations and the capital requirements directive (CRD) are expected in the fourth quarter of this year. The package on crisis management is expected in the first quarter of 2022 and will include the Single Resolution Mechanism regulation, the deposits guarantee schemes directive and the Bank Recovery and Resolution Directive (BRRD). Progress on the resolution framework is needed. If other issues are not addressed, the risk is that the Union goes backwards, and the two key problems remain: the home/host issue and the Regulatory Treatment of Sovereign Exposures (RTSE).

2.5 Banks must embrace cross-border consolidation to lead Europe out of the pandemic

An industry representative stated that 50% of the capital across European banking now sits in institutions that earn less than 4% on capital. That is driven by cooperative banks across Europe and COVID. There is a structural challenge around disintermediation of banks. The Next Generation EU package will represent about 16% of non-financial corporate loans in Europe, so a key question is how banks are playing in that segment. Fintechs are increasingly involved in the core banking opportunity. Climate will require €1.5 2 trillion of financing needs in Europe, much of which will need to be cross-border. COVID has demonstrated acceptance of branch closures by customers and that banks are capable of adapting.

2.6 NextGenerationEU could be a game changer

An international public decision maker noted that that BRRD created a carveout for banks from national insolvency procedures. This carveout is, essentially, for large banks, via the public interest assessment. The scope of BRRD should be expanded, perhaps with bespoke clauses, to cover all banks.

An industry representative noted that the pandemic has generated an unprecedented European policy response, which is a reason for optimism. The NextGenerationEU project requires adequate national policy responses. If the project works, the doom loop approach may lose importance. This may increase confidence and provide the trust needed to agree on EDIS.

A regulator stated that NextGenerationEU should be a trigger to help foster questions on how fast progress can go. NextGenerationEU is likely to be a medium to long-term project and integration is a short term issue.

A Central Bank official commented that the way European institutions at all levels responded to the COVID crisis is a demonstration that political conditions may change. Instruments like contractual arrangements or branchification cannot make enormous changes in a short time. Digitalisation can drive faster progress and may increase free cross-border services. Digitalisation also leads to competitive challenge from entities outside the banking system. National borders make less of a difference in the case of digitally provided services.

3. EDIS is important, but will be extremely difficult to achieve in the near term

A fully-fledged EDIS is a missing instrument of the Banking Union but remains a contentious issue. Much more mutual trust is required to achieve progress in this area.

3.1 EDIS is missing but intractable oppositions remain

An international official noted that the IMF was amongst the first to argue that EDIS is a core component of Banking Union. However, Europe does not have the same banking system it had 10 years ago when this project was conceived. There has been €4 trillion of ECB QE in the interim. At the aggregate level, there is now structurally a highly liquid banking system in Europe, notwithstanding some pockets of weakness. Overall, there are no sharp differentials now in retail deposit rates between the north and the south. Thus, a pragmatic way forward could be to pause the push for EDIS. This is not because it is unimportant, but because it is very intractable at this time and the system is very liquid.

An industry representative commented that EDIS is crucial but trust between Member States must be built to achieve it. It might be possible to work around EDIS by attempting to reduce the doom loop obstacle to integration. In the current exceptional circumstances, there is a global European response, where everyone has an interest in addressing the crisis. As to branchification there is a great deal of unexploited potential in it but it is not clear what the industry can do without significant regulatory changes reducing the impact of the geographical barriers for the free circulation of capital and liquidity.

3.2 Is it possible to move forward without EDIS?

A public representative stated that his previous comments on Italy and Germany are common knowledge in the industry. Mario Draghi stopped the roadmap in May. It is hoped that Mario Draghi can finally unlock some progress on this issue. The idea of bypassing EDIS is attractive because the situation is difficult, but it will be very difficult to proceed without

EDIS. If Santander had not intervened just in time in the case of Popular, ATMs would have been closed. There was no money in the Spanish deposit possible insurance and there would have been banking closure.

A regulator commented that the fact that there is no EDIS is being used as an argument to prevent further integration in case a situation like that of Popular arises. Trust must be built, with guarantees around the possibility of a bank collapsing without having sufficient support in these deposits. As previously mentioned, there is currently a great deal of liquidity. Banks are better capitalised and scenarios such as that of Popular are much less likely than previously.

Aa an aside, an international official noted that the ideal solution involves intervening a bank on a Friday and restoring service on Monday morning. With the Banco Popular situation having played out mid-week, he commented that, arguably, intervention in the Popular situation should have been three or four days earlier.

3.3 Much more mutual trust is required to achieve an agreement on EDIS

A public representative stated that, from the perspective of the southern states, clear progress towards EDIS is needed. Even a minimal EDIS, starting with liquidity and moving towards potential future risk sharing, seems hard to achieve. Safe portfolio and safe assets is a focus of the Parliament. Banks should be helped to diversify, so that some states do not suddenly lose demand for their assets. The new government in Germany will be crucial. The French presidency is also important.

A Central Bank official stated that trust must be built at the higher, perhaps political, level. Previous comments by Gert-Jan Koopman highlighted political change in European institutions that would have been unthinkable five years ago. There is no need to be pessimistic about the possibility of changes in regulation and legislation.

A regulator summarised that there is consensus that EDIS is a desirable and potentially necessary outcome. Potential alternatives for going forward have been explored. It is hoped that these alternatives will not be needed, but it is advisable to prepare for the worst and hope for the best.

IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK

An effective and integrated framework for managing crises is essential to preserve the trust of depositors and the public at large, in order to avoid financial fragmentation and to safeguard financial stability. The EU bank crisis management framework was established in 2014, after the global financial crisis and in reaction to the EU sovereign debt crisis. It consists of three EU legislative texts, which may be reviewed later this year: the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Deposit Guarantee Schemes Directive (DGSD), which all contain review clauses.

In February 2021, the EU Commission launched a consultation for the review of the bank crisis management and deposit insurance framework to gather stakeholders' experience with the current framework and their views on the revision of the framework, which is part of the debate on the completion of the Banking Union (BU) and can be linked, in particular, to its third and missing pillar, the European Deposit Insurance Scheme (EDIS).

A Central Bank representative (Edouard Fernandez-Bollo) opened the session and noted that there has already been a great deal of discussion about the Banking Union (BU) fragmentation and regulation. There is some scepticism about the possibility of real regulatory change to deepen the BU. The topic of this session is an area where there may be regulatory change. This possibility of regulatory change has been anticipated by the Commission with the large consultation, which raised a lot of interest in the proposals of the Commission.

1. Current thinking of the EU Commission following the review of the Crisis Management and Deposit Insurance (CMDI) framework

1.1 Why the EU Resolution framework is not being used should be questioned

A policy-maker noted that, although the EU Resolution Framework has been operational since 2016, it has only been used in one case. It may be an accident of history that the framework has only been used once, but this is probably not the case, and it is likely that there are some underlying factors. The framework has two basic principles: to preserve financial stability in the event of a failing bank and to protect taxpayers if that bank has to be resolved. Experience of the stresses around the framework indicates that these principles are either not aligned or not perceived to be aligned in all cases. As a result, incentives have been created to encourage the use of alternative routes that avoid using the Resolution Framework.

1.2 Any reform of the EU bank crisis management framework must ensure there is always an alignment between preserving financial stability and ensuring that taxpayers' money is not at risk

A public decision maker outlined issues raised by the Commission's consultation. Early intervention is not always simple, but it can make resolution easier. There is a question of whether the public interest assessment (PIA) should be more flexible, to enhance or widen the scope of banks that might be covered. Access to external funding is another consideration. The policy maker also stated that the upcoming review of the Banking Communication should try to align the principle of preserving financial stability and ensuring taxpayer money.

An official stated that in the current framework there is indeed a perceived difference between financial stability needs and protecting the taxpayer. This should be addressed. An industry representative commented that preserving financial stability and protecting taxpayers' money should be the ultimate goal of the crisis management framework. Its rules should be periodically reviewed. However, there is currently hardly any practical experience with the crisis management framework, and it has to be kept in mind that actual resolution or winding down decisions have to be taken during the crisis event. With this, they will most likely deviate from previously agreed plans.

1.3 A crisis management framework with a continuum of solutions is needed, irrespective of the size, business model and situation of the bank. The FDIC example could inspire changes to the crisis management framework

A policy-maker stated that a situation where some banks are not suitable either for resolution or for judicial liquidation should be avoided. In the context of the framework, systemically relevant banks are no longer deemed to be "too big to fail" and are instead resolved if they are failing or likely to fail. Meanwhile, the failure or likely failure of small banks can be managed via judicial liquidation. In contrast, the management of failures or likely failures among the middle-sized layer of banks can be more problematic within the current crisis management framework. The logic of the Federal Deposit Insurance Corporation (FDIC), which can handle any size of bank, should be imported into the EU. To do so, the Resolution Framework should provide for a continuum of outcomes, with proportionality along the curve of banks. The framework must be capable of managing a very large bank with proportionate bail-in and access to external funding but also managing mid-sized and smaller banks, also with proportionate bail-in and an external funding source.

1.4 Access to external funding in resolution must be improved

A policy-maker stated that, since access to the Single Resolution Fund may not be available for mid-sized banks because of the 8% bail-in requirement, an alternative source of private external funding might be needed if the principle of taxpayer protection is to be respected. The use of national DGS could be such an alternative external funding source, assuming DGS funds could be used for preventive (and not only pay-out) purposes. However, if the national DGS would not have sufficient capacity, the next port of call is the State, which is a problem for taxpayers. In such circumstances, EDIS could act as a backstop to national DGS.

Thus, there is an argument for a resolution system that handles both systemically relevant banks under the current arrangements (8% bail-in and access to SRF) and mid-sized banks under similar but more proportionate arrangements (lower bail-in requirement and access to DGS/EDIS). Indeed, the BRRD could be extended to encompass both sets of arrangements. A key difference between the two sets of arrangements would be that under the existing arrangements a failing or likely to fail systemically relevant bank would be resolved and restored to operational capacity, while any any failing or likely to fail mid-sized bank would be liquidated (i.e. exit the market) under the more proportionate arrangements.

A Central Bank representative commented that a continuum that includes bank exit as one of the options for resolution is an interesting idea. DGS may play a role in proposal for resolution.

2. Priorities for improving the EU banking crisis management for small and medium-sized banks

Public Interest Assessment (PIA), level of minimum requirement for own funds and eligible liabilities requirement (MREL) for small and medium-sized banks, and participation of Deposit Guarantee Schemes (DGS) in the financing of preventive measures and in case of resolution were much debated.

2.1 PIA: more banks need to be prepared for resolution, but the main challenge remains a common assessment by resolution authorities

An industry representative noted that there is currently a clear structure in the EU legal framework: crisis management for the larger and more systemic banks and DGS for the smaller banks. It is unclear if the crisis management framework should be applied to medium-sized banks. It would be decisive how these medium sized banks would be defined. By no means small and non-complex institutions should be in the scope of the resolution framework.

An official stated that extending the PIA will not necessarily resolve all issues. In cooperation with NRAs, the SRB had enhanced the PIA framework to capture situations where the rest of the banking sector was affected by an adverse stress test scenario. Reference to these system wide events were introduced as of the resolution planning cycle 2021 and would afterwards work to further underpin analysis of and refine the assessment of critical functions at regional level. This enhancement is expected to lead to more positive PIA, with the consequence that more banks are being prepared for resolution. Operational capabilities and a build up of necessary means – MREL - are needed for the implementing the resolution process. The Single Resolution Board (SRB) and national resolution authorities are considering enhancements, focusing on transfer strategies, tailored MREL calibration and access to funding.

The official further indicated that the SRB operates under the principle of preparing for the worst, so, if in doubt, preparing for resolution. Without preparations for resolution and built up of MREL, options at the point of failing or likely to fail will be limited.

The main challenges faced for a consistent PIA across the EU were: (1) differences between national insolvency proceedings (NIPs), which could lead to different outcomes for PIA, so harmonisation of NIPs or otherwise a common administrative liquidation tool would be very helpful in this regard, and (2) access by the SRB to consistent data at regional level and on DGS capacity. There is currently a good resolution system, with quite tight access to the fund and bail-in, but there is a temptation for national authorities to take the exit point of the 2013 Banking Communication.

An industry representative suggested that with regard to the public interest assessment (PIA) the current EU legal framework does not be changed but the resolution authorities should rather change their restrictive application approach. The current BRRD has a very broad definition of PIA, entailing flexibility for the resolution authorities. It would be a task of the national resolution authorities and the SRB to define a common interpretation of the existing PIA-definition and implement it in a consistent way in all member states.

2.2 MREL needs proper calibration for transfer strategies; a solution to handle banks with a negative PIA exiting the market must also be found

An official stated that there is always the perception that equity-funded medium-sized banks have no access to markets and cannot build up MREL. Therefore, a resolution strategy based on the sale of business or transfers may seem more appropriate than bail-in. However, lack of access to capital markets by these banks is not what we see happening as the market is wide open. Moreover, if banks are predominantly equity funded, a crisis will eat into their capital and at the time they reach the point of failing or likely to fail (FOLTF), there may not be more MREL left. This is the reason why the Financial Stability Board (FSB) did not want equity to feature in TLAC.

2.3 One system across Europe, with the same funding and the same rules applying in all cases

An official stated that the system should not impose a heavy burden on some banks and a lighter one on others. European governance will lead to more transparency and clearer rules. In the spirit of the FDIC, there could be a continuum solution, using one sizeable European Fund.

An industry representative agreed that a single system is crucial. A double system, with an expensive system for large banks and a system at a discount for smaller banks, should be avoided.

2.4 Giving the final say to EU institutions in the PIA in the way the least cost test is implemented would foster consistency of the EU banking crisis management framework and improve its predictability

An industry representative stated that consistency in the implementation of the framework has been an issue. Consistency can be ensured if European institutions have the final say on a number of issues, such as the PIA and the use of preventive or alternative measures funded by mutualised or public resources. If applied consistently across the Banking Union, positive PIA could be extended to smaller banks important for a regional economic system. However, the basic principle that banks with no specific impact on national or regional economic systems- should exit the market when failing should apply and that could be achieved with the help of DGSs, without necessarily going into liquidation as long as a strict and consistent least cost test is satisfied.

In addition, it should be stressed that the MREL market is wide open for small and medium-sized banks. Many of them with much less than 100 billion in total balance sheet are issuing senior preferred debt or subordinated debt at cost close to that of large banks. This means that they can effectively build a good level of MREL too.

Another key principle of the BRRD and the existing framework is indeed that there should be burden-sharing by shareholders and by the creditors of the failing bank first, before any recourse to mutualised or public resources and a proper level MREL should ensure that for smaller banks too. Attention should obviously be paid to retail depositors, though they are already protected, and MREL would further shield them.

Finally, it should be reminded that the Banking Union means a single market for banking. The main objective is to have a single functioning market within which several types of business model prosper. Larger banks should not be overburdened in comparison to smaller ones or to their international competitors.

An industry representative replied that one also has to take into account that small and medium-sized banks contribute to the SRF funding process, although they will never benefit from it.

2.5 The bail-in tool should apply to retail investors

An industry representative commented that the bail-in framework should be applied in a consistent manner. The reluctant application of the bail-in tool by resolution authorities with regard to retail investors is problematic in this vein as this differentiated application is creating conflicts with fundamental rights. The review of the crisis management therefore has to safeguard that the bail-in tool has to be applied to all categories of creditors without exceptions for private retail investors.

3. Diverging views about EDIS

3.1 EDIS is an essential piece of the Banking Union

An industry representative stated that their organisation is a cross-border bank, so everything that happens at a European level is welcomed. It is better that banks are supervised by the European Central Bank (ECB), the SRB and any authority that considers banks across the space. If small banks in some member states do not understand why they have to contribute to Europe, they should ask themselves why they are in Europe in the first place. EDIS is a necessary pillar of the BU. Using DGS funds for resolution of local and smaller banks is not a very good idea. If it is necessary, it should be organised at a European level. The public interest test should be administered by the SRB at a European level.

3.2 Three elements should be considered in the review of the DGSD

An industry representative suggested that three elements should be considered in the review of the DGSD. The first element is the target size such deposit funds. It is different in many member states and the directive states 0.8%. In Belgium there is no target size because it is a quasi tax paid directly to the treasury. The same is true, indirectly, in the Netherlands, where the bank deposit fund is absorbed by the Dutch Treasury as a means to lower the European and Monetary Union (EMU) debt level. This is counter effective to breaking the vicious circle between banks and governments. A fixed target size should be promoted in the directive for all member states. Secondly, financing is different in all member states. Pan European banks do not benefit from this and a harmonised approach is preferred. Lastly, when a bank wants to switch between EU DGS, for example because of a changing corporate structure or a merger, the DGS Directive determines that only the contributions paid in the previous 12 months can be transferred to the new DGS. All other funds paid into the DGS cannot be transferred. This means that the bank moving to another DGS will be asked to build up years of DGS financing as fast as possible, as competent authorities will rightly want to enlarge their DGS to cover for an increase in covered deposits. This means a bank will finance the guarantee for its depositors twice. This provision strongly disincentivises cross border consolidation as well as branchification strategies.

3.3 Ringfencing measures may be triggered and the branchification trend undermines DGS

A regulator commented that the daily supervision in the Single Supervisory Mechanism (SSM) is difficult without EDIS. Andrea Enria earlier noted that the liquidity waiver can cause an issue if there are no European DGSs. It is very difficult for national competent authorities (NCAs) to accept cross-border liquidity waivers within a group. In addition, after 2008, people wish to protect their own national deposit insurance system. This may cause some sort of ring fencing. EDIS is necessary to fully explore all the advantages of the BU. Digitalisation enables market participants to do banking business in the whole European area via normal passporting. The branchification trend will undermine the existing system of national DGSs. If a substantial part of European banks' branchification is going into the market via digital instruments, there will be an imbalance between DGSs.

3.4 The establishment of EDIS is not required

An industry representative commented that there are European solutions for larger, systemic, cross-border banks, for example the Single Resolution Fund (SRF). Small cooperative banks with balance sheets lower than €5 billion do not understand the relevance of EDIS to their position as they have no cross-border business. So if EDIS would be discussed more seriously only larger systemic cross-border banks should be in the scope of such a system. The principle of proportionality is vital in Europe. It is important to have diversity of banking models and banking size in Europe. Care must be also taken that an EDIS is not implemented via a back door, for example if the DGS fund is used in a broad way to finance resolution actions. For resolution actions such as the transfer of assets only the single resolution fund should be used but not the DGS fund. The differentiation between Crisis management for the systemic important banks and DGS for the smaller and less complex institutions should not be therefore maintained.

A Central Bank official stated that there is no intention to use DGS to recapitalise and continue a bank. DGS will be used in a bank exit, very near liquidation. Under current European law, DGS is only mandatory for liquidation.

An industry representative did not agree that the current system is more expensive for larger banks than for smaller banks. The current system reflects only the different risks of large cross-border and small and non-complex institutions.

3.5 EDIS as a test balloon for newly licensed banks and EDIS as a cross-currency scheme represent two possible options for making progress

A regulator commented that a European FDIC would be a perfect solution. This would save time and there would not be two funds, DGS and a resolution fund, and a need to discuss actions on the national and European level. As this is not possible at the moment, there are two other potential options.

The first option is EDIS as a test balloon for newly licensed banks only. Whenever a bank is licensed, supervisors undertake a prudent assessment of the bank in question. This would fulfil the requirement of only mutualising those assets that have been subject to risk assessment at European level. This pilot sample of banks could be used as a test case for a European deposit guarantee scheme. In order to ensure sufficient funding, national DGSs could serve as a backstop. The second proposal is EDIS as a cross-guarantee scheme. Austria has some experience with this system. In the near future, Austria will have three guarantee schemes. This would avoid an ex-ante funded EDIS since the European cross-guarantee scheme would be a backstop for a national DGS. If the responsible national DGS has to intervene, and only if the financial means of the responsible DGS are not sufficient, then the other DGS – EDIS - have to intervene as well. Such a system would need a solid contractual framework.

A regulator advised that reviews of current legislation need to be completed swiftly, most importantly the CMDI review. Most probably, DGSs will stay national for the time being. It is therefore clear that national resolution authorities have to have the decisive role in case of the use of DGS funds. The ECB, SRB and the European Systemic Risk Board (ESRB) could coordinate a more harmonised application of the CMDI. This could start with an assessment of the application of PIA within the Union. In the past PIA for banks with a balance sheet of €100 million have been positive. This is evidence that a more harmonised approach is needed.

3.6 A fully fledged EDIS only for cross-border groups was also proposed

An industry representative commented that flexibility is lacking in the CMDI review. It is important that a flexible use of DGSs for preventive or alternative measures is maintained.

After six years, EDIS is just one of several proposals under discussion. Others include the De Lange proposal in the ECON Committee (European Parliament), the European Deposit Re-Insurance Scheme (EDRIS) of the French banks and the hybrid model of the Austrians. However, the Commission has not yet withdrawn its initial proposal so an open discussion on EDIS is not possible.

An industry representative noted that UBS Chairman Axel Weber has proposed a fully-fledged EU banking framework for cross-border banking groups. These cross-border banking groups could become part of a mutual deposit insurance system. The smaller banks could remain national, be it in their DGS or in their Institutional Protection Schemes (IPSs) as used by the cooperatives and the savings banks in Germany. Smaller banks would also continue to face national insolvency in case of failure. This clear distinction between a cross-border banking regime and a national regime for small and medium banks would be a very simple but cost-effective solution that should be further elaborated upon.

BANK MODEL DIVERSITY IN THE BANKING UNION CONTEXT: BENEFITS AND CHALLENGES

The essence of banking lies in assessing, balancing, and managing risks and benefits. As different types of risk/reward are needed to satisfy different types of customer needs, there is place for different types of banks. A business model can be seen as the sum of the systems, mechanisms and methods through which a bank generates earnings and satisfies its stakeholders in a way that ensures it continues its business.

This panel discussed the diversity of banking models in the European Union, how to preserve them, what the challenges are and what the disadvantages are.

1. Bank variety is shaped by history

Business model diversity is rooted in various features of a culture, including ownership, governance, the extent and complexity of the product mix and value chain arrangements. All bank business models in Europe face similar challenges: fragmentation, lack of profitability and the digital and climate transitions.

1.1 The structure of a banking industry

The Chair remarked that when considering banking diversity in the EU, most people only think of the Sparkassen sector and public banks as the dominant models, and that they do not always seem to be compatible. When considering the structure of financial and banking systems, history is central. The best example is probably the US and the dominance of capital markets there. For a long time there was a ban on interstate banking in the US, so banks could not operate cross-border from one US state to another. Moreover, the holding of equity in non-financial companies by banks in the US was also banned, so the capital market developed by default. Therefore, the banking sector when compared to the level of GDP is very weak in the US, in comparison to Europe. The UK, meanwhile, has both an important capital market and an important banking sector, because the banking sector orients itself towards the European model while the capital market developed because the UK had to finance numerous wars against France. It is unclear that Europe can actually emulate these models and have a free-flow structure that it can change at will.

A regulator noted that regulators have to take the regulated entities into that context. In Europe the structure of the banking sector is often the product of national history more than European history, so there is diversity. What is sought is a regulatory framework that fosters financial stability, adequate provision of services across the board and good services to citizens while preserving financial stability. The differences are not about favouring one business model over another or having a single business model that is superior.

1.2 The structure of the corporate sector

The Chair explained that the structure of the corporate sector is also central when considering the structure of financial and banking systems. Most financing by companies is done by retained profits. The rest of the money that companies need comes from that part of the market where there is the least friction. Markets are never frictionless but depending on the company structure and corporate governance, it is either easier to resort to the banking sector or to capital markets.

1.3 The roots of business model diversity

A regulator emphasised that when discussing about business models we often refer to two quite different parts of the structure of banking institutions. One is the liability structure, particularly the ownership structure, whether these are public banks or cooperatives versus shareholder-based institutions. The other aspect is the kind of activities that the banks perform. That is more on the asset side and whether they are investment banks, retail banks or mortgage banks. Those very different categories are usually grouped within the business model discussions, while the characteristics and requirements underneath are quite different.

1.4 Driving the characteristics of the financial sector

An industry representative pointed out the important role of small and medium-sized enterprises (SMEs) in the EU's economy. One driver for shaping a financial sector is the degree of centralisation in the real economy in the respective state. In Germany, SMEs generate more than half of the value added and stand for 60% of all employment. Bank lending in Europe is between 70% and 80%. Therefore, the diversified banking structure in Germany is the perfect fit to the real economy.

1.5 The added value of universal banks

An industry representative noted, regarding universal banks, that the real complexity is international competition. Europe's biggest competitors for market activities are US universal banks. After 2008 US authorities encouraged universal banks to take over huge parts of the market activities and investment banking activities that used to be in specialised banks. Europe is not isolated, and the trend should be considered. Market activities are worldwide activities and the example of interest rate swaps in euro-denominated swaps is a good one.

1.6 What banking diversity should not mean

An industry representative warned that diversity should not mean keeping banks afloat in the market at all costs. Nor should it mean that some banks should disproportionately finance the collective costs of the system. It should not make people believe that only the biggest banks are dangerous for financial stability. Savings and loans can be very dangerous if they all fail at the same time.

An industry representative noted that too-long business models that do not float, do not meet market needs and cannot be profitable should not be permitted. Moreover, there is a risk of unnecessary complexity. It should be ensured that the burdens and the complexity of structures, products and business models that lead to organisations that are too big or too hard to manage should not be created. Additionally, the risk of institution size can lead to inappropriate risk-taking. There are quite effective ways to deal with that, like being part of larger organisations or associates. Finally, there is a lack of comparability and transparency. These are increasingly important topics for the banking sector. Efforts should be made to develop measurable impacts that are easily understood and comparable, but which do not create much complexity.

1.7 Challenges for all business models

A regulator stated that in the EU the sector as a whole has challenges. First is excessive fragmentation. Then there is a lack of sufficient private risk sharing within the Banking Union. There is the viability of business models in the medium and long term, because the returns to equity that banks are obtaining are too low to attract private capital from capital markets. Lastly, there is medium-term sustainability in an environment where change may need to be driven by technology, and the industry has to adapt. There is also change driven by society and the environmental, social and governance (ESG) challenges. Going forward, the question is how to ensure that the different business models comply with three basic principles: sustainability over the medium term, adequate returns to shareholders and the ability to transfer from savings to investments to finance the investments that European society needs.

2. Banking model diversity as a European asset

A diversified banking sector is beneficial for the real economy and enhances financial stability. Preserving this diversity requires ensuring the sustainability of banking business models. Whatever choices they make, banks need to ensure their business performance is sustainable throughout the economic cycle, including in challenging business environments.

The diversity of the business models may not be considered sufficiently in EU policymaking and even in euro-area supervision. There will not be financial autonomy without competitive and large enough EU entities in trading and investment banking activities.

2.1 Diversity satisfies different stakeholder needs

2.1.1 Diversity as an asset for the financing of the economy

A Central Bank official stated that business models coming from history means that they met their demand. That there are different demands and different ways to meet those demands is good.

An industry representative recalled that the Committee on Economic and Monetary Affairs (ECON) of the EU Parliament has stressed the importance of a diversified banking sector in Europe in a number of reports. All highlight that banking model diversity is a European asset. Empirically, this has been proven during the financial crisis and the COVID-19 crisis. The diversified banking structure in different European member states has supported the supply of financial means for ailing industries and has maintained a viable level of economic activity. More generally, in the EU there are about 4,300 credit institutions, 9% of which are large, 29% mid-sized, and 62% small and not complex. This diversity increases financial stability and allows the demand of the real economies of EU member states to be met.

An industry representative stated that the issue of sustainability is key. Diversity should not be kept simply because of history or because it is seen as a given. Even if diversity has passed the test of time, if it had no strong positives, it would have disappeared along the way. The question is how to work on improving sustainability and RoE of the banking system in Europe while preserving the strong positives and resisting some of the negatives. The ability of various models to follow and take into account customer expectations, to cover a full range of customer segments, and to address various demands like social responsibility, ESG and financial exclusion should all be preserved.

2.1.2 The diversity increases financial stability

The Chair noted that there is an implicit assumption that the European banking system is more diverse than the US system, but the US has more than 8,000 community banks, a number of regional banks and a handful of large money centre banks.

An international official suggested that both the US and European financial systems are fairly diverse. The US has institutions Europe does not have, like Fannie Mae and Freddie Mac, while Europe has other things. Diversity is good in a financial ecosystem, including to support financial stability, as history has shown. The savings and loan crisis in the US in the 80s was a crisis of large numbers of small retail-funded banks. The subprime crisis was a crisis of a relatively small number of large wholesale-funded banks. Generally, one doesn't want to have all eggs in one basket.

Diversity is also good for service provision. An SME might like to go to a smaller bank with which it has a relationship for its financing. A large blue-chip corporate with a great deal of liquidity looking for a safe place to park it goes to larger bank, and because deposit insurance does not help when amounts are large, it goes for the next-safest thing, placing deposits using repos. It is also important to observe that the large banks are very often the link between the banking system and the capital markets. There are many invisible links at play all of the time, links that cannot necessarily be seen on balance sheet. Europe has a larger preponderance of SMEs than the US. Arguably, it therefore naturally has a proportionately larger role for small banks.

An industry representative remarked that if the system is functioning well, it should not be fixed. This does not mean nothing has to be done. It is good that the ECB is concerned with preserving the diversity of the business model. Banking model diversity in Europe should be defended somewhat because it is rooted in the economic system. A diverse model also brings added value to the customers. Having some specialised banks focusing on certain regions, industries and ways of banking makes for greater choice for customers. Diversity brings added strength by diversifying risk. If one bank has problems and there are different banking models, or if one banking model is in dire circumstances, then the others will not necessarily face the same trouble at the same time. The banking system is here to finance, manage savings and play a role in the life and growth of the European Union.

2.2 Ensuring the sustainability of banking business models

2.2.1 What is at stake

A Central Bank official stated that the issue is how to preserve the diversity. Here the problem is financial sustainability. There is a problem of financial sustainability because there is a problem of profitability in the larger sense of the word where profit means the difference between the revenue and the cost that allows the bank not only to cover its costs but to be able to invest in the future. Profit here is not distributable profit to shareholders. Investing in the future is absolutely necessary because there are huge things to finance in Europe. As Europe has a bank finance economy it needs banks that are able not only to continue the provision of the services they currently provide, but also to scale up to finance recovery and transition. However, taking into account the current levels of return on equity (4-6%), there are very few banks that can invest heavily in the future with the current low margins between cost and revenue.

2.2.2 The role of supervisors

A Central Bank official noted that if the onus of managers and directors at a bank is on anything it is on the business model. It is their core role to define the business model of their bank. That is certainly not for supervisors to do. The banks are those who take the risk and those who run and manage the risk. Supervisors should not be dictating the business models or how to correct the business model to attain sustainability.

The approach being taken is to scale up the governance requirements to ask whether the credibility of the business model in the medium term is discussed enough and if the credibility of the revenue projections is challenged sufficiently. Revenue projections are currently not globally credible: if the projections for the banks that will increase revenue in two years were summed up, the result would be an unprecedented explosion of profitability. The first who should be affected by that credibility issue are the management and the governance, so supervisory actions should be increased on those who are responsible for the definition of the business model so that the projections become credible. This is why a great deal of benchmarking is needed. The business model should always be resolvable, but there are different forms not only one to ensure this resolvability.

2.2.3 Profitability will likely differ according to liabilities or asset structure

An industry representative noted that profitability is necessary to maintain the sustainability needed to be able to scale up and to face difficult times. Therefore, profitability has to be judged in comparison to the liabilities and risks. The same type of profitability should not necessarily be expected for banks that have different liabilities or asset structures or for cooperatives and listed banks. Comparisons should be made with comparable banks using the same banking models and not a one-size-fits-all idea about profitability.

2.2.4 Avoiding an obsession with profitability

An industry representative stated that it is necessary to have banks taking higher risks or being capable of executing complex mergers. However, this has to be balanced by locally or regionally rooted smaller institutions covering the needs of the local communities. Investment banking can lead to high gains, but they are very cyclical and volatile; retail banking lacks those peaks, but it is more stable.

It is essential to have more than one business model in Europe, with some focusing on long-term sustainable growth and not on short-term maximisation of profits. The profitability of Europe's banks is considered crucial, but there must be caution not to become too obsessed with it.

2.2.5 Preserving business models as long they are sustainable

A regulator noted that it is important to preserve business models only as long as they are sustainable. Business models have to be coherent with overall financial stability as well. In the global financial crisis, several very small banks with similar business models, but that they all have sustainability problems, they ended up being systemic in their problems. This coherence is important, as is making sure the dynamics of competition, as technology is introduced, work to the benefit of society and consumers.

2.3 The requirements on policymakers when considering regulation

2.3.1 A well-functioning EU single market for financial services should not be at the expense of a diversified banking sector

An industry representative remarked that it is particularly difficult for less significant institutions (LSIs) to cope with the enormous amount of European regulation. Thus far, the implementation of Basel III and the establishment of the Banking Union alone have resulted in more than 500 different legislative texts, and 50,000 pages of rules and instructions. Small or medium-sized banks with a balance sheet of about €1 billion should not be expected to cope with that amount of regulation. It is the resulting fixed costs and economics of scale elements that are affecting smaller banks disproportionately.

It is highly welcome that the European Banking Authority (EBA) is undertaking efforts to reduce administrative costs via its work on the cost of compliance. This will contribute to the objective of a proportionate regulatory environment for the EU's diversified banking sector. It should lead to nothing less than the creation of a level playing field by introducing measured, proportional approaches allowing the entire EU banking sector to strive.

2.3.2 The diversity of the business models is not sufficiently well understood in EU policymaking or in euro-area supervision

An industry representative stated that in EU legislation projects the diversity of banking models has not been appropriately reflected, even in areas where the underlying international standards have actually been neutral. Notably, the transposition of Basel IV agreements puts at stake the decentralised model of cooperative banks with a central body. This is aggravated by supervision practice. The ECB 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 whereby the technical competence of managers is favoured at the expense of the knowledge of local businesses.

2.3.3 One size does not fit all

An international official emphasised that, regarding regulation, supervision and resolution, one size does not fit all. The business of overseeing a large, complex bank is fundamentally different from that for a smaller bank, and the rules should reflect that. Nowhere is this difference starker than in resolution. For small banks the basic function of resolution is often matchmaking. The resolution agency looks for a suitor or an acquirer and uses a purchase and assumption (P&A) transaction. For megabanks, it is a completely different game. It is also important for regulators and supervisors to look at how the large and small banks interact with each other in life. If someone takes a mortgage from a bank in West Virginia it is likely being sold on to a big bank. That sort of interaction should be encouraged for financial deepening.

Finally, proportionality by business model and bank size is desirable, but regulatory and supervisory differences by country are not. The Single Supervisory Mechanism (SSM) and EBA have done good work in reducing the number of European national options and discretions from around 250 to about 160. That good work should be taken forward.

2.4 Financial autonomy requires competitive and large EU entities in trading and investment banking activities

2.4.1 National interests impede progress toward a banking union

An industry representative noted that large banks are the usual link between companies and capital markets. Currently, the concept of financial autonomy is everywhere in Brussels. It is not a consensual notion, but it is discussed and even promoted by the European Commission. There will not be financial autonomy without competitive and large enough EU entities in trading and investment banking activities. Business models have to be improved, and the preparatory work should also be improved. Part of the regulation, and the context, is the lack of a real common capital market. Progress toward the completion of the Banking Union is held back by national interests, which leads to fragmentation.

2.4.2 The Brexit example

An industry representative stated that, after Brexit, one of the objectives both of the ECB and the European Commission is to ensure that clearing activities in major euro-denominated derivatives take place in the EU, especially for interest rate swaps. They want to force EU banks to quit London, which nearly has a monopoly on clearing for interest rate swaps, and to go to the EU. However, they have run into problems because they discovered too late that the overwhelming majority of those swaps, clearing activities, in euro-denominated assets are no longer made by EU banks. In the present state of EU legislation, there is no way to force those non-EU banks to leave London and to go to the EU for clearing.

2.5 The fast-changing environment and financial stability

2.5.1 The new competitive environment and banking diversity

An industry representative conceded there is competition with fintechs, new banks and similar new entrants. However, the basis of banking and what has been the role of banks for at least five centuries is taking the savings of people, companies or states, which have more money than debt, and lending to individuals, corporates and so on. That requires some expertise, which is hard to build. Banks create models and supervisors look at them. This is relatively complex and it is a business where the margins and the margin for error are quite thin. It may be felt that there is excessive or insufficient profit, but the truth is that a bank cannot afford to get it wrong too often. This is somewhere fintechs do not go. There is therefore a role for banks.

An industry representative noted that traditional banks have to create confidence so that people trust them enough to put money there and not on these new platforms. Bankers have to be professional enough to understand the business prospects of a new venture or to make a new investment or an acquisition. This is something that is not easily achieved by artificial intelligence on a platform.

The Chair suggested that, with different parts of the banking business being stripped from banks themselves, there may be a platform-based economy where banks are left with the least profitable bits of banking. An industry representative replied that that is the rule of competition. Supervisors are there to make sure the banks stay profitable and, so far, the relationship has been maintained. Trust is very important and not easily built by the newcomers

2.5.2 New entrants may create financial instability

A regulator added that there should be ex-ante neutrality about whether a technology is good or bad. The implications and risks of the introduction of the technology should be assessed and there should be neutrality about who brings the technology, be it an incumbent, large firm or a new firm coming from the outside, so that there is only consideration of the implications of the technology for the system. One concern is that as new entrants come into the industry they are 'taking the cream' from more profitable parts of the business and leaving banks with the least profitable activities. That might actually be creating financial instability in the incumbent institutions doing multi-products. An industry representative remarked that the new entrants do not 'take the cream' as they all lose money.

A regulator stated that the largest increase in competition can be seen in payments. The relative fees and the relative structure of payments have changed drastically thanks to innovation and competition, to the benefit of consumers, all while preserving stability. Preserving stability is very important. It is important to look into the future and ensure that if an entity does not have a viable business model then failure is fine. Society moves on. Firms are there to serve citizens; they are not to preserve themselves forever.

2.5.3 Diversity also means adaptability and innovation

An industry representative added that increasingly many fintechs want to integrate into more traditional banking groups. There is also a supervision challenge. Those entities are not ready to fit immediately into everything and there are sometimes tense discussions with supervisors to make them understand what is needed. Supervisors admit that the entity has to be integrated while retaining the innovative spirit, but it is difficult to ask the entity to rapidly become fully compatible with all of the rules. There is also the development of the bank as a platform, where banks go to platforms and begin to offer their services. Both aspects are vital for the profitability of the banking system in Europe for the years to come.

SOLVENCY II REVIEW: LOW FOR LONG AND LONG-TERM INVESTMENT CHALLENGES

1. EU insurance regulatory framework: what is at stake at present?

A public sector speaker commented that the Commission will issue its Solvency II review in September, with amendments to the Solvency II Directive and a proposal for a standalone directive on insurance recovery and resolution. Solvency II's introduction in 2016 was a revolution in the rulebook for European insurers and the conclusion is that it is a success. Prudential rules align with advanced risk management practices and the sector entered the crisis in a strong position. Another revolution is not needed, but targeted improvements to the framework are, and the Commission has worked in four areas: first, helping the insurance industry to actively develop Capital Markets Union (CMU) and the European Green Deal; second, improving risk sensitivity in Solvency II in the low-yield environment; third, proportionality is a core principle, but has not worked well in practice, so how to improve it has been reviewed; fourth, enhancing policyholder protection and financial stability, at recovery and resolution and for cross-border insurance services provision.

1.1 Despite the EU insurance industry's soundness, macroeconomic challenges are transforming insurers' risk profiles and business models, and bringing new regulatory challenges

An industry representative noted that insurers are confronted with many challenges. Low rates bite profitability, and a lack of profitability affects viability. That needs a response, which is to look at a portfolio's asset and liability side. On the liability side, there is business profitability pressure. Insurers may take more conduct risk and enhance their appetite to keep the same profitability level. Insurers are advised to take care of this and regulators to monitor it. As with COVID, in a stressed profitability situation, decisions may be made on opportunity cost, which may push insurers out of lines of business, removing society's protection in areas like business interruption. The liability challenge must not be underestimated. On the asset side, low rates mean searching for yield and taking more risk, and so there is good and bad news. The good is that regulators are aware of this. The bad is that low rates came with quantitative easing, which distorts the risk price and the return received from it. Spreads are totally distorted.

If credit spread is distorted, insurers are tempted to try to earn it on the liquidity side, where the correction is seen as lesser, via 30 or 40-year paper. Supply of that paper is insufficient to meet the demand, so insurers go to the less deep and transparent markets and take more illiquidity risk that will need to be managed. If there is proper due diligence and understanding of these risks, things will be well. Insurers may think they are invulnerable as they coped well with the 2008 crisis and, in April, regulators found there was no liquidity crisis for insurers. That experience should not create the belief that this will never be an issue, as then guards will be low.

An industry representative stated that insurers have faced different crises recently, with the 2019 interest rate reduction and then COVID, with a crisis on the interest rate, the financial markets and the technical part. Overall, insurers were resilient in facing these shocks. Solvency II helped, although it is not perfect and can evolve. Through the stress tests and the crisis, relations with the regulator were good, with monitoring that allowed insurers to adapt to the low-rate environment. Insurers are also transforming business models. There has been a push towards a unit-linked model, which helps to change balance sheets. Something to consider is that insurers in the crisis have been good but are changing business models.

1.2 Clarifying regulation and accounting standards' role in the long-term behaviour of EU insurance undertakings is necessary to address fast-developing challenges faced by society and the economy

An industry representative stated there is a need to ramp up long-term investments to benefit the economy at large, the insurers and the insured. Investing for the long term is imperative for the future. What matters is not maximising immediate profits but creating long-term value for society through commitments in the economy. A feature of the past 20 years is the drop in equity investments of insurers. This is primarily insurers' in-house experience but is substantiated by sources like the OECD or the December 2019 Deloitte study, which says: 'While we face some difficulties when assessing equity allocations over historical data series or even still sometimes today, because of the lack of granularity and consistency, an obvious significant decline comes out, yet that can differ between countries in Europe and also between insurers, depending on their risk appetite and strategies. Important drops appear to follow past financial prices, which is certainly the result of several factors, among which the economic environment, the introduction of new accounting and prudential rules appear dominant'.

Studies suggest that average equity investments in Europe are below adequate allocations by 5% of total investment, which is significant. That can be linked to past prices, but this is not obvious. New accounting and prudential regulation standards based on market values inducing volatility in published accounts and excessive cost of capital cannot be ignored. Explanations for low equity investment are supported by a recent Louis Bachelier Institute study which analyses optimal asset allocations derived from the assets and liabilities risk profiles with the search of an optimal asset allocation for a long-term investor. Solvency II constraints are leading to a significant decrease in asset allocations to non-bond assets, for instance, more than halved for equities.

A regulator commented that Solvency II does not appear to have materially affect insurers' equity investments. The situation is different in different countries and jurisdictions depending on insurers' risk appetite, so there is no clear evidence. Overall, the insurance sector's equity investment is stable from 2011, so the evidence does not confirm the study, which is interesting, as everything is when fostering equity investment. Supervisors want to foster economic recovery but will look for evidence. The study's methodology is understood, as its forward-looking approach is not as granular as the regime. New criteria were proposed to qualify long-term equity investment, with measures to foster illiquid liability being invested increasingly in long-term investments and equity. There is a desire to bridge the debate between sceptical supervisors and the industry, which is pushing forward. There is a common interest in understanding what keeps the sector stable and solvent, and how to continue to foster investment in long-term equity. This is the main objective, so it is vital to continue to work together.

1.3 EU regulatory frameworks' relevance should be improved by addressing the short-term volatility of existing or envisaged regulatory measures separate to the insurance business's fundamentals

A public sector speaker noted that Solvency II's impact on insurance companies' equity investments is still unclear. An industry representative stated that low interest rates might continue even if concerns over increasing inflation, lead to an evolving macro-economic environment. Credit spreads are sensitive to financial turmoil and increasing volatility of the solvency ratio, as in the COVID period. Given the long-term investment nature of the insurance business and that the solvency position remained solid across the European insurance market at well above 180%, this short-term volatility has nothing to do with the insurance business's true economic fundamentals.

The solvency ratio's short-term fluctuation requires insurers to provide counter-intuitive explanations of the artificial nature of this phenomenon to investors and the market. To hedge against unexpected fluctuations, insurers are inclined to have a capital buffer well above solvency capital requirements (SCR), leading to over-conservatism and missed investment opportunities. High capitalisation induces an insurance company toward the creation of capital products such as unit-linked or hybrid, in a world of demographic and social trends towards an aging population and a low-income young population that demand pension protection products. Sub-optimal capital allocation risks unnecessary management decisions and deviates from an appropriate asset liability management (ALM) strategy. Solvency II is a qualified success since its inception in 2016. Measures like the volatility adjustments (VA) support the reduction of such short-term volatility. The VA mechanism can be improved, but EIOPA's proposals in the Solvency II review seem to contradict the VA's spirit, such as the risk correction and the liquidity application ratio. If not improved, the industry will set aside too much capital, reducing the flow of funds to the real economy, which is especially vital now.

1.4 Achieving consistency in EU risk assessment tools for sustainability challenges is necessary

An industry representative highlighted the shift to a green economy driven by the Paris Agreement, the Net-Zero Asset Owner Alliance and Net-Zero Insurance Alliance. This requires a fundamental review of revenue-generating sources and the operating process to extend the current risk management framework to manage and report risks related to those commitments and the others that will follow in the future. Climate change stress tests and scenario analyses have been anticipated from the national supervisory authorities (NSAs) , which do not converge and start from different assumptions. There should be one risk management framework for multi-territorial insurance groups. NSAs and EIOPA are invited to harmonise requests as much as possible with clear guidelines, rather than specific prescriptive technical measures, to guarantee future exercises' success.

2. Challenges posed to the regulatory framework by emerging macroeconomic challenges

2.1 The current regulatory framework encourages insurers to model new macroeconomic risk

A regulator stated that whether a risk-based regulatory framework can address all the macroeconomic scenarios is a philosophical question, as there is uncertainty about such scenarios' impact. Solvency II is a risk-based regulatory framework, which does not exclude any specific risk, and although risks from macroeconomic scenarios were not the focus when it was adopted, it does not ignore them. Understanding of the pandemic's impact changed with time, and with macroeconomic risks there is a learning process. Such risks are not specifically foreseen in the standard formula for calculating the SCR, but insurance undertakings are not restricted to analysing risks identified in the standard formula and can develop an internal model. Nothing stops them considering risks from macroeconomic scenarios; indeed, the regulatory framework encourages them to take a forward-looking perspective on risks.

2.2 Unanticipated risks challenge the clarity of insurance policies and the insurability of these risks

A regulator commented that the pandemic showed the importance of writing general conditions in insurance policies unambiguously. Several European countries' courts had to deal with unclear wording in business interruption policies in 2020. If it is not clear, there will be dissatisfied policyholders, which supervisors do not want, and inappropriate risk assessment and pricing from insurance companies. Climate change poses many challenges to the insurability of climate-related risk and makes risk assessment harder, as companies cannot rely on data due to the frequency and severity of natural catastrophes. Risk prevention is important, and insurance must encourage policyholder activities to reduce climate change risks and lower risk in premiums. Risk-aware behaviour reduces risk associated with extreme events caused by climate change. A lesson from the pandemic is that the private sector alone cannot cover all damages from these risks. Besides taking responsible attitudes in relations with consumers, insurers should cooperate with public authorities to develop private-public partnership solutions that provide even better protection.

2.3 Political considerations in the EU insurance prudential framework would weaken its credibility

A regulator commented that many risks affect the industry, like the low-yield environment, climate change, digitalisation and asset price bubbles. Business models are flexible enough to adapt and deal with emerging risks. Climate change may increase the number and severity of catastrophes like the recent floods. This will negatively impact some insurers' profitability this year, but in the medium and long term they can adapt reinsurance strategies and exit specific risks. They can manage this in the framework. Solvency II aims to capture all material risks on a micro level. It should not be disturbed by political or macroeconomic considerations, so adjustments which are not risk-based are unwelcome. A macroeconomic scenario without assessable financial risks is a political ambition. Green support and a brown penalising factor were discussed in 2020 and 2021 with an industry-wide dividend ban for insurers and banks, irrespective of the risk-based capacity. The system should not cover these and if they are macroeconomic scenarios then the risk-based system cannot capture all these scenarios and should not do so.

2.4 Emerging risks tailor expectations between undertakings, the public sector and consumers

A public representative stated that there is a historical shift in the role of insurance in societies, which impacts citizens and companies. For centuries, insurers pushed at the frontiers of what can be insured, which is a foundation of the economic growth model, but now it is often said that the challenges society faces, such as the consequences of climate change, civil resilience, or pandemic risk, cannot be insured. There is an expectation that public authorities will step in when insurance coverage stops. The public sector is asked to 'do the dirty work,' and the private insurance sector takes care of the lower-hanging fruit. This will feed into the Solvency II debate as it touches upon society's tolerance to risk.

The Solvency II review should be rooted in a broad debate on managing expectations for insurance. Key aspects must be improved, such as transparency on cost and coverage, so aligning packaged retail investment and insurance-based products (PRIIPS) and the Insurance Distribution Directive (IDD) is vital. Accountability over time is needed to avoid a sudden increase in cost or decrease in coverage. There should be a regular dialogue between consumers and insurers, not only in bad times. The Solvency II review is not only a technical exercise. It is about redefining society, the social approach to insurance, and expectations from businesses and consumers. Commentary on the need to work together is positive.

3. Specific priorities for the Solvency II review

3.1 The role of insurers and supervisory approaches for the EU's cross-border insurance business

A regulator noted that Solvency II is a success, but refinement to maintain the framework as fit for purpose is needed. Something on long-term investments was observed and proposed to the Commission and may be included or not. Suggestions were made on improving the VA, the risk margin, and the equity risk, especially for illiquid and long-term liabilities. This can be the right incentive to push forward the insurance sector's natural long-term investment intentions. The low interest rate environment needs to be faced. There are plenty of studies. Solvency II was designed before this environment arose, so it is important to take account of reality and face it, whether it is liked or not. This was considered when providing input on adjusting the module on interest rate and curves for discounting liability. The supervisory community believes it is important to highlight this area of concern.

The proportionality principle is a basis of Solvency II that can and should be improved as experience shows that more can be done in applying the framework for the low risk undertaking. Criteria must be defined to identify low-risk undertakings, taking account of the size, nature and complexity of the business. After a simple notification to the supervisor, there should be an automatic application of measures on governance and reporting, as this can foster the application of the principle after the first year of experience. This is not completely revolutionary, but is lessons learned from experience. There is a desire to complement the framework and a separate directive on recovery and resolution is being considered. More was asked for, including a minimum harmonisation on the insurance guarantee scheme. This is important due to the cross-border dimension of the insurance business, to ensure that all European citizens are protected at the same level, regardless of whether they buy their insurance product in the home country or another one in the EU internal market.

A public representative stated that this is a key review for the insurance ecosystem, and as the Chair wrote, the Solvency II review can be a tool to achieve three overarching priorities. First, insurers will channel more investments into long-term and sustainable projects if pushed gently, which means more equity and financing and contributing to the European Green Deal. Second, a cross-border supervision solution requires a balanced approach with stronger regulation and more effective supervision. Third, the effects of 'low for long' on the insurance ecosystem must be kept in mind. The Commission's proposals on the VA, the risk margin and interest rate risk following EIOPA's suggestion are anticipated.

A regulator commented that Solvency II is a complex risk-based framework, and its revision is perhaps more complex than the introduction itself. The industry and supervisors were prepared for the introduction of Solvency II and the transition went smoothly. Hopefully, the revision will go as smoothly. From a supervisor's perspective, there are some weaknesses in the Solvency II regime, including the failure to recognise that interest rates might be negative in calculating the capital requirement and the inadequate methodology for long-term liabilities' devaluation. Then there is insufficient application of the proportionality principle, which should be applied more often in practice and kick in almost automatically when conditions are satisfied. When EU stakeholders were consulted, the response was that the insurance market is diversified and not everyone is happy with the EIOPA proposals. These weaknesses are of common interest to all stakeholders. Differences between member states should be considered and the framework made less burdensome for insurance undertakings by simplifying and streamlining reporting requirements. Solutions for devaluing long-term liabilities and improved capital treatment for long-term investment should enable insurance undertakings to join in the transition towards a carbon-free economy.

3.2 Key performance indicators of an effective evolution of the framework

An industry representative noted that the Solvency Framework worked well in the post-pandemic stress situation. Solvency II's revision is technical and political, as other panellists said. Insurance is an important source of long-term funding for business and governments, and it is vital to encourage long-term investments in the real economy. Technical flows must be resolved. The framework worked well, but adjustments are needed, including the VA, spread risk on corporate bonds and others.

An industry representative thought that alignment is close. A revolution of the framework is not wanted, but more of an evolution. It should be neutral on capital, as there is enough capital in the industry, and it should foster investment in equity and a less procyclical framework, conducive to short-term action. On the neutral framework, the negative interest rate is key. Nobody can be against a revision of interest rates, but it is important to review that carefully, especially volatility. A 100-basis point drop of interest rates might happen frequently at 5%, but in negative interest rates the volatility might be lower, so the calibration has a huge impact on how the neutral transformation is done. The negative interest rate must be accounted for and ways of compensating it found. A framework to invest in long-term assets is critical. As the CFO of an insurer with more than €12 billion of assets, the Solvency Framework is a key metric for investing short or long term, equity or non-equity. The decisions made on Solvency II will be crucial on how the 10,000 million of passive that the insurer has in Europe will be invested. That is technical, but each decision has an impact. For less procyclical activity, it is vital to find a way to better absorb shocks over the period.

3.3 The competitiveness of the EU's insurance sector must be maintained in relation to other regions

An industry representative stated that it is crucial to ensure that the European insurance industry remains competitive at international level and consider how other countries and regions promote insurers' role in society. EIOPA's proposals for a capital surcharge for systemic risk or the possibility to restrict or suspend dividends should be reconsidered. EIOPA has made huge efforts to revise Solvency II, but a courageous commitment is expected to avoid excessive procyclicality in the excess capital charge. A huge increase in capital is not the solution to any problem. This is a healthy industry with large resources, and its financial stability and solidity was evident during the crisis. Further effort is necessary to improve EIOPA's proposal in the interest of the competitiveness of the industry.

An industry representative commented that expectations are high that the review finishes Omnibus II's work in finetuning the framework so that Solvency II can be instrumental in supporting long term investments which are so needed in the environment of recovery and sustainability. The regime must remain market consistent, so value assets at market values for transparency, comparability, economic reasons and relevance, while reflecting long-term business model profiles for their real risks. Assets are traded at market values, so they convey important information that are yet to be handled in the context of the insurers business models in other words the timing of investments and divestments' is critical to shape the realization of profits and losses. Insurers' asset portfolios are managed long-term, which exposes them to risks in a different way from losses resulting from the full sale-out of their assets at the worst time based on adverse short-term volatility. Insurers are rather exposed to counterparty default risks, insufficient returns and performance in the long run, not to short-term valuations Liquidity mismatches are well under control with ad hoc ALM. The Solvency II review must deliver enhanced adequacy of balance sheet liabilities' valuation and a suitable calibration of risks.

On equity investment, eligibility for the reduced capital charge introduced by the 2018 review should be effective. Complexity and inadequacy still prevail. The long-term management of equities must be recognised for assets backing risk margins and own funds as well as assets backing best estimates. Own funds, notably core tier one, have the longest durations and the regime should do justice to their long-term stance and the resilience they bring to liabilities. They enhance liquidity risk management, which should be conducive of good risk management incentives. Criteria (g) of Article 17(a) does not need to be changed and liquidity stress testing remains the best demonstration of the absence exposure to forced sales.

3.4 Preserving the sector's ability to match national specificities requires further adjustments

A regulator considered that balance on a national basis is the priority. It has to be accepted that markets are national, especially in the life business, for accounting, tax and other reasons. An unbalanced Solvency II review could cause substantial risks for insurers and lead to unwanted market exits. The proposal means stronger capital requirements but will not bring more capital into the system. Investors will not invest additional capital into life insurers, and the consequence will be reduced solvency ratios, less ability to act countercyclically and possibly more run-off cases. For a supervisor, that is not a nice idea.

3.5 Giving attention to assets' risk specificities to adequately 'green' the Solvency II framework

An industry representative stated that the opportunity to enhance Solvency II and make it greener should be taken. Eurofi has the bringing of new ideas in its DNA. A new idea needs a purpose, and that is to make Solvency II greener. Incentives must be created within the framework to address transition risk, which is underestimated by many, particularly for asset holding. A proposal could focus on the long-term guarantee package, particularly on VA and matching adjustment (MA) because of relevance, and to avoid criticism such as that from the UK stating that VA and MA are skewed against green investment. This must be addressed as it is not necessarily factual.

On methodology, there is a need to set red lines, and a fundamental one is not bringing a green supporting factor, so that should be avoided. It needs to be simple. Solvency II is too complicated. It should be simple to implement, because waiting to change the whole Directive means it will be in 2025, or 2026 perhaps. Something needs to be embedded in the framework, and the framework recognises in its recitals that there are assets and investments with higher recoverability, and evidence is needed. Literature and data have been collected, particularly by Moody's, showing that the recoverability of investment in green infrastructure is higher than the average recoverability of other paper. On this basis the proposal could be that when calculating VA and MA, part of the credit risk is taken out and a flat standard for any type of asset percentage of 30% of recoverability ratio is taken, which is clearly justified for green investment, infrastructure, or bonds, like the one the Commission, amongst others, are pushing. It merits looking at and considering deviating from 30% to make it bigger.

SESSION SUMMARIES

IV

CMU IMPLEMENTATION

CMU ACTION PLAN IMPLEMENTATION: HOW AND BY WHEN CAN DECISIVE PROGRESS BE MADE?

1. Status of CMU implementation

1.1 Importance of CMU for the EU economy

A policy-maker stated that the Capital Markets Union (CMU) is as important as it was when the project was launched back in 2015 and for the same reasons, including complementing the Banking Union (BU) and developing alternative sources of finance. In the current context there is also the objective to support the recovery from the pandemic. Additionally, the massive funding needed for the green and digital transition has to occur also via a well-functioning, integrated capital market. The CMU also plays a key role in the open strategic autonomy objective of the EU. The core of this objective is that the world is inevitably more fragmented post-Brexit, and geopolitically it is more complex than it has been for some time. In this context ensuring the resilience and stability of the EU financial system is essential and this notably requires the development of European capital markets.

An official agreed that CMU may support the open strategic autonomy objective which for the EU means having the choice of financing sources and being able to find them within the EU. Another official added that CMU is urgently needed, not least because of Brexit, but also because of COVID and the recovery which require significant funding resources.

An industry representative noted that Europe needs powerful and deep market liquidity to allow companies to access the best terms for capital. In order to support the post-COVID recovery, there cannot just be reliance on NextGenerationEU (NGEU) debt and monetary policy. Developing capital markets, and particularly equity markets, at a sufficient scale for them to be competitive at the global level is also essential.

1.2 Progress in the implementation of CMU action plans

A policy-maker highlighted that all of the legislative proposals that were foreseen in the 2015 CMU action plan have been delivered or adopted, with only one exception. The work is not finished however and several new legislative proposals are coming forward that will be useful for CMU. These include the review of Solvency II, ESAP (the European Single Access Point), which will make it easier for investors to find data on EU companies, the review of the ELTIF framework and also the reviews of MiFID and MiFIR, which are very relevant for CMU. In addition some improvement can be seen on the ground, as shown by the CMU indicators which are regularly published.

An official commended the Commission for putting in place key performance indicators (KPIs) to measure the progress of CMU. This is something that was lacking at first. Measurements will be annual and long-term.

Another official noted that the Commission's CMU action plan is comprehensive, and Germany made it a Council Presidency priority to prepare Council conclusions and to reach consensus among member states in December 2020 on the order in which the important building blocks of CMU should be worked on. That is a very good starting point, and now is the time to do the legislative work. The Chair agreed that these Council conclusions reached in December 2020 are an important step forward, but regretted that some important actions regarding insolvency or tax procedures in particular, which are important for the development of cross-border investment, were pushed forward to the longer term.

The second official considered that the Council conclusions of December 2020 on CMU are already ambitious and it is encouraging that they were endorsed by the EU political leaders. For topics outside the remit of Finance Ministries such as insolvency legislation, making progress is quite challenging. When the Council conclusions were being prepared in the previous months, that was one of the most sensitive issues. There is no appetite among the justice ministries to harmonise insolvency legislation. The prevailing view is that basically all member states have the world's best insolvency legislation that cannot be modified. That makes it very difficult for finance ministries to start a discussion on this topic.

An industry representative warned that the pace of CMU delivery is insufficient and that there is a great deal of frustration concerning the CMU within the financial industry. The initiative has so far resulted in the delivery of fragmented and partial measures and it is difficult for most stakeholders to grasp the overall picture of what is being achieved. This explains the lack of political drive in the implementation of the CMU. While politicians understand the importance of the CMU as an objective, they find it difficult to get actively involved in its implementation because of the complexity of the project. Another industry representative agreed that there is frustration at the slow progress of the CMU initiative. While it is easy to subscribe to the 16 actions that have been listed as part of the latest CMU action plan and that aim at increasing SME access and retail participation in particular, it is difficult to identify real game-changers for the development of EU capital markets.

2. Opportunities and trends supporting CMU

2.1 Opportunities for the development of capital markets in the post-COVID context

An official highlighted that the starting point of EU27 capital markets is quite low. The first objective should be to develop these markets, before integrating them in a union. The current recovery phase and the longer term challenges regarding the green and digital transformation are an opportunity to develop EU capital markets further in order to bring more capital and private money in for the investment needs of Europe and for the future growth needs of all member states.

An industry representative stated that there is an enormous opportunity for Europe to build up its capital markets in the current post-COVID period which requires significant investment. There is also broad consensus in the population that the move to a net-zero society must be tackled now and there are huge savings pools in Europe that may contribute to this objective.

Another industry representative agreed that the vast European savings base should be taken advantage of for developing EU capital markets. Certain statistics suggest that Europe's capital markets also have a significant catch-up potential in terms of integration, size and depth compared to the US. In Europe, there are 22 different stock exchange groups, 35 different exchanges for listings, 41 exchanges for trading, and 40 different central counterparties (CCPs) and central securities depositories (CSDs). In the United States there are two stock exchanges for listing, 16 stock exchanges for trading, one CCP and one CSD. There is roughly $15 trillion of gross domestic product (GDP) in the EU, and $21 trillion in the US, so the numbers are very similar. Europe has a larger population than the US, so it has some catch-up potential and is nowhere near the capital markets development needed for its economy.

A policy-maker cautioned about such comparisons because US capital markets have not developed in the same way as European ones historically and the EU is not integrated in the same way as the US. For example the pension system is set up in a different way in the US and is capital market-based and that is not something that can realistically be copied in Europe. The industry representative responded that such differences should not be a reason for minimising the ambitions of capital market development in the EU. In addition the fundamentals of the market are similar: 'a bond deal is a bond deal'. Goals should therefore be established for European capital markets that are appropriate for the scale of the ambition desired.

2.2 Main market trends supporting CMU

An industry representative advised that there are underlying trends on which the CMU could capitalise going forward and that have accelerated at unexpected speed with COVID. These trends include the growth of retail investment, sustainable investing and the increased demand for private assets. In terms of the retail space, there is an entirely new ecosystem emerging following COVID, with new online brokers in particular which facilitate access to capital markets and gamification trends. Retail participation is a good thing, but much of it is pure speculation. People mainly rely on different forums and YouTube channels for financial information. There is a need for policy-makers and regulators to address these developments and also for renewing the regulatory frameworks, because innovation is running ahead. This trend is here to stay, and it is expanding into other places such as cryptoassets which are largely unregulated.

Secondly there is broad agreement that the demand for sustainable investments is the path to a zero-emissions society, the industry representative emphasized. Demand for these assets has been skyrocketing and now 64% of investments in asset management products are going into sustainably labelled products. More transparency and disclosure is needed around what sustainability is to avoid greenwashing. Providers have adopted the Sustainable Finance Disclosure Regulation (SFDR), but this needs to happen quickly because the assets are moving.

Thirdly, on private asset demand, interest rates are at zero and will remain at zero for the foreseeable future at least in Europe. The demand for private assets is going up daily in this context. Investors indeed realise that traditional assets such as fixed income, real estate or even blue-chip stocks are no longer providing sufficient income or return and the place to move to is private assets, which is a huge universe. There are many more private companies than there are public companies, but it is a space that is not easy to access from a regulatory or sophistication perspective. Finally, digitisation is going to be essential for increasing retail investment. It is a good thing, but it needs to happen in a controlled way.

A policy-maker agreed with these trends which are here to stay. The pandemic, resulting in people spending a great deal of time at home, in front of a screen, is one reason for the development of online retail investment in recent times. Another reason is the negative rate environment, which means that traditional savings accounts no longer produce any interest and that savers are looking for other assets that may provide yields. In terms of crypto assets, some regulatory actions are being taken by the Commission with the Markets in Crypto-assets (MiCA) and the Digital Operational Resilience Act (DORA) legislative proposals.

3. Way forward for the implementation of CMU

3.1 Key priorities going forward for CMU

Some panellists highlighted priorities in the action plan published by the Commission in September 2020. An official considered that reviewing Solvency II is key to bringing in more capital by encouraging insurers to be more active on capital markets. Legislation cannot solve the issue by itself, but it can give a positive signal to insurance companies to invest in capital markets. The European Long-Term Investment Fund (ELTIF) can also do that, but the starting point is currently quite low. It is also important to have an efficient market infrastructure and to be careful about the competitiveness of financial actors.

The official added that securitisation is also a very important topic for bringing more capital into European markets. The EU simple, transparent and standardised (STS) framework is appropriate and the criteria are relevant, but it remains quite penalizing from a prudential point of view compared to other products. In addition, if a framework designed for US markets is applied, one consequence could be that European markets start to look more like US markets.

Another official agreed that it is very important to work on enabling insurers to make more equity investments within the risk-based framework of Solvency II. Another key objective for the coming years is to improve the access to finance and to the data needed for investments, for which the ESAP proposal can play an essential role, proposing to implement a unique access point at the EU level for corporate and SME data. At the moment it is very difficult to access this data in different EU member states, to compare it and then to make investment decisions. Listing rules also need to be streamlined, especially with regard to small and medium-sized enterprises (SME), for which it must be easier to go to the market. Market structure is a further issue to be worked on, the official suggested. Some issues were addressed in the capital markets recovery package. In addition to this a strong focus is needed on equity markets in the MiFID II review. There has to be a level playing field between the different trade execution venues. With regards to bonds and derivatives, the issue is harmonising the transparency requirements, and also simplifying the waiver regime. The cost of market data also needs to be addressed.

Other panellists were in favour of a restructuring of CMU around a smaller set of key priorities that would be easier to pursue and communicate. An industry representative suggested there should be a fundamental 'reboot' of the CMU to refocus energy on a much more limited set of priorities. Three regulations at most should be focused on, and not directives, because a CMU needs identical rules within the capital markets. When rules are merely similar they are different, and if they are different then it is not a union. These regulations should not reinvent the wheel but focus on some key actions needed to develop capital markets in Europe.

The first item is the prospectus. There should be a single prospectus with a single outline, eliminating gold plating. One feature of this prospectus should be that it decides on the proportion in the national language and the proportion that can be in another European language. It is critical to have the same rule so that the rest of the world will recognise the prospectus. The second regulation concerns reporting. In an ideal world, there would be a single, universal document format across the continent. This is not easy to achieve, but the reporting for non-financial data, which is in the pipeline could be a starting point. This could be an important accelerator for the development of ESG investment. The third regulation is more ambitious and concerns insolvency rules. These rules which have existed for 1,000 years are practically impossible to converge, even if they are more similar than might be thought. An alternative could be to create a European credit instrument with a sui generis set of insolvency rules, through which a borrower from country A can borrow from country B and take securities in country C, and then those securities would be enforceable against a third party e.g. when they are publicised in a distributed ledger technology (DLT) single register through a common set of rules. Suddenly all of the professional users would have a single European credit instrument. If these three tangible changes can be delivered, then the markets will realise that life can be made simpler.

Concerning the communication around the CMU, the industry representative suggested that European political leaders should be told that they are not going to achieve CMU but the Schengen of transforming saving towards economic growth. This could potentially motivate political leaders because citizens like Europe when it delivers fundamental improvements in terms of integration such as Schengen, the euro or the single market. This idea could also simplify the debate around central supervision. Currently, when people are against central supervision it is not known whether that is because it may be inefficient or because they want to keep things at home. The argument is that regulation is not convergent enough or not sufficiently similar for single supervision to be possible. The three regulations mentioned above could constitute a basis of identical rules for making central supervision possible.

Another industry representative agreed about the need to be specific in the CMU action plan, and to tackle a few objectives upfront. ELTIF is one of them, but it is not feasible currently. The minimums have to be lowered. An evergreen structure is needed in terms of the redemption structures, and more than 30% of user-type products need to be allowed to go into that vehicle. ESG data transparency is also essential and is a lynchpin of the desired outcomes in terms of sustainable finance. MiFID should also be updated to allow digital advice and hybrid advice.

A third industry representative suggested that Luxembourg law could become the predominant law for credit instruments in the EU since the NGEU programme has chosen Luxembourg law for some of its issuance. This is a similar idea to the sui generis European credit instrument proposed by the previous speaker, but would not require defining a new law. In addition to these 'tactical' approaches, there is a need to step back and define a political objective for CMU that is ambitious, attractive enough and that can be easily communicated. What may be needed is a consolidation of more European capital markets in order to create more depth and access for the largest companies. This would be a similar intention to the one that motivated the introduction of a monetary union in Europe. There should also be consideration of the most effective ways for Europe to create deeper and more integrated capital markets, in order to make its economy more investable for European and foreign investors. This may require revisiting current approaches and trade-offs consistently with the realities of the European market and economy. Hubs, for example, could be created for achieving a greater depth of capital markets activity. These hubs could be agreed between different member states to create specialisms by country, but ultimately still retaining a certain amount of capital market activity in countries, while creating that greater depth.

A policy-maker observed that one challenge with CMU has always been that it is not about one measure or putting one new institution in place. Many things have to happen in parallel, whether that is legislation or action on the ground by market operators. For a well-functioning CMU, areas that go beyond pure financial market legislation will need to be looked at as well, such as insolvency laws or taxation, which will be challenging. The Commission has started using regulations more in recent years. Previously the entire financial services acquis was directives. Sometimes there are legal reasons for using directives, where the legal basis in the treaty foresees only directives, but in most areas there can be regulations or directives, and that is also why we have now MiFIR alongside MiFID and CRR in addition to CRD. However, using regulation also means less national discretion and more common rules. Supervisory convergence is also very important for CMU. The issue is trust between the national competent authorities and the European supervisors. The right balance has to be found. There has been much progress since the European Supervisory Authorities (ESAs) were established 10 years ago, but there is still some way to go.

3.2 The need to build stronger political commitment around CMU

An official stated that CMU has to be politically driven. It is about trying to have a consensus on the need to enlarge and develop capital markets, and enlarging capital pools for the benefit of all, and not about competition between Member States. There are many objectives in the Commission's action plan. Some will probably have more impact than others, but overall it is very important that there is sufficient ambition for each objective, which was not achieved after the first CMU action plan where some proposals were not taken sufficiently onboard.

The Chair suggested that the Commission could press the Council and Parliament to set delivery deadlines, to have a tripartite institutional agreement between the Commission, the Parliament and the Council on a framework for delivery and to agree on fast track procedures under the treaty to accelerate certain items. That may have a snowball effect demonstrating that things are happening. A policy-maker noted that there is a gap between the general political commitment to CMU and the progress made in the implementation of the initiative. A stronger dynamic needs to be built around certain sub-components of CMU and the importance of progressing quickly on CMU needs to be better communicated to EU political leaders. However, deadlines may not be that helpful, because the Commission cannot impose deadlines on the co-legislators, and strict deadlines may create deception if they are not fully respected. Regarding fast-tracking, there can be a political discussion and debate with the co-legislators to ask for as decisive action as soon possible, though that is difficult to realise outside of crises.

The official emphasized the importance of ensuring that ministers and political leaders understand that CMU can be a win-win initiative. Ultimately, it is not about the relative strength of financial actors in each member state but the strengthening of the financing of the overall EU economy and its positive consequences on the growth of capital markets in each member state. There is a need for simple facts and examples. All member states have corporates that need financing. Scale-ups in particular are an eloquent example for political leaders. Many member states are concerned that their successful companies are seeking money outside the EU for their growth and ultimately growing outside the EU. The question is therefore how to develop large pots of money in Europe that may finance these companies. This includes developing the capacity for European insurers and pension funds to invest in such private assets. Once this has been done asset managers will fill the gap. Some member states such as France have started working on this issue, but a European approach is needed. There are also issues related to fragmentation and the different interests of member states. It is important to give signals to political leaders so that they understand what can be achieved with a common European approach.

An industry representative considered that the political commitment that may be needed for achieving the CMU has to be expressed concretely. The starting point is that Member States have very different positions in the financial sector with some having a large financial industry and other being finance takers. Some also have an ambition to have Europe in a position to transform the strong European household savings into strong European investment in strong European blue-chip companies, but this is not the case for all. Aligning those different interests is challenging. Politicians and elected leaders need to understand about the objectives and benefits. Making CMU simpler and more focused is paramount. Secondly, they need to take into account the benefits of CMU for citizens and corporates, which requires focusing on actions that simplify their lives and increase their competitiveness. Thirdly, there is a need for a new narrative connected to the big picture of what we want to achieve with the CMU because nothing can be changed without storytelling in a democracy. A strong narrative helps political leaders to move forward whereas a weak narrative creates resistance to change. Resilience and recovery are probably the best objectives to make the CMU more relevant and justify a reboot of the initiative.

RETAIL INVESTMENT STRATEGY: OBJECTIVES AND PRIORITIES

1. Retail investment trends in the EU

1.1 A low level of participation of EU retail investors in capital markets

A policy maker explained that the main starting point in the reflections of the Retail Investment Strategy lies in the very low participation of retail investors in capital markets in Europe and the growing awareness that developing retail investment is essential for ensuring the financial future of EU citizens, particularly in an environment of low interest rates.

An investor representative explained that bank deposits do not dominate household assets in Europe. Financial savings represent 40% of EU household assets, according to Eurostat when some 60% are in real estate and property. The discussion is therefore about 40% of household assets, of which 30% is in bank and savings accounts, 39% in life insurances and personal pensions, 8% in investment funds directly invested in by households, 4% in listed equities and 2% in listed bonds. Securities such as investment funds, equities and bonds regulated under MiFID therefore only represent 14% of the financial savings of households as direct investments, compared to approximately 40% 40 years ago.

An industry representative gave some additional statistics from Austria, where the Central Bank has reported that Austrian private individuals have around €280 billion in current and savings accounts, producing a quasi-zero interest rate. With an inflation rate of roughly 2.8% to 2.9%, private individuals are losing around €8 billion per year, which is a loss in purchasing power and a threat to future pensions. Generally speaking, the penetration of investment products in Austria and Central Eastern Europe (CEE) is much too low, amounting to e.g. 10% in the Czech Republic and 4% in Croatia.

Another industry representative emphasized that high savings rates and the preference for deposits are present in many European countries. Many EU citizens consider bank deposits and savings to be safe assets, but with practically no interest and an inflation rate of around 2.5% that means that they are losing money and missing out on long term saving opportunities that they could achieve more effectively by investing in capital markets.

1.2 Evolutions with the COVID crisis

A public representative stated that the COVID 19 crisis, which has had adverse impacts for many EU citizens has also offered some opportunities on the investment side, with many retail investors considering equity investment for the first time. This shows that when they are provided with the right tools, context, and framework retail investors will definitely consider entering the markets.

A regulator noted that increased retail investor trading activity has been observed in a number of European countries since March 2020. This trend was confirmed in Belgium for example by two quantitative surveys on retail participation in June 2020 and June 2021 that were based on MiFIR data relating to transactions executed between 2018 and 2021. The number of investors trading BEL 20 shares increased sharply from February to May 2020 and the number of investors in stock exchange index shares increased fivefold compared to the period before the crisis. In Belgium, young and infrequent investors became much more active in terms of share purchasing during the first lockdown, since they were able to save money and had time on their hands. Following the second lockdown at the end of 2020 there was a further increase in the number of active investors and of new investors entering the market. These positive evolutions, which concern mainly young and infrequent investors are encouraging. It is hoped that they will continue in the future. In addition the potential downsides of gamification and the need for sufficient financial education and diversification must also be considered in the EU initiatives underway, the regulator stressed. A policy maker added that the momentum around young people entering capital markets was facilitated by the use of new technologies and financial applications.

An industry representative explained that market data shows both an increase in precautionary savings rates across the EU and an acceleration of new investors coming into the market. There have been significant online broker account openings in Germany, where trading volumes are up by five times. In Denmark, inflows in mutual funds were multiplied by 10 during the first 20 months of the COVID 19 crisis compared to the previous 20 months, with 50% of investors claiming to be driven by the negative interest rates on deposits.

Another industry representative agreed that recent trends since the outset of the COVID 19 crisis are encouraging for retail engagement, but the question is whether people are really starting to invest or whether they are mainly speculating.

2. Objectives of the EU Retail Investment Strategy initiative

A policy maker stated that an important objective of the Retail Investment Strategy is to increase retail participation in capital markets in the EU because savers currently do not benefit enough from the opportunities offered by capital markets. In some member states, this will make it difficult for many citizens to meet their retirement needs and more generally it is also an obstacle to the further development and integration of European capital markets. There are many reasons for the low level of participation of retail investors in capital markets in the EU including financial literacy and distribution issues, which the European Commission is intending to address. In doing so, it will also be important to bear in mind that retail markets differ significantly across the EU in terms of investment cultures and levels of financial literacy, which requires finding responses that fit with the various national situations.

Another issue that the European Commission is intending to tackle with the proposed Retail Investment Strategy is the low level of satisfaction of many stakeholders with the current investment environment, the policy maker mentioned. The investor protection framework needs to be improved to ensure that clearer and more understandable information is given to investors, that any advice given is accurate and fair, and that potential conflicts of interest are addressed notably concerning inducements. Another objective is to enhance the consistency of investor protection approaches across different sectoral legislations and to ensure that supervisors have the proper tools and powers to crack down on poor practices and investment scams. The European Commission has already made some progress on these different issues, but further work is needed. The intention of the European Commission is also to harness the benefits of technology and innovation and build on the increased appetite for sustainable investing, which are likely to drive retail participation in capital markets going forward.

If the European Commission manages to attain these objectives, more trust should be instilled among retail investors and they will be more willing to participate in capital markets. However policy-makers and industry representatives will have to engage constructively because they will quickly encounter extremely difficult issues such as the tackling of inducements, the adjustment of disclosure and suitability regimes and the challenge of reducing complexity.

An investor representative emphasized that the Retail Investment Strategy is a once in a generation opportunity to make a difference in investor trust and foster the development of capital markets for an innovative and sustainable economy. Different elements including investor protection, value for money and pension adequacy need to be considered in this context, as more citizens are encouraged to move their savings to investment products for the preparation of their retirement instead of the traditional pay as you go state run systems.

A public representative added that a holistic approach covering a wide scope of products and of private and public sector stakeholders and considering new trends such as digitalisation is necessary to bring more retail participation to the capital markets. The educational capacity relies on member states, and therefore they must be involved in this initiative. Entrepreneurs and small and medium-sized enterprises (SMEs) must also be included in this effort, alongside individual retail investors.

3. Key policy priorities for increasing retail participation in capital markets

3.1 Improving financial information, education and financial capability

A public representative stated that while investor protection measures and addressing new issues such as gamification are important, retail investors must also be provided with adequate financial education and access to full and transparent information in order to enhance their understanding of capital markets, which is the best way to improve their protection. Retail investors who have been able to save significant amounts of money in their bank accounts can make their own decisions provided they have the right level of information and explanation. Ensuring that they achieve a sufficient level of diversification in their investments is also essential. The different situations of member states in terms of retail investor culture and financial education need to be considered. A European perspective is needed with a clear legal framework, but understanding the singularity of each member state is essential for increasing the participation of retail investors, because the same answers will not work in all member states, particularly those where retail investment is practically inexistent at present.

One aspect which is often overlooked when discussing retail investment is the issuer side, the public representative stressed. The financing of innovative projects and companies needs to have a more prominent position in the public debate. SME managers and entrepreneurs especially need to be encouraged to seek sources of financing in the capital markets when launching new projects, rather than relying exclusively on bank debt, which requires enhancing their financial culture. Bringing small investors into a project from the very beginning is also an option that should be considered by more European entrepreneurs. Moreover, employee shareholding should be further encouraged in Europe because this will contribute to enhancing the knowledge and experience of citizens in capital markets.

An investor representative stated that financial education and information on capital markets and products are essential for increasing retail participation in capital markets, but this can only be done at the retail point of sale. The current problem is that advisors in most European distribution systems are sellers of products remunerated by sales commission and not advice fees. This limits the development of the lower cost instruments such as index exchange traded funds (ETFs) or listed equities because there is no commission on those products. The investor representative acknowledged the objective put forward in the Retail Investment Strategy to move towards more bias free or independent advice, which would contribute to improving investor education about the opportunities offered by capital markets and the characteristics of different investment products, including those that offer best value for money.

An industry representative emphasized that investor protection and investor empowerment are both essential. Investors' trust needs to be enhanced, but it is also necessary to address the complexity of capital markets for investors and the confusion that this may create for them in order to encourage them to make their first investments. Indeed, generic financial education and advice at the point of sale are not sufficient for developing financial capability because people need to experiment with capital markets. A way to encourage this would be to develop a programme open freely to all EU citizens that would allow them to evaluate their financial positions and develop a lifetime plan for financial resilience. While financial education remains a national competence, the EU could have a role in setting some standards and encouraging the development of this type of programme at domestic level. The industry speaker added that digital investment platforms can play a role in the improvement of disclosures and information provision for retail investors, particularly for the younger audience. It is therefore necessary to support such developments with appropriate regulation. For example, the key information document (KID) of the Packaged Retail Investment and Insurance Products (PRIIPs) legislation needs to be adapted to the digital world in order to encourage new investors to benefit from these tools.

A second industry representative stated that investor protection and education are both important, but an appropriate balance is necessary between the two. Financial literacy needs to be improved, starting in schools, but more effort is also needed to inform citizens about the basic facts of investing, such as the loss in real terms that leaving money on a bank account represents. Concerning investor protection, it is important that regulation should empower retail clients to make investments without imposing unnecessary obstacles or burdens related to investor protection objectives. Over the last few years, many experienced clients have indeed stopped investing because of the burdens imposed by the new MiFID regulation.

A third industry representative emphasized that a key objective of retail investor education is getting savers to understand the benefits of diversification, which also requires providing them with clear disclosures across product categories. Another major objective is getting investors to understand volatility and the implications of liquidity premiums which require investing for a sufficient period of time and accepting that higher longer term returns might involve short term losses. While providing financial education is essential to increase the level of confidence of investors, some will still seek direct advice with more or less support and human interaction. This requires continuing to provide retail investors with access to different forms of advice at different prices from branches and other points. Digitalisation is a huge opportunity that will hopefully be a way to propose educational sessions for investors during which the basic concepts of investment and the long-term benefits of investing can be explained.

A regulator highlighted Wikifin, a financial education initiative that has been put in place in Belgium by the supervisor of financial markets (FSMA) targeting teenagers, which is an interesting illustration of public/private cooperation in this area. Some 16 million people have used the Wikifin website and the Wikifin Lab, which is an interactive education centre on finance, is fully booked until 2022.

3.2 Reducing product complexity and costs

An investor representative considered that when it comes to increasing retail participation in capital markets, a priority should be given to the simplest products and the most effective ones for funding the EU economy. However, these only represent 14% of current retail investments. The share of index funds or ETFs, which are the simplest and lowest cost securities, held by retail investors is very limited in the EU, at 10%, compared to 50% in the US, according to ESMA. A much larger share, representing almost 40% of financial savings, is composed of complex multi layered packaged life insurance or pension products that also have a higher cost and less attractive value-for-money. For example a recent study showed that the average fees of personal pension products in France (Plan d'Epargne Retraite) are around 3%, compared to 1% for US individual retirement accounts. Not all retail investors should invest directly in equities and bonds, but they should have access to adequate professional services, able to direct them to the most appropriate investment solutions.

An industry representative agreed that the priorities for bringing retail investors to the market relate to the simplicity of products, the ease of investing, adequate value for money and the possibility of diversifying investments to a great extent. An industry representative felt that while it is necessary to offer retail clients fair and appropriate investment opportunities, the problem is not on the product side at present.

A regulator stated that the supervisor of financial markets (FSMA), which is organised according to a so called 'twin peaks' model, takes a proactive approach to this issue, acting whenever necessary to ban products that are too complex or have a doubtful added value for retail investors. FSMA was the first supervisor in Europe to formally ban binary options, different forms of contracts for difference (CFD) and the use of bitcoin for derivatives for example. This was done because these products seemed too complex for retail markets. Regarding overly complex structured products, a soft law approach was implemented in conjunction with the financial market players concerned.

ASSET MANAGEMENT TRENDS AND POLICY IMPLICATIONS

1. Main trends and opportunities in the asset management sector

A regulator stated that since the beginning of the COVID crisis in March - April 2020 there has been a strong recovery both in terms of flows into funds and performance, with also a growth in assets under management (AUM). The panellists then discussed the main current trends in the asset management market and the opportunities for driving the growth of the sector further.

1.1 Digitalisation

An industry representative explained that digitalisation is a key trend in the asset management sector and is going to have a major material impact on the way that asset managers, wealth managers and financial players across the value chain interact with their clients. Technology now offers the ability to connect various systems through application programming interfaces (API) and the ability to use cloud computing to decrease the overall cost of maintaining a wealth management or asset management system for example. Digital platforms can also be built to serve consumers in a better way than an individual advisor. This does not mean that individual advisors will disappear but their work will increasingly be automated using digital tools, which will increase the potential time that can be spent on actually counselling their clients. Advisors can add their own view of alpha, but their main contribution is to be behavioural coaches and avoid errors or adapt recommendations thanks to their individual understanding of end customers. Another industry representative added that products such as real estate funds can also be digitised with a tokenisation approach. This has successfully been tested by their company.

A regulator emphasized the strong acceleration of digitalisation adoption by retail investors. It was already a trend before COVID, but there has been a paradigm shift since then and there is an increasing number of 'digital natives' in the market. This is both an opportunity and a potential threat if not implemented properly. Digitalisation is an enormous opportunity for the democratisation of financial services and for increasing retail participation in capital markets, but the channels and products for doing so need to be well-designed and with a fair approach.

Another regulator agreed with the previous comments. Rapid digitalisation and innovation based on technology are an opportunity for the asset management sector. The first duty as supervisors is to ensure that this opportunity delivers value for money for investors. Investors should benefit from the same level of protection whatever the medium they use for investing, but that does not necessarily mean that the same rules should apply e.g. to digital and physical channels. It is well known that when a customer uses a digital medium they do not pay the same attention to the information provided for example. Supervisors need to think about how they make sure that accurate information and appropriate advice are provided to customers in a digitalised environment, in order to ensure they get the same substantial level of protection and advice as in a physical context. Many domestic supervisors in Europe have put in place processes to support technological innovation e.g. with a dedicated team which serves as a point of entry for companies who come with a digital project that does not fall naturally into one of the existing boxes of regulation. This will also help regulators and supervisors to shape the way they think about regulation and supervision in the future.

1.2 Value for money and cost reduction

An industry representative noted that a second trend in the asset management sector is increasing value for money for investors through low-cost investing solutions. Their company has globally experienced an increase in the assets managed in lower fee vehicles and a decrease in assets managed in high-fee vehicles, partly driven by the acceleration in indexing and exchange-traded funds (ETFs). Europe however remains far behind the US in terms of the amount of assets managed under these strategies, showing a significant room for progress in this area. Even though asset management fees have decreased on average in the last 10 years, European investors are still paying too much, the industry representative believed. It is not uncommon for investors to pay 2% to 2.5% in total fees. As a result, the investor is taking all the risk, but they have to give around 40% of the returns back to the industry. This is explained in part by the fact that in Europe there has not been a movement to fee based advisory services and low-cost products, so the overall cost of investing has not decreased contrary to the US.

1.3 ESG investing

An industry representative stated that the growth of ESG investing continues unabated. Their company has hit $ 2 trillion AUM (assets under management) in this area in a relatively short period of time. Most of the cash flow of active index is going into ESG-oriented products at present. But there is still a great deal that the financial industry and regulators can do to ensure that investors are provided with relevant information on the ESG impact of their investments.

A regulator noted that at a high level in policy terms the focus on a green digital and inclusive recovery is the right way forward, but for it to be effective, retail investors need to invest in safe products and safe markets that help them to achieve their short, medium and long-term saving and investment goals. A trustworthy environment needs to be created and ESG products need to be implemented correctly with no excesses of greenwashing in particular.

Another regulator agreed that the right level of investor protection is needed in this area. This is in line with the objective of the Capital Markets Union (CMU), which is to make capital markets work for the recovery and bring the investor back to the centre of this project in order to channel more savings into the economy.

1.4 Widening the range of AIF funds accessible to retail investors

An industry representative explained that a growing opportunity from an investor perspective is to widen the accessibility of alternative investment funds (AIF). The Alternative Investment Fund Manager Directive (AIFMD) regime has been very successful, but the market and investor set that it applies to is too narrow. These funds can be passported across Europe under the AIFMD, but only to institutional and professional investors. There is no harmonised AIF framework for retail, which means that it is impossible for managers to market retail AIFs with enough scale. The institutional market has been very successful, but at present there is a growing demand for AIFs coming from retail investors such as high net worth investors and from defined contribution (DC) pension plans, which cannot be answered across the EU because of the restrictions of the AIFMD regime.

The industry representative added that giving retail investors a wider access to AIFs and related asset classes would support improved investment opportunities and investment in the EU economy. Examination is needed on how AIF regulatory regimes can be evolved in line with the UCITS regime so that the benefits that institutional investors have enjoyed for many years with AIF asset classes can be extended to retail investors. Digitalisation can play a part in this, but a harmonised regime is first needed to allow more AIF funds to be marketed cross-border to retail investors.

A regulator noted that it is important to ensure that the offer to the investor in terms of AIFs is well-designed and safe and that retail investors are offered an appropriate level of protection. Retail investors investing in AIFs should be provided with the same level of protection that they get with UCITS.

2. Policy priorities in the context of the AIFMD and ELTIF reviews

The panellists suggested policy measures for supporting the growth of fund investment in the EU building on the trends and opportunities mentioned above.

2.1 Improving the ELTIF framework and adapting it to retail investment

A regulator observed that European Long-Term Investment Funds (ELTIFs) have many interesting characteristics for investors and for the CMU, providing long-term investment opportunities. However, they have not shown the vitality that was expected since they were launched and the ELTIF framework is now under review. Putting investors at the centre of the CMU project is essential, which means providing them with the appropriate level of protection and the right investment opportunities and conditions. ELTIFs could be a key instrument for developing retail investment, but it needs to be clarified for investors that ELTIFs are different from UCITS, in terms of purpose and investment horizon.

An industry representative agreed that investors should be at the centre of asset management policy initiatives, in order to take into account their needs and make sure that they can obtain a proper return with the right level of protection. Not all AIFs would be suitable for retail investors, but ELTIFs could be a way to provide retail investors with appropriate AIFs. ELTIFs have significant potential but have not really worked to date, as the investment restrictions within ELTIFs make it impossible for managers to deliver a viable return to investors in most cases. The first issue to examine are eligible assets in order to make sure that managers can actually invest capital effectively to deliver a return to the investors which is commensurate with the risks. It would also be beneficial to look at the liquidity provisions of ELTIF in order to provide more liquidity. Currently liquidity provisions are higher for AIFs than for ELTIFs.

A regulator stated that the lack of uptake of ELTIFs demonstrates that the framework needs to be made more effective, while maintaining the original purpose of these funds. There is a case for a recalibration of the type of investments that can be made through this framework, but the very-long-term nature of this investment may mean it is not suited for retail investors in all cases. Increasing flexibility in terms of redemption e.g. around redemption points could be considered, as well as an improvement of the suitability and appropriateness requirements concerning these funds in the MiFID context.

Another regulator suggested that the access to some AIFs should be facilitated for retail investors, as part of the CMU objective to improve access to the capital markets for retail investors. However, AIFs should not be widely opened up to retail investors, given the heterogeneity of AIF funds. The first priority would be to enlarge the investment universe of ELTIFs, which can benefit from access to a retail investor base. Funds that are invested in real estate and mortgage assets for example are good candidates for being reclassified as ELTIFs. The AMF in particular is open to having a discussion on that matter. Its concern will be to ensure that the asset classes eligible for retail ELTIF passports are asset classes that are sufficiently simple and understandable for investors everywhere in the EU. Proposals have also been made in the context of the ELTIF review to reduce the minimum entry threshold of €10,000 per retail investor. The regulator added that providing retail investors who invest in ELTIFs with some degree of liquidity would be appropriate. A solution could be to open up periodic redemption periods during which there would be partial liquidity granted to retail investors.

2.2 Further aligning the AIFMD and UCITS directives

A regulator stated that the AIFMD review should also be used as an opportunity to provide for a better alignment of rules between the AIFMD and UCITS directives. Some differences are relevant since the two directives have different objectives and scopes.

UCITS is a product-related directive whereas AIFMD is a manager-related directive. However there are a large number of managers who manage both AIF and UCITS funds, which means that they are subject to diverging sets of requirements. That is not a desirable situation, so an effort should be made to streamline the requirements of the two directives. Streamlining is needed particularly in three areas: (i) liquidity requirements where AIFMD is more granular concerning the provision of liquidity management tools, (ii) risk management for which there are conflicting requirements between UCITS and AIFMD, and (iii) delegation where the two directives could be better aligned. The possibility of delegation should be maintained because it is very useful for asset managers, but in certain cases delegation leads to a situation where the asset manager that delegates in fact does not have the power to make decisions on investment management or risk management decisions. This is an enforcement issue that needs to be addressed.

Another regulator noted that the European Commission proposals on the review of the AIFMD and ELTIF frameworks should be expected in a reasonably short period of time. AIFMD is a great success story, but some of its features could be further enhanced, such as those concerning liquidity management. There has been a live stress test in the COVID-19 circumstances and the European Systemic Risk Board (ESRB) is examining issues and possible improvements in that area. The AIFMD review is a real opportunity to enhance the availability and the effectiveness of liquidity management tools in particular and to ensure their deployment and use, including by enhancing the internalisation by redeeming investors of transaction costs such as liquidity premia. The regulator added that it would also be to the advantage of everyone if there was a common EU legal framework across the AIFMD and UCITS which governed the availability of additional liquidity management tools, as it would allow having a consistent basis throughout the EU, especially during times of stress. Swing pricing and anti-dilution levies could address issues like first-mover advantage in particular.

The regulator emphasized that delegation is a challenging issue, but if done properly it can bring advantages of diversification and specialisation in the asset management industry. It can also assist in reducing costs and creating efficiencies, but it is very important to ensure that there is high-quality, substantive oversight and control by fund management companies who delegate portfolio management activities. There is a case for improving the requirements regarding delegation in the AIFMD and harmonising them with the UCITS framework, but the focus should be on effective oversight, requiring fund managers to have sufficient resources and competencies to manage effectively and control their delegates.

2.3 Tackling inducements

An industry representative considered that the inducements policy should be revisited as a result of digitalisation and increased levels of consumer interest in investing. Inducements in the asset management space are not very productive because of their lack of transparency for investors. More can be done to educate investors, improve cost disclosure and facilitate access to advice at a lower price, taking advantage of digitalisation. The future is going to be towards digitalisation, which will allow a reduction of costs across the entire value chain and more transparency in the asset management industry across Europe. In the UK and the Netherlands there has been a positive impact of banning inducements and it is hoped that this trend will develop in the EU.

A regulator stated that supervisors need to make sure that a degree of advice is readily available for all types of customers in a context where financial advice will probably be increasingly charged to the consumer through fees. Unsophisticated customers will not pay for financial advice, therefore care must be taken that advice remains available to all customers.

The industry representative acknowledged the concern expressed by certain regulators that reducing inducements may lead to some investors not benefitting from any advice because they are not ready to pay for it specifically. However, fee-based advice is now dominant in the US and there is no evidence that getting rid of inducements in the UK has created any advice gap. In the US this evolution happened because of competitive dynamics, but the competitive dynamics in Europe are not robust enough to make this happen. Regulatory intervention is therefore required in order to push the market along. There is also an opportunity to encourage the use of digitally-based advice that could be across a sliding scale from basic, simple advice all the way through to sophisticated financial planning, thus contributing to achieving the objectives of the CMU. Their organisation already has a direct to consumer advice platform in the UK, and will be opening one in Germany within the next few months.

The industry representative moreover stressed that retail investors can be relied upon to be a significant source of long-term invested capital. When there is market disruption it is usually the larger institutional investors and the chief investment officers of larger organisations that make bad behavioural mistakes with respect to investing, not retail investors. For example last year there was a ‘dash to cash’ during the early part of the COVID crisis, which did not come from retail investors, but from larger institutional investors who are the ones who should receive curbs on their ability to move in and out of investment vehicles at will.

2.4 Enhancing supervisory convergence and coordination

A regulator considered that greater supervisory convergence is needed to foster the build up of the single market in the asset management sector. The main priority is to clarify the cases where there are overlapping requirements and uncertainty in the responsibilities of the supervisory authorities of the asset manager and of the funds when are domiciled in different jurisdictions. An ESMA letter from August 2020 underlined that there was a degree of uncertainty and sometimes a degree of overlap between the responsibilities of various supervisors in the asset management sector. Work is needed to clarify this and to make sure that there is a good degree of coordination between supervisors.

A proposal made by the French AMF would be to recognise the role of a lead supervisor for each asset manager in the context of the review of the AIFMD. The lead supervisor would be responsible for supervising all the activities of a given manager and would have access to the information that is provided to the supervisors of all the funds of the manager. The idea is to foster greater cooperation and information sharing between supervisors without putting into question the respective role of home and host supervisors.

2.5 Providing an EU loan origination fund framework

A regulator suggested that loan origination AIFs could be a great success on a pan-European level if a framework was put in place. A number of EU countries already have domestic frameworks for such funds including Ireland, Germany, France, Spain, Italy, Portugal and Malta; Ireland for example has about 61 loan origination funds with around €7.5 billion AUM. A pan European framework would produce a level playing field, efficiencies and economies of scale in this area, which would favour a diversification of sources of funding and be beneficial for investors.

Another regulator stated that there are concerns from regulators and macroprudential authorities on possible risks arising from loan origination funds. However, it was noted that loan funds are important instruments in providing funding to the firms, also in cases where traditional funding sources (like banking credit) is not possible, and so the regulator asked whether the appropriate mitigation mechanisms and instruments are in place to address those risks and make loan funds a reliable source of funding.

The first regulator agreed that there needs to be an appropriate balance of risk and benefits. Looking at the different regulatory requirements in the existing domestic frameworks shows that there is sufficient experience now to put together a framework at EU level with the right balance of opportunity and risk in order to make loan origination funds a quality addition to the AIFMD framework.

EU CONSOLIDATED TAPE: MAIN CHARACTERISTICS AND IMPLEMENTATION MODALITIES

1. Objectives and potential benefits of the EU Consolidated Tape (CT)

The Chair stated that while the emergence of consolidated tapes (CT) was one of the expectations of MiFID II, none have emerged so far. The MiFID II review is a timely opportunity to revisit this issue. The potential usefulness of the CT now seems to be a given. The issues remaining to be discussed are more of an operational nature, concerning the content of the CT, the instruments to be covered, the type of information to be provided and the timetable of implementation. There are also questions around the institutional setting of the CT and the type of business model and governance needed for an efficient and useful CT.

Several panellists emphasized the benefits that a CT could provide in terms of data transparency and consolidation and the potential impacts on the effectiveness of EU capital markets. The role that a CT could play in supporting best execution was also stressed by certain panellists.

An industry representative noted that the objective of setting up a CT is closely linked to the Capital Markets Union (CMU) initiative, for which a liquid and transparent capital market is vital. Financial markets in Europe are still not as accessible with respect to price transparency as, for example, the US. A CT would support the CMU by offering better price transparency, which should in turn facilitate the improvement of capital market allocations. Market participants, investors and issuers want to have a timely view on how assets are priced and where assets are traded and the CT should help to improve this information, which currently is not optimal in Europe.

A second industry representative suggested that timely access to comprehensive data about market activity, specifically the price and size of trades in equities, bonds and derivatives, is critical to healthy markets, helping to lower the cost of capital both for the public and private sectors. Such information empowers investors, both large and small, to accurately assess execution quality and facilitates the achievement of best execution. This information also removes information asymmetries, allowing all liquidity providers to better manage risk and, in turn, more confidently quote prices, commit capital and warehouse risk across all market conditions. Transparency also makes markets more resilient, especially in times of stress, by ensuring that new information is efficiently assimilated and reflected in current price levels. Finally a European CT would help to further integrate EU capital markets in line with CMU objectives.

A third industry representative emphasized that a CT would support fair and efficient capital markets in different ways including by lowering data costs. Little has changed in terms of data transparency since the first MiFID II discussions in 2014 and there are possible failings, particularly in the pre-trade transparency of the fixed income markets, which need to be fixed. Very sophisticated and large entities will always go to the most comprehensive data source for their modelling and will pay the money for it, but many smaller players in the marketplace cannot afford that. There needs to be a price point at which people can come in and participate in this CT data. A CT also has broader implications in terms of research and innovation, since access to a wider set of data will support innovation in the European capital markets. Democratising data via a CT therefore has potential benefits beyond the current market participants.

A regulator observed that momentum is building around the CT initiative and it is now time to move forward with it, because it is a key part of the CMU. The speaker's institution is supportive of the priority put on the CT within the MiFID II review by the European Commission and it is working on different proofs of concept to help accelerate the implementation of a CT. The absence of a consolidated, standardised and reliable overview of transactions executed on EU financial markets is a major obstacle to the development of EU capital markets and needs to be addressed. Price and market information also need to be more integrated in Europe and price discovery has to be facilitated with the availability of EU-wide reference prices across different asset classes.

A regulator considered that the CT is primarily about the data consolidation, which is essential to facilitate the meeting of supply and demand. There is a great deal of fragmentation of trades in Europe, so a CT should be useful, although it is not a silver bullet for the CMU. According to ESMA, there are 400 trading venues in the EU27 and 200 systematic internalisers (SIs) and Brexit is bringing further fragmentation, therefore data consolidation is essential. Concerning best execution, the regulator noted that while a CT can be useful for best execution as a reference it is not sufficient to achieve best execution.

A public representative considered that the CT has many potential benefits. It can be a useful supervisory tool for ESMA and the national competent authorities (NCAs) to acquire the full picture of what goes on in the market at the cross-border level, which is not possible at present. All market participants should also be able to have access to a high-quality data stream provided on a reasonable cost basis thanks to the CT. That will be particularly beneficial for smaller market participants. Having a full picture of transactions should also enhance the price formation mechanism, particularly in markets where much trading happens off-exchange, which is quite widespread in the EU. The key precondition for these benefits to be possible is however that market participants contribute to the CT and that the data being consolidated is of the highest quality.

An industry representative explained that fixed income instruments are much more numerous than equity instruments and often trade with significant gaps between each transaction for a given instrument, so order book protocols used for equities are simply not sustainable for bonds because there are not enough concurrent bids and offers. In the absence of frequent transactions and the visibility of pricing afforded by order book execution, the fixed income market routinely employs pre-trade predictive models and post-trade review models. CT data would be of immense benefit for optimizing these models in the fixed-income space, thus improving price formation and best execution. In addition, although a CT will not replace exchange data, it is likely to reduce market data costs.

Another industry representative however considered that there is a broader issue of market structure and transparency that needs to be dealt with before embarking on the CT project. Generally speaking MiFID's transparency objective has failed especially on the equity side where there is a proliferation of trading venues and dark trading and the reliability of reference prices has worsened with MiFID. While some observers emphasize the level of competition that has been achieved in the market with MiFID, the reality is that the EU's capital markets are significantly behind the curve across all proxies. The EU had 7% of all initial public offerings (IPOs) globally last year, while 60% went to Asia and the US. The EU had about 9% of the total share in trading, which is also far behind the curve and the same is true for total market capitalisation. A recent study by the French AMF shows that while SIs were initially introduced in the market for handling large institutional orders, the average size of orders is relatively limited, particularly for ELP SIs (Electronic Liquidity Providers) and there is only a 1.4% contribution to the transparency of markets in terms of total volume. In the bonds market the level of non-transparency is particularly high with a structural problem in the design of the market. At the beginning of 2020 only 3.1% of bonds were liquid and transparent. ESMA's work in this area needs to move forward possibly with more radical thinking on the waiver regime for example. Overall, it should be recognised that exchanges (regulated markets) are already providing their high quality data for free on a 15 minutes post-trade basis, while all other trading and execution venues would not do so. As such, it was important to recognise the market failure around much needed high quality data from the OTC, dark pool and SI segments. Once this data quality is ensured, one would likely see the emergence of private sector CT offers.

Concerning retail investors, the industry representative considered that there is not much benefit to expect from the CT in terms of costs, because if someone goes to their broker there are completely different pricing factors that play into the bill and therefore increasing retail investment requires a different set of actions. Therefore, and before conceptualising the CT in more detail, it is key to be clear about the use case and the concrete objective so as to avoid a costly and lengthy project that may ultimately be limited in actual application and overall added value. Another industry representative agreed that there are other barriers for retail investors in Europe if they want to trade, but equities are usually liquid enough for retail investors and there is good pre-trade transparency.

2. Priorities in terms of asset class, type of data and venue coverage

2.1 Priorities in terms of asset class and type of data

Some panellists were in favour of giving the first priority to a fixed income CT.

A regulator preferred a post-trade CT aimed at fixed income as a priority, as there is a bigger asymmetric information gap that can be filled relatively quickly in this market. Fixed income should therefore proceed first and market participants should be incentivised to improve data quality and respect delays in transaction reporting.

An industry representative considered that price transparency in equities is relatively good whereas in fixed income instruments it needs improvement. Pre-trade transparency is a difficult concept for bonds because the notion of liquidity differs depending on which types of investors are involved. Liquidity requirements are indeed different for institutional and retail investors. While more data is generally better, there can be misleading data that can result in the wrong conclusions and beyond a certain level, transparency can actually hurt markets.

A second industry representative noted that there is support both on the buy and sell sides for a CT particularly in fixed income instruments. Good CT post-trade data in fixed income could be a proxy for pre-market information, which is considered to be very poor at present. That is in itself a reason to pursue a CT. The difference between instruments, e.g. between equity and fixed income, however needs to be taken into account. There has to be care to construct a CT that is appropriate for each of the asset classes, rather than a one-size-fits-all approach.

A third industry representative agreed that the focus should be on a post-trade fixed income CT. While in isolation there are strong arguments for implementing a CT for equities in order to increase transparency and reduce costs, comparatively to fixed income, equities already have an abundance of transparency thanks to exchange data and order-book execution.. Moreover there are two reasons for aiming for a post-trade CT. First is that fixed-income instruments trade with much less frequency than equities. When looking at trading an instrument today that traded a month ago, the real data point is what it traded at and not necessarily the surrounding pre-trade quotes. Also, the implementation effort for a pre-trade consolidated tape and post-trade consolidated tape collection is probably identical, but the much larger return on investment (ROI) is in the post-trade space.

A fourth industry representative stated that in the EU CTs can and should be both tailored to and phased in by asset classes. The equities and the fixed income markets are different, but tailoring and phasing in a CT that is appropriate for each of the different instrument categories is possible. There is no reason to prioritise or delay the development of a CT for one asset class versus another, they can proceed in parallel. The US has separate CTs for different categories of financial instruments. The US capital markets benefit from pre and post-trade CTs in the equities and options markets, as well as post-trade only CTs in the corporate bond markets, municipal bond markets, mortgage-backed security markets and over-the-counter (OTC) derivatives markets. Starting with post-trade transparency in each of the asset classes is the logical starting point and in the fixed income space, a post-trade CT is likely all there will be, judging by the example of the US where the TRACE system for corporate bonds is a post-trade only CT.

The third industry speaker considered that developing CTs in parallel would be feasible if there were parallel regulations driving the projects, but there is the risk of having a single regulation which does not respect the differences between the asset classes, which would present a problem for parallel delivery.

The Chair suggested that for a parallel implementation and regulation of different CTs to be possible the issue of the business model of the CT also needs to be considered, whether this will involve public or private participation and whether there are natural monopolies per instrument or category of instrument. In addition there is also the question of the availability of data for non-equities. With the current transparency requirements there would almost be no relevant information in a non-equity CT to start off with.

A public representative suggested that priorities need to be defined in terms of instruments. The benefits will probably be greatest for the bond markets where, generally, transparency levels are much lower than the equities markets. However, given the existing solutions in the equities markets, beginning with equities would probably be sensible. Other asset classes could then come at a later stage. Given the failure of the first attempt to implement a CT with MiFID II, a cautious, step-by-step approach seems more prudent than attempting to implement a CT for all asset classes at once. A regulator agreed with the idea of a cautious approach and added that for equity and non-equity instruments the correct approach is to be pragmatic and to start with post-trade data. There are different data demands from different kinds of investors and this should also be considered. In any case data quality and machine readability are essential, as well as cost-benefit analyses, legal analyses of property rights and defining the connection with APAs (approved publication arrangements). Everyone hopes that a private solution will emerge, but private consolidators need incentives and there needs to be an adequate regulation in terms of pricing.

An industry speaker disagreed that an equity CT would be easier to implement than a fixed income one. Current functional fixed income APAs are testament to the fact that a fixed income CT can be produced as easily as an equity one, because the operational delta between running an APA and a CT is not that significant. The issue is more about agreeing the common data standard for the CTP to actually consume. However there is a need to have one common voice setting that data standard.

2.2 Coverage in terms of venues and instruments

An industry representative stated that the CT should provide 100% coverage of venues and instruments, otherwise it will not have enough added value compared to the data which is already made available by exchanges freely on a 15 minute post-trade basis. There is further work to do requiring all execution venues, including SIs for example, to actually send and deliver a daily file on what has happened in their systems. If a 100% picture is achieved across all venues then there must also be a conversation on the accessibility to all of the venues for retail and institutional investors, because many alternative execution venues, such as the SIs, are not accessible on a non-discriminatory basis to all market participants.

Looking more concretely at the reporting pools, machinery is needed to build a list of SI data per instrument that needs to be disclosed the industry speaker suggested. On the bonds end, there seems to be a structural problem in the design of the overall transparency system. There is also a broader discussion to have on the need to change some of the existing Q&As into actual guidelines and to apply them. What is put into law has to be enforced. It cannot be the case, for example, that there are still netting offers out there for what are supposed to be bilateral setups. That is a breach of the law in terms of MiFID Article 16A.

A second industry representative disagreed about a 100% coverage for the CT. Such a requirement would probably lead to the failure of the CT project, because there is always some activity at the fringes that is hard to capture and is not necessarily vital for the performance of the CT.

A third industry representative suggested that for equities and exchange-traded markets it is important to consider separately the consolidation of pre-trade quotes and post-trade executions. In the US 100% of post-trade equity executions are covered, whether they are on or off-exchange, but the rate is effectively lower on a pre-trade basis because only displayed quotes on exchanges are included (and not non-displayed quotes on exchanges or off-exchange trading). It is essential to have a post-trade CT because, whether on-exchange or off-exchange, the post-trade CT brings 100% of market activity together in a transparent fashion. Not every instrument across the entire financial market has to be covered but every instrument within a given asset class should be.

3. Data quality and waiver issues

The Chair highlighted the need to further discuss the issue of data quality and whether it should be a prerequisite for a CT or whether developing a CT will help to improve data quality. There is also the issue of lacking data mainly for non-equity markets.

An industry representative emphasised that data quality is a pre-requisite for the CT, and what is needed in terms of data quality needs to be defined first. This is one of the lessons of the 2008 financial crisis. Appropriate market data is the starting point for any investor decision but it is also a key component for ensuring financial stability and defining monetary policy. More transparency is needed and the required overall market structure has to be constantly monitored. All of the deferrals and waivers that are used in the market need to be reviewed. In terms of data quality, there is also a significant problem around reference data in the EU. Harmonisation is needed, not only of the terminology but also of the overall classification across all member states. The use of NRCF I-codes is needed.

A regulator suggested that it is time to start rationalising the deferrals and reducing the number of waivers. This could help to make more data available and ensure that the CT has a better business case. The Chair noted that if the current set of waivers and requirements for bond transparency is maintained then that will considerably limit the interest of a bond CT.

An industry representative stated that CTs are only as valuable as the quality of the data that they collect and disseminate. That is why it is essential to address the current deficiencies that the European Commission and ESMA have already identified with respect to the scarcity, quality, timeliness and accessibility of post-trade transparency data, particularly in the bonds and OTC derivatives markets. In addition to ensuring that all on-venue and off-venue transactions are covered, particularly in the fixed income space, rationalising the current inconsistent and excessive deferral regimes must be a priority. In the US setting a maximum 15-minute deferral for larger sized block trades in corporate bonds and in OTC derivatives has been sufficient to maximise the benefits of transparency.

A public representative stressed that the main requirement for a CT is getting data quality up to a certain standard. Data quality is a pre-requisite for a CT before thinking about the governance structure and the business case of the CT. If poor-quality data is consolidated there will be a poor-quality CT. Part of the data quality issue can be fixed by working on the deal data reporting and the actual reporting templates of MiFID II. Currently, those templates still leave too much room for inconsistencies.

Another equally important factor is enforcement. For a CT to work, increasing and maintaining data quality has to become a priority for supervisors, who should be in charge of safeguarding data quality. Currently, most regulated markets deliver useful data in line with MiFID II requirements. The same is unfortunately not true for many smaller trading venues, especially SIs or dark pools. A solution may ultimately be to impose fines on the firms delivering poor-quality data.

The Chair concluded by saying that the legislative proposal by the Commission is awaited on this subject, and that there will perhaps be an opportunity to foster this project under the upcoming French presidency of the European Union – in close consultation with all stakeholders.

CLEARING: REMAINING CHALLENGES AND WAY FORWARD

1. Lessons learned from the COVID-19 crisis in the clearing space

The Chair stated that the clearing sector weathered the impact of COVID-19 very well. A key aspect of clearing is the presence of infrastructures that inherently have a financial stability dimension. In aggregate, European central clearing counterparties (CCPs) seemingly have been faring better on aggregate than their peers outside the Union, which both gives credit to the industry and to the regulatory framework (i.e. EMIR and the anti-procyclicality measures (APC) established by ESMA).

An industry representative observed that the pandemic demonstrated that the measures defined by the G20 concerning CCPs following the 2008 financial crisis are effective. Despite record volatility in March-April 2020, the financial system remained stable and performed as designed and CCPs played a key role in this regard. EMIR has enabled the EU to improve its central clearing ecosystem and is serving as the global benchmark. The margin models have also proven effective and showed fewer procyclical effects than seen elsewhere in the world.

A Central Bank official agreed that CCPs generally performed well during the COVID volatility period of 2020, which was unprecedented in certain aspects with the largest equity move in over 20 years and record volatility in certain markets. The key lesson is that the reforms put in place following the 2008 financial crisis to enhance and encourage the use of central clearing have fundamentally worked. This also changed the way that the financial system works and how it behaves under stress. The experience of March/April 2020 was an ultimate stress test of the clearing system. This time there was no worry about the risk of a large clearing member defaulting or of potential impacts on the whole financial system. Not all CCPs were created equal across the system however. There were very significant increases in initial margin in some parts. Also the realisation of market losses by participants was much faster than in the past due to reforms of variation margin, which is an improvement. The Central Bank official mentioned that international work is ongoing on these issues. A consultation should be released in the following month outlining the conclusions of an analytical phase that drew on a very large collection of data. The impacts on liquidity, and whether there was the right level of preparedness are being assessed in particular.

A second Central Bank official concurred that EMIR 2.2 has successfully passed the test with this unprecedented crisis and proven to be quite efficient. There are no major problems with EMIR, which is the most developed CCP framework at the global level. With the very challenging situation at the beginning of the COVID crisis, initial margins (IM) and margin costs were significant in Europe, but clearing members were generally well-equipped to face these increases in margin calls. They were able to post an additional €30 billion of initial margin to EU and UK CCPs in a matter of one month. On a global scale, the clearing initial margin increased by €300 billion from February to March 2020, especially on exchange rate derivatives, interest rate swaps and FX swaps.

An industry representative agreed with previous speakers that the margin models worked as intended. They were predictable, and there was no change in process, behaviour or parameters across both LCH entities, the result being very gradual, very linear and in single-digit percentages. A degree of caution is however required in this area, because results can differ across CCPs, asset classes and jurisdictions. However, relatively high-calibre, predictable risk management and resilience was generally demonstrated in Europe throughout the COVID crisis.

2. Main challenges related to Brexit in the clearing space

2.1 Fragmentation and financial stability implications

A policy-maker emphasised that Brexit was a fragmenting event. Generally, the EU financial system and the EU financial markets reacted well. However, Brexit has potential financial stability consequences in the clearing space that need to be tackled. The Commission indeed considers that having a high amount of clearing of euro products outside of the European Union following Brexit creates a dis-equilibrium and potential financial stability risks. Work is ongoing in this space to determine what can be done to improve the situation. All of this is also somewhat linked to the whole debate about the EU's open strategic autonomy.

That debate must not be seen as a zero-sum game or an opposition between the EU and the rest of the world, but as an objective for the EU to ensure its own financial stability with the various necessary market infrastructures including CCPs.

A Central Bank official stated that nine months after Brexit the trading and clearing landscape of the EU has already started to shift significantly. On the trading side, the market has been largely relocated to the continent especially to Amsterdam for equity trades. Such changes occurred without major difficulties thanks to the high substitutability of the EU in this area. On the clearing side the situation is more difficult to change, but following the Commission's recommendation to reduce systemic exposure to third-country CCPs, several EU participants have started migrating their positions in interest rate derivatives clearing for example to EU-based CCPs. Although these changes are moving in the right direction they are not yet sufficient to ensure EU financial stability. Some UK-based CCPs are still in a situation of quasi-monopoly for clearing activities in euro. This heavy dependence of the EU financial sector on third-country CCPs remains an important source of concern. The possible solutions that may include the de-recognition of some of the most systemic UK-based CCPs are being assessed by the EU public authorities from a financial stability perspective. The right balance needs to be found also taking into account the market and cost impacts in order to create the right incentives and provide market players with sufficient certainty.

Another Central Bank official stressed that while these post-Brexit financial stability implications need to be taken into account it is also important to consider that the clearing system is fundamentally designed with a cross-border perspective. When the reforms were put in place in 2008 they envisaged CCPs that would have deep pools of liquidity, and that globally significant financial markets would be able to rely on CCPs that were not necessarily tied to a jurisdiction. Currently there is an identical legal framework for clearing in the EU and UK, which provides the tools needed for that. Appropriately managing financial risks on a cross-border level requires deep information sharing and cooperation, which is already happening between the Bank of England and ESMA. The tools and interfaces to address post-Brexit financial stability concerns are therefore in place, as are international standards to ensure that regulation across borders is based on a common view and common set of standards, taking into account the lessons learned since the 2008 financial crisis. That can be a basis for addressing post-Brexit financial stability concerns in a way that does not unpick the global financial reforms put in place in 2008 and that leverages the existence of cross-border CCPs that not only contribute to financial stability but also make central clearing more economical.

An industry representative agreed that stability and resilience should be ensured from a cross-border perspective because markets, participants and currencies are global. By definition financial stability and resilience are a common objective for which global cooperation is needed. UK-based CCPs are global businesses with global participants based in a large number of jurisdictions. The resilience and stability in these CCPs should therefore be leveraged by having robust, resilient cross-border supervision and regulatory oversight, which is quite feasible. ESMA's third-country CCP supervisory oversight is moving in the right direction and is similar to the one conducted by the US CFTC and the Bank of England. In addition there is already proof that this can work since the majority of dollar products are cleared in the UK with oversight from the US. Cross border supervision is key to stability and resilience and we have the right tools to address concerns ex-ante threaded through EMIR.

A policy-maker disagreed about looking at financial stability only from a cross-border perspective. In addition, the argument that because everything worked very well in March/April 2020 proves that there is nothing more to do is somewhat short-sighted. The possibility of a highly unprobable event with very high impact happening cannot be excluded, which is why the EU needs to be vigilant when it comes to its own financial stability. That is why the issue of dependency on CCP structures in the UK is being considered.

2.2 Recognition of UK-based CCPs

An industry representative warned that there is a timing issue with the recognition of UK-based CCPs. EU market participants should be informed about what is going to happen in terms of regulatory developments as soon as possible and, at the latest, prior to the end of March 2022 in order to address the ongoing uncertainty confronting EU clearing members and their clients. If the temporary recognition is to expire at the end of June 2022 then UK CCPs will need to take steps to terminate membership of relevant EU clearing members in good time, meaning three months' notice, so as not to breach Article 25 of EMIR. Work on this important political issue has to speed up. Over-the-counter (OTC) derivatives are concerned as well as other segments such as cash equities. A further challenge concerns EU clearing members. Following the working groups on clearing set up by the Commission, it is understood that it is not currently the intention of the EU authorities to propose measures or incentives to both EU clearing members and third-country clearing members. However, a policy of euro clearing that would only apply to EU-based clearing members would be damaging for those firms from a competitive standpoint, and would not meet the expected political goal of the EU institutions.

The Chair stated that the ongoing review of the temporary Tier 2 CCP recognitions is a key priority. Following the publication of the methodology that would be used, the ESMA CCP Supervisory Committee has been embarking on comprehensive stakeholder engagement, collecting data from a wide variety of players. This will allow a deeper assessment than in the past of potential risk concentrations, cost issues and netting and liquidity issues This will help to inform the evaluation undertaken by the ESMA CCP Supervisory Committee and the Board of Supervisors, as well as the recommendations that may be made to the European Commission before the year's end.

3. Main remaining challenges and issues in the European clearing space

The Chair considered that there remains a wide range of risks to be tackled in the clearing space concerning CCPs, including market concentration risk, default management, and recovery issues. Some emerging challenges will also need to be taken into account going forward in the clearing space, including climate risk, cyber resilience and potential disruptions coming from digital innovations.

An industry representative added two further challenges that need considering: the reference rate reform and the implications of client clearing. Concerning the reference rate reform, globally the industry is in a major transition from the old LIBOR/IBOR to new reference rates. That is an existential challenge for the industry and a great source of risk. Although there is much talk about the technical details, the top priority for many firms is ensuring that they safely, soundly and seamlessly get all of the reference rate transition done over the course of the year, excluding dollar, for the IBORs and LIBORs. This is a cross-border, cross-regulator and multi-currency task which is particularly challenging. Secondly, access to client clearing and clearing member capacity will continue to be very important. Uncleared Margin Rules (UMR) phases 5 and 6 are coming in, as well as the clearing obligation for pension funds. Regarding repurchase agreements (repos), LCH has launched sponsored access both in the EU and UK in order to provide buy-side clients and dealers with access to reliable funding and liquidity, the importance of which was shown at the outset of the COVID crisis. Clearing plays a part in these improvements, but it is not the only solution. It is also important to be able to support the issuance of more recovery and debt instruments like NGEU (Next Generation EU) and SURE (Support to mitigate Unemployment Risks in an Emergency) debts.

Another industry representative added that for the upcoming MiFID II review open access needs to be further discussed. While it is generally understood that open access rules may need rethinking with the emergence of new infrastructures, ESMA recently issued a statement on open access to CCPs for exchange-traded derivatives (ETD) where it indicated that national competent authorities (NCA) are expected to not prioritise actions on this matter. On cash equities, the experience shows that open access spurred competition among market infrastructures and led to a general decrease of costs, demonstrating that it continues to be a relevant topic.

4. Ongoing regulatory and supervisory initiatives concerning EU and non-EU CCPs

A policy-maker noted that from a policy standpoint clearing supports the broader Capital Markets Union (CMU) and Economic and Monetary Union (EMU) agendas. It is regulated by the EMIR framework which demonstrated its fit-for-purposeness during the COVID crisis and will be completed and by the CCP recovery and resolution regime for which Level 2 technical standards are being defined with the support of ESMA. This regulatory framework is also broadly based on the international guidelines that were defined after the 2008 financial crisis and will be updated in a coherent way with international discussions in this area.

The Chair also emphasised the quantum leap that has been achieved in terms of CCP supervisory convergence in the EU with the implementation of the ESMA CCP Supervisory Committee which is now operational and is also starting to engage with third-country CCPs. There is a perception that EMIR 2.2 has not fundamentally changed the existing supervisory set-up for EU CCPs, but actually a huge amount of progress has been made with the ESMA CCP Supervisory Committee becoming a key cornerstone of the overall framework, monitoring college decisions, the actions of NCAs and possible changes in the margin models of CCPs. Another aspect which needs to be considered is the financial stability dimension and the fact that in clearing, and the CCP area in particular, risks do not necessarily concentrate in the host jurisdiction of a CCP, given the structure and the way the clearing business has been organised with the reliance on clearing members. That is recognised by EMIR 2.2, and the direct supervision by ESMA of those CCPs which are supposed to be of systemic importance for EU financial stability has been built up.

4.1 Margins, liquidity and anti-procyclicality measures

An industry representative was supportive of the reviews that are underway to improve current measures with a timeline set for year-end. The EU authorities are reviewing existing anti-procyclicality (APC) requirements to enhance their functioning. The international standard-setting bodies are also analysing the impact of the pandemic on margins and liquidity compliance. Some elements however need to be considered in the context of this analysis. First, in the bilateral space, where APC measures are not applied and the full rollout of margin requirements has been repeatedly delayed, the effectiveness of risk management standards to create a level playing field between the bilateral world and the CCP world has to be reassessed. Secondly, globally competing CCPs must not be incentivised to undercut margin requirements. A minimum standard that could ensure global consistency in this respect should at least be considered by the international community.

A Central Bank official stated that the question of initial margin (IM) has to be considered further, because the challenges observed were mainly due to the integration of market volatility by CCP models and not as much by position changes from members. The question of procyclicality and the need to have more global convergence on the tools and recommendations with respect to margin procyclicality and transparency remain key. A balance should also be struck between model reactivity to stress and the smoothing of peaks and troughs, because a situation where the same model would apply or be imposed on all CCPs may have the unintended consequence of reducing the anti-procyclicality benefits of a sound diversity of approaches. The official added that the FSB and CPMI-IOSCO are currently working on these important and challenging questions, which are however not the only ones to be tackled. Lessons should be drawn from all vulnerabilities observed during the crisis. In particular, there are improvements needed in member robustness, particularly in funds. There are also vulnerabilities related to the liquidity of some entities and issues related to liquidity pressures that need tackling. The CCP recovery and resolution framework also needs to be generalised.

An industry representative considered that the topic of operational resilience deserves more attention when it comes to infrastructure. Whilst margins are discussed a great deal, there has not been much discussion around the massive spikes in volumes handled by CCPs. There were large volumes across all of the different asset classes as well as large changes in asset prices. There were major flows, and very significant margin calls and margin flows as well. All of that put stress on the infrastructure. Although al went well during the COVID crisis, it is important to continue to find ways to embed a culture of operational risk resilience and risk management, not just in the CCPs but also in the wider settlement, payments and collateral ecosystem which is highly interconnected.

Another Central Bank official emphasized that looking at transparency is going to be fundamentally important. It is not certain that every CCP and every client understands the functioning and implications of margin models and that the level of transparency is sufficient. There is a need to improve this and to make sure that comparable metrics across CCPs and markets are available and also that these allow to define what level of IM requirements may be needed in normal and stress situations. Liquidity preparedness is a second issue to consider, especially concerning non-bank clients. There is a very wide range of practices and a wide range of preparedness. There is also an issue around potential liquidity management strategies all being the same. That is something that the FSB work mentioned by a previous speaker is addressing in particular.

There has to be more of an international conversation on these issues, the Central Bank official believed. The conversation within Europe ended up with EMIR and APC measures and now the level of implementation of these measures needs to be assessed, as well as their effectiveness. There is also a broader global conversation about responsiveness to volatility, which is an inherent feature of CCP models, and which should be maintained. However, there will be a trade-off between the initial margin level going into a stress and how quickly initial margin needs to rise in a stress. There should be a global conversation on the costs and benefits of that, together with some level setting. Not all CCPs were created equal and there has to be consideration of how to have a global conversation that allows regulators, supervisors and international standard setters to think about what is appropriate.

The Central Bank official agreed with a previous speaker that operational resilience is another important topic in this context. The Bank of England published a new policy on this in the last year to complement the EMIR requirements. The financial resilience aspects talked about with margin are important, but it is important to ensure that operational resilience keeps pace.

4.2 CCP recovery and resolution (R&R)

An industry representative noted regarding CCP R&R that the EU has taken a leading role globally in pursuing a regime that balances the needs of the different stakeholders. However, the fact that the second skin in the game that is embedded in the system may be financed by existing CCP capital means that it will not shift the loss-absorbing responsibility away from clearing members. There should not be any compromise on the incentive structures of the CCP. The level playing field dimension is also important here.

The international standard-setting bodies should continue their work in the R&R space, and the EU should actively participate in this discussion in order to put forward a balanced approach.

An industry representative stressed the importance of the publication of the proposed regulatory technical standard (RTS) on CCP R&R. The introduction of a second skin in the game in the form of a second tranche of direct CCP capital is welcome, although this will not be used before assets of non-defaulting clearing members have been used by the CCP. One important point are the calculation amendments of the second tranche of the skin in the game. This is still to be defined and the consultation is still open. While the range for setting this skin in the game is floored at 10% and capped at 25%, it is necessary that the set parameters should be well determined. Their institution, a major clearing member, favours a high percentage.

POST-TRADING: PROGRESS MADE AND PRIORITIES FOR SUPPORTING THE CMU

1. Progress made in the post-trading area in terms of efficiency and integration

1.1 State of play and main achievements

A Central Bank official stated that 'the glass is neither completely full nor completely empty' with regard to post trading. Much progress has been made with the Central Securities Depositories Regulation (CSDR) and TARGET2 Securities (T2S). 10 years ago, it would have seemed unbelievable that 10 of the 15 original Giovannini barriers would be solved with a settlement efficiency of 94%, including overnight settlement. However, post trading is similar to 'a jigsaw'. There are many pieces to assemble to achieve sufficient harmonisation and integration and it will be challenging to put together the remaining 20 or 25 pieces. In addition, there is still a low level of cross border settlement in the EU. Only 1 3% of T2S transactions are cross CSD, although certain CSDs provide cross border services which are not included within this statistic.

A second Central Bank official agreed that both T2S and CSDR have contributed substantially to integrating securities settlement across Europe. T2S harmonisation was promoted by the Eurosystem, but the fact that it was embraced by the market has made the difference. A considerable amount has been achieved since its launch, particularly in the areas of messaging, operating hours and settlement finality. There has also been progress on corporate actions, even if the issue is not entirely solved. Prior to the implementation of T2S, market practice varied widely across Europe. The obstacles to achieving integration and the smooth functioning of financial markets were well known, having been identified by the Giovannini group and several reports by the European Commission, but little progress had been made. The fact that the drive for harmonisation was channelled into a single securities platform and a concrete settlement solution with T2S, has enabled the realisation of tangible benefits for all actors in the market. In other words, T2S provided a concrete action plan to address the harmonisation challenges in the market and to advance integration.

A third Central Bank official concurred that there have been achievements both in terms of the harmonisation of rules and operational integration with T2S and CSDR, which are complementary and mutually reinforcing initiatives. There have been several key achievements in relation to harmonisation. First, the common authorisation process means that CSDs are subject to a single set of safeguards at EU level. Furthermore, CSDR introduced a framework for increased cooperation between the authorities concerned. Each authorisation process is managed by a national competent authority (NCA) with the close involvement of other relevant authorities, including the central bank of issue (CBI). This introduces a horizontal perspective on the common points of attention in the process which has fostered more convergence among the authorities. Secondly, T2S has been a key driver of regulatory harmonisation because it supported the introduction of a single regulatory framework at EU level, the CSDR, which replaced national settlement regimes. The progress made is attested by the performance of post trading during the COVID crisis and demonstrates that Europe is moving in the right direction in this area.

An industry speaker agreed with the remarks made by the previous panellists on achievements in the post-trading space and emphasised the resilience and seamless performance demonstrated by Central Securities Depositories (CSDs) during the pandemic. While there are still obstacles to cross-border settlement, a considerable degree of resilience has been built into the system. However, there are differences between equity and fixed income markets. For fixed income, there has been more and easier integration than for equity. In respect of bonds, the European Commission has started Next Generation EU (NGEU) issuance. €45 billion was issued seamlessly and there were no problems raising the money, indicating that the settlement system is working correctly.

Another industry representative also highlighted the differences between the wholesale and retail markets in terms of cross-border integration within the EU. In the wholesale market, there has been substantial progress in terms of cross border trade. A key example is the repo market. During the COVID crisis, there was a large amount of cross border activity and the migration of the euro repo market from LCH Ltd to LCH SA is also positive. However, in the retail market there has been practically no improvement, with no cross border activity happening within the EU. The only significant cross-border trading at present happens with the US. This is due in part to the excessive cost of cross border post trade within Europe, which is a major inefficiency. Improving the situation does not seem to be part of the objectives of European regulators, although a focus has been put in the Capital Markets Union (CMU) action plan on the growth of retail investment. The EU has a very efficient market infrastructure, but it is mainly functioning on a domestic basis at present. Hopefully, the ongoing consolidation of European stock exchanges around Euronext will contribute to a further integration of post trading.

1.2 Pending issues and obstacles to integration

A Central Bank official agreed with previous speakers that, despite significant efforts and initiatives from all stakeholders in terms of regulation, supervision and operations, the level of cross border settlements remains quite low in Europe. This means that there are further improvements to make on the harmonisation of settlement services and rules, and that significant barriers remain to be tackled. A second Central Bank official was not pessimistic. Only around 10% of the T2S harmonisation agenda remains to be fulfilled, which means that work remains to be done, but these are very complex issues which will take time to address, and have been slowed down by COVID. Progress is being made in different areas. One is currencies. The Danish krone has been integrated into T2S alongside the euro, and other currencies will potentially also soon be available. The further integration of CSDs is a second area where progress is underway. There is some integration of CSDs at the EU level, the interaction between international CSDs (ICSDs) and CSDs settling in T2S is likely to improve and the Finnish market will also soon join T2S. However, futureproofing should be a key consideration in the post-trading area, because it is important to determine regularly whether the right priorities are being pursued. It could take more than five years to address insolvency law fragmentation, for example, which is heavily rooted in national laws.

A third Central Bank official acknowledged that harmonisation is not an 'easy effort'. The T2S harmonisation process started many years ago and is still not finished. The European Central Bank (ECB) published its 11th progress report in January, which recorded 90% compliance with the T2S harmonisation standards, meaning that 10% is still outstanding, as mentioned by a previous speaker. However, the degree of progress has slowed down over the last few years, which is natural because the outstanding elements are necessarily the 'stickiest issues'. There remains work to do on corporate actions in particular, but much has already been achieved.

An industry speaker was less optimistic, however. Using the metaphor of the glass of water, the glass is 'slightly half empty' in the speaker's view due to the amount of work still outstanding, especially in respect of the continuing fiscal and legal barriers. From an external perspective, there are still 27 different markets in Europe and it is essential that work continues on further integrating post-trading in the EU. The discussion started with the work of the Giovannini Group in 1996 and their report in 2001. Some of the Giovanni barriers are still relevant today, such as barrier 3 on corporate actions and barrier 11 on domestic withholding tax regulations. CMU could provide the political momentum needed to tackle these issues, because the CMU will not exist if there are 27 different approaches to insolvency law or processing withholding tax, which disadvantages foreign intermediaries in particular. The CMU action plan, which introduces tangible actions, such as action 10 on withholding tax or action 12 on shareholder rights is an opportunity to overcome some of the key legal and fiscal barriers which hinder cross-border capital markets in the EU. It is essential to push the agenda forward here and pass the necessary legislation. The progress made over the last 20 years in the trading space, in areas such as trade execution and execution modes, thanks to MiFID I and MiFID II proves that this should be feasible.

A second industry speaker noted that the post trade space has been discussing 'barriers' for the last 20 years, but this is too strong a word for what remains to be done, which is closer to tackling frictions or inefficiencies. This constant reference to barriers tends to discredit the progress that has been made over the years, which is significant. There are inefficiencies which create extra costs, but it is still possible to conduct post-trading activities on a cross-border basis. Withholding tax procedures is a topic that has been discussed for a very long time. Hopefully digitalisation can help to solve this issue, making the process more efficient even without broad harmonisation, if national tax authorities progressively digitalise their processes. Additionally, it is surprising that securities law harmonisation does not feature in the CMU action plan as it is a major element of friction at the cross-border level.

A third industry representative noted that there is no harmonisation of insolvency law and of the legal status of bonds and shares in the wholesale market. In the retail market, there is also no fiscal harmonisation and there are some specificities in different markets that create fragmentation. France, for example, has the Service de Règlement Différé (SRD), which is part of a Euronext specificity called the Règlement Mensuel. The SRD allows clients to purchase shares on credit and pay at the end of the month, which is very efficient. This is only one of many specificities demonstrating the fragmentation that exists in post trade. The fact that such barriers have been discussed for many years possibly indicates that achieving full harmonisation in these areas may be 'wishful thinking', however it is essential to address the retail cross-border market as a priority in any future post-trading initiatives in order to increase retail participation in capital markets.

2. Ongoing policy initiatives and additional actions needed

2.1 Ongoing Eurosystem initiatives

A Central Bank official emphasized that a substantial amount of work has been achieved around TARGET Services[1], even if some pending issues remain. The ECB is continuing its efforts in this area, working on a consolidation of TARGET Services and the introduction of a new Eurosystem Collateral Management System (ECMS), which will facilitate even more efficient, harmonised and widespread use of central bank money settlement in euros. TARGET Services consolidation, which is scheduled for November 2022, will bring an enhanced set of tools, a consolidated view of balances and holdings for market participants and higher overall efficiency in euro liquidity management across wholesale services on the TARGET side, as well as securities settlement in T2S and instant payments. Like T2S, ECMS will advance harmonisation, making collateral management more efficient for counterparties who participate in ECB

1. TARGET Services are a set of services developed and operated by the Eurosystem which ensure the free flow of cash, securities and collateral across Europe. These financial market infrastructure services include: TARGET2 for settling payments; T2S for settling securities; TIPS, which is a service for instant payments; and ECMS, which is a service for collateral management. All of the services settle in central bank money. The Eurosystem also engages in a number of initiatives which aim to promote efficiency and innovation and ultimately achieve greater integration in financial markets in Europe. In line with this strategy, the Eurosystem is investigating ways to enhance its financial market infrastructure to continue to meet the needs of the market, to stay ahead of cybersecurity challenges and to keep up with the latest technological developments.

credit operations. Debt issuance and distribution is a further important topic for the ECB. The ECB established a Debt Issuance Market Contact Group (DIMCG) last year, which is working on identifying issues, finding ways to improve efficiency in primary markets for debt instruments and seeking to achieve a better integration between pre issuance and post trade services. The DIMCG will conclude its work by the end of 2021 and it will then be taken forward by the ECB.

Another Central Bank official described the current level of fragmentation of the post-trading market with 27 markets, 37 CSDs, eight third party agents and over 200 custodians. This means it is essential to be realistic about the improvement objectives. ECMS is designed mainly for the Eurosystem, but it will have far reaching effects beyond the Eurosystem. ECMS will not only allow the consolidation of 19 back office applications into one, it is also an opportunity for market participants such as large banking groups to have access to several central banks in a central place, which will foster harmonisation. However, to further enhance harmonisation, more than regulation is needed because a number of the remaining T2S barriers that need addressing are outside the remit of central banks, in particular those that relate to corporate actions and withholding tax. T2S and ECMS are a demonstration that public involvement is beneficial in this area, but there is also a need to involve market players at an early stage because ultimately the new standards will be implemented by the market, which means that their commitment is needed as well as a monitoring of the progress. Triparty services is a further area where greater harmonisation could have a substantial impact. For the time being, there is a focus on corporate actions, collateral and the billing process in the efforts being made to harmonise triparty services, but there are other areas to address, such as taxation and margin calls. This is more applicable to the wholesale market than the retail market, however.

An industry representative highlighted the importance of creating a euro benchmark to compete against other existing benchmarks. With the Commission issuing a substantial amount of debt, there is a need to make progress on insolvency law, which is different across EU countries. The European Distribution of Debt Instruments (EDDI) initiative could be a solution in this regard.

2.2 The ongoing CSDR review

An industry speaker explained that the forthcoming CSDR review, which will be a refit, will aim at correcting the main elements that are causing friction, rather than attempting a major policy overhaul. The requirement for CSDs to obtain a passport in order to provide services to foreign issuers should be amended for example, because it is lengthy and to some extent unnecessary process. Additionally, after having a licence for a year, there is a requirement for CSDs to complete a quasi new application to demonstrate continuing compliance with CSDR. This is too cumbersome and should be revised to a more proportionate level. The problems have been identified and it seems likely that these issues will be addressed in the CSDR review.

Another important area of focus is the long-debated settlement discipline regime, the industry speaker added. At present, the implementation date for the settlement discipline regime is February 2022, which is only 6 months away. Much has been said about the negative effects of the mandatory buy in regime, and CSDs are quite worried about it. There is a market impact, but there are also level playing field issues for CSDs, because non EU CSDs are not subject to such a buy in regime. There has been some political agreement on the need to address this. The buy in regime could become voluntary rather than mandatory, but this would create a timing problem as a result of the February 2022 implementation date. This date should be changed, and many players in the market have been calling for quick feedback from the Commission on this point for several months. The possibility of a delay must be enacted in law, but this would also raise doubts as to whether the entire settlement discipline regime will be delayed. There is no need for delaying all settlement penalties, the speaker believed. These should be implemented, but the buy in regime should be put in place later and in a different form. Ultimately, this will require changes at Level 1 also, where these rules are defined.

An industry representative agreed on the need to solve the timing issues regarding the implementation date for the buy-in regime. The public authorities and the private sector are working very hard on this issue. A solution should eventually be possible, but this is a tricky subject.

Another industry speaker stated that there are some other areas that require further thought in the context of the CSDR review. First, there is currently no depositary passport across the 27 EU member states. At present, offering depositary services entails acquiring a licence in every member state, which seems incompatible with the objectives of the CMU. Secondly, there is a risk of moving backwards in terms of integration if legislative initiatives in contradiction to CMU are introduced in CSDR. This is true of the mandatory buy in regime in particular, which is in total contradiction with the goal of building integrated, deep and liquid European capital markets. The mandatory buy in regime will drive even more players out of the European markets, which cannot be the intention.

A Central Bank official agreed with the need for clarity on the settlement discipline regime and possibly for reconsidering the requirements. Another Central Bank official emphasized that the review of CSDR is important, because it addresses areas that are relevant for the CMU. In this respect, passporting is a key element. There are at present some complexities in the requirements concerning the assessment of member states' national laws, which will be considered in the context of the CSDR review. Another important area within the scope of the review is the provision of banking services. The CSDR has introduced a strict set of requirements to limit settlement risk in commercial bank money. However, the market did not develop services in this area. A review is needed here but it should not endanger the final purpose of the rules, which is to limit settlement risk when commercial bank money is used. Finally settlement discipline, which has emerged as a somewhat controversial point, is a complex set of rules, in part due to the large number of actors involved and the actions needed to implement it. The result of the public consultation points to a lack of clarity and to some disproportionality between the rules and the objectives. The review should provide the opportunity to tackle these two issues.

2.3 The implications of digitalisation and digital assets in post trade

An industry speaker emphasised the need to take digitalisation into account, as it is now a reality in post trading and has the potential to transform the sector. This means that EU legislation such as CSDR and SFD must be adapted to the digital world. There is however sometimes a naïve belief that digitalisation will remove the barriers that post trade is facing in the EU, but digitalisation will necessarily integrate the existing fragmentation of rules, such as withholding tax, for example. The need for enhancing harmonisation will therefore not stop in the digital world. A Central Bank official suggested that the DLT pilot regime will enable supervisors and relevant stakeholders to understand better how innovation and technology can impact CSDs in particular and whether rules need to be adjusted or completed.

A second industry speaker also highlighted the risk of fragmentation in the crypto space, as European national markets are currently designing different laws on digital assets. This is reproducing the same error as in the post trade space, potentially creating new barriers, and should be avoided. Other industry speakers on the panel concurred that Europe is repeating the same mistakes in the digital space, which will create problems in the future. A Central Bank official agreed that avoiding fragmentation in the developing cryptoasset space in particular should be a priority.

2.4 Supervisory convergence

An industry representative raised the question of the possible evolution towards a common supervision of CSDs in the EU. CSDR is a major step forward, but this identical law should be applied in the same way everywhere in order to enhance harmonisation, which requires supervisory convergence and possibly a common supervision of CSDs. One example is around payment for order flow for which, on the retail side, Germany is more flexible than France. Another industry speaker suggested that the question around whether CSD supervision should become more unified at EU level is mainly a political debate.

A Central Bank official explained that the supervision of CSDs is a topic that has been discussed at the ESCB (European System of Central Banks) with Eurozone central banks in the context of the CSDR review. The ECB feels that while a more consistent application of CSDR rules is needed notably to ensure a level playing field, there are other ways to achieve this objective than moving towards a single supervision of CSDs. Supervisory convergence and cooperation could be further enhanced. There are many tools available to facilitate supervisory convergence, such as Q&As and voluntary colleges, which have not yet seen much use. The current arrangements, including the CSDR toolbox for achieving supervisory convergence, should also be further taken advantage of with a more proactive identification of interpretation issues and a timelier tackling of divergent supervisory practices. Cooperation between authorities could also be enhanced, including with the ECB as central bank of issue and other authorities with legitimate interests in non domestic CSDs. More intensive dialogue supported by assessments and input can help to achieve a clear understanding of most issues in the post-trading space. While central banks have been very much involved in the authorisation, review and evaluation processes, they must now play a more meaningful role. The contribution of central banks to the supervisory process should have a more binding character. Hopefully, this will be achieved in the revisions that arise from the CSDR refit process.

SECURITISATION: CALIBRATION ISSUES AND FUTURE STEPS

1. After the many legislative and regulatory initiatives in relation to the regulatory framework for securitisation in the European Union, a new impetus is expected in the coming months from the Commission

A regulator noted that many of the risks that were noted before 2006 and 2007 materialised. Efforts have been made in recent years to resurrect the market, which have been successful, so the market is now at a crossroads.

A regulator noted that a new regime has been applicable since 2019. Two legislative changes were adopted in April 2021, one on Simple, Transparent and Standardised (STS) for synthetic securitisations, and one on securitisations for non-performing loans (NPLs). A European Banking Authority (EBA) paper on significant risk transfer was issued in November 2020. The Commission recently launched a 69-question questionnaire. A report to the Council and Parliament is scheduled for the beginning of 2022, with a potential legislative proposal following this. There is a call for advice to the joint committee of the three ESAs. However, market participants are somewhat gloomy or disappointed.

2. Securitisation market participants express a deep disappointment about the number of operations and their size

A regulator noted that disappointment is often expressed when securitisation is discussed, because perhaps the number of operations and the size of operations are not where they were expected to be. However, a lot of progress has been made and the situation may have been worse without these measures.

A regulator noted that there was a significant drop in the issuance of securitisation after the current financial crisis, and an even worse drop after 2011/2012. There was a pickup in issuance in the years 2013 to 2017/2018, but this dropped again and reverted to the mean in 2019 and 2020.

An industry representative stated that a commentary published by the European Stability Mechanism (ESM) indicated that the European securitisation market was 75% of the US securitisation market in 2008, while in 2020, it was only 6%. The new placed issuance in Europe in 2020 was about a ninth of what it was in 2008. For the industry representative's organisation, what goes to investors is what matters when considering the market size: at present, about half of the total issuance tends to go to the investor, with the other half retained by the originator to use in operations with the central bank. STS is a great initiative that has removed some of the stigma. However, there were only around 400 issuers in the last two and a half to three years, of which only a quarter issued STS, and of that only about a seventh or an eighth were first time issuers. And many of the issuers retained the securitisation themselves. In 2010 the European insurers held about 10% of securitisation as part of their assets under management; this number is down to 3% in 2020. This is not surprising, given the complex regulatory framework and the collapse of issuance.

An industry representative stated that the private market has declined as well, especially due to capital constraints and COVID. There is an artificial inflation of STS notifications in asset-backed commercial paper (ABCP) because ABCP have to notify for each part of the transaction. If this is corrected for, instead of 172 notifications for ABCP last year, there were 69 private transactions, versus 86 public deals. The private market is well below the public market and has reduced. Practitioners must decline many good transactions, which have very little risk, because the capital formulas are too harsh.

2.1 The STS regime intended to remove the securitisation stigma has proved to be workable

A regulator stated that the new STS concept represented 30% of the market in its first year and 40% at the end of 2020, which is impressive. The joint committee and the EBA have been reviewing its operation. Most challenges faced by the industry are due to limitations that were either intentionally prescribed by the regulation or could be solved when providing further guidance to interpret the STS criteria. The STS helps to reduce the stigma of securitisation amongst investors. Issuance is picking up and continued to do so even in COVID times, which may indicate resilience. The STS criteria for ABCP appears to be functioning as expected. There is no crowding out of non-STS by STS currently.

2.2 The reasons for a limited success of the STS regime are manifold: a very recent framework, cost and complexity of the STS rules, harsh prudential treatment of securitisation, and cheap liquidity provided by the ECB to EU banks

A policymaker stated that securitisation is a key measure from the first Capital Markets Union (CMU) action plan and remains an important part of the tools needed to make CMU a success. The new framework has not so far reinvigorated the EU securitisation markets in the way the European Commission intended.

A regulator stated that the expected increase in the investor base for the entire EU securitisation market has not been seen. This is most likely related to the density and the complexity of the STS rules, the due diligence and transparency requirements, and the limited benefit in terms of pricing and prudential treatment. The STS level has not been used in practice for ABCP programmes. There is limited experience of supervision of securitisation. The EBA advocates for an extension of the STS level to synthetic securitisation. This has been agreed by the co-legislators. Significant response for recognition is still very difficult and the rules should be clarified. There are some regulatory constraints that could be removed for the securitisation of NPLs.

An industry representative stated that, although the authorities expected that the STS regulation and the cash reserve ratio (CRR) capital charges would result in a growth of the market, this was an illusion. The decline in the market should have been expected due to the increase in the capital charges. The public market has declined since January 2019 when the new rules came into force. The significant risk transfer (SRT) market is a key market for banks currently to reduce their risk-weighted assets (RWAs) and manage new capital burdens, but the new rules have discouraged and made it more difficult for banks to do SRTs. An SRT is also a key tool to reduce systemic risk, so discouraging this market increases systemic risk.

A policymaker commented that it is difficult to assess fully the impact of the new framework since it has only been in place for a little over two years, including the COVID period. The ECB is still providing a lot of liquidity, so there is a great deal of cheap funding available, which might lead to a reduced incentive to use securitisations.

2.3 The detrimental divergence between the regulatory framework for securitisation in the EU versus the regulatory framework for other comparable asset classes is not justified

An industry representative noted the discrepancy between the established regulatory framework for securitisation and the regulatory framework for other comparable asset classes. This is not justified by data. The impairment rate of European securitisation investment rate is close to zero. The European structured finance downgrade rate is smaller and lower than the downgrade of European covered bonds. The liquidity of European residential mortgage-backed securities (RMBS) is equivalent, and in some cases better, especially for auto asset-backed securities (ABS), than the liquidity of covered bonds. The large discrepancy in regulatory treatment of comparable exposures is one reason why investors and issuers are not coming back to the securitisation market.

2.4 The STS regime does not address the specificities of private-placed issuances where investors were already appropriately protected

An industry representative commented that the regulation has achieved its purpose in the public market. There were excesses in the public market in the past where investors were loading ABS on their balance sheet with little due diligence and relying on the rating agencies. This has been corrected by the regulation. However, the regulation is not fit for purpose in the private market. Full due diligence is carried out when clients in the private markets are financed through ABCP or through warehousing. Private market actors have access to all the data they need, can talk to the company, do their own credit analysis, do not rely on rating agencies and do their own stress testing. The regulation has not provided added protection but instead created new obstacles, such as harsher capital rules and reporting requirements.

3. To review the current framework, the Commission has launched a consultation on the whole spectrum of issues: size of the market, due diligence burden, jurisdictional scope and supervision, possible equivalence regime, contribution of the framework to financing sustainability transition and the post covid EU recovery (NPLs securitisations)

A policymaker indicated that the consultation considers whether the regulation is fit for purpose and if it has improved access to credit, widened the issuer space and revived the European securitisation market. Questions are also asked around due diligence, jurisdictional scope, supervisory issues and the third country dimension. The consultation also touches on disclosure, sustainability issues and environmental performance. There is also a mandate from the Capital Market Recovery Package to consider sustainable securitisation. In that context, the green bond framework that the Commission proposed a few weeks ago is also quite relevant.

A policymaker stated that publication of the report on the consultation is expected at the end of 2021 or the beginning of 2022. In parallel, input from the three ESAs, in particular on capital requirements, is being sought, through a call for advice. Whether legislative changes are needed will be considered subsequently. The previous legislative process around this issue in the Council and Parliament was lengthy and complicated, partly due to the legacy issues from the financial crisis, connected with securitisation. Opening the framework could be a complex process. She confirmed that a holistic approach and level playing field issues should be borne in mind when considering the treatment of different financial products.

3.1 Related capital requirements will also be reconsidered and a call for advice is being issued to the joint committee of the European Supervisory Authorities (ESAs)

A policymaker noted that the capital requirements were a focus area when the current framework was being discussed and negotiated. There is often a focus on banks, but insurance companies are also important players in this area. Capital requirements of securitisation is not at the centre of the Solvency II review. However, if the capital requirements in the banking sector were to be reviewed in the future, the insurance sector should also be considered. In this context, we need to be mindful of the Basel framework. In future, there may be a reason to deviate on this issue, but the justification would need to be carefully considered. In any event, no decision had yet been taken on this matter.

3.2 Making capital charges on insurance companies, liquidity treatment and due diligence obligations proportionate is essential to bring back EU investors to the market

An industry representative stated that the investor base has not expanded. In comparable markets around the world, insurance companies are key participants. Participation of insurance companies is very limited in Europe, partly due to the capital requirements, so a first aspect to consider could be Solvency II recalibration. In many cases, investors' money allocated to securitisation is being managed by asset managers indirectly, because meeting all the due diligence requirements by direct investors is very complex. It is often not proportionate to the risk involved. The liquidity treatment (lack of comparability) is another concern. There should be a decisive levelling of the regulatory playing field for comparable instruments in Europe. It takes around 60 minutes to place a covered bond and several weeks to place a securitisation bond. If a level playing field is not achieved in all aspects of the issuance and investment process, transparency and due diligence of placements, there will be no meaningful development of the securitisation market in Europe.

An industry representative commented that, if the European securitisation market does not grow, the only way an investor can build a securitisation portfolio is through the broader global markets.

An industry representative stated that the current template requirements on disclosure requirements for private transactions do not work from a cost-benefit perspective. It was initially expected that the templates would only apply to public transactions, because more standardisation is needed for public trade and transferable securities. The European Securities and Markets Authority (ESMA) consulted on that basis, but made a different proposal after that consultation closed, with private transactions also in scope. The templates have now been in use for around a year and most originators agree that they are not appropriate for private transactions. They require a lot of data to be collated, which is expensive and time consuming. For certain asset classes, the granularity and precision of the data can be a breach of confidentiality obligations.

An industry representative stated that in his experience investors do not want or need this additional data. The industry representative's organisation has been producing the templates for around nine months, but only one out of around 50 investors has actually asked to see the templates. The requirements could be slightly relaxed for private transactions, maybe with a comply or explain approach in the templates. Carving private transactions out of the disclosure requirements entirely is the preferred solution. At the same time, it should be clarified that private securitisations are trades that are not publicly offered or publicly distributed.

An industry representative commented that it is difficult to understand why there is such a big difference between securitisation and corporates regulatory treatment under Solvency II, when in the US the respective regulatory capital was realigned. However, the US regulation (NAIC) for insurers was not risk sensitive enough. The new NAIC proposal, which is now being finalised and is going to be implemented soon, makes US securitisation solvency treatment much more risk sensitive, the cliffs are not there and that is very positive.

3.3 To calibrate the capital charges stemming from agency risk appropriately, one should leverage the STS rules and retention obligation added value, and factor in the regulated private markets' specificity

An industry representative stated that capital calibration is very harsh and has been designed in the wake of the financial crisis to address issues such as agency risk. An awareness of the different segments in the market is needed when recalibrating the capital charges. The most extreme example is the SRT market, or a market where the banks are retaining senior tranches of their own assets. In these cases, there is zero agency risk. The banks have full information, so there is no need to have a capital surcharge for SRT transactions and for transactions where the originator senior tranches of its own assets. The public market is at the other extreme, where the risk of agency has been significantly reduced with the new regulation. Retention has greatly improved the alignment of interest between the originators and investors. There may be some scope to reduce the capital charge, but it should be limited in the public market.

An industry representative noted that another segment is the private market whereby banks fund their clients through ABCP and warehousing. Banks involved in this market have more information on the assets than investors in the public markets, because they have direct access to the company and a better understanding of the structure. Indeed, they arrange a structure that is adapted to their risk appetite. The banks design reporting consistent with the way the transaction is structured, so do not need the ESMA templates.

3.4 The actual risk suggests a relaxation of the P-factor and securitisation related bank liquidity rules

An industry representative commented that the p-factor needs to be reduced materially by at least 50% from current non-STS and STS levels with even higher reductions required for SRT transactions. With the implementation of the new Basel rules and the output floor, there could be a significant stop on SRT transactions if these changes are not implemented. Consideration of how to improve demand in the public market is necessary. The liquidity capital ratio (LCR) is extremely restrictive and could be revised. In the private funding market, the credit conversion factor, which is 100% for committed undrawn lines, could be revisited. This is completely unjustified, because for corporates, the CCF is 55%. There are more conditions to draw on a securitisation facility than on a corporate facility. The EBA paper on tranche maturity guidelines was very helpful for the market, but it only addresses public deals and should also cover private deals.

A regulator stated that there has possibly been a collective overshoot in relation to due diligence and the granularity of the data. Feedback from the private sector is useful and evidence on calibration will need to be carefully reviewed, although the STS market segment has only been operational for two years.

3.5 Dramatic reductions of SRT related SSM approval timelines and their test assumptions should also be envisaged.

An industry representative commented that the SRT process is a key issue for banks that need to manage their capital. Despite improvements, there is still a disconnect between these transactions, which have a commercial timeline, and the deadlines requested by the ECB. The EBA paper on SRT has introduced welcome clarity but could stop the market. Some aspects in the proposal are welcomed but some will not work. The market test to show that the transaction has been priced correctly by the market requiring selling 25% of the senior tranche, compared to the ECB requesting 70% now, is a welcome development. However, some of the tests in this paper, such as the CRT test, have some unrealistic assumptions that the unexpected loss only occurs in the last year.

3.6 Deeply negative impacts of the Basel III output floor on SRT are anticipated and clarifications are urgently needed

An industry representative commented that there is uncertainty around Basel IV output floors and how they will apply to securitisation positions. It is difficult to plan a securitisation now that has a five-year legal life because there is uncertainty about what the capital rules are going to look like in four years' time. The main concern is how output floors are going to apply to synthetic risk transfer trades on advanced portfolios[1]. Under the output floor proposals, capital requirements for a retained securitisation tranche on an advanced basis will be floored at 72.5% (in the end state) of the RWAs calculated for that same tranche under a standardised approach. If a base case of needing to use the SEC-SA approach (standardised approach) is taken, the result is likely at least a factor of three times more capital requirement than required now. If STS cannot be achieved, the requirement is likely to be significantly higher than that. That will mean that a lot of transactions that are in the market now will simply not work.

An industry representative stated that many SRT securitisations are carefully structured to be optimised under an advanced model approach. A standardised approach will always lead to a very high RWA requirement, because the first loss tranche or the sole protection tranche will not be thick enough. It is probably an area where the capital floor does not work very well. One approach to mitigating some of the negative impact may be SEC-ERBA, the external ratings based approach, being available as a different standardised approach. That is counter to the express policy requirement to rely less on external ratings but should be considered. Industry policymakers are encouraged to decide precisely how securitisation will be treated under these capital floors as soon as possible.

3.7 On SRT, beside the legislative process initiated, the EBA could make significant progress in the short term. Regular work between issuing banks and their supervisor should create mutual trust and reduce securitisation cost

A regulator commented that it is comforting that there is agreement that the framework needs to be improved as soon as possible. The openness of the consultation indicates that there is also willingness in the public sector to review the framework. To some extent, good progress is being made. A great deal of progress could take place around SRT in the short term. An even slightly stronger mandate for the EBA to advance the issue would be of benefit. Several things can be done to harmonise SRT and make it work a bit more quickly. Ex ante discussions about those structures are needed between the banks and their supervisors.

A policymaker commented that the interactive process of considering the current framework is positive. However, the energy and effort spent on improvements should not take all the attention away from trying to make the current framework work as well as possible in the current situation.

A regulator added that it is important for banks to understand that they also benefit. Although the excess spread, they will be able to read from a specific transaction may not be exactly the one they would like to benefit from, in the medium to long run repeated use of the same structure and supervisors being more comfortable with that will improve the velocity of the asset.

1. The advanced measurement approach (AMA) In the Basel Framework allows a bank to calculate its regulatory capital charge using internal models, based on internal risk variables and profiles

SESSION SUMMARIES

V

DIGITALISATION AND PAYMENTS

DIGITAL TRANSFORMATION IN THE FINANCIAL SECTOR AND POLICY IMPLICATIONS

1. Digitalisation trends, drivers and opportunities

1.1 Main trends and drivers of digitalisation in the financial sector

An industry representative stated that digitalisation and technology have been a crucial part of the financial services industry for decades, but some new developments need to be considered. In addition to financial customer data, there is now the possibility and the need to make use of data across industries in order to develop innovative financial service offerings. Today, partnerships are a prerequisite for innovation. For example partnering with cloud service providers (CSPs) on infrastructure and platform allows financial institutions to develop more scalable, robust and stable service offerings for customers.

Another industry representative stated that customer needs and expectations are a major driver of innovation in the financial sector. A recent McKinsey report suggests that banks are being disrupted more by their customers' expectations, than by fintech. Online banking has been widely used for a number of years but a new approach, with new services and capabilities is needed at present to move at the speed that customers are expecting in terms of digitalisation. All major financial institutions have large legacy systems with which it is difficult for them to achieve a proper level of operational resilience and to effectively protect against cyber-risks. Moving to the cloud allows them to respond more effectively to the expectations of their customers, while offering enhanced security, risk management, scalability, availability and resilience. The cloud also enables progressive scaling up to address novel requirements without needing to predict the full extent of future developments. The ability to build out dev-test environments moreover facilitates the creation of new business models, which allows a faster response to customer requirements. Working with financial institutions so that they can achieve their business goals is a key focus of the speaker's firm, a major CSP, however the regulatory environment can be an obstacle in certain cases. The industry representative finally noted that COVID has accelerated the movement to cloud services and that financial institutions that had been using cloud services for some time were able to adapt more easily to the changing remote working environment due to COVID and could more easily scale up their online activities.

A policymaker agreed that although an adjustment in business models would likely have happened anyway, the pandemic played a role in accelerating transformations both on the demand and supply sides.

A third industry representative concurred with previous speakers that developments in digitalisation and awareness about the importance of data in finance are not new, but they are accelerating. Technology and finance are converging and the scale of technology use is increasing in line with increased demand.

An official agreed that the digitalisation of the financial sector is driven by demand and supply factors such as customer requirements, particularly those of digital-native consumers, competition from newcomers such as fintechs or big techs going into new fields of business and the efficiency gains that the technology enables.

A fourth industry representative stated that evolving needs of clients are inevitably driving improvements in financial products and services, the benefits of which can be seen across the financial sector with the progressive integration of new technologies such as blockchain and artificial intelligence (AI). The pace and embrace of digitalisation however differs greatly across jurisdictions. According to a recent study by the Cambridge University Centre for Alternative Finance, the World Bank and the World Economic Forum, growth in the EU's broad fintech and digital-finance sector is lagging significantly behind the US and China, alongside digital payments, lending and capital raising sector growth. EU policymakers should prioritise reversing this trend by cultivating and supporting a proportionate regulatory and supervisory ecosystem that may allow financial firms to make the most of digitalisation.

1.2 Opportunities associated with further digitalisation

An industry representative outlined examples of new opportunities offered by the use of technology and data analytics in the financial sector. At a moment when manufacturing industries are starting to transform their business models offering products such as machinery or cars as a service, it is essential that financial services institutions are able to incorporate their services into these new business models. Instead of selling a product once, there is a permanent cash stream around which financial services can be proposed, as customers pay whenever they use the product. This also reduces balance sheet size and capital outlays for customers and avoids incurring depreciation expense. Customer data can also provide vital information if appropriately processed. In March/April 2020, a great deal of companies were seeking liquidity and additional credit lines. Three or four months later, many treasurers realised liquidity needs were lower than originally thought. State-of-the-art AI, machine learning and data analytics would have provided these customers with more precise insights for adjusting their liquidity needs. A further area where technology can support innovation in the financial sector is central bank digital currencies. These should allow the achievement of efficiency gains particularly in peer-to-peer payments in the inter-banking-payment area, as these cross-border payments could be massively accelerated, reducing inefficiencies and improving the cost-income ratio of financial institutions.

A second industry representative considered that new digital currencies will need to be assimilated into the current financial infrastructure and use cases. It is not yet clear how current protocols will need to be adapted to leverage these new technologies, but progress is needed in that area, in part because the existing financial system is relatively fragmented. Digitalisation offers many new opportunities in terms of efficiency and synergy gains within the EU and more internationally that need to be taken advantage of. A policymaker emphasised the previous point on fragmentation. Digitalisation can help to reduce fragmentation in the financial single market and globally with the progressive emergence of an ecosystem leveraging the capabilities of financial institutions and fintechs.

A third industry representative commented that digitalisation provides 'a myriad of opportunities' in the asset management value chain in particular. There are two clear priorities for the sector: open finance, which is the extension of open banking principles to a broader range of financial products and services, and the tokenisation of assets, including investment funds, enabled by distributed-ledger technology (DLT). Open finance can give European consumers more control over a wider range of their financial data, provide consumers with an aggregate view of all their financial information, liabilities as well as assets, in a consolidated manner, and significantly improve the financial planning and investment opportunities of customers, particularly those who are underserved and underinvested. As for tokenisation, it can improve client onboarding, particularly through the use of digital IDs or security profiles, and reduce costs and frictions associated with client servicing such as subscriptions and redemptions.

The industry representative added that open finance and tokenisation taken together could help to make a step change in terms of financial planning and investment and contribute to unlock historic levels of uninvested cash in the European market to the profit of the European economy. The European Central Bank (ECB) estimates that euro-area citizens have accumulated an additional €540 billion of excess savings over the course of the pandemic while investment rates remain at a record low level. With the EU's post-recovery plan still to be funded, the EU must find ways to make investing easier, safer, cheaper and more efficient and digitalisation and the digital finance strategy have a key role to play in this regard.

2. Main regulatory challenges associated with digitalisation in the financial sector

An official explained that different regulatory issues need to be tackled for accelerating digitalisation. The increased pace and scale of digitalisation require more flexibility and speed on the regulatory side, as well as new competencies. It is important indeed that the regulatory side is able to fully understand and anticipate technological developments that may affect the financial sector, in order to avoid lagging behind evolutions in the business. However it is difficult for regulators to rival with the private sector for the hiring of the proper profiles.

The Commission should also be in a leading position in terms of policy-making in this area, because digitalisation provides opportunities to move towards a more unified financial market. For example fundamental reforms in areas such as e-identity, are needed.

A public representative noted that, at the beginning of the pandemic, the use of digital financial applications increased by more than 70% in Europe in only 10 days. This can be alarming from an customer protection perspective, because it shows that the market tends to move very fast and that regulators might be outpaced by such evolutions. Many digital developments in the financial sector however also have positive implications in terms of customer protection. Outsourcing to cloud service providers (CSPs) for example provides more efficiency for the financial industry and also allows better protection from cyber or operational risks. Blockchain technology is a second example. Often associated with cryptocurrency, it can also play a key role in the improvement of KYC solutions or real-time payment processing.

The public representative also emphasised customer protection issues associated with digitalisation that also need considering. The use of AI for financial services can boost innovation but it is important that its social and ethical aspects are well understood by regulators, which requires a constant monitoring of transactions using AI and of customer behaviours. Finding the right balance between fostering innovation and not invading the personal data of every customer is also currently an active topic in the European Parliament. AI might also lead to changes in the labour market. A further source of innovation that needs to be considered from a customer perspective is the digital euro project that the ECB has launched in July 2021 for a trial period. Regulators can attempt to act quickly to address these different changes, but this requires a great deal of monitoring. A key aim in this perspective is the creation of futureproof legislation. The Digital Operational Resilience Act (DORA) is a good example of this, where Europe is in a leading position. Europe is good at exporting standards and norms and it is hoped that this will also be possible in the data and operational resilience space.

An official added that there is a need for financial regulators to master the new risks created by increasing digitalisation concerning data privacy, data protection and data uses, as well as increasing cybersecurity threats in this context because there is no effective market response to these increasing risks. Although cyber insurance can help, it is first essential to diminish risks and the consequences of potential cyber-attacks. DORA is an important step forward in this perspective and it is hoped that a general agreement can be achieved on this legislative proposal by year end.

3. Regulatory priorities associated with digitalisation

3.1 Ensuring consumer protection and risk mitigation

An official considered that the main role of regulators is to identify the actions required to ensure financial stability and consumer protection, without trying to master all the aspects of technologies, because that is out of reach for them. Legislative processes should also be reconsidered in the light of increasing digitalisation because they are too lengthy at present. By the time Level 1 discussions are completed, which may take 2 years or more, underlying technologies or their use might have evolved. More flexibility should therefore be introduced in the regulatory process particularly when the changes needed are limited, for example through no action letters being given to the Commission or European supervisors.

A public representative stated that the main focus of the European Parliament in the area of digitalisation is to ensure that consumers' interests are taken into account and to guarantee consumer protection. Two key aspects of digital transformation are being considered in this perspective in terms of regulation: cybersecurity and digital identities. Concerning cybersecurity, there is active work underway on DORA in the Parliament to ensure that all actors operating in the financial sector are covered by the legislation, taking into account the increasing trend of services outsourcing. The fact that DORA notably includes an oversight framework for some critical ICT providers, including major CSPs is essential from a customer protection perspective. The Network and Information Security (NIS) directive, the European cybersecurity directive, is also being updated, with new sectors being added. The new regulation will apply in the same to companies of all sizes, which may be challenging for the industry but offers more protection with a higher general level of oversight. Massive cyberattacks on important institutions and entities all over the world are taking place on a daily basis, so updating the directive in that direction is crucial. Efforts on cyber-security should not be restricted to Europe however, because cyber-risks have a worldwide impact.

3.2 Reducing fragmentation in the EU digital finance market

An industry representative stressed that their organisation, a major CSP, is in favour of an increased harmonisation of regulations. Their customers operate in many different jurisdictions and there is now a worrisome trend towards fragmentation of the regulations concerning new technologies and data in particular at the international level, which is increasing the burden for financial institutions. Progress within the Financial Stability Board (FSB), in terms of exploring a coherent, cross-border regulatory framework, is encouraging however. DORA, which proposes a unified way of examining and supervising significant technology providers in the financial services industry is also a step in the right direction. It is important that players of different sizes can prove that they can work within the risk tolerances, capabilities and requirements for stability, security and resilience. However standards should be aligned at the international level so that regulatory processes are not duplicated. Such a level of regulatory consistency has been achieved in the derivatives market after the 2008 financial crisis, therefore it should be feasible in the digital space.

A second industry representative considered that the EU Digital Finance Package is a timely response to the opportunities and challenges created by digitalisation, however there is a sometimes restrictive interpretation of sovereignty, introducing challenges in certain proposals, such as DORA, that need addressing. Some stakeholders indeed suggest that measures need to be taken in the regulatory requirements to retain European digital sovereignty and sometimes even retain Member State sovereignty on these issues. That would lead to more obstacles being put in front of technological developments for European companies, which are already lagging behind those in the US and China. Instead of a narrow interpretation of digital sovereignty, that would require building separate EU infrastructures from scratch, the sovereignty debate and digital regulation more broadly should also take into account the opportunities offered by the single market and the broader global market. In Europe, a consistent, innovation-friendly regulatory framework that overcomes country-specific regulations should be the way forward.

The industry representative suggested a number of policy priorities that would support further digitalisation across the EU in this perspective. First, is a KYC process leveraging electronic identification and verified data. After a customer has gone through the process of identification, one company could bequeath that certificate to others. Secondly, the creation of a single European rulebook focused on outcomes rather than individual technologies would encourage innovation by providing companies with more flexibility. Thirdly, Europe could encourage a holistic B2B2C approach regarding secure data management across industries, allowing trusted collaboration between companies, while ensuring that General Data Protection Regulation (GDPR) requirements are respected for consumers.

A public representative agreed that efforts should be made to overcome market fragmentation in Europe. Digital identity solutions are one of the key steps to remove fragmentation in the financial services market across member states while also protecting consumers. This should be facilitated by the electronic Identification, Authentication and Trust Services (eIDAS) regulation, which is under discussion and will support cross-border ID services. A new proposal for a regulation on digital identity is also being developed at the European level, aiming to improve security on a cross-border level with an extended scope. An industry representative agreed that initiatives to establish a true European digital ID are essential for supporting the digitalisation of the European financial sector. An industry representative stressed the importance of improving the cross-border coherence of regulation. Technology and finance are becoming truly global and as a result more difficult to supervise, because at present there is no global regulator or supervisor. This highlights the importance of pursuing convergence across national or regional supervisory groups in Europe and also with the US and Asia.

3.3. Ensuring a level playing field across entities operating in the financial sector

An industry representative suggested that the appropriate way to regulate tech entities operating in the financial sector still needs to be defined considering the features and impacts of entity-based prudential regulation and activity based regulation. Banks are regulated as holistic entities with prudential requirements applying to all their activities, whereas tech companies are regulated in an activity-based way, which may create level playing field and also financial stability issues. Technological advancement should also be reconciled with some of the regulatory priorities in the EU, such as the Capital Markets Union (CMU), so that digital companies develop in a way that can support on-going objectives in the European financial sector.

An official agreed that the regulation of tech entities is challenging, in a context where an increasing number of newcomers, both fintechs and bigtech entities, are focusing on certain activities of the financial value chain. There needs to be a level playing field between entities covering a wide range of business, such as banks which are subject to prudential requirements for all their activities and tech entities focusing on specific activities. Level playing field issues also need to be tackled concerning data. More data can help to provide clients with better services, but there needs to be sufficient reciprocity between different data sources. The Payment Services Directive (PSD2) in particular creates an unbalance between banks and fintechs to the benefit of the latter. It would be preferable to regulate the use that is being made of the data. The European financial data space project represents an opportunity for considering this.

3.4. Supporting developments in the area of tokenisation and open finance

An industry representative stated that their organisation is strongly supportive of the European Commission's Digital Financial Strategy, which has the capacity to deliver new opportunities for European consumers and help to encourage more investment to the benefit of the post-COVID economic recovery. The Commission's proposal to create a pilot regime for market infrastructures based on DLT is welcomed in particular and should include UCITS, as proposed by the European Parliament. Policymakers should however go further in two areas, the industry speaker believed. The first area is the tokenisation of assets, including investment funds, for which an efficient and robust ecosystem needs to be established. Co-legislators are encouraged to consider the benefits of including exchange-traded products and alternative investment funds within the scope of the DLT pilot regime in order to take advantage of the potential of tokenisation in the asset management space. Secondly, the industry representative acknowledged that the regulatory agenda on open finance is moving, since the European Commission announced its intention to come forward with a legislative proposal by mid-2022, but considered that this is too slow. In addition care must be taken to appropriately consider the needs of the industry in the course of this legislative process.

TECH COMPANIES IN FINANCE: MAIN POLICY OPTIONS

1. Opportunities and challenges from the increasing role of tech companies in finance

1.1 The increasing use of technology in finance and the acceleration due to COVID

An industry representative stated that technology has become one of the main drivers in finance and COVID has accelerated that change. Technology has significant impacts in terms of automation and the development of open and interoperable systems. In the past few years it has moved from being a side project to something that is entrenched in the way that business is conducted in the financial sector. In addition, the days of legacy silo systems and locked-in data will soon be over. Many financial companies and executives now see technology and tech companies more as an example to follow than as a threat.

A Central Bank official agreed that COVID has accelerated digitalisation in the financial sector in particular, changing customer behaviours. 40% of people in the eurozone decided to use less cash during the pandemic, which has increased the market share of electronic money and payment institutions. In Q1 of 2021 the income for those payment institutions was four times higher on aggregate than in 2020 in certain countries such as Lithuania.

A regulator agreed that technology is transforming financial services and has become central to financial services in all market segments. One potential benefit of digitalisation is increasing inclusion and facilitating access to financial services for a greater number of retail clients. This is a key driver for the Capital Markets Union (CMU) which aims at increasing retail participation in the capital markets, even though there are major challenges for regulators in making sure that the adequate safeguards are in place. A second benefit is for anti-money laundering (AML), as digitalisation can help to capture those risks in a much more efficient way.

An official agreed that the emergence of bigtechs and fintechs in financial services has the potential to bring some benefits in terms of competition, providing a larger set of opportunities for consumers and investors and also financial inclusion, particularly in certain jurisdictions.

1.2 Role of tech companies in finance and related opportunities

An industry representative stated that there are three different roles that tech companies can play in the financial sector: first as an enabler, providing third-party services such as cloud services to the financial industry, second as an intermediary, such as portals which control the client relationship and third as a provider of financial services to customers. The latter role should be regulated in the same way as financial institutions.

An official saw a key dividing line between services that tech companies are providing directly to the public and those they are providing as back office functions to financial institutions. This distinction is important from a regulatory and a public policy perspective. In the United States the services that tech companies provide individuals or businesses with are still largely dependent on an integrative, traditional financial system and some of these market segments have been dominated by non-banks for decades. For example concerning payments tech companies are only offering a subset of consumer and merchant-facing services, not the entire payment stack. A change however is that in the past, these services were provided by specialized tech companies, whereas now larger and more diversified players are entering the financial market. During the pandemic, financial institutions also saw the benefit of third-party providers such as cloud service providers (CSPs), which can contribute to greater financial sector resilience and continuity.

Another industry representative explained that technology providers act as partners of financial institutions in the drive to digital transformation to help them unlock data-led innovation and meet their security and compliance needs. Cloud services in particular have the potential to unlock immense opportunities, especially in data heavy industries like financial services, but the technologies have to be understood by clients and used properly. Cloud adoption is progressing in the financial sector but there are still opportunities ahead particularly concerning core financial activities. In a global Harris poll of 1,000 leaders from the financial services industry on their state of cloud adoption, 83% reported that they are using some form of public cloud as part of their IT infrastructure, with only 17% being exclusively 'on-prem'. Around 90% of respondents agreed that cloud can help financial services to adapt to changing customer behaviours and expectations, enhance operational resilience, support the creation of innovative new products and services that can enhance data security capabilities, and can help to better connect siloed legacy software infrastructure within financial institutions. Only 47% of the workloads of the respondents who declared that they are using a cloud-based strategy were reported to be on cloud and most of them tended to be non-core workloads, showing that financial institutions are still cautious in their approach to the cloud.

Giving a perspective on the development of fintech companies in Europe, a Central Bank official stated that 19 fintech unicorns have emerged so far in Europe in 2021, which represents a significant increase compared to previous years and fintechs now represent almost half of unicorns in Europe. There is currently accessible liquidity and investments into venture capital and private equity are growing. This shows the strong expectation among investors that financial services will be increasingly provided by tech companies. The return on equity (ROE) obtained with investments in US-based bigtech companies (25 to 30%) is also much higher than with the traditional European banking industry (5%).

1.3 Challenges raised by the increasing role of tech companies in finance

A regulator emphasised that last year ESMA published an analysis of the impact of bigtechs in the financial sector in its 'Trends, Risk and Vulnerabilities' publication. Although in Europe these entities are currently relatively small in terms of footprint, the analysis shows that they could grow quickly given their scale and business model. ESMA also identified issues in terms of concentration and competition and what that would mean particularly in terms of consumer impact and costs.

The regulator explained that ESMA has subsequently been asked by the European Commission to conduct a call for advice aiming to assess the role of tech companies and their potential impacts on customers and to define the regulatory implications of their growing presence in financial services. This assessment will cover three main areas. First value chains, how tech providers fit into the current financial system and the potential issues raised by players regulated in different ways operating in the same financial value chain. Second, digital platforms that offer different types of services. And third, entities that offer both financial and ICT (information communication and technology) services and the clarifications that may be needed in this regard. ESMA will provide recommendations for securities markets and the EBA and EIOPA will be examining in parallel the situation in the banking and insurance markets.

2. Regulatory approach for addressing the increasing role of tech companies in finance

2.1. Main issues and policy options to be considered

A Central Bank official considered that a decisive moment in the approach to regulating tech companies is coming. The challenge is supporting innovation on the one hand and maintaining financial stability and a level playing field on the other. In recent years the first phase in the regulatory cycle by some authorities was to support innovation in a safe environment with the concept of sandboxes. The second phase was to extend financial regulation to fintechs. The current third phase is examining the need to adopt a more holistic approach to big tech companies covering financial regulation and also other issues such as data security, data governance, operational resilience and fair competition. An additional complexity may arise from the fact that these are global companies that require a global approach.

An industry representative suggested that there needs to be a detailed assessment of the impacts of the different roles played by tech firms in the financial sector, not only from a level playing field perspective but also from a financial stability standpoint. If parts of the financial market are being captured by tech companies and appropriate rules are not put in place, this could result in a large proportion of the market not being adequately regulated.

Another industry representative acknowledged that while technology can bring many benefits in terms of resilience, efficiency and security, it also comes with some risks. However, there is a whole spectrum of available options to tackle these risks that needs to be considered, of which regulation is only one. The possible added value of these different options needs to be evaluated before deciding on a policy approach. On one end of the spectrum there is the 'wait and see' approach, and on the other end there is regulation and oversight, which can be an important tool to bring certainty to the markets. The Digital Operational Resilience Act (DORA) for example introduces a new oversight framework for critical IT third-party providers, which will bring more certainty, more harmonisation and common supervisory approaches to the use of cloud services in particular. In between these two approaches there are different other possibilities. One is the sandbox approach, which is an experimental process. Another is standard setting, which can be very effective at the global level for imposing common standards e.g. concerning interoperability or security. Self regulation and codes of conduct are another possible tool that is particularly useful in the first stages of the development of a new technology. Standards can also be effectively developed around supervisory practices, as has been done for cloud services with the cloud outsourcing guidelines and joint supervisory approaches introduced by the ESAs, which are a flexible way to respond to new market developments.

The industry representative concluded by emphasizing that bigtechs approach their products and services in a way that can also help to support risk mitigation, notably with regard to concentration risk and operational risk. Their company, a major CSP, favours portability, interoperability and customer choice in the way products and services are provided, in order to avoid business continuity and lock-in issues. These aspects need considering in the policy work going forward.

A Central Bank official stated that regulation must be defined in a way that does not stifle innovation, for example blocking the entrance of tech companies into financial markets on the basis that they are of a different nature, because tech companies have the potential to provide significant added value to consumers and the real economy. Bigtechs in particular are powerhouses of innovation and have many resources. There is also a need for clear definitions of what a digital market is and what a gatekeeper is for example in order to avoid decisions based on political motivations.

A regulator observed that addressing these new developments is challenging for financial supervisors because they are happening on a cross-border and cross-sectoral basis, evolve at a fast pace and also imply engaging with data or competition regulators.

A third industry representative noted that two aspects need considering when thinking about the regulation of technology and tech companies. One aspect is the need to upskill regulators in technology and the details of its implementation. The second aspect is agility. Sandboxes have been put in place, as well as different communication channels for smaller and larger tech companies, but there is a need to accelerate the feedback loop between regulators and tech companies in order to adjust regulation faster .

The pace of innovation is indeed accelerating and the impact of technology on different players also needs to be taken into account and can often only be seen once it has been implemented.

2.2 Activity vs entity-based regulation

An official emphasised the disruption created from the increasing role of bigtechs and fintechs in finance, as well as the need to define a regulatory response that may allow to obtain all the benefits that bigtechs and fintechs bring to the financial system, while mitigating the potential risks that these evolutions may generate for consumers and the financial system. The Bank for International Settlements (BIS) and the Financial Stability Institute (FSI) are both working on this The key question is whether the current activity based financial regulation is appropriate for addressing the financial services provided by bigtechs, or if another approach is needed.

The official acknowledged that the financial entities of bigtechs are subject to the same activity-based regulations as financial institutions when they offer financial services like payments or wealth management. They need to hold a licence and to comply with the corresponding rules, which are designed to apply to different types of providers offering the same service. There could be some loopholes in the current framework that could benefit non-banks in areas like consumer protection, AML and combatting the financing of terrorism (CFT), but those types of loopholes have more to do with the implementation and supervision of existing rules. Thought is however needed on whether that activity-based approach is sufficient to address the risks posed by bigtechs operating in the financial services market, which run a unique business model based on data and technology, allowing them to benefit from strong network externalities. This gives rise to new challenges concerning the possible concentration of market power and data governance, which may not only affect market competition, but also eventually increase the vulnerability of the financial system. The official added that most of the risks that bigtechs generate and that may potentially become systemic are associated with interactions and possible spill-over effects across the different products and services that they offer such as e-commerce, payment services or credit underwriting. Those risks cannot be addressed solely by piecemeal activity regulation and a ‘same activities, same regulation’ approach. There is therefore a strong case for completing existing activity-based rules with entity-based rules for bigtech groups as a whole, aiming to address the implications of the combination of activities that they perform. Several jurisdictions are considering entity-based rules for bigtechs. In the US for example the House of Representatives has recommended in a recent report the introduction of specific obligations for large technological companies. In China, regulators are now enforcing specific anti-trust rules for bigtechs that involve mandating large bigtechs that offer several financial services to become financial holding companies subject to a specific regulatory remit. The case for entity-based rules will be further strengthened, the official felt, if the plans pursued by some bigtechs to implement global stablecoins crystallise, as this may potentially disrupt payment systems worldwide and affect the ability of central banks to properly control the monetary system.

As for the EU, the recent Digital Financial Package contains a number of newly created entity-based rules that will apply to bigtechs, the official observed. The Digital Markets Act proposal includes specific requirements to prevent market abuse by firms that are considered to be ‘gatekeepers’ and establishes specific obligations for bigtech platforms to protect users’ rights and prevent their misuse for illegal purposes. In the area of operational resilience, the DORA proposal addresses the increased reliance of financial institutions on critical third-party technology providers. While these proposals are moving in the right direction, the possibility of introducing a more comprehensive regulatory framework for the operation of bigtechs taking into account the impact of potential disruptions to the operational continuity of their services on the economic and financial system needs to be considered. This is likely to be a focus of the international regulatory debate in the future.

An industry representative considered that a holistic approach to bigtech entities is the right one. A significant step forward has been to examine financial conglomerates or holdings and see whether they should be regulated on a total entity level. In recent years there have been negative examples in Germany in particular, where banks part of a technology holding could not be properly regulated.

An official explained that the US is engaged in a similar effort. President Biden has tasked Treasury through an executive order to examine the competition from entry of large tech firms and other non-banks into consumer finance products in particular and a report is being developed on this for 2022. These evolutions give rise to important questions for financial authorities, including the operational resilience and financial stability risks that may be created, the role of financial regulation in addressing these risks and the type of regulation needed, the expertise necessary to supervise these requirements, and how that competence may be built up.

The official added that the US Treasury is working together with other members of the Financial Stability Board on third-party service providers, including a toolkit on supervisory approaches. The US Treasury is promoting a risk-based and outcomes-based approach to these issues. The elements of vendor choice and financial institution responsibility are being emphasised. Policies should provide regulated firms with clear expectations for risk management and due diligence in the selection of their suppliers. It is also important that there is continued responsibility for compliance within financial institutions. It is a delicate balance when the main benefits of third-party use arrive from specialisation of that third party, while many of the risks are associated with the possible loss of accountability by the financial institution. The official concluded that when jurisdictions consider policies in this area that they seek to avoid any unintended consequences on other jurisdictions such as data localization, that could have negative effects on operational resilience, innovation, and other policy objectives.

A regulator noted that in the past the entity versus activity-based regulation debate in other areas of the non-bank sector such as asset management, has not been very helpful because it created a stigma effect. The international regulatory community should focus on risks, whether they are appropriately identified and how to tackle them from a financial stability perspective. In addition, it is important to consider that the regulatory debate concerning fintechs and bigtechs has moved from concerns mainly around the level playing field with financial institutions to the tackling of more practical challenges related to the emergence of new tech players. A pragmatic approach that is working for supporting innovation in a safe way is the European Forum of Innovation Facilitators (EFIF), which is a hub of all the sandboxes operating in Europe. The EFIF conducts tests at a cross-border level in order to help tech entities to scale up their operations across the EU in the context of a supervised framework.

An industry representative considered that bigtechs could become too big to fail at some point, which has to be examined very carefully from a financial stability perspective. Any issues that create potential risks for consumers either through the direct provision of financial services by bigtechs or by the provision of third-party services should also be addressed very carefully. What is needed is the development of more fintech unicorns, particularly in Europe. It is therefore important that the possible regulation of large tech companies does not have negative impacts on innovation and on the scaling up potential of fintechs.

DIGITAL OPERATIONAL AND CYBER-RESILIENCE (DORA, NIS)

1. Objectives and status of the DORA proposal on ICT risk management

The Chair explained that research from the Global Domain Name System (DNS) Threat Report had revealed that nine out of 10 companies worldwide were victims of a cyberattack in the previous year, showing the importance of the issues addressed by the EU Digital Operations Resilience Act (DORA) legislation. The legislative process concerning the DORA proposal and involving the Parliament and the Council is underway. Digital innovation fundamentally changes banks' and other financial institutions' business models. This has the potential to make them more competitive and profitable. However, it also makes them more vulnerable to information and communications technology (ICT) risks, be it on premise or related to third-party providers.

An industry representative gave an idea of the magnitude of cyberthreats threatening society at present and of related reporting challenges. In 2020, their company, a major tech company, blocked close to 6 billion malware threats on endpoints controlled by their system. This is not only in finance and is a global figure, but it is a figure for only one tech company and shows the importance of the problem that needs to be addressed.

A public representative explained that the European Commission published the DORA proposal last November 2020. In March, a draft report was published by the rapporteur and there are now discussions within the European Parliament's ECON Committee to arrive at a consensus. DORA is an ambitious proposal which is important for ensuring the integrity of financial services faced with significant threats in terms of cybersecurity. DORA aims to ensure that there is built-in integrity in the financial system, setting a benchmark at the international level in this field, and also aims to increase uniformity in the EU policy approach, undoing the current patchwork of guidelines, regulation and oversight at member-state level.

The guiding principles of DORA are proportionality, future-proofing and competitiveness, the public representative added. The desire is to ensure there are proper guidelines, oversight and regulation in place, which are also fair, reasonable and proportionate, in order to avoid overburdening the industry and supervisory authorities. In terms of future-proofing, financial services now live in quite a dynamic space with the increasing use of cloud-computing and ICT, and new technologies are continually evolving. The objective is for the financial industry to be able to adapt to these evolutions and benefit from future innovations in a safe way and for the area of cyber-resilience to be future-proofed and flexible.

An industry representative stated that digitalisation provides many benefits within the financial services industry, contributing to extend financial services to excluded or underserved individuals, enhancing customer experience, increasing efficiency and leading to lower transactional costs. These benefits are enhanced through the interconnectedness of the financial markets, but that increases reliance on the digital infrastructure used to deliver financial services. DORA aims to provide a cohesive approach to cyber-resilience across the EU, recognising that independent national approaches to this cross-border risk will limit the effectiveness of financial institutions and authorities to deliver on their resilience objectives. Concerning financial market infrastructures, DORA is aligned with CPMI-IOSCO cyber-resilience guidelines.

Another industry representative explained that until recently cybersecurity was only a minor item in regulation. Only in 2017 were the Supervisory Review and Evaluation Process (SREP) guidelines of the EBA updated to include a meaningful section on cybersecurity. DORA is aiming to address some of the inevitable consequences of the rapid speed of regulatory change that has been taking place within the EU and the industry representative agreed with the objectives set out including proportionality, future-proofing and innovation. If done well this will result in more resilient and more innovative financial services. Future proofing is particularly important because cyber-risk is changing so rapidly that firms must have the ability to adapt equally as quickly or risk becoming victims.

2. Potential areas of improvement of the ICT risk mitigation provisions of DORA

2.1 Future-proofing, proportionality and flexibility

An industry representative noted that, as a Level 1 text, DORA provides an outline that will ultimately need to be specified by the European supervisory authorities (ESA) and the European Union Agency for Cybersecurity (ENISA) for its implementation across the EU. A balance needs to be struck between being prescriptive in certain approaches in order to provide sufficient guidance, and allowing for sufficient flexibility to cover a broad range of financial institutions. It is important that the regulatory technical standards (RTS) outlined in the Level 2 text should be created in partnership with financial institutions to ensure that proportionality is maintained.

Another industry representative stated that future-proofing DORA can be best achieved by avoiding technical prescription and focusing on outcomes. For example, legislation should not prescribe how a firm achieves its data recovery in the event of a data integrity incident. Prescriptive rules could limit firms' ability to quickly adapt their strategy as technology changes. Future-proofing and granting firms that flexibility also results in a much greater proportionality, since it allows firms to make decisions that fit their risk profile.

The Chair noted that proportionality is also needed in the way supervisory tasks are carried out with a risk-oriented approach. Bearing this in mind, proportionality will be an important aim when developing the regulatory standards for implementing the DORA rules. A regulator emphasised that one size does not fit all in this context. Supervisors have a very positive view of the DORA proposal. The measures included are fit for purpose, but it is key that they remain proportionate because there is a wide variety of entities in the scope of DORA and many dimensions to cover. Implementing DORA will also require significant efforts from financial entities and the supervisory community given the number of requirements. Technical standards will be developed in conjunction with the financial entities that will have to implement them, but the diversity of entities in scope needs to be taken into account along with their digital maturity.

EIOPA welcomes the introduction of proportionate provisions in DORA and the recommendations of the Parliament report going in this direction. The DORA regulation should allow proportionality as a general principle. The goal is to have an overarching proportionality principle applied to the full DORA regulation, so that in the future there is no doubt that proportionality still applies, even if it is not referred to in specific articles or if specific exemptions do not exist.

EIOPA's remit covers insurance companies, insurance intermediaries and institutions for occupational retirement provision (IORP) and there are very different situations there. Insurance companies are already subject to a certain number of requirements in the area of ICT risk management, thanks to Solvency II and the recent EIOPA guidelines on ICT and on outsourcing to the cloud, which will facilitate the implementation of DORA, although new developments will be needed in the areas of incident reporting and testing. The situation is completely different for intermediaries or IORPs, for which the implementation of DORA will require significant efforts, to be balanced with a proper application of the proportionality principle. Intermediaries need to be considered differently from big insurance companies or banks, the regulator suggested, but exclusion should be based on risks in line with the resiliency objectives of DORA rather than on the small size of intermediaries. If intermediaries conduct business and insurance-distribution activities on behalf of insurance undertakings covered by DORA, they will be provided with adequate network and information systems, and the security of these systems will be the responsibility of one or more entities under the scope of DORA.

In addition to this, the supervisory authorities at both the European and national levels should consider how to approach operational resilience risk related to digitalisation for entities excluded from DORA, possibly with simpler national approaches, because these entities should not be allowed to become weak links within the financial system. Proportionality might also require different implementation timelines, with larger transitional periods for smaller entities, for example the regulator stated.

2.2 Incident reporting

An industry representative suggested that there should be a greater alignment of DORA with the ongoing global cyber-resilience initiatives in areas such as incident reporting. The recent spate of ransomware attacks has increased the focus on this area. Foundational to any cyber-incident reporting is terminology and how cyber events and cyber incidents are defined. The original DORA text introduced a new term, 'major ICT-related incident', which may further fragment what is required for financial institutions to report. A 2021 IIF staff paper on the importance of more effective cyber-risk reporting highlights some of the challenges faced by financial institutions in this area, and potential policy solutions that may offer insights to help build the DORA cyber-incident-reporting framework in a consistent way.

Another industry representative agreed with the importance of aligning DORA's incident reporting requirements to forthcoming global standards from the FSB. The industry representative also suggested that policy attention should start shifting away from the collection of large quantities of information to how that information is analysed and redistributed as intelligence into the industry. Intelligence from authorities should aim to help firms to identify what to look for in their systems e.g. IP addresses to track or signatures in malware. There are improvements that can be made in that field that will outweigh what can be done by collecting even more information. For example cyberthreat notification does not seem to add much value. An excessive provision of information may increase cybersecurity risk when that information is highly sensitive, the industry representative stressed. Several points in DORA (e.g. Art. 13) include requirements for firms to reveal information on vulnerabilities, either publicly or to clients, but revealing its vulnerabilities may increase risks for a firm while providing little practical benefit to end users. That simply makes it more likely that those vulnerabilities will be exploited and so it creates significantly more risk. Supervisors should continue to instead push financial entities to reduce the amount of time it takes between identifying a vulnerability and patching it.

2.3 Threat-led penetration testing

An industry representative suggested that threat-led penetration testing is another area that requires further optimisation. It requires strong intelligence and specialised experts to execute. The European Central Bank (ECB) Threat Intelligence-Based Ethical Red Teaming (TIBER) framework allows for member states to build bespoke threat-led penetration-testing requirements. Limited availability to experts in this space may however impact the ability for all in-scope financial institutions to execute such testing. Moreover, the requirement to have assessors certified per member state may impact the accessibility of these assessors for all financial institutions.

Regarding contractual obligations, financial institutions continue to rely on outsourcing and other third-party arrangements to deliver financial services. However, several challenges associated with these relationships were outlined in the 2020 Financial Stability Board's report relating to outsourcing and third-party relationships. For example, requiring ICT providers to participate in threat-led penetration testing may prove difficult for financial institutions to negotiate.

3. Issues and challenges raised by the ICT third-party provider provisions of DORA

A public representative noted that the role of third-party ICT providers has significantly evolved in the financial services sector compared to 10 years ago. They are now critical components of the sector and there is a whole range of providers in this space, which has to be regulated. Ensuring the reputational and operational integrity of financial services in Europe, requires addressing issues raised by third-party providers as well as by the providers of financial services. There had not yet been a formal discussion on the third-party provider part of DORA in the ECON Committee at the time of this panel discussion but a decision will be made on that particular issue in the near future in order to ensure that there is not an unbalance in terms of obligations between regulated financial entities and critical third-party providers (CTPP) subject to very different obligations.

3.1 Oversight regime for Critical Third-Party Service Providers (CTPP)

An industry representative stated, regarding the oversight regime for CTPPs proposed in DORA, that it is important to modernise regulation and provide a harmonised set of rules, because of the fast-moving pace of technology and its pan-European character, and DORA plays an important role in that. Cloud services in particular are a key driver of the digitalisation of different sectors including financial services, so it is quite natural for it to be part of this regulation. In terms of the scope of the oversight, it is currently foreseen that the identification of CTPPs will be carried out at the provider level, without distinguishing between the types of services offered by those providers, even though they can be quite different and do not all concern financial services. There should be more clarity on what the focus of the overseers should be. In terms of process, the Commission proposal was also relatively silent on what the interaction between the oversight authorities and the CTPPs should be, so there is a need for further clarity here.

Harmonisation is another issue, the industry representative emphasized. Given the dichotomy between the oversight authorities and the national competent authorities (NCAs), if DORA makes room for national fragmentation there will be problems in terms of compatibility and consistency of the requirements. There are also consistency issues between DORA and the Network and Information Security (NIS) Directive concerning resilience measures for CTPPs. If there are incompatible resilience recommendations, measures and obligations then it will not be possible for cloud service providers for example to implement them both.

A regulator stated that there are two important points for making the CTPP oversight framework effective and efficient. The first is having an adequate representation of different financial sectors, for which third-party providers are relevant. Therefore, the system of having potentially three lead overseers is important. Clear and balanced roles, responsibilities and powers between national and European authorities are also absolutely crucial. A joint ESA executive body, which will be small and functional, with proper technical capacity and expertise, and with limited membership from the European authorities and NCAs, is the right way forward, together with the establishment of cross-ESA teams to work on the oversight of CTPPs.

In addition it is important to consider how cross-ESA teams work, because there cannot be a patchwork of implementation. Currently, NCAs reassess the situation and may have different nuances concerning the lead overseer's recommendation on issues such as the level and maturity of non-compliance, but in this area there needs to be a European approach based on the recommendations of the lead supervisor and then a national implementation consistent with the findings of the lead overseer. The regulator highlighted Article 37 of DORA, where paragraph 4 in particular has to be correctly implemented. There needs to be flexibility from national supervisory authorities while focusing on the impact of the non-compliance of their supervised entities. This is the only way to have a European approach that is focused on specific supervised entities, without reassessing and giving different nuances to the assessment of the lead overseer.

Another regulator concurred that, under the present architecture, this is the right approach for moving forward. Convergence, cooperation and consistency are fundamental to having a proper way forward with respect to supervision in this area.

3.2 Concentration risk, location and sovereignty issues

An industry representative noted that DORA wants financial institutions to identify concentration risks with the major ICT providers they use. While this may be possible internally to their organisations, they cannot do this at market level because they do not have access to the data that would be needed to understand how other financial institutions are using their cloud service providers or other ICT providers. In addition, financial institutions often do not inform cloud providers or ICT providers of the services that they are running on their infrastructure, so the latter may not know whether or not they are running critical operations. These requirements therefore need to be further clarified both at Levels 1 and 2.

Answering a question from the Chair about the domestic or global dimension of cyber-resilience and the possible need for enhanced sovereignty in this area, an industry representative stated that policy-makers want to ensure they have the right to exercise authority over the providers in this area. However, unlike some traditional areas of financial services regulation such as capital requirements, technology operations do not easily fragment along national borders. Fragmentation in the technology estate of a financial institution creates more complexity, which creates an increased chance of failure, makes it harder to apply security controls across the entire estate and increases the attack surface that has to be defended.

Localisation and the accompanying fragmentation of technology operations creates real risks and barriers to the ability of financial entities to make their digital operations resilient, the industry speaker felt. One example of where DORA may contribute to localisation is Article 31. It is a challenge to work through how best to achieve the national resilience objectives that are legitimately being sought by policy-makers without adding any increased technology or cyber risk through localisation requirements. Such requirements have even started to appear between member states and risk becoming a barrier to a single market within the EU. The natural tendency of assuming that proximity equals security has to be resisted and there has to be consideration of what outcomes are sought, what has to be done and how it can be achieved without adding cybersecurity or IT risk to the financial sector.

4. Adapting the supervisory approach and architecture to cross-sectoral risks such as cyber-security

The Chair noted that supervisors who traditionally focused on a specific financial sector are now being asked to apply multisectoral financial regulations such as DORA in a number of cases, which is more complex.

A regulator suggested that the main issue for supervisors is the interconnectedness within the financial system and the importance of having not only regulation that is harmonised with the introduction of DORA, but also consistency in the level of supervision. This raises a number of questions to be addressed by the MEPs currently considering the DORA proposal. One is whether there is the right architecture to allow a proper and consistent supervision of cyber risks within Europe. Another is if the current architecture at supranational level with a largely sectoral approach to financial supervision is correct. That should be considered particularly given the evolution of regulation, which is becoming more cross-sectoral, not only in the field of cyber risks but also in areas like sustainable finance, anti-money-laundering (AML) and combating the financing of terrorism (CFT).

DORA addresses the issue of the fragmentation of regulation with a single rulebook that regulates the area of cybersecurity. However, over 40 supervisors will be responsible for supervision in this field, which may create fragmentation, leading to possible supervisory gaps and system failures. That leads to another set of questions. One is whether the supervisory architecture should be considered at the national level and whether the NCAs will have sufficient human and technical resources to effectively supervise DORA. Another is what can be done at the supranational level in order to support the NCAs. It can also be asked how a degree of consistency can be ensured and if it should be more compliance-based or more outcomes-based. Just as there is a recommendation for the ESAs to look into setting up a central hub for incident reporting, there should be an invitation for them to assess the architecture of financial supervision and the resources that are needed at European and national level for achieving the objectives of DORA.

A public representative noted that it would be a catastrophic failure of public policy if a uniform regulation such as DORA was then being enforced and overseen in a patchwork fashion across the EU. The European Parliament is very conscious that there needs to be a sufficient degree of uniformity in the oversight across member states and that the proper oversight architecture needs to be put in place in order to achieve that. The adequate resources will also have to be put in place. In order to ensure effective reporting and an assessment of that information by the oversight bodies, the proper resources have to be in place, both in terms of sufficient capabilities and sufficient people on the ground, otherwise there will be significant difficulties.

Conclusion

The Chair summarised that it is critical for the DORA legislation to not hinder digital innovation or overburden the financial industry in Europe. Level 1 regulation should be technologically neutral and principle-based to allow quick adaptations to technical innovation. A sound institutional architecture is also crucial. The supervisory authorities should have clear-cut competencies in order to avoid overlaps or gaps. The importance of adopting a proportionate and risk-based approach, not only in the day-to-day oversight but also in the regulation, was also emphasized.

NEW TECHNOLOGIES IN SECURITIES MARKETS: USE CASES AND POLICY IMPLICATIONS

1. Opportunities and challenges related to the use of new technologies in securities markets

1.1 Progress in the use of new technologies (cloud, AI, DLT) in securities markets

A regulator stated that when the impact of distributed ledger technology (DLT) was first discussed five years ago, the usual assumption was that uptake would be rapid in centralised securities markets and that DLT would replace conventional technologies in most of post-trade operations. While changes have not gone that far, the direct and indirect impact of DLT on securities markets is quite significant. In the US the decision by DTCC to move to a T+1 settlement delay by 2023 is partly a response to the increased credibility of the DLT settlement process. Shortening the settlement process is a welcome decision because it reduces risks and frees collateral, making the settlement process more efficient.

More changes will come, the regulator believed. There will be an increasing recourse to DLT in securities markets in the coming years and the recent involvement of central banks in this area, with the ongoing development of DLT-based settlement systems allowing payment in central bank digital currency (CBDC), is a game changer. If this can be done effectively, supported by adequate changes in the regulatory framework, this will change central banks' perception of these systems, triggering radical change. Several EU central banks are already experimenting with major commercial banks the issuance of bonds settled in digitalised central bank money. The next step is trying to address the secondary market. At this stage experimentation is limited to pilot projects but, at some point, the European Central Bank (ECB) will need to be involved in these initiatives in relation to the digital euro project.

An industry representative observed that the uptake of technologies such as artificial intelligence (AI), cloud, DLT and digital assets, which can be used in combination in securities markets, is progressing at different speeds. AI and machine learning in particular are already being used at a significant scale by many financial organisations for activities such as trade processing. An industry representative noted that the uptake of new technologies is faster than is probably thought. This is an electronic age and has been for more than 20 years. The industry is probably six to seven years into the DLT journey, for example.

A second regulator agreed that the use of new technologies is progressing in securities markets. Over the past six years, more than 700 firms have used the FCA's regulatory sandbox, with a progressive shift towards sophisticated cryptoasset usage. While blockchain is still the most frequently tested technology in the sandbox, AI and machine learning are becoming equally prevalent. Incumbent fintech firms are also attempting to shift customers towards open banking payments, although consumer adoption is expected to lag in this area.

1.2 Use cases of new technologies in securities markets and related opportunities

Several panellists highlighted examples of the use of new technologies in securities markets. An industry representative agreed with a previous speaker that the implementation of DLT systems is taking longer than anticipated in core securities markets, but it is easy to identify the potential benefits that DLT-based systems can provide in terms of reduced reconciliation and frictionless settlement. Risk controls for calculating net asset values (NAVs) on portfolios is also an area where technologies such as AI can easily be adopted and quickly generate cost and risk reductions, since embedding the regulatory framework in these processes when automating them is relatively straightforward. Custodians currently have to calculate hundreds of thousands of NAVs of various portfolios all to different standards. AI models can be used to predict the extent to which the output is correct and prompt a manual check if there is an error, while the rest of the work is done automatically. Cloud is another key area that is developing at present. One of the areas of focus is trying to make applications cloud-native over time, particularly for digital assets. Cloud solutions also make the deployment of blockchain solutions easier. The tokenising of securities is a further area in which developments are underway.

A second industry representative outlined examples of applications of DLT in the securities and derivatives markets developed by banks. A first example is Paxos, a DLT-based application based in the US, which achieved T+1 settlement earlier in 2021. It has not been fully implemented yet but demonstrated that T+1 can be a reality with DLT technology. Paxos also solves problems in other areas such as clearing, helping to optimize variation margin calculations (VM) and to reduce fails associated with collateral chains. Another example of an application of DLT which has been successfully implemented, is the High-Quality Liquid Assets Exchange (HQLAx) platform based in Luxembourg, which aims to eliminate the cash leg on certain transactions, supporting delivery versus delivery (DVD) transactions as opposed to having a delivery versus payment (DVP) creating intraday cash.

A third industry representative stated that the buy side is also actively using various technology tools. AI is used on the front-office side to analyze trades, volumes and prices and also in the legal department to screen external documents. There are also various DLT projects in which asset managers are participating, such as the bond issuance initiative mentioned by a previous speaker led by the Banque de France and which is settled in central bank digital currency. DLT will bring much value in the investment fund market on the asset side, because it will help to speed up and reduce the cost of settlement and also increase competition among trading and post-trading market participants. It will also help to accelerate the distribution of fund units. Cloud services are also increasingly being used by asset managers for achieving economies of scale. Cryptoassets are not yet being invested in by the industry representative's asset management company but this cannot be excluded in the future – in particular once the regulatory framework will have been consolidated by legislations such as MiCA.

1.3 Challenges related to the use of new technologies in securities markets

An industry representative emphasised the importance of clarifying expectations related to new technologies. There is sometimes an expectation that they will suddenly replace legacy systems in banks, but change will be more gradual. Existing services and platforms will continue operating and new capabilities will incrementally be added to these systems, which means having for some time a parallel operation, which will increase costs and complexity for financial institutions and their clients in the short term. One element hindering progress in some cases is the ecosystem if all partners are not ready at the same time. This is partly a question of interoperability, which is needed not only between different blockchain protocols but also data layers. Solutions exist to tackle these issues, but the digital and blockchain spaces do not have the same level of agreed market standards or interoperability protocols as the traditional market and so further progress is needed on this.

A second industry representative agreed that interoperability of DLT systems is critical as it will not work if there is no connection between DLT participants and traditional ones. This is partly in the hands of the participants themselves, but a pan-European regime or cross-border minimum convergence framework would facilitate interoperability legally speaking for centralised and decentralised DLT systems. Afterwards, market players will need to agree among themselves to interoperate, otherwise there will be no secondary market for exchanging what has been subscribed on the primary market on the DLT. France has a DLT regulation at domestic level, but it is taking time to achieve interoperability in practice. Concentration in the cloud services market is a further issue. In effect, there is an oligopoly of cloud providers which are mainly non-European. This creates key issues regarding the relationship between those cloud providers and users such as asset managers: the relationship is not in favour of the users because oligopolies always have the power to impose their conditions, either in terms of fees or regarding contractual obligations. Claims vis-à-vis non-EU cloud providers might also pose legal issues. There are also major security issues with cryptoassets and stablecoins that need to be addressed.

A third industry speaker agreed that developing interoperability in the DLT space at the legal, data, technological and cross-border levels is essential. Once that level of interoperability has been reached, Europe will have at its disposal a DLT environment that should benefit banks, infrastructures and also the customers that they serve.

A regulator stressed the cybersecurity and data protection risks that the increasing use of new technologies involve. For that reason, the latest sandbox cohort in the UK is encouraging solutions targeted towards fraud and scam detection and widening access to these solutions for small and medium-sized enterprises (SMEs). Data protection and ethics are other potential areas of concern with the developing use of AI and machine learning systems. Firms are collecting an ever increasing amount of data about customers and so they must be transparent with them about how the data is used and also ensure that consumers are aware of this and sufficiently protected. Data is central to the regulators' work in this area, with the development of analytical and data science capabilities and a cloud-based unified intelligence environment, to programmatically detect risks of harm. Further thought and collaboration are needed on those issues going forward.

A fourth industry representative agreed that while new technologies provide opportunities, they come with new risks. It is crucial not to reduce the level of security and investor protection achieved with existing systems and embedded in existing processes.

2. Regulatory and supervisory implications of the development of technologies in securities markets

An industry representative emphasized that technologies evolve quickly, and it is almost impossible to predict what the possibilities will be in the future, so it is complicated for regulators to be fully up to date with market evolutions. The question is how to regulate the unknown and find a balance between protection and innovation. The extremes are clear. It is easy to clamp down on innovations or to let them develop freely, but neither option will help to move things forward in a proper way, so balance must be found. Pragmatic approaches are needed in regulation and supervision, which means acting in a fast and flexible way. There is already a high regulatory pressure in the financial sector, the industry speaker added, so although new measures may be needed with digitalisation, care must be taken not to discourage the emergence of new players and business models. It is vital to avoid unnecessary additional regulatory burdens and to analyse the result of existing regulation via key performance indicators (KPIs) and monitoring and to verify whether the goals are being met. Continuous and factual reviews of regulations are required so that they can be updated according to new developments in the market. The final goal is to maintain a high level of safety in the financial market, while allowing innovation and growth.

A regulator acknowledged that the pace of change is increasing and that it is challenging for regulators to keep track of innovations and find the right balance, but this is essential as digitalisation will continue to change business models and impact people's personal lives. Regulators are supportive of new technologies that bring a benefit to businesses and consumers, but market integrity, financial stability and investor protection must also be preserved. The National Competent Authorities (NCAs) and the European Supervisory Authorities (ESAs) have to continuously update their knowledge and the skills of their personnel in these areas, as well as their technical possibilities in order to be able to conduct fit-for-purpose oversight.

The market is also becoming more complex from a regulatory perspective, the regulator felt. Cloud service providers (CSPs), which are providing new forms of infrastructure are operating remotely and the cloud market is concentrated. Regulated financial firms are using fintechs for part of their business in niche areas and outsourcing services to tech companies, increasing interconnections, and these services cannot easily be substituted once they are in place. The datacentric nature of business models is another issue, with an accumulation of huge amounts of data which raise potential privacy and reliability questions. There have also been many changes in distribution, including the emergence of 'neobrokers,' operating in securities markets, but it is not always clear who the contractual partner is and whether consumers understand what they are buying. These rapid changes mean that regulation has to evolve accordingly. Even though two of the frameworks of the Digital Finance Package are not yet agreed in Council, there is a call for the ESAs to provide the Commission with new evidence on digital developments in the financial markets and their policy implications which will help to adjust the framework if needed.

A second regulator highlighted that some changes are blurring regulatory boundaries. The platformisation of markets (i.e. the expansion of digital platforms such as bigtech or equivalent platforms in different economic sectors including financial services) is a general trend and is attracting a large number of new retail clients with new investing patterns. This may have significant consequences for the functioning of financial markets. Effects have not all been seen yet in the securities markets, but these evolutions could potentially challenge existing price formation and product commercialisation patterns. This issue has been highlighted by ESMA in a recent report on organised trading facilities (OTFs).

A third regulator stated that when it comes to innovation and the balance that is needed with ensuring safety, regulatory sandboxes are an appropriate response, allowing firms to experiment and test new solutions with real customers in a safe environment. A regulatory scalebox is also being introduced in the UK in addition to the sandbox, aiming to help growing fintech firms to scale up their operations and continue testing new technologies. The sandbox and scalebox also allow the FCA to have an accelerated view of how new technologies and firms are developing, as well as create a regulatory nursery environment where firms can experiment new concepts while getting used to operating with regulatory requirements and oversight. Another area of focus concerning fintech is the transition to net zero, since sustainability and climate change initiatives are also being looked at with a tech approach.

3. Expected impacts of EU digital finance policy proposals on securities markets

The panellists were generally favourable to the Digital Finance Package proposed by the Commission aiming to support digitalisation in the European financial sector, while ensuring that the necessary protections are in place and that European players are provided with a market environment where competition can develop in an appropriate way. Some fine-tuning of these different initiatives was however proposed by the panellists.

3.1 DLT pilot regime

An industry representative stated that blockchain is the most disruptive technology in securities markets, so the DLT pilot regime is a step in the right direction. It is a technology-neutral sandbox, which will help regulators to define the right policy approach and should help DLT to develop in a flexible way. The 'same business, same risk, same rules' principle should be applied in order to avoid the creation of a new specific framework for DLT-based operators and markets. Common regulation is indeed essential to provide a level playing field between DLT and non-DLT infrastructures and avoid market fragmentation and regulatory arbitrage or loopholes. A European approach is also urgently needed in this area in order to avoid some countries advancing alone, as is the case at present. This may mean having less flexibility in the regulation than some stakeholders would want, but this will help to reduce complexity.

A regulator agreed that the sandbox approach of the DLT pilot regime is an interesting proposal. While the DLT pilot regime is an adequate starting point, the regime for DLT will need to be adjusted because DLT is normally decentralised, so it is awkward to have a DLT pilot regime that only covers centralised business. 'Decentralised finance' (DeFi) business models and the issues they raise will need to be added to this approach, as that is a completely different world.

A second industry representative agreed that the current DLT pilot regime is too narrow, focusing solely on centralized models. Regulators should not be afraid to disrupt the existing system and entities. A centralised system around market infrastructures was created because that was the most appropriate organisation at the time and what corresponded best to existing technology. The new DLT regime needs to reflect on-going changes with an evolution towards more decentralised systems which can be beneficial in terms of efficiency and cyber-security in particular.

A third industry representative also felt that the DLT pilot regime as proposed does not go far enough and will not bring sufficient disruption in the market. While regulators may generally prefer to preserve the present centralised infrastructure for financial stability and level playing field reasons, it is also necessary to consider the initial objective of the pilot regime, which is to foster innovation in the EU securities market. The right balance therefore has to be found and it would be detrimental to Europe if the scenario observed in the cloud space with the EU being reduced to a consumer of digital solutions provided by third-country players was reproduced for DLT because of a lack of innovation.

A fourth industry representative was favourable to the DLT pilot regime as it will facilitate DLT interoperability at the pan-European level. Some issues remain to be clarified such as the responsibility of fund depositories if the settlement of assets through a DLT system goes wrong.

A regulator stated that a fully-fledged market infrastructure based on DLT cannot be developed in the current European regulatory environment, which is why the DLT pilot regime is needed now. The end of the trial period is relatively close and discussions in Council and Parliament have significantly improved the initial Commission proposal in line with remarks made by previous speakers on the panel. The pilot regime has been opened up to new entrants, systems based on public DLTs will be accepted and the thresholds have been raised. Some further amendments could be considered, such as keeping the role of ESMA in issuing recommendations in order to speed up the process and eliminating the need to negotiate an exit strategy before entering the market.

3.2 The Digital Operational Resilience Act (DORA)

An industry representative emphasised that cloud is another important technology that helps financial institutions to be innovative, flexible and to scale up, while saving costs with pay-per-use models. ESMA's cloud outsourcing guidelines and the DORA proposal are useful to support the uptake of this technology, as well as the on-going work to define minimum regulatory standards for third-party providers. It is important however that the European market remains open to non-European service providers in order to maintain its competitiveness at the international level.

A regulator welcomed the oversight regime proposed in the context of DORA for critical ICT third-party providers (CTPP). Some issues still need to be considered such as the potential challenge for the ESAs of sharing responsibilities and working together effectively in the supervision of CTPPs. Providing sufficient proportionality in the DORA framework is also essential.

A second industry representative supported the DORA proposal. One important area is the due diligence to be carried out by users over third-party providers. If cloud providers do not want to collaborate, this may create a legal risk for user, and therefore it is hoped that DORA will help end users to ensure that due diligence can be actually performed.

3.3 Markets in cryptoassets regulation (MiCA)

A regulator considered that MiCA is welcomed because, with the development of tokenisation, cryptoassets must be regulated, both from an industry and an investor protection perspective. A certain number of problems need to be addressed, in particular where to draw the line between a financial instrument under MiFID and a cryptoasset covered by MiCA. Furthermore, capital market regulation, such as the Alternative Investment Fund Managers Directive (AIFMD) also needs to reconsidered in the context of MiCA.

An industry representative agreed that, as long as they are not regulated, cryptoassets will not be invested in by the industry representative's asset management company and so MiCA will be beneficial. An industry representative added that it is vital to have a clear definition of securities and non-securities in MiCA, rather than just a definition by exclusion.

3.4 White paper on AI

An industry representative considered that the White Paper on Artificial Intelligence and upcoming regulatory proposals in this area are important steps. The contribution of the White Paper on ethics and the elimination of biases are valuable points, but more can be done to help break the current fragmentation within the EU, where some jurisdictions have developed detailed regulation of AI, whereas others only have limited rules. It is necessary to align European approaches before embarking on more ambitious initiatives. The US and Asian countries are ahead in this area, as the model they have chosen is to foster market leadership rather than safety and consumer protection. If Europe only focuses on regulating AI, it will not make sufficient progress in this area. There needs to be a clear ambition for leadership in AI with financial aids, the promotion of best practices and guidelines that can help an effective ecosystem to emerge.

GLOBAL CROSS-BORDER PAYMENTS: KEY DRIVERS

1. The recent impetus given to cross-border payments at the global level

A representative of the public sector stated that cross border payments face multiple challenges. The experiences of end users and service providers can be impacted by high cost, low speed, limited access, and insufficient transparency. A foundational step of the G20's October 2020 roadmap to address the key challenges is the definition of quantitative targets for cost, transparency, speed, access across wholesale and retail, and remittances. The Financial Stability Board's (FSB) public consultation ended in mid July 2021. Most of the work on the 18 other building blocks of the roadmap has been taken forward by the Committee on Payments and Market Infrastructures (CPMI) and the FSB.

2. Challenges and success factors for cross-border international payments

2.1 Measuring what is happening end to end in the international payment value chain to allow public and private sector cooperation to spot and address the most relevant challenges

An industry representative stated that he has been working with banks for a number of years on removing friction and improving payments. He welcomes the way that those obstacles have been framed and structured.

There is hope in the fact that 42% of the GPI (SWIFT standard for Global Payments Innovation) payments are credited within five minutes and 56% are credited within 30 minutes. The obstacles include having good data to orient where SWIFT puts its efforts. SWIFT found that an average of 80% of the time spent executing payments on its network was spent at the beneficiary bank side. This is attributable to legacy technologies, time zone differences, capital controls and compliance controls.

It is necessary to have data to measure what is happening end to end. Division exists and the real issue is how to progress together to make a real difference.

2.2 Each specific customer need requires dedicated efforts to deliver speed, efficiency, proximity, security and trust, so the access of non bank payment providers to payment infrastructures and the consistency of AML regulation require specific attention

An industry representative stated that the FSB rightly acknowledges that any payment strategy should recognise the uniqueness of the respective customer and their needs. The solutions that customers use are largely driven by factors including access. The key driver tends to centre on speed, efficiency and proximity.

Many global customers still lack basic infrastructure to make and receive electronic and mobile payments. Security and trust are paramount.

The first area that needs attention is the fragmentation of anti-money laundering (AML) rules, which is a particular issue for the remittance sector. The absence of full consistency somewhat inhibits the development and implementation of efficient solutions for AML and combating the financing of terrorism (CFT).

Linked to this is the question of access to payment infrastructure. More efficient regulation at the international level should provide the banking sector and central banks with sufficient comfort to share vital common infrastructure. Consumer protection and transparency are also important in defining the regulations.

A representative of the public sector highlighted the key success factors for delivering progress in the projected timeframe. The G20 report sets out 19 building blocks.

2.3 Although progress supposes moving forward the whole 19 building blocks identified by the FSB, delivering consistent and relevant international rules and standards, improving existing payment infrastructures and their access, and exploring new payment infrastructure arrangements are essential to improving international cross border payments

An official stated that the G20 roadmap describes a comprehensive set of actions across the 19 building blocks and a range of areas to remove frictions. A coordinated approach and a sustained initiative supported by the public and private sectors are necessary.

Technological changes can go a long way, but they alone might not deliver the desired scale of improvements in cross border payments. Therefore, the roadmap demands consistent and relevant international rules and standards.

AML/CFT is one element of this, but other elements include data protection and data privacy rules. The CPMI especially focuses on the building blocks that it is leading. Improving existing payment infrastructures and exploring new payment infrastructure arrangements are very close to the CPMI's heart and mandate, along with the role that central banks can play in establishing liquidity bridges with one another.

The CPMI is also working on forward looking payment infrastructures and payment service level agreements. SWIFT GPI is a very good example of how a multilateral service level agreement can improve cross border payments. The necessary step change will only happen if the problem is tackled comprehensively.

An industry representative stated that the cooperation between the private and public sectors in this endeavour was important when he was in the ECB.

An industry representative stated that it is difficult to pick just one or two building blocks. Building block 5 is applying AML/CFT rules consistently and comprehensively, while building block 6 is the need to better align data frameworks and for any potential conflicts between AML and data privilege[?]. In addition, building block 8 concerns fostering know your customer (KYC). Building block 10 on direct access to payment systems is particularly relevant to Western Union's sector, as is building block 7 on safe remittance corridors.

A representative of the public sector stated that the long list of issues needs to be addressed comprehensively.

3. Despite (or rather thanks to) many innovative technologies, leveraging existing infrastructures by improving and interlinking them is an attractive route, though it requires clear objectives, willingness, teamwork, governance and resources

A Central Bank official stated that it is necessary to start with what is already there, which allows for quick progress. It is possible to rely on what has already been tested. However, several promises have been made in the past 20 years without success. The reasons included a lack of business case.

Talking about technology and innovation frequently means talking of cryptocurrencies, but there has also been a great deal of innovation in payments. For example, many instant payment systems are new technologies.

There are also new standards. Many of the systems are based on ISO 20022. If the idea of strengthening the integration of a specific region exists, there is also political support to do so and invest in it. Most recent developments include the Nexus project presented by the Monetary Authority of Singapore.

Work and a holistic approach are necessary to keep the momentum. Accessibility is also important, and it is necessary to reflect on how to bring in people in countries where the financial inclusion is not as high. Finally, the settlement cross currency is an issue.

3.1 CLS efforts to extend a PvP service to a much broader set of currencies in 2022 is an example of efforts leveraging both existing tools and innovation

An industry representative stated that the cost currency is probably the issue. Relying on experience is probably the strongest eventual decision.

CLS has developed a PvP mechanism that allows it to answer building block 9 of the FSB roadmap in a way that is fairly strong, but only for a limited number of currencies. Further developing the possibility of coverage of PvP in a much wider number of currencies remains to be seen.

Different services have identified the possibility of bringing better clarity on all these cost currency exchanges. CLS has set out a different platform for matching trades and looking at different currencies. CLS put CLSNet into the market some time ago.

CLS wants to be able to bring PvP service on a much broader set of currencies as soon as possible. It is developing a pilot model to see how to implement those models. By the end of 2021 or the beginning of 2022, it expects to announce some ideas for developing those additional capacities for the ecosystem. The impetus that the CPMI and FSB has launched is supported by what the ecosystem is seeing.

4. The perspectives of possible disruptive options such as central bank digital currencies, global stablecoin arrangements, and new multilateral payment platforms to improve international cross-border payments are being assessed

A representative of the public sector stated that there are also more disruptive or innovative options to consider. He asked what the possible benefits of introducing a multi currency central bank, digital currency, and stablecoins would be for cross-border payments.

An official stated that these new payment infrastructures and initiatives have great potential, but the emphasis is on potential. Focus area E[1] of the G20 programme covers the CPMI's potential to offer cross border payments.

Most central bank digital currency (CBDC) investigations by central banks currently focus on domestic issues and use cases, but CBDCs still have the potential to enhance the efficiency of cross border payments. In collaboration with the Bank for International Settlements (BIS) Innovation Hub, the International Monetary Fund (IMF) and the World Bank, the CPMI has conducted a stock take on provisional domestic CBDC designs and central bank experimentation to determine how to use them for cross border payments.

4.1 Possible scenarios explored: a national retail CBDC available to anybody that is also used for cross border payments with limited to no coordination between the central banks; CBDCs with some degree of interoperability; and a single, multi CBDC system across jurisdictions

An official stated that a retail CBDC could also be used for cross border payments with limited to no coordination between the central banks. The second scenario assumes some degree of interoperability between the CBDCs. The third touches upon the multilateral payment platforms and implies cooperation of a higher magnitude. A single, multi CBDC system could exist across jurisdictions.

4.2 Digital currencies' success factors

An official stated that a quarter of the central banks that responded are already incorporating interoperability features in their considerations and explorations, according to a CPMI survey. The design of global stablecoin arrangements requires a sound legal underpinning in all relevant jurisdictions, adequate governance, and risk management that is comprehensive and adequate.

1. The 19 building blocks of the global roadmap for enhancing cross-border payments are arranged into five focus areas

4.3 The complexity of international payments means the progress of CBDCs and stablecoins in this area is still limited, so no improvement strategy can be put aside at present

A Central Bank official stated that CBDCs have potential in the areas of money, infrastructure and schemes. Many stablecoins are connected to decentralised finance, and several initiatives focus on regulatory compliance. The idea of multi currency stablecoins is not currently the highest priority with regard to CBDC. CBDCs take time, and the discussions are sometimes very difficult, even at the domestic level. The complexity of adding the cross border component should also be well known.

The construct is attractive, but it might not be easy. The ultimate question will be whether to 'tune up the old cars' or 'buy new ones'. It is not possible to eliminate certain alternatives, and there might not be a one size fits all solution. CBDCs might be mainly implemented for the settlement part in certain use cases.

5. International payments require standard rules and making rich data available end to end, whatever the current or new technologies and the systems that will all have to interoperate, so the likely model is a hybrid one

An industry representative stated that SWIFT will start with a 'hybrid car' as opposed to a 'completely new electric engine'. SWIFT is an infrastructure provider and does not decide on the asset or currency that is used.

A great deal of effort is going into ISO 20022 data end to end. Europe will move its high value payment system to that richer data in November 2022. Some compliance challenges in AML could be resolved with good data.

SWIFT also needs to resolve cases and exceptions in the community. It does sanctions and KYC checks, which will need to happen regardless of the payment system that SWIFT puts in place. SWIFT will need to ensure that different banking systems interoperate, which has already happened. Interoperability is important if there is a token on one side and an account on the other.

6. Regulatory and supervisory challenges

6.1 Innovation, cross border transactions development, and Big Tech and fintechs entering the market require adapting regulation and supervision and fostering cooperation and consistency, notably in AML and consumer protection, and level playing fields in order to achieve further integration and efficiency while leveraging innovation and avoiding piling up regulations

A representative of the public sector stated that regulatory and supervisory obstacles and evolutions are required to support progress. New players and less-regulated actors are also entering. There is also a need to adapt regulation and regulate further. Furthermore, proper risk management and the stability of the payment system are necessary.

A Central Bank official stated that a number of newcomers have also entered the market and sometimes had problems with compliance or AML. This is even clearer in cross border payments because the risk potential is much higher. Other issues are supervision and the need for international cooperation in the Big Tech sphere.

An industry representative stated that regulation is especially important for new technology enabled payment propositions. Crypto asset solutions and stablecoins have not been widely adopted. International consistency in the regulation of these payment propositions is necessary. The future is going to be shaped by interoperability and open frameworks.

Western Union welcomes transparency and customers knowing the cost associated with transactions upfront. The payment services directive (PSD) and PSD2 show that regulators are not lagging behind in Europe. Continuous recognition and progressive improvement will continue to drive the adoption of technology enabled payment methods.

6.2 Regulators jumped into innovation and have succeeded in remaining technology neutral

An industry representative stated that regulators have largely succeeded in examining challenges and issues in a technologically agnostic manner. It is advisable to look at risk perspective and understand new technology. Playing with new developments is important.

6.3 Further clarity on the respective priorities put out by central banks and regulators regarding wholesale and retail service is necessary to better address their specificities

An industry representative stated that regulators, and in particular the central banks, should clarify the priorities that they give to retail payment focus. The ecosystem of the wholesale has particular problems, so the challenges probably have to be answered in a different way.

NEW EU RETAIL PAYMENT ERA: REGULATORY CHALLENGES AND INFRASTRUCTURE ISSUES

1. EU payment landscape

1.1 Competitive challenges in the payments area that trigger regulatory challenges

A policymaker remarked that the competitive challenges in the payments area are enormous, and that is probably what makes it so exciting and interesting. There is a very interesting combination of incumbent operators, some with a high degree of market power and who must fend off the competitive threat from new entrants. There are disruptive new entrants with new business models and new consumer experiences with which they can bring real added value, but some struggle to find their way and their position in the market. There are other new entrants that are, at the same time, disruptive and incumbents, namely the digital giants who are leveraging their market position on the data side.

The challenges for regulation and enforcement are numerous. One is more on the traditional side of regulatory and enforcement work, which is interchange fees. The Interchange Fee Regulation (IFR) has been hugely successful and has brought competition to Europe in the payment area. The question of whether putting a limit to interchange fees has resulted in an increase in other types of fees by international schemes is being investigated. The Commission is in the fact-finding phase regarding the revised Payment Services Directive (PSD2) and next year there will be a study. The Digital Markets Act is much more advanced and is now being discussed by co-legislators. This is starting from the point that regulation is also needed to ensure interoperability, non-discriminatory access and to prevent self-preferencing and the undue exploitation of data for a host of services, including payment services.

A public representative remarked that work is ongoing on establishing the Parliament's position on the Digital Markets Act in various committees. It should help to level the playing field between the financial services providers and the giant digital services providers acting globally. The Parliament will call for open access and for the ability to have much broader interoperability between those who are providing various digital services and those who are focusing on financial services.

For some of the other initiatives that are important for payment services providers, there is the Commission's digital financial services package from September 2020 and Parliament is actively discussing its position on the Digital Operational Resilience Act (DORA). The issue of crypto assets linked to the preparation for central bank digital currencies (CBDC) is also being discussed in the European Parliament as part of the work on the Markets in Crypto Assets (MiCA) regulation.

1.2 Efforts for broad reachability

A Central Bank official noted that in the second quarter of the current year 10% of all credit transfers were instant. However, empirical evidence shows that there are huge differences between euro-area countries. There are a couple of very well-advanced countries and then there are others that are lagging. To unlock the full potential of instant payments, there is a need for broad participation.

There being differences in reachability in instant payments between countries impedes cross-border usability and may prevent instant payments from becoming a truly European payment instrument. Making participation in the Single Euro Payments Area (SEPA) credit transfer instant and mandatory for all euro-area payment service providers might seem like an easy solution to the problem, but a more holistic approach is needed. Even in countries with comparably low adherence rates, instant payments could be available to most customers if those banks that have signed the SEPA Instant Credit Transfer (SCT Inst) scheme have most clients. There are already several countries where nearly all banks offer instant payments but where the usage is still relatively low.

Payment service providers must ensure that attractive service offerings based on instant payments are available and convenient. The estimated share of instant payments is, according to European Payments Council (EPC) statistics, rising continuously. One of the most promising initiatives for a pan-European solution is the EPI, which heavily relies on instant payments. This can and should be a booster for the use of instant payments in the near future. Additionally, the Eurosystem will solve the SCT Inst interoperability problem at the back end of payments starting in November. It is no longer necessary for banks to be the client of more than one clearing house to reach all payment service providers, due to TARGET Instant Payment Settlement (TIPS) serving as an interoperability hub.

1.3 The ECB's strategy

A Central Bank official noted that the European Central Bank (ECB) published an explainer of its retail payments strategy in May 2021. A key element of the strategy, which was first announced in November 2019, is the full deployment of instant payments. An important aspect of that, where the ECB plays the role of operator, is in moving the automated clearing houses (ACH) from TARGET to TIPS to ensure that cross-border instant payments go through with the same ease as domestic ones. Banks also have to become reachable in TIPS as of year-end.

Another issue in cross-border intra-euro-area instant payments is compliance. Instant payments have a significantly higher rejection rate if cross-border, because of differing applications of anti-money laundering (AML) regulations and as compliance rules are not homogeneous. In normal SCT (SEPA Credit Transfer) payments things are manageable, but with instant payment there is no time for a manual intervention to remove false positives. Further pillars of the retail payments strategy are notably (i) the improvement of cross-border payments and (ii) the support for innovation, digitalisation, and a European payment ecosystem. The latter also relates to legislative initiatives like reaping the full potential of PSD2, open banking / open finance, and electronic identity.

An industry representative agreed that instant payment will not be successful if the AML cross-border problem in the EU is not resolved. If consumers experience one out of 10 transactions being rejected, they will not use the process as their major payment means.

A Central Bank official added that the broader Eurosystem strategy also contains support for the continued usability of cash, which remains important. There are people who may also in the future prefer to not (or be unable to) use digital payments, and for those the availability and usability of cash should be maintained in any case.

2. Digital payment provides everyone opportunities

An industry representative stated that this is a new era, and it can be a European one because there are elements of what Europe has already put in place that put it at an advantage over many other regions. Over the past months, some of the opportunities have been properly grasped, including using digital payments to create virtual foodbanks when the physical ones could no longer exist, or giving the vulnerable and those who were shielding the ability for others to shop on their behalf. When businesses, particularly small businesses, digitise they can reach more customers beyond those who just walk through their doors.

2.1 Payment effectiveness and reliability

An industry representative remarked that in all the technical discussions about all the aspects there is a need to stay anchored on those elements that the EU has always focused on: consumer trust, competition and, increasingly, how to build a sustainable economy. With regards to trust, focus must remain on the core things that people expect, which is that whatever form of payment they are using works. The environment has changed from a cybersecurity point of view, even over the last three or four months. That is something that will have to be worked on by the private and public sectors together, and something where data is going to be increasingly important.

An industry representative noted that the biggest demands consumers have are for the system to work and for it to be secure. There are more requests on complete consumer protection, for example on merchant disputes. That is an area that is not developed equally everywhere or for all payment situations.

2.2 The single EU payment market and the Consumer Credit Directive

An industry representative suggested that one of Europe's biggest assets is the single market. Significant progress has been made thanks to PSD1 and PSD2. Though there remain some barriers and challenges, there is also a major opportunity by creating a single credit market, which would allow non-banking financial institutions to have a credit licence and be able to passport that licence across Europe.

In 2008, the objective of the Consumer Credit Directive was to create that single market. Unfortunately, it has not really materialised, and the Commission is launching a revision. There must be caution not to use too broad a regulation brush, which paints products that are very different the same colour. There is a need to distinguish between products that can drive indebtedness and bear a cost, and those that come for free and are not as risky from an indebtedness standpoint. The proposal to introduce a cap on interchange is concerning. It conflicts with the principle of open and competitive markets. The proposal to allow the 27 member states to determine, on a country-by-country basis, the formula that would define that cap would create unnecessary barriers.

2.3 Data ethics

An industry representative emphasised that the EU led in terms of the General Data Protection Regulation (GDPR) but the questions of ethics and how data is used need to be worked through. There are ever more choices for payments at point of sale, but that choice must be enforced because it does not always exist. Choice is important for competition and innovation, and in a world where resilience should not rely on single points. The brilliance of open banking is that it is not just about creating new financial services, but also about making the existing ones work better. Open banking, because of its use of data, is enabling a completely different experience that existing institutions, as well as new ones, can take advantage of.

A sustainable economy looks like an inclusive economy. All businesses should have access to some of form of taking digital payments. As society eases or lifts restrictions, the one constant is the need for a Plan B, and it needs to be digital. Equally, there must be consideration of the potential that digital gives consumers in terms of agency over their lives. What people do every day and how they shop is how they express a form of agency, and digital payments can increasingly allow that.

2.4 Enhancing customers' payment choice and control

An industry representative noted that consumers demand wallets or envelopes for all kinds of digital payments, including currency conversion that is easy, smooth and on demand, with the choice to determine which currency services to use and which payments to make. Whilst there is an appetite there is also a great deal of questioning about whether it is safe, so there is a need to educate consumers. Consumers want control. They want to be able to manage their finances and see immediately what is going on. The biggest overall challenge for instant payment will be the move from a cash and card world. Instant payments have to be introduced into the commercial environment. A whole set of digital rules need to be defined around liability, refunds and recharges.

3. Key success factors

3.1 The added value for consumers

An industry representative explained that the overall question is whether to have something that copies the card or whether to create a second, differentiated product. The whole journey of introducing instant payment to commerce and making it an equal or even a substituting proposition for cards will take some time. There must be readiness for managing two infrastructures at the same time. Consumers want the choice between cash and cards, as well as instant payments in different forms such as the request-to-pay form or just sending money. It is an area of diversification in Europe and this diversity or the solutions there will have to be lived with.

3.2 EU priorities regarding the digital euro and cash

An industry representative noted that there have to be stable conditions in Europe for the business model. There needs to be viable over time because all the changes in payments take quite a long time. Though there is a need for new regulations and changes, overall, the challenge is that many of the solutions have to be implemented. There is a need to collectively set up priorities and deadlines. Europe is not talking about instant payment but, at the same time, it is talking about the digital euro and about getting rid of cash. Clarification of how all of this should happen, how it fits together and how to complete the different elements is crucial.

4. A digital form of money is a missing link within the eurozone digital value chain

A Central Bank official stated that the pace of digitalisation has never been faster. Digitalisation calls for a safe and efficient settlement asset, including the appropriate infrastructure with a digital form of money that is efficient and cost-effective, and can be seamlessly integrated into almost any kind of business process. This will also lead to the question of whether central-bank money needs to be digitalised. The Eurosystem has to be prepared to ensure the provision of safe and efficient payments in the future. In addition, the digital euro has the potential to protect European digital and monetary sovereignty.

A digital euro could counter potentially dominant big-tech market positions, based on their platforms and their commercialisation of data in the payments space. It could also potentially serve as a backup in a situation where a dominant non-European payment-service provider might exclude Eurosystem users from its services, based on extraterritorial regulations or even extraterritorial sanctions.

An industry representative noted that currencies are not only a very important part of monetary policy and financial stability but are also a part of communities and a representation of sovereignty.

4.1 Digital forms of money and central bank money

A Central Bank official noted that the retail-payment world has, in the past, relied on a mix of central bank money usage in the form of banknotes and the provision of electronic payments by the market, and that the trend is towards digital payments. Extrapolating that trend ends in a world where the availability and usability of both central-bank money and private means of payment would be lost. The ECB remains convinced that the availability of both to citizens is crucial. The investigation phase, as of 1 October, will answer the question of what the functional scope and design of a digital euro should be, along with the potential use cases. The question then is how the usability of central bank money would be preserved in this new world, where the private sector offers various good solutions. One conclusion is to not replicate the entire front-end universe that the industry has developed. The digital euro solution should maximise the added value of central-bank money in the retail-payments space. The idea is to not 'crowd out' existing providers.

An industry representative highlighted the need to analyse the challenges in order to make CBDC commerce-ready, to find out how it would impact other payment means, what it would mean for the full set-up of the European market infrastructure and how this would complete the set-up so far seen on instant payments.

4.2 Competition and regulation or CBDCs

An industry representative noted, on the question of acceptance, that currently there is the settling in of digital fiat currencies. It is possible to settle in any fiat currency, whether it be a retail CBDC or something that, ultimately, could be translated into a banknote. Working together on thinking about acceptance, but also making sure that consumers can use it and settle into it, is something to support.

An industry representative stated that digital currencies, like instant payments, are thought of as exciting opportunities, as they create a new level playing field for new players to come in and to innovate. This is a good thing, and a framework to define some rules and to bring in some infrastructure is welcome. However, this is where the regulator should stop because the players then need to work on the use case and to find opportunities. Competition is key. It is what brings more products, services, and choice to the consumer. In some markets, the IFR, which was meant to lower competition, strengthened the market share of incumbent schemes. There has to be caution about what is defined as a digital currency.

A policymaker suggested that the ideal is to regulate that part of the infrastructure where market power is built. In the digital world, that is typically the markets where there are very strong network effects and tipping points where, after a certain point, there is no space for competition. What should not be regulated is where there is competition and different operators, because there will be more innovation and better conditions for consumers. The real difficulty is that things constantly change.

A public representative remarked that it was not known that the COVID-19 pandemic would enormously accelerate the development in the real world in terms of the uptake of digital payment technologies. There must be a very careful investigation of possible use cases of a digital euro. Then there should be a rapid implementation phase because there is currently a time horizon set by the ECB of 10 years following the investigation phase, and that may already be too late to be in the lead in the area of digital public or private currencies.

SESSION SUMMARIES

VI

ESG AND SUSTAINABLE FINANCE

DIVERGENCE OF ESG APPROACHES AT THE GLOBAL LEVEL: WHAT IMPACTS?

1. ESG challenges for the financial sector are being addressed but concern remains

1.1 ESG considerations are now mainstream for financial markets

A public sector representative stated that environmental, social and governance (ESG) is becoming increasingly mainstream. Differing approaches across the world mainly reflect different starting points.

An industry speaker stated that ESG and climate change considerations are a routine part of any Moody's discussions. Almost every time, there is a dialogue around ESG considerations for a particular issue or market. Although some debate whether there is too much emphasis on ESG or climate change, this is as important a consideration for many investors as looking at banks' asset quality, insurers' underwriting capability or their capitalisation.

1.2 Greenwashing, capital misallocation and insufficient financing available are the three issues for which the financial sector is central

A public sector speaker stated that there are three big public policy problems: the potentially serious misallocation of capital without clear disclosures in the context of known science; the problem of greenwashing; and the fundamental public policy issue that any credible scenario in which climate catastrophe is avoided features private markets and private capital playing a central role in channelling trillions of dollars' worth of investment. The financial sector is central to all of those questions.

An industry speaker stated that the point around greenwashing is critical because everyone in both the private and public sectors really wants to avoid it.

1.3 Challenges to address in order to reduce the greenwashing concern

A regulator stated that the rules regarding selling financial products to investors can be made extremely complex, but it is also possible to get a long way at a relatively simple level. Asking where people want to invest, why, and whether they are investing in something that is focused on activities that are indubitably at the green end of the taxonomy is very important. Institutions or projects should not sell brown as green.

Another problem with labelling is that trying to simplify everything down to one indicator might overdo or underestimate the number of dimensions that exist, but intelligent labelling can achieve this.

2. The observed speed of climate risk raising requires being pragmatic by focusing on delivering equivalent/interoperable sustainability labelling and reporting outcomes globally, and agreeing on common principles

An industry speaker reported that 81% of senior executives stated that standardisation of measurement and reporting standards would help to accelerate their net zero efforts. Convergence and standardisation are the ideal outcomes. Their institution is very supportive of the concept of double materiality while recognising that financial materiality will probably take some more time.

Convergence is the tip of the iceberg, which is a rapidly melting one. Without real progress, the world is probably on track for a 1% drop in emissions by 2030 versus the necessary 45% drop. Once there is some agreement on the approach of materiality, there will be issues around implementation, data identification and collection. It will be necessary to decide on how these have to be inputted, the computing, the outcomes that will need to be measured and how this will be adopted. This will be subject to various public and private reporting frameworks, and the necessary APIs and data repositories to collect this information.

This could take decades and, unfortunately, time is not on our side.

The aforementioned also does not mention convergence in other areas of ESG outside of measuring climate risk. Policy and regulation are critical enablers to scaling finance to make these outcomes happen. The focus should shift more to practical outcomes and interoperable regulatory standards that can be achieved in a much shorter timeframe.

An industry speaker stated that Moody's recognises that most of the proposals are currently around principles. There will be more harmonisation of data and metrics over time.

A public sector speaker stated that standards are necessary. There is a balance of arguments, but climate change has created an imperative for action at pace. However, a coherent international standard is necessary.

An industry speaker stated that there is also optimism around agreement on some of the ESG principles. The sustainable finance taxonomy is a very solid piece of work with very strong definitions. There is a risk that what is sustainable within the European context makes a huge amount of sense, but would not necessarily if taken word for word and applied to a country like Bangladesh. It is necessary to untangle the issue around the areas of common agreement on what would work in both markets and strive for interoperable frameworks, rather than attempt harmonisation.

A public sector representative suggested focusing on coalescence around intelligence, ideas, and interoperability because full convergence will not realistically be reached. It is advisable to focus attention on minimising this divergence before managing what is left in a way that allows the financial sector the best chance of delivering on its own net zero requirements.

3. ESG criteria heterogeneity is the only aspect of the existing data and disclosure divergence issue financial markets must deal with

An industry speaker stated that Moody's relies heavily on the skills and experience of its analysts, but it uses a lot of data from a wide variety of sources. When Moody's considers data and disclosures, it notes that it already lives in an imperfect world. It already deals with wide varieties of data and a lack of consistency in data and disclosures in its analysis. Moody's is developing an approach to allow for a lack of consistency.

4. The benefits expected from further convergence, lead to supporting initiatives such as those put forward by the TCFD and the IFRS Standards Board

An industry speaker stated that Moody's is also very supportive of the consistency and harmonisation approaches that have been put forwards by groups like the Task Force on Climate Related Financial Disclosures (TCFD) and the International Financial Reporting Standards (IFRS) Sustainability Standards Board's proposals. Having more standardised disclosures will reduce the complexity of analysis that an investor, credit analyst, or equity analyst needs to go through. The second benefit of more harmonisation is around the cost involved. A more harmonised, standardised approach to disclosure will also make it easier for firms to disclose how they are progressing towards their carbon targets. In addition, it will be much easier for investors to judge who is performing well.

An industry speaker stated that the broad answer is speed of progress. Insofar as it is possible to have more consistency, it is possible to move faster to solve this issue. A financial institution can harness capital and bring global players and standards to the table because it operates globally.

Bank of America is not necessarily waiting for the public sector, although several private sector initiatives are happening. One of those might achieve momentum and become the dominant one until something else comes along. This will happen until or unless regulators produce something. Non governmental organisations (NGOs), journalists and public bodies will want this; asset managers and investors will look for it.

A regulator stated that there are various ways of looking at the situation, but it is not as bad as it is feared to be. TCFD is one of the more global pieces of standard setting of recent years in the financial domain. It originated when not everyone saw the problem as urgent. The basis can be built on for a 'TCFD Plus' that moves away from principles and description to data and definitions. A competition between different approaches, models, and thought processes could lead to a richer way forward.

A regulator stated that he is sceptical about waiting for perfection. There is a broad consensus that it is necessary to start moving fast. The financial risk management problems are especially complex.

A public sector speaker stated that TCFD is an architecture, but it does not deliver the necessary underlying standards. The IFRS is the appropriate forum to take this forward in its new proposed International Sustainability Standards Board.

The other aspects of ESG are important, but climate is the focus. The second step is as much of the global financial system as possible engaging with the IFRS and the International Sustainability Standards Board (ISSB) to take the second step before considering jurisdictional adoption and implementation.

An industry speaker stated that Japan has adopted TCFD, so it covers single materiality. However, the Japanese Financial Services Agency's (JFSA) reaction to examples of disclosures for financial institutions and other general corporates was very helpful. It also supports some of the private sector's activities. More of a dialogue between the public sector and the private sector could be necessary to accelerate private companies' activities.

An industry speaker echoed Bernard Mensah's point that a great deal of activity is happening in the private sector. One example is the work of the Taskforce on Scaling Voluntary Carbon Markets on scaling robust and liquid voluntary carbon markets. Allowing the markets to innovate and try to create new products to move capital is important.

A regulator stated that coalescing around the intelligent types of definitions that emerge is how this will inevitably move forward. If this is not moving fast enough, the public sector can push. If it is going 'completely wild', the public sector can try to channel it.

5. A dynamic materiality approach consisting of a progressive shift from the simple materiality approach toward the much needed double materiality should help to address part of the related complexity

An industry speaker stated that the first part of MUFG's carbon neutral declaration from May 2021 is the bank's aim for net zero emissions in its own operations by 2030. The second is net zero emissions in its entire financing portfolio by 2050. Ambitions around the first target by 2030 are single materiality ones. One challenge centres on MUFG's operation including four partner banks across the Asia area. In these countries and industries, the policies around climate change are very diverse. The key part of engaging with those countries could be consistent disclosures.

The 2050 target is a double materiality matter. The bank has started assessing its targets and action plan. Through such processes, the bank intends to set its interim target by 2030. The nature of the banking activities is a matter of double materiality.

The bank could be a producer as well as a user of disclosure data and information. It should utilise two buckets of its disclosures effectively: enterprise value reporting and sustainability reporting. This is the concept of dynamic materiality. The EU is the global leader in seeking consistent disclosures and methodologies; it also advocates double materiality.

5.1 Non financial disclosures should be consistent with the role assigned to the financial sector regarding sustainability transition of economies

A public sector speaker stated that double materiality is incredibly important for its impact on the environment. It is not possible to have an effective mechanism for directing the investment needed to fund transition if no data or information in the system articulates firms' impact on what there is an attempt to solve. This will be challenging. On the balance of the risks, it is important to move quickly on single materiality.

5.2 Convergence also expresses a need for further regulatory certainty regarding ESG targets

A regulator stated that many are trying to approach the issue from different directions, so it is understandable that there is a desire for certainty. However, this could lead to consistent but poor disclosure. As people seek standardisation, they are not just trying to seek convergence around a set of standards that has the most effective group of lobbyists.

A public sector speaker stated that convergence is important, but none of it should stand in the way of domestic initiatives to move forward on this issue.

5.3 Double materiality disclosures may lead financial regulators to state non financial stances on capital allocation, although these are in the exclusive remit of investors and policy makers

A regulator stated that her views could be different from her colleagues at the SEC. The SEC is working on rules along the lines of climate and human capital disclosures, drawing from a request for comment that the acting chair lead put out in spring 2020.

The general way that ESG disclosure is being approached is concerning because the role of financial regulators is sometimes forgotten. It has historically been inappropriate for financial regulators to take merit positions on capital allocation. The SEC's role is to get material information to investors who can then use that information to make decisions about long term capital allocation and the long term financial value of companies.

Double materiality is premised on the notion that financial disclosure should be about more than a company's long term financial value, but it should be about the outward effects of the company. If the SEC took on that kind of task, its job would be boundless, and its disclosures would be endless.

Cross border work is very important. The end objective of a more sustainable global economy with prosperity for all is not served by all of the SEC's international colleagues using a single set of disclosure standards. Doing so runs the risk of directing all capital in the same direction. Adding climate and social crisis prevention to the SEC's mandate will not be any easier.

A regulator stated that the panellists' problems are intertwined ones around climate, environment, and social issues.

A public sector representative agreed with the but stated that regulators are not being asked to allocate capital.

5.4 Financial regulators should remain focused on the financial sector while understanding and managing climate and sustainability related risks

A regulator stated that he had started his approach to the issue by questioning the mandate that supervisors have to oversee aspects beyond financial risk management. He sometimes detects scope creep among supervisory agencies on this topic and others.

There are four types of risks in the context of climate change in the financial industry: physical risks, transition risks, the risk that the market has insufficient information, and the risk of greenwashing.

6. Addressing greenwashing risks requires urgently defining reliable disclosures

A regulator stated that the risks of disclosure and greenwashing are linked. Greenwashing means that a product created to satisfy an apparent demand ends up alienating that demand. It is also widespread. BaFin recently proposed definitions for when a product can call itself sustainable, which have been predictably unpopular. They have also been criticised for going too fast and being inconsistent with other approaches that might come later. However, even if the prefect solution does not exist, it is time to move.

Private sector initiatives are also necessary to address greenwashing, and competing labels and standards may be fruitful

A regulator stated that there are various ways of looking at the problem of inconsistency in global markets. Being global means being multi local, and there is a cost to that.

Competing labels might exist. It is maybe sometimes necessary for them to converge at some point, and some public sector persuasion is necessary if labelling and definitions are to converge.

RENEWED EU SUSTAINABLE FINANCE STRATEGY: IS IT SUFFICIENT?

1. Main stakes and challenges specific to the EU Renewed Sustainable Finance Strategy (RSFS)

1.1 Achieving integrity, quality, and transparency of the data

A public representative stated that the upgraded work touches almost all of the key elements: the integrity, quality and transparency of the data, the reporting mechanisms created, and the global element. The EU needs to be the motor that drives a global reporting scheme and a global data scheme, with comparability. This covers all environmental factors such as biodiversity, land use, emissions, and circularity, but also reflects on the social side. It is important that the science base and what the industry does is up to the challenge, so it does not end up with side-tracks and sunk investments.

1.2 Mainstreaming green in the financial regulatory framework as well as in financial institutions' strategy and management is an ambitious target

A public representative noted that green elements need to come into banking. It should be compulsory for credit ratings to rate the environment and environmental, social and governance (ESG) factors.

The Chair highlighted that not all legislation could be rewritten, but what could be done is to bear in mind the sustainability angle in any upcoming reviews of, for example, Solvency II, of the Alternative Investment Fund Managers (AIFM) Directive or in the EU implementation of the most recent Basel package.

An industry representative stated that the initial action plan is continuing to help push sustainable finance into the mainstream, particularly with the prudential climate risk-type regulation. The business strategy is demand-led, as clients continue to be interested in investing sustainably and aligning with some of the larger and longer-term policy outcomes.

1.3 Transforming the economies to sustainability requires a better combination of public and private sector sustainability initiatives, and of frameworks leveraging the financial sector and policies defining unavoidable sets of 'carrots and sticks'

A public representative observed that industry works in different silos and is heavily concentrating on the private sector. There needs to be harmonisation of both public and private finance on reporting, metering, rating and channelling public money. There is work on how to integrate, with political pressure, those two sectors. Following that, there may be some ideas about what to do voluntarily and what needs to be regulated in companies' transition plans, such as ecological competence support.

An industry representative added that very large numbers are often thrown out around sustainable finance. As of Q2 the figure is about $2.5 trillion for sustainable investments in terms of funds, and around $2.6 trillion globally in terms of sustainable debt across bonds and loan instruments. They are single digit percentages on the total investible assets globally. The numbers that are often cited are $5 trillion to $7 trillion of investment that is needed annually to help achieve the Paris Agreement and the broader Sustainable Development Goals (SDGs). There is clearly still a long way to go, but it is about sustainable economies and societies, not just sustainable finance. The finance sector can be a critical leverage point, but ultimately it is the real economy that is going to be transitioning to renewable energy.

An industry representative noted that in the summer the Swiss people voted down the government's climate plans that had been developed over a number of years. When paying for climate-change mitigation there are a number of different views. It is important not to underestimate the challenge.

1.4 Combining incentives and obligations as well as targets and transition paths, avoiding disruptions, tailoring risk mitigation tools relevant to new types of risks, achieving workable and proportionate rules, and mobilising and addressing the needs of the wide variety of economic players are some of the challenges posed to the Renewed Sustainable Finance Strategy

A public sector representative stated that the renewed strategy is a good piece of work and an important refinement of the first one. The questions are how it can be implemented, what are the first steps that are needed to support the ambitions of the EU, how the taxonomy will be developed going forward, and how the financial sector will participate. Banks and insurance companies may need to put aside capital to account for sustainability risks.

The Chair agreed on the need for balance and the fact that there are diverging views between member states. Not everyone starts from the same place. Inclusiveness is very important in the renewed strategy.

An industry representative noted that a legislative framework should not be created if it is excessively complex for many financial-market participants. There is a risk that sustainable finance efforts could be damaged if the rules are quite difficult to comply with. Sustainability rules need to allow financial institutions to support activities by companies such as energy companies. Disproportionate investment is necessary for all transition-related sectors.

An industry representative highlighted that in May 2021 the Japanese government published basic guidelines on climate change transition finance. These are still very conceptual, and it is practically impossible to cover all business activities. A degree of discretion is needed to allow companies to assess whether financing is justifiable from a sustainability perspective.

2. Regulatory aspects

2.1 Key concerns and implementation challenges

A regulator supported the sense of urgency that has been expressed. It is important for the Commission to build a comprehensive legislative framework that covers the entire value chain. Sustainability is now an integral part of ESMA's mandate. The prevention of greenwashing is at the heart of ESMA's concerns and is a key priority. Appropriate disclosures can also help to avoid misallocation of capital. The European regulation already adopted should help, with the Sustainable Finance Disclosure Regulation (SFDR) and other proposals on the table, but there are still concerns. Some definitions are not clear. There are concerns as some members that what ESMA has done is not enough.

A regulator added that there are implementation challenges. It is important not to miss the opportunity of having consistency across all legislations in terms of definitions, scope and implementation deadlines. The other aspect is proportionality. If the system is too complex or excessively burdensome it may be difficult for corporates to comply, whereas they need to be onboarded and in the system. Skills and capacity-building is yet another challenge that cuts across the entire industry. The key challenges are preventing greenwashing, maintaining trust, and making sure the implementation works well.

An industry representative welcomes and applauds the EU for its new strategy. It is comprehensive and builds on the work that has been happening over the last several years in pursuit of the Green Deal. The overall emphasis has been on disclosures which raise awareness of what is truly a sustainable investment. This helps to battle against greenwashing, which was and still remains a big challenge. Over the next decade there need to be significant changes in capital flow, which will go beyond the world of sustainable investing. To achieve this, honesty is needed. Most capital is being deployed by companies, not by investors. In order to change those capital flows, companies themselves need to change strategy. Investors only have two routes: they can divest and no longer invest in the company, or they can escalate their stewardship. Divestment, even at large scale, will not achieve the changes that are needed in the real economy. Investors need to commit to changing companies' strategies through their stewardship approach.

2.2 Greenwashing and taxonomies

The Chair noted that greenwashing is directly linked to regulatory issues. The more discretion and flexibility and the less precise rules a sector has, the bigger the potential for the problems of greenwashing.

A public sector representative stated that the taxonomy, disclosure, and labels will work to implement the EU Sustainable Finance Strategy. The taxonomy is still not developed, so there are sectors that are still missing. Europe already has a well elaborated disclosure scheme and is dealing with EU green bond standards at the moment. It is about preventing greenwashing and ensuring investor protection in this context. The right balance needs to be achieved with the objective of maximising the large capital flows to sustainable finance that are needed for the strategy to be met.

A public sector representative recognised that remarkable progress has been made since the first action plans in 2018. Europe is a strong global leader in sustainable finance, both on the market and on the policy side. However, where the challenge now lies is that progress is still too slow considering the magnitude of the challenge, the urgency, and the fact that time is running out. It is important to ensure a high level of ambition and, at the same time, to ensure consistency and practicality of the measures, taking into account that Europe has also already produced an impressive body of legislation. Europe cannot think in the binary terms of 'dark' and 'green', since it might leave too many behind. Small and medium-sized enterprises (SMEs) deserve special attention and support.

A public sector representative added that transition is important, as recognised in the strategy. It is important to make sure this is fit for purpose as a transition tool without overwhelming market participants. Major policy decisions have to be taken to Level 1, but a taxonomy is needed that is credible, otherwise it will not be useful for investors. Therefore, it cannot contain nuclear energy. There is increasingly a need to have even more certainty about the concrete contents of sustainable investment.

An industry representative noted that although the taxonomy is good at identifying the green half of the equation, transition metrics are the most important. For each sector there are different ways of looking at scope 3 emissions, and there has been a lot of excellent work in the private sector between investors as part of Climate Action 100+ (CA 100+) on building on the benchmark. The stewardship side is the principal lens by which companies are changed, rather than leaving them to a world of foreign, misaligned capital. A stewardship code is needed that articulates the principles.

A public sector representative stated that everyone knows the RSFS is insufficient to tackle the major environmental challenges, as the strategy must be clear and readable. Inclusivity is needed, as if there is a strategy then there will be companies and financial actors which will try to escape from it. Most people do not believe that the finance sector is serious when it speaks about sustainable finance. Finance is now regarded as a major actor for transforming the economy. Banks are not only regarded as followers, but as actors for the transformation. Greenwashing was a good signal three or five years ago when it meant that the finance sector regarded green as an important challenge. It is now a burden, as the public does not believe the effort is being done. The industry needs to have incentives for long-term investing and for investing in sustainable finance, and disincentives when organisations are caught.

A public representative added that SMEs are a big bulk of the economy. An easily accessible data space should be developed, as people can then derive what the total impact is.

A public sector representative asked whether assets that have the taxonomy of green, will have the same return as those that are not labelled. If they have a lower return, then the question will be on how to attract new products. The answer is by taking the upside of the non-labelled assets. Banks must think not only about labels and taxonomy but about the impact and the result of it.

The Chair observed that Europe is on the right track, although it is very clear that the challenges are formidable on many levels. There is also a need for global coherence, consistency, and inclusiveness, as well as an inclusive transition.

2.3 CSRD, international coherence, compatibility, and transition

A public representative noted transitional activities are a big risk, such as the transition from coal to gas, building infrastructure for hydrogen that is based on fossil fuels, or the wrong type of bioenergy. That should be regarded as greenwashing as well, which is why there need to be globally unified indicators and a strict bottom line in terms of Do No Significant Harm. It is important to get rid of the $40 trillion of assets that are in unsustainable sources. It is beneficial that there are initiatives like net-zero stewardship that can push big companies that invest to have a transition plan up to 2030 or 2035.

An industry representative stated that their company is very interested in international alignment and standards. There needs to be a strong link between the next round of the European effort with international efforts. The industry representative's company is very much in favour of double materiality and impact-type reporting, but to do it well there is absolutely a precondition to get information from corporates, investee companies, counterparties, and clients. Alignment on the reporting standards is very important. The industry representative's company is very supportive of the International Financial Reporting Standards (IFRS) work on the Sustainability Standards Board and encourages a high degree of alignment between what Europe moves forward on the Corporate Sustainability Reporting Directive (CSRD) and the European Financial Reporting Advisory Group (EFRAG).

An industry representative stated that their company is trying to seek transition as a concept in the truest sense. Financial institutions are left to their initiative to work out the relevant transition path with their customers. One thing that is important to discuss is the importance of consistency among the ESG transparency and disclosure requirements. The hope is that regulators or policymakers will align the concepts under the different disclosures with standards. The recent work of the European Banking Authority (EBA) in aligning Capital Requirements Regulation (CRR) Pillar 3 and EU taxonomy disclosures is noteworthy.

A regulator observed that ESG data has been the missing piece in the overall strategy until now. Information is needed from the corporates in the first place, so that investors and financial institutions can analyse it, understand their exposure, and manage their risks. The CSRD will help address some of the shortcomings of the Non-Financial Reporting Directive. While there is a need for international consistency, in the EU, there is strong support for double materiality.

A regulator added that ESG rating is very important to their institution, because market participants are looking for that information notably to meet regulatory expectations and to respond to investor demand. But assessments are very diverse. We see very low correlations. Although it is totally understandable that there can be different qualitative judgements, there is a need for a robust framework to ensure information provided is reliable, up to date, transparent and based on consistent methodologies.

A public sector representative stated that the CSRD is the missing link between the other pieces of work. The participation of the wider population and retail investors is important, as and therefore greenwashing should be avoided.

EU TAXONOMY AND CSRD: POLICY TRENDS AND IMPLEMENTATION CHALLENGES

1. Taxonomy and the CSRD aim to provide reliable and comparable knowledge of the sustainability of companies and daily processes of the financial sector as the progress of economies is too slow

An industry representative stated that much has been invested in understanding sustainability data. The evolution is wonderful, but this is a 'code red' situation for humanity. Risks are rising rapidly and in a non-linear fashion. Around 77% of global companies, or the top 12,000, publicly report carbon targets, which is good, but those targets show a 72% shortfall against the Paris Agreement. There is commitment, but a huge shortfall. 66% of companies face high risks from the impact of climate change, according to S&P analysis of 3 million assets owned by 110,000 companies. Greater transparency on risk and opportunity is needed to understand how companies are transitioning and adapting to climate change, which is critical to S&P's work to serve the market with sustainability intelligence of the highest quality that enable investment decision making and enable capital to flow towards sustainable outcomes.

An official stated that progress is still too slow considering the magnitude of the challenge being faced and that time is running out. This decade will be decisive in answering whether climate change can be limited, and the transition of the economy managed quickly and as needed. A key challenge to overcome for the transition is in finding the right levers to pull. Financial markets can play a key role if there is reliable, comparable, and good-quality knowledge of sustainability aspects at a company level.

The taxonomy and the Corporate Sustainability Reporting Directive (CSRD) aim to increase knowledge and are complementary. The taxonomy will only work if information on firms is in place and so good results are needed on CSRD. Germany is happy to contribute at the European level and supports double materiality for CSRD reporting that shows how sustainability, risk and opportunities affect companies' business models and their impact on the environment and human rights. A credible and practicable taxonomy is required. The financial industry, the real economy, and small and medium-sized enterprises (SMEs) must make use of the taxonomy and the data and deliver high-quality data. A practical approach from market participants to use taxonomy and CSRD to make the transition possible is key.

Once frameworks are in place and the relevant information is available, it must be integrated in daily decision-making. Financial institutions can use it to better manage financial risk in their portfolios, identify sustainable investment opportunities and support clients and investees in managing the transition. The financial sector's role is critical to help the industry and SMEs to manage this. Companies will benefit from a better understanding of business risk, opportunities, and competitors' positions. Regulations, the taxonomy and the CSRD are essential to manage the transition. The Chair (Sébastien Raspiller) highlighted the key term 'double materiality.' There is no point in collecting data that is not linked to the goal of carbon neutrality by 2050.

2. Nuclear energy, financial sector remuneration schemes, transition acceleration, a more inclusive transition, and helping investors to identify whether a financial product is green or not are some of the remaining policy challenges faced by the EU sustainable finance framework and taxonomy

A public representative stated that the taxonomy and the non-financial reporting directive (NFRD) is needed as the taxonomy shows where to go and how activities fit into a sustainable society and economy, while the disclosure regulation and the CSRD show who went there. It is a work in progress and the proposal is far from perfect. Work started in 2018 knowing that the order of the legislation was not logical and that it would be incomplete to start with, but these are vital building blocks to make the financial sector sustainable and to contribute to a sustainable economy and society. It was not easy and there was much discussion of the regulatory technical standards (RTS) and the delegated acts. Nuclear energy is on the table. Some member states think it is good, but this is toxic and could potentially lead to a 'meltdown' of the taxonomy. When there is discussion, it is relevant, and that is good.

The public representative stated that it is about building blocks, but movement is needed. It is not only the regulatory setting of the financial markets and financial markets participants that is important. Markets need to be clear that they serve people and the planet, as this provides their licence to operate. It should be reflected in financial market participants' internal organisation, and it is vital to look at remuneration policies because, if they are still in financial terms, it shows the business is not serious about sustainability even though it has sustainability reporting. If a CEO is still remunerated only in shares, it is not likely that the company is sustainable.

Environmental, social and corporate governance (ESG) work needs to expand its focus from the E and, within that, climate change, to the S regarding energy challenges. The transformation must be inclusive. If it is not, it will be a bumpy road and the building blocks will not be as effective as they should be. Not everything is about data. Data is important for standardisation, but not all risks or adverse impacts can be captured. Risks from issues like child labour, forced labour or land grabbing cannot be standardised. It does not mean the risk is not real. The aim is to serve people and the planet and make profit to arrive at that.

An industry representative noted that there is a great deal of talk about environmental data and that is critical, but there is also a need for inclusion and diversity. There are more aspects of the issue than just the environment. It is important for society and for economic growth that it becomes more inclusive.

An official agreed it is important that the financial sector gets reliable information from the real economy and corporates. There must be regulations and requirements to make it easier for clients to identify whether a financial product is green. Guidelines or something from ESMA or other European bodies are needed for a level playing field, particularly regarding the directive on undertakings for collective investment in transferable securities (UCITS) and other products for retail investors. There is still some work ahead.

An industry representative commented that, from a policy perspective, internationally commonly agreed convergence and investor education are key so that end investors understand easily what is and is not sustainable and can mandate asset managers to invest on their behalf into sustainable companies. It also needs to be guided by policies. Asset managers and investors depend on simple and transparent policies, but this is driven by the end investor community and investor education, to make them aware that their capital can have an impact. That is key to unlocking the sustainable finance agenda.

An industry representative stated that insurers need help. Outcomes should be as simple as possible when reporting to financial markets and clients. Good advice and dialogue on an investment's evolution must be accessible to all, including those without high-level financial or environmental education. Comments about data collection sequencing are positive, as the financial sector had to wait for data from corporates to give high-quality reporting. Adapting work processes is also supported.

An industry representative stated that making change requires supporting change and there is an opportunity to create a framework in the taxonomy around transition. An example is the sustainable bond market and its support for raising capital used to transition. The new standard for EU green bonds, linked to the taxonomy, can create a framework for transition, and help achieve targets within the sustainability finance policy.

An industry representative stated that CNP is among the European market leaders for personal insurance and is in favour of the Commission, governments, and the Parliament's efforts to help, as the concerns are felt deeply. CNP promotes sustainable investment, sustainable economies, and social organisation. Around €350 billion of reserves is managed, so sound and clear criteria are required to guide in channelling investments where they can be useful to the transition. Insurers are concerned by risks related to climate change or social challenges and underwriters must integrate it all, so criteria that can help is good. Clients are advised on investments and so sharing their dedication and willingness for new products related to environmental protection and the transition is essential. The work in progress is welcome.

Common standards are required, and it would be good if they were global. Wide coverage of this set of indicators is needed, not only on the environmental, but on all aspects of ESG. It would be good to cover not only dark green potential investments, but to be guided in the election of dark or light green, white or black products or corporates, to nuance the evolution of existing reserves and assist insurers that are invested in sovereign bonds and fixed income. Taxonomy about sovereign bonds would help, and the wider they are the better.

A regulator stated that transparency and sustainability are important for investors but will not bring about climate transition alone. Fair carbon pricing mechanisms and other measures are needed.

3. Addressing the fragmented non-financial reporting landscape and unlevel playing field, and closing the data gap, require a clear and robust set of rules and sustainability reporting standards

An official emphasised the availability of quality ESG or sustainability data and reporting. No policy or strategy can be successful without quality data, which means relevance, faithful representation, comparability, verifiability, and auditability. The 2014 NFRD and subsequent guidelines were innovative but insufficient to create a comprehensive and quality data landscape, so a costly multiplication of individual efforts and of private initiatives exists. It is fragmented. There is an emphasis on ambitious public policies. A public representative raised the focus on sustainability objectives and that there is a need to move forward on the quality of sustainability data and reporting. The CSRD was proposed by the Commission in April and is following the legislative process. The CSRD intends to create a mandatory environment of sustainability reporting based upon providing a clear and robust set of principles and rules to apply and innovative sustainability reporting standards. The Commissioner and Executive Vice-President Dombrovskis stated 18 months ago that it would be impossible to move forward without standards and proposed that non-financial reporting should be on a level playing field with financial reporting.

Standards are progressing and the EU is in a front-running position. At the Commission's request, EFRAG launched a taskforce a year ago. The first phase was preparatory work, as it is a dense report. When the legislative proposal was tabled, the Commission requested EFRAG start elaborating standards and that a prototype will soon be available, which is an element of a global set of standards, on the basis of a working paper on climate. It is ambitious and there will be much discussion before it is finalised. The goal is to deliver standards by June 2022 to allow for implementation by reporting entities in 2024 with 2023 as a reference.

4. As SMEs play a key role in growing the economy and creating jobs, they should comply with the same rule framework as larger ones based on a simpler framework after a compliance period

An industry representative stated that the taxonomy and the CSRD are welcomed to help clarify which critical ESG and sustainable data points need to be disclosed. That will help investors compare information efficiently. The multiple reporting standards for corporates can be harmonised. Two important areas are implementation and developing an effective sustainable finance policy for corporates, focusing on SMEs, and transition. Many growth companies have come to Europe's public market in recent years. Small start-ups that raise capital in the public market grow into larger companies and create economic growth and jobs. Many of these are on board with sustainability or have sustainability as a core business model.

SMEs should be subject to the same rules of sustainability disclosure, irrespective of their financing mix, as for large companies. Smaller companies cannot comply with the same rule framework as large ones, so the proposal that SMEs should have a simpler framework and an extended period for compliance is positive. This special standard for SMEs is important and must be truly adopted, as SMEs play an important role in growing the economy and creating jobs. It also links these regulations and Capital Markets Union (CMU).

The Chair noted that there is a question of why listed or unlisted would have an impact on reporting when talking about going green. The call for proportionality and the specifics on it is also understood.

5. Investors demand accelerating transition so asset managers strengthen processes and capabilities for a better systematic engagement on ESG with companies

An industry representative commented that the biggest challenge for the asset management industry is sequencing. Asset managers must comply with the Sustainable Finance Disclosure Regulation (SFDR) from March 2021. However, the corporates invested in will only have to comply with the revised version of the NFRD that is deeper and wider in scope on ESG data from 2024 onwards. Asset managers are asked to disclose data that is not yet available from the corporates. Fidelity International is an active asset manager and is overcoming this through engagement with companies that are invested in and assessment of their published sustainability reports. ESG ratings from rating agencies are analysed. An internal analyst investment capability engages with the management of companies invested in directly to validate the data and assess its quality. An ESG propriety rating tool was developed which gives managers' assessment on how the corporates are doing on ESG and how they benchmark with each other. There are two benefits of this. The data assists corporates in improving sustainable performance and incentivises them to become greener and more aware of their social impact. If it succeeds, then investments will have an impact. The engagement fulfils fiduciary duties to investor clients as the stewardship role means acting on clients' behalf to ensure that investment is made into sustainable corporates and sectors. The end investor gives the mandate, and they have a choice of investing sustainably or not.

A regulator noted that the supervisory view is that CSRD and the taxonomy will enable transparent, relevant, and comparable reporting on corporates' sustainability. This helps investors and financial institutions to assess firms' sustainability risks and enables a better risk-return assessment, and this applies whether it is brown or green. It also provides information to those who want to direct firms to sustainable sectors and transitional activities. It also helps protect investors against greenwashing. Clear labels help retail investors not to be fooled and assist corporate management with reporting. It makes them more likely to move towards a sustainable way of working. It will enable more dialogue or engagement, as Natalie Westerbarkey commented, not only in the private sector, but also in public debate.

An industry representative hoped that policymakers progress the agenda quickly under the Slovenian Presidency in Ljubljana, the French Presidency in 2022 and the Czech Presidency in the second half. It is pace over perfection. Everything in the industry's power must be done to the best of its ability to implement a sustainable agenda and not wait until policies are finalised. The race to net zero is on.

6. Data to clarify near-term impacts on business models, non-financial information comparability, the consistency of information and the applied scenarios are challenging at EU and global levels

An industry representative stated that issues of consistency, comparability and relevance are widespread and there are huge information gaps and data holes in the marketplace. Companies report well, but often not in a comparable way, and beyond the top 5,000 companies reporting drops sharply. The Commission's efforts in the taxonomy and the CSRD are welcome, as they help to plug some of the gaps and ensure consistency in information flow. There is a need to translate the non-financial into the financial. Double materiality is important, but there is a link between the two and, whether it is long-term or short-term, financial impacts must be understood in financial terms. Electronic tagging is also welcome. A critical component of the CSRD's success is that if information is electronically tagged by companies at source, it democratises the information flow for capital markets and reduces the burden for companies. While there may be upfront costs in electronically tagging disclosure, it should reduce companies' burden as they face less questionnaires from multiple organisations. The evolution of the taxonomy and the CSRD is anticipated.

The financial sector can be part of the solution, with 70 trillion of assets signed up to the Glasgow Financial Alliance for net zero, so a significant commitment. The problem is the information gap. There are many long-term commitments, but not much evidence of how to transition to 2025. This is unusual for markets. Normally there is a great deal of near-term information, and not many 2050 revenue forecasts. Here, it is the opposite, with many long-term commitments, but not as much on the level of business model transformation required to reach a meaningful change in sustainability characteristics by 2025 or 2030. The question is how to address that. The CSRD and the taxonomy will help, as an issue for financial institutions is good-quality information to develop plans and targets and transform business models. Without that, decisions are made without the requisite evidence. One issue is the information gap in private companies. A private equity investor or bank needs a great deal of information from private companies, and not much is flowing now. Other gaps have been identified, particularly on forward-looking information and the consistency of climate change scenarios. Long-term commitments need to be supported by near-term plans; the taxonomy and the CSRD will help, but a great deal of disclosure from companies will be needed to get things moving faster.

An industry representative agreed there is a data issue for corporates and investors. The regulation is an opportunity to align and clarify critical data points. Local data is available and harmonising it to make it more relevant is an important task. A public representative (Paul Tang) stated that work needs to be done and is being done. There is a question, from being at Eurofi and talking to asset managers and institutional investors, of why it is not possible to share more data. Perhaps data has the character of public good and so there is not enough cooperation among market participants to share data and make progress.

7. As portfolios are global, comparability between EU and non-EU data sets is essential

A regulator commented that, with these directives, the EU plays a leading role in bringing about transparency and comparability. Sustainability is not a local or European issue. It is a worldwide issue, as investment portfolios are often global and comparability between EU and non-EU corporations and investments is essential. The IFRS's work on this is welcome. The EU should not slow down but it is good to have this work in coordination. Coordination is challenging, but aligned standards are vital, and one standard or comparable global standards should be the aim. The AFM supports the high ambitions of the CSRD and also the focus on double materiality. This can be instead of the single materiality of the IFRS, but a way to progress would be to have international standards as a building block with additional EU requirements on top, so something that is comparable and then the European topping up.

An industry representative agreed about dual materiality as the company's impact on the climate and the climate on the company are financially material. Acting quickly and in concert is key. An official stated that EU standard setting does not operate in isolation and there is a goal of co-construction at international level. Not all jurisdictions are on the same page, so a baseline is considered. Meetings are being held with the IFRS foundation and it is hoped that this will develop. A public representative noted that dichotomies still exist between European and global standards, but global standards are welcome if they embrace double materiality. This will be a dichotomy for some time.

8. Rating agencies fill a crucial gap in the availability of sustainability information. However, there is reduced transparency on their data processing and rating methodologies, and ESG ratings can differ

A regulator (Laura van Geest) stated that the SFDR, the CSRD and the taxonomy are progress towards creating a framework for effective transparency on sustainability matters. This has been done in the wrong order, as is clear from asset managers that have implemented SFDR in the Netherlands. Even if this is a good framework, the ESG data and the rating agencies' part is still lacking. They fill a crucial gap when corporations do not have sustainability information readily available both within the EU and outside it.

There are questions of why they need to be regulated and why also by French colleagues. It is not that regulators like to regulate whatever moves, but because there are potential conflicts of interest within organisations that sell data and provide data ratings. Regulators are concerned about the lack of transparency on data processing and rating methodologies and that ESG ratings from one company to another can differ widely even on the same topic. The ESG reporting chain will only lead to transparency and comparability if all links in the chain are strong.

9. Implementing new reporting requirements, defining new investment products and embedding sustainability in internal decision-making processes is complex and costly

An industry representative noted that it is good to be in touch with the building of these regulations and to exchange how it is on the ground. The impact of new reporting requirements is significant, but manageable, partly as insurers have been asked for so many supplementary reports in the last decade that they can adapt processes to new requirements. However, if it is manageable, it also has a cost. As an example, information documents have to be adapted to clients. CNP has 50 million clients and so the annual overall document costs around €10 million a year. If that is multiplied by the number of documents that have to be sent, it is something material. It will not change financial results and there have been no problems in the market because of it. Conditions exist to take it the right way, which already happens in corporates and companies, and decision-making processes are being modified in a number of areas. The first to be impacted is the investment decision-making process. Insurers are used to assessing levels of risk and to choosing investment by arbitration between levels of risk and return and diversification.

There is a new set of standards and criteria. Teams in investment committees are appraising investment projects through the taxonomy. It is already real in companies and that is true also in marketing. Often when colleagues propose new products, especially for unit-linked retained investment products, they include the green key in the product. It is a key feature, and a new product would not be issued without several options which can be presented to customers as compliant with the taxonomy, so there are requirements. It also has an impact and is important in risk assessment processes and procedures. Last year France had the first stress test linked to environmental criteria. The environment of the risk is not fully considered, but this is new, and it is happening. Things are being implemented at some cost. It is a supplementary burden of reporting, so while insurers are not keen on more requirements for reporting, it is being processed without major difficulties. The most difficult part will be the quality of the data coming from the corporates.

An official stated that the gap will be reduced if the CSRD is fully adopted and if the standard setter does a good job. Instead of being confronted with multiple initiatives with huge, related costs, it is vital to simplify. A mandatory environment based on robust standards is one solution.

10. Avoiding greenwashing, keeping trust and further clarifying transition pathways and final targets are key success factors

The Chair agreed that it is key to avoid greenwashing and to keep trust. The journey has many building blocks. It is key to also find ways to educate the average person. Data reporting should serve a purpose but is not there yet. More technical and academic work is also needed. It is not only about data; it is also about developing technologies, including ones to measure adequately.

There is a strong political commitment to carbon neutrality by 2050 and there should be a way to be sure of measuring whether this has been achieved or not, as that will be asked by every citizen in the coming years.

CLIMATE AND SUSTAINABILITY RISKS IN THE BANKING SECTOR

1. The climate change challenge impacts banking sector risk and requires banks to fully play a role

A Central Bank official described how Europe has witnessed several extreme weather events in the past few months and the latest Intergovernmental Panel on Climate Change (IPCC) report concludes that a further rise in temperatures is inevitable. The banking sector must determine how to account for and manage climate risks and ensure that banks remain prudentially sound in doing so. Additionally, banks have a role in financing the transition. New investments will be needed; stranded assets will require disposal; and cleaner energy with lower emissions will need funding. It is important to understand the role of the banking sector in the transition. This role is complementary to the role of governments, which must take the lead in the fight against climate and sustainability risks through subsidies, taxation and pricing. The panel session would focus on three elements: the achievements of the banking system in understanding climate risks and incorporating them into business models; the role of banks in financing the transition and the extent to which tension exists between green innovation and the sector in general; and, finally, measurements and disclosure. Managing climate risks requires a proper understanding of risks and transparency around those risks, which means measurement, valuation, and disclosure are important.

2. Highlights from the preliminary results of a recent ECB survey

2.1 EU banks are beginning to understand the challenges around climate and sustainability

A Central Bank official noted that climate risk is an increasingly urgent topic for banks. The ECB recently conducted a survey of banks in the eurozone. Since European banks do not generally lag in this area, the survey provides a reasonable picture of the global situation. The preliminary results indicate that banks have a growing appreciation of the problem. The survey found that there are people in the banks who care about the issue. The survey demonstrated that banks are in different situations and there is no 'standard' situation. Some banks have developed interesting technical methods for handling these issues, but others are only now discovering their importance. Banks express concern about climate risk, but there are gaps around the technical question of how to transition from this being a concern to understanding how it relates to their business models. The banking sector's business models will have to change as part of a major economic transformation, and most banks have still not done this.

2.2 EU banks must make progress on measuring climate and sustainability related impacts on risk

The Central Bank official described how only 20% of the banks which consider climate as an important issue have begun to review their business models due to a lack of the necessary technical elaboration. To determine how to transform a business model, it is necessary to measure the impact and to understand the economic impact of these drivers on different types of risk, along with distributing the risk among different activities and clients.

2.3 The feasibility of progress is linked to the 'data gap'; there is a need to generalise existing best practices and incentivise clients to provide further data

The Central Bank official noted that banks told the ECB a substantial amount despite there being no regulatory obligation on their part to do so. There is no obligation on clients to provide information to banks. The EU banking sector lacks the data to transform its general concerns into something operational for risk management and governance within banks. The ECB wants to generalise best practices in the industry, because there are best practices for almost everything. Banks can already ask customers for data as part of the Know Your Customer (KYC) process. When a customer asks for a business service, its counterpart can and do ask for data from this customer. This practice could ultimately form part of European regulation, but banks can already do it. The use of proxy measures for client risk could also incentivise clients to engage. If proxy measures suggest that a client is risky from a climate perspective, the bank might limit its operations with that client, what will incentivise the client to provide the information.

Another Central Bank official agreed that the lack of access to data is hampering progress, but the data will never be available if regulators and supervisors do not demand it. The fact that only 20% of banks take account of climate risks is somewhat sobering. The first Central Bank official emphasised that the industry is lagging worldwide. There is good practice everywhere, but it is not sufficiently generalised.

2.4 The mindset gap, the organisational gap and the data gap

An industry speaker explained how the most important element of climate and sustainability risk is uncertainty. This is a new risk, and not much is known about it. The industry must understand how to address climate risks properly, because private financial institutions are facing different kinds of gaps. There is a knowledge gap and a data gap because the industry does not have data for most of its clients. Additionally, there is a gap of in terms of mindset or mentality. The industry is made up of bankers who understand credit risk and financial risk, but they are not prepared for this. Finally, there is also an organisational gap. Banks are organised in siloes but sustainability is extremely transversal. There is a need to ensure the clear integration of this risk within an entire organisation.

2.5 The importance of integrating sustainability components within internal norms, processes and controls and the need to accelerate this process

The industry speaker outlined its financial institution's good progress on climate risk. Financial institutions are 'strange animals', which can be defined as sets of norms, processes and controls. The speaker confirmed its institution is integrating climate risk into its norms, processes and controls using a top-down approach, which is internally known as its 'risk planning processes'. The institution is seeing good progress on risk assessment and in the definition of how climate and sustainability risk impact traditional prudential risk. Currently, the institution is working on developing a risk appetite framework and stress scenario definitions. These scenarios are the best way to quantify long term impact. In terms of bottom up developments, the institution is seeking to integrate this risk management into its credit risk and collateral management frameworks, especially in relation to collateral valuation. The industry understands that there is a challenge around the uncertainty of ESG risk. The stress scenario exercise being conducted by the institution will support its learning process, but this uncertainty means that the exercise will have different data, methodologies, capabilities, and scope. Secondly, there is a challenge around the timeframe. The integration of these risks into financial institutions could have undesirable consequences, and timing will be a key element of managing this process. The support of the ECB guidelines and the work being done by the EBA will assist this process, however. There is also a need to incorporate social risk, the 'S' in ESG, in a much more active way. In particular, it will be very important to integrate Europe's ageing population into the industry's assessment of social risk.

Responding to a query from a Central Bank official about the timeline, the industry speaker suggested that data is the main source of delay. To understand the impact of environmental risk for asset valuation and balance sheet management, there is a need for more data about retail and small and medium-sized enterprise (SME) clients. Data from small clients will be extremely critical. This good quality data will appear in two- or three-years' time, suggesting a timescale of three years for a phase out programme.

3. The banking sector must consider the implications for emerging markets and ensure the transition is a global issue rather than a European one

A Central Bank official moved the discussion to the role of the banking sector in financing the transition. A structural change in the economy requires a new type of asset and new types of companies, which must be financed and funded. This raises questions around how innovative economic activities can fit into the EU banking model. In this regard, there are questions around the stability of the regulatory and legal requirements that affect clients' future performance.

In the context of the role of the banking sector, an industry representative paraphrased Thomas Jefferson: 'Banks are more powerful than standing armies'. While some people might disagree with this, Thomas Jefferson's point is valid in relation to the climate transition, because banks will be central in having a responsibility to be part of the solution to address climate change. To highlight the urgent need for action, the industry representative stressed that the lengths of some careers of bankers and regulators attending the EUROFI conference have been longer than the remaining time available to the 2050 deadline highlighted by the IPCC for meaningful action to be taken to solve the climate crisis. When considering the role of financial institutions, it is important to bring climate and ESG into banks' purpose and strategy in a 'real' way. Climate change and the green transition is the defining risk management challenge and commercial operating opportunity for all bankers. ESG knowledge should be as essential as credit knowledge as part of a banker's core capabilities.

People who work in financial institutions located in Europe must acknowledge their core leadership role in enabling a just transition. There must be climate justice; it cannot be 'just us'. The industry and the world will only be as strong as the weakest link in the climate change chain. The COVID crisis provides an example of what this should not look like. Governments have spent almost 15 trillion on vaccines and support for COVID, largely in developed markets, yet there remains an extremely large adaptation financing gap along with a vaccination gap. There are several ways to ensure a just transition, however. Taxonomies are extremely useful, but the banking sector must consider the implications for emerging markets and trade and capital allocation. Stress scenarios are also an essential tool. The Network of Central Banks and Supervisors for Greening the Financial System (NGFS) has done powerful work on this. When unpicking this type of work, it is important to consider the implications for emerging markets due to the need to drive a properly differentiated and equitable transition. Many banks across the sector are investing in clean or green technological innovations and confirming that firms have the right mindsets while ensuring that emerging markets are being served. Banks are establishing venture and philanthropic funds around clean tech solutions, skills building, awareness and capability building. It will be essential to ensure that emerging markets are properly covered in this regard when funds are being allocated. These are key priorities for financial institutions headquartered in Europe. A Central Bank official agreed that the transition is clearly a global issue. Banks should ensure they include all regions of the world in the transition.

4. Regulatory concerns around climate and sustainability risk

4.1 The full, timely, and consistent implementation of Basel III will ensure the banking system is resilient in the event that the path of the climate transition is not smooth

An official highlighted the global leadership role that Europe has played and continues to play on climate risk. Governments will provide the first and best solution in relation to taxes and subsidies. Banks will complement that, but governments must lead. The official noted that Thomas Jefferson must have been a regulator to suggest that financial institutions are more powerful than armies, given the experience of trying to get Basel III agreed over many years. However, there is a clear link between the implementation of Basel III and climate risk. The pandemic has demonstrated the importance of bank resilience and the beneficial role that the banking system can play. It is possible that the path of the climate transition will be far from smooth and orderly, which will require the banking system to be resilient from the outset. Banks will need capital and liquidity buffers to absorb large and abrupt shocks. The best way to ensure this is for banks and supervisors to implement Basel III in a full, timely and consistent manner.

4.2 The industry should treat sustainability risk like other material risks

Linked to the idea that the sector should not wait for everything to be perfect, the official stressed the importance of treating climate risk like any other material risk. There are challenges around data gaps and methodological challenges, but the materiality of climate risk requires further investment in risk management processes. This will involve governance, internal controls, risk measurement and management, and understanding how these factors impact credit market liquidity and operational risk. If the data do not exist, this should be done qualitatively. Banks must be able to do their own stress testing and scenario analysis. Ultimately, this will feed through into how banks allocate capital. This will transition to something far more complicated and advanced, but it need not start this way. The Basel framework is broad and requires banks to account for material risk, and climate risk is a material risk. Banks have made considerable progress around supervision, and it is now possible to incorporate climate risk into the Basel framework.

4.3 However, sustainability risk has important specificities which must be factored into banks' approaches to risk assessment and mitigation

The official emphasised that, somewhat paradoxically, the challenges around climate risk also make it unlike any other risk. In addition to data challenges, complexity and global nature of the risk, there are also very long-time horizons, which are not usually considered by bankers and supervisors. The speakers in earlier sessions of the Eurofi conference expressed the implicit assumption that being green is positive for net present value (NPV). The entire industry works on this assumption, but it remains incredibly difficult to make progress on climate risk. While it is true on average, however, there are always large outliers. There will be divergence and heterogeneity in the transition. There will be some significant differences across regions, sectors, and individual entities, and these must be accounted for.

A Central Bank official noted that the official had indicated there was a need to start tackling climate risk immediately even though the process will not be perfect. However, this could lead to the misallocation of capital or resources. If the process is not done correctly, it could lead to polluting industries being financed while green industries are not. The need for progress could create risk around misallocations or banks not properly managing the credit risk connected to sustainability risk. An official agreed, emphasising that, while investing and diverting resources to things that are green will be better, it is important to remember that many green investments will not succeed. Green might be better than brown on average, but there will be risky green investments. The industry must be resilient in general, not only resilient in terms of green versus brown. It is possible to make substantial progress on allocation decisions without having the most sophisticated quantitative model. The industry can make progress on allocating capital by taking those first qualitative steps.

An industry representative explained that climate change and its management is a priority for their organisation. Financial institutions play a critical role in supporting clients' transition pathways and huge investment will be required to implement changes in businesses to ensure sustainability. Such a shift will require funding from not only banks but cross-regional investors. Harmonised disclosure regimes will help ensure relevant risks and opportunities are uniformly understood.

The industry representative's organisation is in discussion with clients about their carbon reduction plans. The financial industry must start work on this and there are three key challenges form them: the pace of transition, assessment of physical risk and the harmonised framework. First, the urgent need to transition should be balanced against the need for continued operations and benefitting the wider economy through increased economic output. Policymakers should consider the broad impact of reforms to determine their feasibility and sufficient implementation period. Climate change is a medium to long-term goal for society, so industries should not be bogged down reactive unreasonable short-termism. Second, physical risk is important for clients. The Japanese government has created hazard maps to prepare for significant natural disasters. These help market participants to quantify their exposure to the physical risk of climate change. Third, a transparent and harmonised global framework will incentivise stakeholders through the transition. EU and global initiatives are underway which aim to resolve existing regulatory fragmentation and divergence in market practice. Their implementation will accelerate the transition and encourage market participants to consider their exposure to sustainability risks. Banks and regulators should act to facilitate reforms.

A clearer, globally aligned standard will help the private sector to implement reforms, because the private sector does business globally. Therefore, the EU should coordinate and accelerate the discussion on a global basis.

5. Challenges around data, definitions and disclosure

A Central Bank official turned the discussion to the question of data, definitions, and disclosure. The EBA has recently done impressive work on disclosure standards, although there are issues with both European and global standards and issues around the quality of those standards.

5.1 The lessons learned from the EBA's EU wide pilot on climate risk

A regulator suggested that his preference would be to be pragmatical, but it is important because the industry will only be able to learn 'by walking'. In the EBA's view, financial institutions must assess where they are and where they want to be, and then determine whether their path, strategy and business model are consistent with this. In Spring 2021, the EBA published results on credit exposures obtained from voluntary collaboration with 29 banks. Banks are more willing to engage with regulators on climate issues, than in other areas, because both the industry and the public authorities realise they are learning about this together. The 29 banks which participated were large banks in Europe, and they account for 38% of the EU banking sector's exposure. 50% of their corporate exposure, excluding SMEs, is to sectors that are subject to transition risk and 35% of their exposure is in sectors considered high greenhouse gas emitting sectors. The EBA has developed the 'green asset ratio' to understand the percentage of a bank's portfolio that is green. 7.9% of these banks' portfolios were green or involved in what are considered green activities. This is non-financial corporates exposure, excluding SMEs. It is up to each of us to consider these numbers as high or low, but they are the numbers.

5.2 There are significant information gaps around sovereign, SME and household portfolios

The regulator stated that the balance sheets and substantial exposures of banks can be divided into four categories: medium and large non financial corporates, which the EBA's exercise in green exposures cover; sovereigns; SMEs; and retail households. In the latter three categories, there are large information gaps to assess climate risks, and little progress has been made. The work done on retail and SMEs has been poor, and there is very little information regarding sovereigns.

5.3 There are improved prospects for progress on mortgages and SME portfolios

There will be easier progress on households, because their largest exposures are mortgages and there is a substantial amount of information around the energy efficiency of housing and certificates. These could be used on a massive scale. It may also be easier to make progress on SMEs, because it will be possible to apply a simplified version of the risk scoring metrics used to assess medium and large corporates. The topic of sovereigns will be tricker, however, and it is also more sensitive in other ways.

5.4 Banks can further embed sustainability risks in their business models by reporting on the EBA's disclosure implementing technical standards (ITS)

The regulator emphasised the importance of developing concrete proposals for how banks should work on climate risk. The EBA recently issued a consultation on the Pillar 3 disclosure implementing technical standards, which should be approved by the end of 2021. The EBA expects banks to start reporting on this basis by 2023. This is something 'exploratory' for the EBA. Climate risk is challenging for regulators, because they are not used to talking about estimates and ranges for climate risk rather than requesting the reporting of precise numbers. Here, the regulator is seeking quantitative measures for physical risk and transition risk and quantitative measures on banks' mitigation actions. The EBA is asking banks to report on this. This is also done qualitatively by asking banks how they are embedding ESG risks in their governance and business models, which is fundamental to any risk management framework. The EBA is also asking banks to report on their green asset ratios, which has been somewhat controversial. However, this is positive; if it were not controversial, it would probably be irrelevant. There are valid concerns around the misallocation of capital, but here it is important to distinguish between type one errors and type two errors. Type one errors are decisions that prove to be correct but were not taken, and type two errors are decisions that prove to be incorrect. The challenge around climate risk is the danger of making a type one error. The world must ensure that it makes the right decisions and makes progress quickly.

A Central Bank official noted that there are often complaints from the sector about the use of different measurements, systems, and rules. There are differences between European, global and Basel rules. The regulator agreed that there is no single standard across the globe. Basel is a global consensus implemented at a national level. Hopefully, the world will be able to establish a global body, but, in the absence of one, Europe has 'relative leadership' on climate risk. That leadership should not be compromised at the cost of finding a global consensus.

5.5 The development of common language and definitions is essential for the assessment of sustainability risk, despite the challenges around data

An industry representative highlighted the importance of definitions. The terms 'climate risk', 'sustainability risk', 'environmental risk' and 'ESG risk' are often used interchangeably. One step forward would be to develop a common language and nomenclature. The desire for global coordination depends to a large extent on the degree to which participants understand each other and determines the extent of progress that can be made. There is a concept of 'green is good, and brown is bad'. While this is correct on average, it's important to note that the overall picture is more complicated. As innovation occurs, there will be sunrise industries and sunset industries, both of which will carry their own risks. Understanding the interrelationships is important: doing something right sometimes produces unintended consequences. For example, when considering a just transition, an emphasis on thinking about physical risk for the areas being particularly impacted might lead to capital not being allocated to the places which need it most. There is probably more data on the climate risk than in many other areas covered under the umbrella of sustainable risks. Climate change has clear and measurable targets such as the net zero target under the Paris Agreement. However, there is a lack of data and targets for other SDG goals such as gender equality leading to micro issues such as funding gaps in start ups by women founders. If sustainability risk can be systematically linked to targets under the Sustainable Development Goals (SDGs), the data will grow naturally. Scenario analysis and tools are another important priority. It is important to consider the purpose for which scenario analysis is used in climate and environmental risk. Whether it is in business strategy or risk management, those contexts require different types of data and support.

CLIMATE AND SUSTAINABILITY RISKS IN THE INSURANCE SECTOR

1. The role of insurers in mitigating climate and sustainability risks

A regulator stressed that climate and sustainability risks are unquestionably the biggest risks faced not only by the financial industry or the public authorities, but society as a whole. There is a growing call from society, including people and politicians, for the financial industry to act. Insurers have a larger role to play here than other financial players. The panel would focus on the risks and the role of insurers in risk mitigation, ensuring a swift transition to a more sustainable and resilient economy and the role of insurers there, and how the industry can maintain its momentum and make progress.

1.1 The role of international standard setters on data gaps and gaps within supervisory standards

An official stated that the focus of the International Association of Insurance Supervisors (IAIS) around environment, social and governance (ESG) has been on the 'E' and, within the 'E', on climate risk. This risk is at the heart of the insurance industry's business model. The insurance risks from climate are at the heart of enterprise risk management for insurers. Building on international best practice, IAIS has issued practical guidance on how to supervise the risks that insurance companies face from climate on both sides of their balance sheet. Disclosure is essential for the development of proper information about the risks of climate change. Insurance Core Principle 20 discusses disclosure, and IAIS has supported the disclosures suggested by the Task Force on Climate related Financial Disclosures (TCFD). However, these ideas should be turned into concrete standards. In that context, IAIS welcomed the IFRS Foundation's workstream to develop sustainability standards. IAIS will very soon publish its Global Insurance Market Report, which is a macroprudential risk assessment of the risks faced by insurers at a global level. Following this, IAIS will assess the gaps within its supervisory standards in order to determine whether there is a need to address climate risk more specifically. Given that climate risk is a systemic and long horizon financial stability risk, IAIS is seeking to understand how it can be incorporated more regularly into its global monitoring exercise.

1.2 There are other important ESG priorities beyond climate related risks

1.2.1 The direction on general sustainability issues is not yet clear

An industry speaker highlighted the potential to use the UN's Sustainable Development Goals (SDGs). Insurers should consider the different components of the SDGs, how to measure them, and the requirement for data and methodologies. There are also other important areas such as biodiversity and nature based solutions. Regulators and industry should address these issues together and ensure there is transparency and accountability in how they are accounted for. The industry must determine how to move in one direction. For global sustainability, the direction is unclear. On carbon, the industry has made a good start. However, this cannot happen simply in the EU or the Americas; Asia must also be a part of this effort.

1.2.2 Priorities around diversity, equality and inclusion

An official highlighted the importance of diversity, equality and inclusion. The need for progress here has been endorsed by the Executive Committee of IAIS. The IAIS strategy will probably cover the implications of social risk in relation to treating customers fairly, governance and risk management, and IAIS members and IAIS itself. A public representative agreed on the importance of diversity. Female representation on boards is around 25%, which is clearly not enough. ShareAction published research in May this year suggesting that there is little board level investment on ESG. Only 31% of companies discussed sustainability related risk in their group risk committees.

2. Insurers are both risk underwriters and institutional investors

An official considered that the insurance industry and the regulatory community have a significant role to play around climate risk. Primarily, insurers face solvency risk as a result of climate related risks, the relevance of which is demonstrated by the higher number of catastrophes occurring around the globe. However, insurers also have a role to play as institutional investors. Insurers play a meaningful role by choosing what to invest in and whether a particular investment is viable.

2.1 The challenges around managing disruption and ensuring insurability require further action

The official explained that insurers must ensure the continued availability of insurance products around the globe. The significant increase in the frequency and severity of catastrophes creates concern over whether these risks will continue to be insurable in the future. The insurance industry knows the types of risks which they have an appetite to insure; they know the risks that they are willing to accept on their balance sheets and how much of their capital they are willing to expose to these risks. Insurers will have to liaise with the regulatory community and other stakeholders outside the industry to understand how communities can remain insurable in the face of these risks. As the climate transition begins, it will not be a question of whether insurance entities consider these things but how they are considered. There is a substantial amount of work on this underway at IAIS. In the United States, the National Association of Insurance Commissioners (NAIC) is undertaking a significant effort to consider these risks and work with stakeholders to determine the role it can play in this critical social issue.

An industry representative described how people can talk about how they want the world to be and how they might influence it, but the world itself is changing. Clearly, climate risk impacts both sides of insurers' balance sheets. It affects both assets and underwriting, but this is often not straightforward. Many of the risks that insurers underwrite are second, third or fourth order climate risks. Employers' liability risk seems distant, but it can be impacted by climate risks. The insurance industry and government have a strong history of risk pooling. It cannot be beyond the ability of the insurance industry to work with governments and private finance to develop solutions not only for climate change adaptation but to improve society's resilience to the consequences of climate change.

An official described how the asset side of the balance sheet is one part of the insurance industry's role in the transition. However, any sustainable economy must be able to withstand more frequent catastrophes and recover from them extraordinarily quickly. One of the reasons the insurance industry exists is for this process of recovery. Regulators are developing their own ways of addressing climate risk, but the insurance industry can play a role here through Own Risk and Solvency Assessment (ORSA) reporting, enterprise risk management reporting and comprehensive assessments of asset and liability risk. When natural catastrophes happen, it is important to minimise the disruption for the economies that are impacted and the insurance companies that pay the claims. Coverage gaps exists in relation to a number of different catastrophes, and the industry must determine how to provide more robust coverage for these catastrophe risks. A regulator noted that these coverage gaps are developing at a time when these catastrophes are no longer once in a century events. There must be a way to manage these events as a society instead of relying on public solutions.

An official explained that IAIS is currently working on global standards and gaps. The insurance sector has a crucial role to play in this debate, but climate risk affects all areas of financial services, which means that similar exercises are happening in banking and elsewhere, including by the Financial Stability Board (FSB). As the global standard setter in insurance, it is important for IAIS to assess global risks, develop the data and methodologies to make this assessment and feed into the FSB's cross sectoral risk assessment. IAIS members have different mandates, however; as a global standard setting body, IAIS must take a global approach and focus on risks and policyholder protection.

An industry representative highlighted the importance of the propensity to pay, which is a more acute issue on the liabilities side than on the assets side: for example when an ESG fund is launched by a firm, money flows to them, while when insurers or reinsurers launch a climate dedicated product, clients do not bang on the doors of agents and brokers to say they are happy to pay higher premiums to compensate for the risk. The propensity to pay and the ability to fund the transition will be key, because there is a collective benefit and a positive externality here.

2.2 Competition issues around cooperation on climate insurance solutions

An industry speaker highlighted the need to 'shout out' governments and politicians, and explained the antitrust issues caused by firms' cooperation on climate issues. Each Net Zero Insurance Alliance (NZIA) meeting begins by reading an antitrust statement in the presence of lawyers. The NZIA has done multiple studies to assess where the green lines, red lines and grey areas are.

3. The high expectations on insurers and the need for mobilisation

A public representative stated that there are very high expectations on insurers, which is somewhat concerning. There is a question around who will lead if insurers do not. On the asset side, insurers have trillions of euros of assets under management, but only a fraction of that sum is invested sustainably. On the liability side, the consequences of climate change have been evident in the recent forest fires and flooding in Europe. At this stage, only 35% of the potential damage is insured. The insurance companies are allies in this fight. Some insurance companies are frontrunners here, and they can lead the rest of the sector. At present there are more words than actions in the financial industry. After 100 companies signed up to a financial industry roundtable in the US, two researchers assessed their actions and found that the companies did nothing. The world cannot afford this type of greenwashing.

3.1 Leveraging the frontrunners through common standards, appropriate underwriting practices and a reduction in uncertainty

An industry speaker agreed that different parts of the industry are allies who will have to work together. Being a frontrunner will pay off in terms of competitive advantage, but the existence of frontrunners will not create change on a global scale. This demonstrates the need for global standards and transparency around standards in order to make advances across the industry.

Another industry speaker highlighted the need for consensus and collaboration in the transition. The most profound changes happen when industry and regulators sit across the table from each other, roll up their sleeves and collaborate. Tackling climate change is a shared goal, and the CEOs of companies have a vested interest in addressing the climate crisis. In respect of the transition, there is a need to operate with due speed while highlighting the importance of operating deliberately and cautiously. In 2020, an FSB report highlighted the dangers of making policy changes too quickly. Unexpected policy changes can create financial stability risks, but the industry does want to move swiftly and deliberately.

An official emphasised the role of global coordination. It is a very positive development that colleagues from the industry are calling for global standards and a global level playing field, but this is also a task for governments. Governments must set out stable climate paths and policies against which the regulators and the industry can assess their progress. In terms of methodology, there has been good work done by supervisors on scenario analysis and stress testing. This type of analysis is dependent on carbon prices, scenarios and assumptions about what will happen if there is a disorderly transition. The existence of globally coordinated climate policy paths would make this exercise much easier.

An industry speaker emphasised the importance of underwriting standards, noting that these could be incorporated into risk mitigation. The industry speaker highlighted the example of the Brumadinho dam breach in South America. After such a disaster, it is beneficial to analyse underwriting standards and determine global best practice. Governments and industry associations can set standards, but global insurers can push for the best standards to secure the best outcome for the transition.

An industry representative stated that this is something that must be done in partnership with all parts of the finance industry, governments, and the carbon intensive sectors themselves. The first key ask for government is around carbon pricing. It will be difficult to set a carbon price. Even the current US administration has no appetite to establish a tax, but the situation is different in Europe. Establishing a carbon price could involve removing or changing fossil fuel subsidies, providing sustainable fuel or renewables subsidies, the use of feed in tariffs, or scaling the voluntary carbon markets to set a proxy price. A carbon price must be established, however, because without an economic driver it will be very difficult for insurers to make the right decisions for business and the finance sector.

3.2 The frontrunners are participating in global initiatives, engaging with carbon intensive companies and integrating sustainability into their businesses

An industry speaker stated that the progress made by Allianz consists of three 'plus one' areas. First, Allianz has integrated sustainability considerations into its core business activities. A considerable amount of work has been completed across the business from underwriting standards to core processes. Second, Allianz has developed qualitative and quantitative reporting and controlling processes based on the adaptation of internal corporate and functional rules. Thirdly, Allianz has integrated sustainability assessment processes into its risk management frameworks. In terms of 'plus one', the insurance industry is participating in voluntary projects such as the UN sponsored net zero initiatives such as the Net Zero Asset Owner Alliance (NZAOA). The industry has made tangible commitments; some insurers are 'putting their money where their mouth is' and transitioning their investment portfolios.

An industry representative agreed on the need for the industry to 'get its act together' by transitioning from words to action. The question of climate risk is not only about investment decisions; it is also about underwriting. This issue is about the industry 'standing on its own two feet'. This is why eight of the world's leading insurers and reinsurers formed the NZIA, which produced a set of tangible commitments at the G20 Venice climate summit. The group wants to steer the net zero effort to ensure that insurers play their role fully. The industry is only one part of the ecosystem, however. The players in the insurance industry are allies: the regulators; the industry in its roles as insurer and investor; and the clients. This chain of responsibilities creates the possibility of collective action, which is a founding principle of the NZIA.

3.3 The importance of ESG issues beyond climate and sustainability risk

An industry representative highlighted the importance of the broader topic of ESG. It is easy for people to focus on climate as a subset of the 'E' in ESG and forget the 'S' aspects of climate risk, such as the just transition. The world needs to figure out how to manage the complex changes that will have to happen in the coming decades if it wants to reach the net zero goals set by the Intergovernmental Panel on Climate Change (IPCC). There will be dramatic impacts on economies, citizens and individual companies.

3.4 It is essential for investors to engage with carbon-intensive companies

An industry representative described how people make commitments, state ambitions, and sign up to being net zero, but there is a risk of this being 'just talk'. CA100+ is an investor group that seeks to engage with the most carbon intensive investee companies. Almost all of these companies have net zero commitments, but a recent benchmarking exercise conducted by CA100+ indicated that these companies are not spending money on this. It is prudent to be sceptical and hold people to account. Data and its ability to inform the commitments being made through the NZAOA and NZIA will be a very important topic.

3.5 Data and transparency are vital to avoid greenwashing

An industry speaker emphasised that the role of the insurance industry is to accelerate this transition. In order to do this while avoiding the pitfalls of greenwashing, it is important not to move excessively fast but also to move at sufficient speed. One key challenge is around the availability of data, how to use that data and the consistency of the data. Data is an essential part of the solution, but it cannot be used without a methodology. Carbon is an instructive example here. The CRO Forum developed a methodology for measuring carbon intensity, which the TCFD and the Partnership for Carbon Accounting Financials (PCAF) are now using. The methodology is not perfect, but the data it produces is sufficiently accurate to be able to record, for example, what the carbon footprint of an underwriting portfolio is on a step by step basis. Reinsurers also face a further challenge, because their clients are other insurance companies, which have to provide data to the reinsurers for them to report. Regulators, standards setters and the industry should develop these measures together. If an insurer 'does their own thing', it will not help anybody if what they are doing is not aligned with what is happening in the real world and what other insurers are doing. The industry must compare 'apples to apples'. The more collaboration there is between regulators, supervisors, and the industry, the easier it will be to develop standards. Ultimately, carbon standards are relatively simple. The more difficult ones will come with the other dimensions of sustainability.

3.6 The significant challenges around data require common pragmatic solutions

An industry speaker agreed that data is a significant challenge. When it comes to managing data, firms look at what companies disclose and then apply methodologies and metrics. The modelling will improve as the industry 'follows the science' and more historical data becomes available.

Another industry speaker stressed the importance of data, especially in relation to carbon. In the reinsurance industry, data is very important for treaty insurance business, which is a large bucket of risks underwritten in one contract. This is similar to the look through issue on the asset side. To measure and steer the data in respect of carbon, the industry will require proxies and assumptions that it can use to develop a picture that is meaningful for the move towards decarbonisation. The NZIA's important metrics workstream would be an appropriate place to begin these discussions.

An industry representative reiterated the importance of data. It is important to ensure the industry does not wait for everything to be flawless before it begins this work; the world will be 'roasted and toasted' by the time it is ready. The industry must act now based on the available scientific evidence. The industry will also learn by doing. The metrics currently available are not perfect, but they are certainly better than nothing. The learning curve will be steep, but this means the metrics will improve quickly.

Another industry speaker stated that the insurance industry requires high quality and comparable sustainability data. Close cooperation with the IFRS Foundation, for example, could be a good way to develop global sustainability data. Another industry representative agreed on the need for standardised data. It is extremely important that regulation enables transparency and disclosure here. There are substantial pitfalls around double counting, for example, especially in underwriting portfolios.

3.7 The insurance industry can have a real world impact by using more sustainable practices

On a positive note, an industry speaker highlighted two examples where insurers could have a real world impact without waiting for regulation. First, in claims handling and claim payment, there are some double win or triple win situations. Remote or smart assessment can enable insurers to pay claims without visiting a site and insurers can foster a 'repair versus replace' paradigm in order to drive the circular economy, along with green replacement or green mobility replacements.

4. Concluding remarks: the public perspective

On the subject of the call for governments and other institutions to support the efforts of insurers, a public representative highlighted the "Fit for 55" proposal, which is about reducing CO2 emissions 55% by 2030 and moving to zero by 2050. The public representative stressed that the transformation of societies and economies must be inclusive. ESG is not only about the 'E'; it is also about the 'S' and the 'G'. The transition could be a 'very bumpy road', and there are always elections ahead. Currently, Europe is looking to 26 September and what will happen in the German elections. Next year, Europe will look to France and then Italy. While the road could be 'bumpy', the financial industry is 'on the road'. Sustainable finance is a work in progress, and this also applies to the insurance industry. The review of Solvency II is approaching, and it will be important to enshrine double materiality and to consider stewardship, the reporting requirements and investment in long term assets. However, the public representative stressed that the discussion gave him a 'warm feeling'. The alliance here could be called the Eurofi alliance. Hopefully, it will be about actions, not words. A regulator hoped the present discussion would indeed result in action and not simply words. Hopefully, all the participants would act on this call to work together and build this Eurofi alliance.

SPEECHES

Andrej Šircelj

Minister of Finance, Slovenia

Keynote speech

Distinguished guests, ladies and gentlemen, thank you for these nice introductory words. First of all, I would like to thank you for inviting me to this event. It is a really nice event and the first time for me to be here in person. The last time, we talked via video, and I am really delighted to be here.

Secondly, I would like to welcome all of you warmly here in Slovenia, and I hope you get to enjoy some of its beauty. I know that you have very heavy schedules, but I hope that you also find time to explore Ljubljana and Slovenia. The weather will be good – we ordered it so – and I think that everything will be fine.

It is great to see a live event with such participation happening at home, especially in the time of the Slovenian Presidency, which I would like to say something about. Tomorrow, we will start with a meeting of the Eurogroup and then of the Economic and Financial Affairs Council (ECOFIN) under the Presidency of Slovenia.

In my opinion, we are now standing at a crossroads where it would be hard to look forward without looking back. The pandemic was a great shock to all of us, and people and companies have endured a lot. But we are already witnessing improvements, also in Slovenia. I believe and I would like to emphasise that it is necessary to note the importance of vaccination. We are in the same boat and we need this. We know also that the vaccination is stabilising conditions and minimising downside risks first to our health and second to our economies. It is good for business, for health, for international markets, and for all of us.

I also believe that this crisis taught us a lot. After the initial shock, we reacted swiftly. The measures were robust, efficient and, most importantly, decisive. In my opinion, these are the most important lessons learned: that we have to be quick and decisive in making strong decisions. It is also a task for the future that we have to have answers before the questions even arise.

We also have to be aware of the opportunities that the future brings. One of the biggest is the wholesome implementation of our common Recovery and Resilience Facility (RRF). The main goal of the Slovenian Presidency is to finish with the adoption process of the Council implementing decisions that we began in July. We all need resources to further support the recovery, and this will help not only individual member states but the EU as a whole.

Efficient implementation and achievement of the goals of our recovery plans will set the EU on the track of higher competitiveness on the global stage with more investments in green and digital transition, research and development, inventions and innovations. Most importantly, I am convinced that this mechanism that was agreed upon in the spirit of solidarity will also improve the living conditions of our citizens. I also strongly believe that we are members of competitive economies and, of course, we have to also look at our competitors' inventions, innovations, research and development. We have to improve this ratio in comparison with the US and China.

However, it does not end with the RRF, so me let me touch upon some other important areas that we, as a Presidency, will focus on. We will discuss some of them at the informal meeting over the next two days. In my opinion, one of the most urgent issues is the impact of climate change. This is also important for financial stability and the performance of financial services. We have to promote the transition to sustainable finance while ensuring financial stability.

In addition to that, huge resources are needed to shift the economy towards green and sustainable investments and industries. Many subjects will undergo structural changes when migrating towards zero emissions. The migration will be assisted by the financial system through investments in technology, infrastructure and networks. Now is the time for a bigger role of the EU capital markets, which can fully come to life only within the capital markets union. Besides the improvement of the capital market, let me highlight some other reforms: EU green bond standards, harmonised tax treatment, and the convergence of national insolvency frameworks.

We have to pave the way for a resilient and sustainable economy. We must also contribute to structural changes by encouraging sustainable investments. Fiscal policy plays a critical role in the green transition by creating initiatives in both consumption and investment decisions as well. One of the key tasks ahead will also be to define sufficient adjustment time to stimulate the recovery process. In addition to this, we will need enough fiscal space for new investments. I believe that many discussions on this topic will follow in the coming months. I look forward to them and hope they will result in a joint solution.

Of course, I have to touch upon the field of taxation, where a lot is happening in the EU and globally. Modernising the global corporate-tax system to fit in with the challenges of the digital aid is crucial to promoting economic strength in the EU. Revised global corporate-tax rules that are appropriate for the 21st century would have an important impact on the EU internal market's competitiveness and uniformity. I also believe that a global deal would ensure fairer and more equal treatment of countries around the world.

To conclude, I believe that better times are ahead of us, but we must watch for opportunities and successfully tackle the challenges. As the Slovenian Presidency, we do not want to be actively engaged in shaping the future only while we are at the steering wheel. It is in our best interests to pave the way for further discussions and decisions, and to contribute to inclusiveness in joint actions in the future as well.

In unity, there is strength. I believe that the EU, and especially our cooperation and coordination in recent months, is an exemplary case of this. I also believe that, in the future, our strength and unity will only improve. Thank you for your attention, ladies, and gentlemen. I enjoy being here and wish you all the best, today and in your lives. Thank you very much.

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Q&A

David Wright

The Minister is kind enough to take one or two questions. Perhaps I can start with two specific questions related to the economy in Slovenia.

How you do you estimate the current economic and financial situation here in Slovenia? What do you think will be the most important RRF contribution for your country? What are you expecting from the RRF for Slovenia?

Andrej Šircelj

Thank you very much for this question. I would like to say that, when I started as a Minister, it was at the beginning of last year, a lot of people said to me that I am too optimistic. I was also an optimist during the pandemic. Our policy at that time was to secure jobs. We secured jobs, and we paid quite a lot of money for that. If we are looking at our public finance and budget deficit, we will improve these in the coming years. On the other hand, we did not lose any jobs and, today, more workers have jobs than in 2019, before the crisis. Our unemployment rate is around 4.2-4.3%, which is quite good. We need 20,000 more technically oriented workers, so this is good.

If I look at our exports, they are very good. We export a lot of our products to western Europe – to Germany, France and Italy. These include pharmaceutical products and car components, and we are competitive. We could be more competitive, especially because our taxes on the labour force are quite high, but this government is trying to make some improvements in the tax sector.

Let me say that if you look at the estimations of international organisations like the International Monetary Fund (IMF), European Bank for Reconstruction and Development (EBRD) and the European Commission, as well as domestic institutes, we could say that we are number six in terms of our gross domestic product (GDP). That is also very good. We know that maybe it happens now, but we would like to continue with this in order to secure jobs and to invest more in recovery and resilience, to modernise infrastructure and to invest in digital systems.

Our government has one very important programme, which is around de-bureaucratising. In Slovenia, there are approximately 20,000 different regulatory acts, and nobody can follow all of them. I know that it is like that in other countries too, but we have started with this de bureaucratisation to minimise bureaucracy and to simplify procedures. It is possible to do so through digitalisation, for example. It is also a parallel project, and we are on a good path towards doing this. It is very important.

If I look at our cities, I see quite happy people. People enjoy working a lot. The standard is quite high. Not only in Ljubljana but in other areas, the way of life is quite good and of quite high quality. This is also our aim and our objective in terms of people's quality of life. If you are happy here, I invite you to come again. Thank you very much.

Boštjan Vasle

Governor, Bank of Slovenia

From strengthening post-COVID recovery to greater economic and financial resilience

The COVID pandemic has been permeating our lives and economies for a year and a half now. The initial shock is behind us and we are facing alternating periods of tightening and easing of restrictive measures. However, many of us are now vaccinated, which contributes to the pleasant fact that we can be here in person today.

In this speech, I will focus on policies for strengthening the recovery of the European economy from the pandemic crisis and enhancing economic and financial resilience to potential future shocks. It is important that this severe crisis does not go to waste, to paraphrase Winston Churchill.

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Before I develop my main points, let me briefly reflect on recent economic developments and the response of economic policies to this once-in-a-lifetime health shock.

After recovering from the previous financial and sovereign debt crisis, the growth of the European economy had been slowing in 2018 and 2019 under the influence of increased tensions in international trade and other challenges in European industry. Despite this weakening of growth, however, we did not expect such an economic turnaround as happened with the outbreak of the COVID-19 pandemic. Serious disruptions in global supply chains and the announcement of lockdowns affecting large parts of our economies were followed by tensions in the financial markets and the sales revenues of many companies have dried up almost overnight.

The response of macroeconomic policies to this extraordinary health and economic shock has been extensive and well coordinated at both national and EU levels. The exogenous nature of the shock and lessons from previous crises have contributed to a broad consensus between policymakers and international institutions on the need for a strong response from fiscal and monetary policy, each supporting the economy within its own mandate.

Committed to stabilising the financial system and protecting the euro economy, the Eurosystem acted early and decisively, deploying monetary, prudential and supervisory policies. With our bold response, sovereigns and banks, and thus also businesses and households, have had uninterrupted access to financing under favourable conditions throughout the crisis.

Highly supportive economic policies have mitigated the economic downturn and deflationary pressures, greatly reduced the scope of socials hardship, and limited the number of business failures that usually follow an economic downturn. We helped to set the stage for the rapid economic rebound that has followed the reductions of pandemic-related restrictions in the third quarter last year and in recent months.

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The economic recovery is strong, but new waves of the pandemic may slow it down. The priority of economic policies is to continue providing support to the economy until the recovery is set to last and uncertainty subsides.

However, as the pandemic has been with us for quite some time now, it is important that policy support is targeted at the most affected and vulnerable households and businesses and that it does not hamper structural adjustment, as this could undermine productivity growth, which has slowed markedly in Europe over the last 25 years. The main operational challenge is how to distinguish between viable and non-viable businesses. For those that have dismal chances of survival, it is necessary to prepare the ground for the most efficient liquidation process. It is important that capital is freed up and directed to promising activities and that workers who are likely to lose jobs are equipped with the skills for reallocation as soon as possible.

The eventual unwinding of the remaining pandemic support measures should be gradual and guided by stable improvement in economic data. In the medium term, fiscal and monetary policy will need to begin rebuilding space to address future shocks. However, planning for necessary structural reforms, to the pension and healthcare system, for example, should start as soon as possible, as their implementation usually takes time.

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The European banking system remains resilient, as shown by recent stress tests carried out by the EBA and the ECB. Its solid position reflects, among other things, the cleaning up of balance sheets, recapitalisations, and strengthening of regulatory and supervisory frameworks after the previous financial crisis. The path of strengthening the resilience of the banking system is not yet complete, however. It is therefore necessary to continue towards the completion of the Banking Union and bank resolution framework, including a common backstop, and with harmonisation of national insolvency laws. As the health and economic situation stabilises, additional attention should be paid to the long-term challenges of many European banks, namely low profitability and the issue of sustainability of bank business models.

As the recovery continues, banks will continue to play an important role in financing businesses and households. However, in the medium term the sources of financing of the European economy should become more diversified, so the action plan for capital markets union (CMU) should be ambitiously pursued.

A further challenge that accompanies the current recovery is, in addition to new waves of the pandemic, asymmetry between sectors and countries. This issue is partly addressed by the recovery and resilience package known as the Next Generation EU. The package has not only been designed to boost aggregate demand in the medium term but also addresses longer-term challenges such as greening of the economy, Europe's lag in digitalisation, country-specific structural challenges and economic resilience in general. The package has been designed to channel more resources to vulnerable, most affected countries. The success of the package is important not only for increasing aggregate demand and strengthening long-term economic potential, but also for the possibility of future use of such a solidarity mechanism of financing investments and reforms. Further progress in European fiscal integration would be welcome, but this should go hand-in-hand with fiscal prudence and reduction of risks.

To strengthen economic and financial resilience, action is urgently needed in various areas, not just economic ones, which is an important lesson from this health crisis. In addition to lowering the risk of future pandemics, which could otherwise emerge more often than in the past, we need to address more consistently the risks related to climate change. Governments and parliaments have a key role to play, but we should also contribute to the efforts, each institution within its own mandate. At the Eurosystem, we are gradually incorporating this ambition into various areas of activity, from monetary policy and management of the non-monetary portfolio to banking supervision and monitoring financial stability.

The pandemic crisis has accelerated digitalisation, which also represents a path to faster recovery. As our lives become increasingly digital, be this in terms of interpersonal communication, finance or health services, we are becoming more vulnerable to cyber attacks, which continue to spread and are becoming more sophisticated. Efforts need to focus not only on protecting critical infrastructure, but also on raising wider societal awareness and a culture of cybersecurity.

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The topics I have touched on will be discussed in the panels of this forum. So let me conclude with a final thought that the decisive and well-coordinated response of national and EU economic policies to the pandemic shock has revealed the power of European unity. In the same spirit, we should head also towards addressing other challenges, especially strengthening resilience, and deepening Economic and Monetary Union.

Valdis Dombrovskis

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

Keynote speech

Ladies and gentlemen,

It is a pleasure to be with you again, this time in person, and in Slovenia too. Such a change, and a very welcome one. Thank you for inviting me today.

These have been a difficult two years for everyone in Europe. We have faced unprecedented challenges for the economy, all aspects of society and for everyone's daily lives. Still, we managed to act quickly and decisively. We helped people to cope.

This showed the strength of European unity and solidarity. Let me offer you two examples.

Our vaccination strategy has proved successful, despite some initial criticism. By the end of August, 70% of EU adults were fully vaccinated - more than 256 million people, even though with big differences across countries and regions.

The EU's digital vaccination certificate allowed people to travel this summer, making it a much holiday season than a year ago, making it a much better holiday season than a year ago. And we set up short-time work schemes to keep millions of Europeans in a job during the crisis. The SURE scheme has supported around 31 million people and 2.5 million companies. This accounts for more than a quarter of total employment in those Member States taking part.

So I think we can say that the European response has been a success.

Our unity has inspired confidence from people and companies alike, and – I hope you can confirm - also in financial markets. And it has contributed to the recovery that we are seeing now. There are grounds for optimism.

All EU countries are expected to return to their 2019 GDP growth levels this year or next, and the economic differences between them as not as great as first expected.

Unemployment has not dramatically increased and job numbers are improving steadily. The much-feared wave of company insolvencies did not really happen. Non-performing loans have not risen. But this does not mean that the risks have gone away.

So we need to stay vigilant and continue to pursue the right policies, including the Action Plan on non-performing loans, especially as support measures – including moratoria – are now being phased out. Europe's banks remain solid. In this crisis, they have been a part of the solution.

Now we have the Recovery and Resilience Facility – the RRF - to fund a sustainable and lasting recovery, with a solid focus on the green and digital transitions as sources of potential growth.

The first RRF funding has started to flow. I cannot overstate the importance of this instrument. Putting it into full effect across all Member States is vital for our long-term future, for our economic potential and cohesion.

But let me now sound some notes of caution.

This is not a time for complacency.

New risks are appearing and there are still many unknowns. The uncertainty continues, starting with the coronavirus itself. We also know that the virus will stay with us for some time. The reality is that we will only be safe, and our economies regain their full potential, when the whole world is vaccinated.

The EU has been playing its part here, exporting vaccines across the world, including through the COVAX facility. Since December 2020, we have sent 700 million vaccine doses to 130 countries worldwide. Many vulnerable countries are at high risk or in debt distress.

One way to support them is by reallocating the newly issued IMF Special Drawing Rights to help provide liquidity for vulnerable countries.

I would ask EU countries to support and take part in this exercise.

Ladies and gentlemen,

As circumstances change, Europe should be changing as well. We should adjust and reposition ourselves to cope with new realities, moving forward from the 'pandemic policy' approach. It has served us well, but it is time to move on.

There are three areas of challenge that I would like to highlight, starting with fiscal matters.

We know that the level of fiscal support applied during the pandemic cannot stay in place forever. While we should not withdraw it too early, neither should we remove it too late.

Too early – and we risk harming the recovery and damaging our economies.

Too late – and we risk overburdening public finances and fuelling inflation.

So this will be a balancing act. We should start gradually reducing fiscal deficits and debt when the time is right, while improving the composition and quality of public finances. That will create room to invest in areas of growth potential, like the green and digital transitions.

This is about 'and', not 'or'. We will need to bring down deficits and invest - which will require finding revenue sources, solid planning and making good use of the RRF.

This brings me onto a second balancing act: between fiscal and monetary policy. As we know, monetary policy is independently steered by the European Central Bank.

Up to now, the interaction between the two has worked well – and it is important for this to continue during the recovery. Now we have rising inflation, above the ECB's 2% target. Euro zone inflation hit a 10-year high of 3.0% in August, up substantially from 2.2% in July.

However, the inflation rise looks to be driven mostly by temporary factors at this stage. So let us not jump to conclusions quite now. But we need to watch inflation and adapt our policies accordingly - if required.

For monetary and fiscal policies to keep working well together, we need credible fiscal strategies for the medium term. We should come to a clear way forward by spring next year, as part of the European Semester.

Europe's economies should also be able to adjust without bottlenecks. For this, the labour markets must work well.

To avoid labour shortages, already emerging in some sectors and countries, we need active labour market policies that facilitate job transitions – like improving skills.

Viable companies may need additional well-targeted solvency support.

However, Member States should be careful to make sure that this support does not end up with unviable companies, thereby locking in resources needed for more productive purposes.

The green and digital projects financed through the RRF will also bring vitality to Europe's businesses and entrepreneurs.

The third area to attract our attention over the next months is the EU economic governance review.

The existing framework has worked well overall, including under the recent exceptional circumstances. It has the flexibility necessary to deal with large shocks. However, our review also highlighted several challenges that the crisis has reinforced.

Since debt levels have increased and divergences widened further, we must have a credible debt reduction rule that works for all Member States.

In addition, we should make better use of good times, to allow more spending in bad times. Nobody knows when the next crisis will happen. So public finances should be in the best possible position when that day comes.

As I said earlier, we need to improve the composition of public finances, prioritising productive investment.

Lastly, the economic governance framework has become too complex. We should simplify it.

The debate comes first, however. Consensus is crucial, because a fiscal framework can only then be effective if there is a strong political commitment to adhere to it.

Ladies and gentlemen,

I believe that we are now well on the way to healing the scars of the crisis, in terms of getting through its initial severe economic impact and building for the future.

Europe's economy is turning a corner: the signs are better for 2022 and beyond.

As we move into the post-crisis phase, I know that we can continue to rely on the support of Eurofi and its members. As always, the financial sector has a vital role to play in developing our economy, both now and in the years ahead.

Thank you.

Mairead McGuinness

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

Speech on AML legislative package

Ladies and gentlemen,

It is a pleasure to be with you in Ljubljana today, rather than addressing you from behind a screen.

The pandemic is not yet over but we have reached more than 70 percent of adults in the EU fully vaccinated, and we are able to meet in person once again.

Our work has continued throughout COVID, of course.

Just before the summer break, the European Commission adopted a new Anti-Money Laundering package. We are cracking down on money laundering.

Criminals laundering money undermine the integrity of our financial system. Behind this dirty money are crimes that have an awful impact on citizens, society and communities.

Recent financial scandals have been a wake-up call. These scandals have shown the weaknesses in the EU system – that our rules have not been clear or consistent enough, and they have not been enforced as effectively as they should have been.

And many of these scandals have had an international dimension – demonstrating the need for a more European approach.

So with these AML reforms, the Commission is getting tough on financial crime and dirty money. This is a game changer.

We will establish a single rulebook: so that the rules on money laundering are consistent across the EU.

And we will create a new Anti-Money Laundering Authority at the European level, as a European supervisor and a hub for AML expertise, coordinating national supervisors and the Financial Intelligence Units.

Let me briefly go through the reform package.

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The first part of our reforms is the single rulebook. We want to make sure that the rules against money laundering across the EU are consistent.

Up until now, there have been five AML directives.

They were always transposed into national legislative frameworks, so we have 27 different sets of rules, with too many differences between them – and various infringement proceedings as Member States lagged behind on implementation.

Now we have proposed an AML Regulation, containing directly applicable rules, alongside an AML Directive that is much more detailed and granular.

The Regulation will contain directly applicable rules that financial institutions have to apply, for example on customer due diligence. There will be stronger transparency on beneficial ownership so there is clarity on who really owns or controls a company.

The new Directive will set the rules for national institutional and sanctioning frameworks. That means the rules to be applied at national level will be harmonised, while also respecting national structures.

There will be clear standards that national authorities must meet, reinforced sanctions, and better rules for cooperation. And we will continue to make sure we enforce the rules already in place.

As part of this single rulebook, we are also proposing an upper limit of €10,000 euros for cash transactions across the EU.

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.

Two-thirds of Member States already have limits on cash transactions, and those lower limits can be kept in place. But we have decided that a limit of €10,000 euros 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.

We also need to adapt our AML rules to technological developments. Currently, AML rules only apply to part of the crypto sector. Our measures will extend the framework to the entire crypto sector. All crypto asset service providers will have to apply AML rules.

And crypto-asset transfers will be made fully traceable, just as other money transfers already are, bringing the EU in line with international standards.

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The second part of our reforms is a new Anti-Money Laundering Authority at EU level.

At the moment, resources and practices vary a lot between different Member States. And there are inconsistent approaches to cross-border situations. So now we are setting up a new AML Authority to sit at the heart of the EU's supervisory system. It will directly supervise some entities in the financial sector exposed to the highest risk of money laundering. And the Authority will have teeth: it will be able to make binding decisions and impose significant sanctions.

But the AML Authority is not there to replace national supervisors. Instead, it will be there to coordinate, share information, and allow the development of a common, consistent supervisory culture.

Indeed the Authority's own direct supervisory work will be carried out by Joint Supervisory Teams – with EU supervisors working hand-in-hand with national supervisors.

But the work of the Authority will go beyond direct supervision. It will develop common methods, enable information sharing, and allow expertise to be exchanged.

It will be a central hub for AML knowledge and expertise – helping all supervisors across the EU step up their game. The AML Authority will also help Financial Intelligence Units work together more effectively. Again, this is about having a European-level centre to help national specialists come together.

The AML Authority will host the communications network FIU.net. It will organise and carry out joint analyses of suspicious cross-border activities. And the Authority will enable FIUs to help each other and allow their practices to converge.

By bringing together information from the national level, the Authority will also be able to look at trends at a European level – helping us better understand how to prevent money laundering in the first place.

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With this package, we are going after dirty money and tackling financial crime.

And we are doing that with a much more European approach. We will have clear, consistent rules across the EU.

We will bring national knowledge and expertise together in the new AML Authority. That will also give us a better picture of the situation across Europe.

I know there is a concern across the European Union about money laundering and the crimes it enables. There are also concerns in the financial system today about the fragmented AML landscape, and different demands in different Member States.

This package aims to address these concerns.

The European Parliament and the Member States have a strong desire to get this job done and to make sure that our system does not allow dirty money to get washed through.

We are counting on the support of all stakeholders. Thank you.

Gert Jan Koopman

Director General, DG Budget,
European Commission

Impacts of the NGEU package on EU capital markets and the international role of the euro

Thank you very much, David, for your very kind words. It is good to see you. I regret that I cannot be with you in Ljubljana. I would have very much liked to do that, but Next Generation EU is keeping me very busy, notably on the funding side where a number of important decisions were taken and announced earlier this week. I am delighted to be able to join you virtually and say a few words about how this programme is impacting the EU capital markets and the international role of the euro.

I will start with where we were a year ago. The past year has been a journey for us. A year ago we were a small issuer of debt doing back-to-back financing at small scale for instruments like the European Financial Stabilisation Mechanism (EFSM), the Macro-Financial Assistance (MFA) and the Balance of Payments programmes. This was in the range of a few billions a year.

With the onset of the pandemic, this has changed completely, following historic decisions by the EU Leaders in the course of 2020. As a result, in September 2020 we started rolling out our social bond programme, known as SURE, that has had a huge impact on the markets. Then, in the summer of this year, we managed to get the Next Generation EU funding going, allowing us in the space of 12 months to raise about €150 billion for the European Union. That is the largest ever amount raised by institutions in the EU and it puts us at the same level as many large Members States.

Naturally, that has had a profound impact on the EU capital markets and what we see is a very strong interest, not just from European investors but also from global investors in these bonds. I will come to that in a moment, but I thought it might be interesting to speak a little bit about these different steps and how we have actually gotten to this point. What investors might want to look at is the very rigorous legal framework that we have built and that sets out a first-class governance framework for this very important operation. We have also naturally been working very, very closely with the investor community and the rating agencies to explain how funding the budget through borrowing, which is a historic evolution, is actually a very safe investment proposition given the guarantees enshrined in primary EU law.

That legal framework gives us a lot of comfort, given that, at the end of the day, we are still a supranational issuer. It is backed up by a very robust delivery capacity which we have essentially built from scratch in the space of a year. We have tripled the size of the teams by bringing in some very experienced colleagues from Member States' DMOs and from international organisations, and we have also built the infrastructure that has allowed us to quickly go to the markets in full transparency. A few examples. In May this year, we decided to use Système de Télétransmission des soumissions aux adjudications du Trésor (TELSAT), the Banque de France operator of French issuances, to organise our EU-Bills and EU-Bonds auctions, and the first auction is taking place next week on Wednesday. We also created a Primary Dealer Network group, where we now have 41 institutions supporting us.

Given the size and the scale of these operations, we had to provide the necessary guidance and predictability to the market, so we issued a funding plan which we first did in June. In a spirit of full transparency, this week on Tuesday we confirmed our funding plan for 2021 as originally announced in May. The unchanged parameters of the funding plan demonstrate that our forecasting capacities and management of proceeds processes are robust, which has given confidence to the market.

As of the beginning of September, we still have €35 billion of long-term bonds to raise in the remainder of this year and we will be issuing several tens of billions' of EU-Bills, which of course is a novelty. That will allow us to get to the point by the end of the year where we will have built a complementary reference curve for a triple A safe euro asset. I think that is very important. Market participants tell us that they are looking for this and we will be offering that through these mechanisms. By having resort to money-market operations, but also bills, we essentially have an iron cast guarantee that all of our liquidity needs can be met at all points in time. This is important given the nature of disbursements we undertake under our programmes, which are dependent on decisions by the politicians in the Council.

The latest addition to this is the Next Generation EU Green Bond framework, which we announced just two days ago, and which will comprise up to €250 billion worth of green bonds. This is a very rigorous framework anchored not only on the International Capital Market (ICMA) principles for green bonds but already incorporating strict taxonomy standards in its design. It is truly a very ambitious framework with rigorous reporting, both on the use of proceeds but also on impact side, which we published on Tuesday. On this basis, we will be organising the inaugural Next Generation EU green bond issuance as soon as next month. This programme will make the EU the biggest green bond issuer and we in the Commission will be running the biggest green bond programme in the world. This is yet another testimony to the priority that the Commission attaches to sustainability. These are big steps. I think with that we are extremely well-prepared to go to the market and not just fund the needs of the budget and loans to our Member States but also to strengthen the EU capital markets and the international role of the euro.

I would like to say a little bit more about this as it is highly pertinent. The availability of a highly rated and liquid asset in euros has been something that we have been debating ever since I joined the Commission more than 30 years ago now. It has been a long journey where I think the determination to stand together and address the challenges of the crisis has actually allowed us to build this instrument. I must admit that there was some trepidation ahead of the first issuances, because obviously we knew it worked in theory, but whether it would work in practice would remain to be seen.

The reality reassured us. These bond issuances were massively oversubscribed by a factor of eight to 10, even though the size and the volume of these issuances has been record-breaking in many dimensions. In practice, the appetite was confirmed.

As I said, talking to international investors, it is very clear that we are only at the beginning of this process and that the diversification in their portfolios across the globe is something that they intend to do also by including our bonds. I already mentioned that we are building this complementary reference initiative by issuing at different maturities throughout the curve, from very short-dated bonds of three or five years, all the way up to 30-year bonds. Given the nature of this scheme, we will actually be maintaining that curve by being very regularly present along it for the next two to three decades. By entering the money market with EU-Bills, we will give investors access to liquidity in a new instrument which benefits from a triple A rating, and which has a lot of advantages. We are already seeing a lot of interest to date, even before we have organised the first auction and I am very, very pleased to see that this interest is not just limited to Europe.

Finally, I think the European capital markets, as the home of Environment, Social and Governance (ESG) investing, has been bolstered by the SURE programme. It is the biggest social bond programme in the world and actually doubled the entire size of this market after its introduction. I already spoke about the Next Generation EU green bonds which are the largest green programme worldwide. In that sense we are also changing or assisting, I would say, European capital markets to evolve in a direction for which there is an enormous amount of interest.

There has been a debate, and I would like to close with it, about whether moving so boldly into the capital markets, as a supranational issuer, we are at risk of crowding out our sovereigns. I think the evidence that we see to date, and admittedly it is early days, is that exactly the contrary has happened. What we see is crowding in.

We see no evidence of peers in the Member States coming under pressure as a result of this programme. In fact, there is a recognition in many third countries beyond the borders of the EU, that actually this is going to strengthen our capital markets and will lead to a more attractive investment proposition, not just for us and not just for the debt class of assets but probably also for other capital market asset classes going forward. We think that we have made a good start. The omens are very positive, but clearly now the challenge is to continue and realise the potential fully. This means very close attention to execution and delivery, and I look forward to many contacts with colleagues who are now in Ljubljana but also colleagues in the capitals to continue this conversation.

Thank you very much.

Thomas Östros

Vice-President,
European Investment Bank

Towards a green and digital recovery

When the Covid-19 pandemic started more than one and a half years ago, I think few of us could have imagined the situation that we now find ourselves in. The pandemic has had an immense disruptive impact on our daily lives and on our European economies. But the pandemic has also established a sense of urgency to switch our economic path to a more sustainable one. It is now common to say that the pandemic has made digitalisation and the green transition more important than ever.

The Covid-19 recovery is an opportunity to drastically increase both climate investment and the adoption of digital technologies.

The European Union's recovery strategy aims to transform the economy by making it more green and digital. The recovery can also accelerate the pace of digital innovation and adoption, which will require not just digital infrastructure investment, but also the appropriate enabling conditions.

European firms are telling us that they expect the use of digital technologies to accelerate even further following Covid-19, but some are in a difficult position to achieve such a transformation, when we ask them about their investment needs.

According to our EIB Investment Survey where we asked more than 12 000 European firms, the adoption of digital technologies by firms in the European Union is improving, but it has not yet closed the gap with the United States.

By 2020, 37% of firms in the European Union had still not adopted any advanced digital technologies, compared with 27% in the United States.

There is also a risk of digital polarisation among European firms. Poor digital adoption by small businesses explains most of the observed lag between the European Union and the United States.

To achieve sustainable growth, Europe must embrace the potential of digital technologies. The digital revolution has already transformed industries, production processes and ways of living and working, but many of these shifts are only just starting. As with previous technology waves, taking an early lead can be critical for lasting competitiveness.

With the global innovation and technology landscape changing rapidly and with the winner-takes-all tendencies of digital technologies, Europe risks becoming entrenched in its position as a follower on digitalisation.

Digitalisation is an opportunity, not a threat. Our data show that digital firms are more productive, employ more skilled workers and foresee more employment growth opportunities ahead.

By taking action to help European firms invest in the new technologies they need, we can spur growth and help close the divides that exist within Europe, strengthening our cohesion.

Addressing barriers to digitalisation is crucial. Exploiting the full potential of digital transformation requires skills and managerial capabilities. Our analysis shows a strong correlation between managerial practices and digitalisation.

Access to digital infrastructure is converging across Europe, but more needs to be done to accelerate the spread of fast connections. Although access to finance is not the major impediment to digitalisation, it can be a barrier for small firms.

Investments in digital infrastructure will be key to reducing digital polarisation. Digital infrastructure, which played a critical role during the Covid-19 pandemic, should be therefore high on the digital policy agenda. 16% of EU firms consider the available digital infrastructure as a major impediment to digitalisation, compared to only 5% in the United States.

But this assessment varies significantly across EU Member States. For example, firms operating in countries where a high share of municipalities report that they have high quality digital capacities and infrastructure tend to also have higher rates of digital adoption. This further highlights the importance of digital infrastructure in supporting the digital transformation of businesses.

Climate change and environmental degradation present an existential threat to Europe and the world. Smart use of clean technologies can serve as a key enabler for climate action and environmental sustainability and accelerate the European Union's objective to become the first carbon-neutral continent by 2050.

For European firms, climate change poses two kinds of risks: direct physical risks and transition risks. Physical risks, such as those caused by acute weather events, are easier for firms to observe, understand and mitigate.

Transition risks aggregate corporate exposures to various risk factors, taking into account the adaptation and mitigation capacity of each country. For businesses, the repercussions go beyond profitability, as supply lines, demand and ultimately even business models could be at stake. These risks are less evident to address, as they depend on global commitments to reduce their economies' reliance on fossil fuels.

Firms have a harder time understanding the threat the transition poses to the demand for their products, their supply chains and their reputations.

Despite the costs associated with transition risks, the majority of firms in the European Union seem unaware of these risks. Firms that are aware of the risks the transition poses to their business activities are more likely to invest in climate measures to front-load the reduction of their carbon footprint.

Climate change's ultimate economic impact may still be hazy for many businesses, but more EU firms are investing to protect themselves than US firms. Around 45% of EU firms say that have invested in climate change measures, according to the EIB investment survey 2020, compared with 32% of US firms. Nearly half (47%) of EU firms surveyed say they have invested in energy efficiency, a ten percentage point rise compared to 2019.

Beyond finance, the corporate sector also requires critical advisory support to foster technology adoption and help improve management practices.

Our advisory services have provided substantial technical and financial expertise for projects in less developed regions with weaker institutional frameworks.

One example of this is the ELENA (European Local Energy Assistance) facility: managed by the EIB and funded by the European Commission, ELENA provides technical assistance grants to local and regional authorities for the preparation of energy efficiency and renewable energy investment programmes.

To build back better, we need proactive public and private investment. We need to create a virtuous circle, in which the private and public sector work together to invest in greening and digitalising the European economy.

In this context, the Recovery Fund could prove a formidable ally. The wealth of resources put in place are an invaluable opportunity to prepare our economic transformation.

To be at the frontier of the next waves of climate and digital innovation we need to ACT NOW!

Petra Hielkema

Chair, European Insurance and Occupational Pensions Authority

A supervisor's perspective: 10 days in

Ladies and gentlemen,

Thank you for this invitation to speak at Eurofi both to the organisation as well as the Slovenian Presidency. It is a wonderful event and I am happy to participate even though it is via a screen and not in person.

Only last week I started as the new chairperson of EIOPA and having the opportunity to join Eurofi within my first 10 days is a pleasure. Naturally, it's too early for me to present a full vision or strategy for the years to come. Nevertheless, on a higher level, there are already some key topics and issues worth highlighting.

And so I am glad to share with you today some of the most pressing challenges that I see for our agenda and topics that need to be discussed. And when I say 'our' agenda, I mean the challenges not only for EIOPA or for the sector, but also for supervisors and society.

COVID-19 continues to be high on the agenda. Here, we will support the recovery as we also continue monitoring the market, with an eye on new risks that may emerge as the exceptional crisis measures are phased out.

Beyond COVID, the most immediate challenge is climate change. Every day, there is news of yet another climate change related event. In Europe, in recent months, we have seen devastating floods and fires. The impact on individuals, communities and economies is serious.

In Germany alone, the recent floods led to claims of around 5.7 billion euro and the total recovery package is expected to be around 30 billion euro. We cannot ignore these figures.

Change is needed, adaptation required and here the insurance and occupational pension sectors can help.

Both have considerable sums to invest for the long-term and can choose where to invest their assets. In carbon or in wind? In oil or in hydro? Serious choices that need to be taken in a well informed, forward looking and balanced way. I am happy to see the discussion gathering pace, but I also see that many of the hard calls still have to be made.

The insurance industry can also lead in the transition to a more sustainable and resilient economy.

First of all by incentivising business to operate responsibly. Secondly by engaging with policyholders and the public on taking preventive measures, helping people and society become more resilient to climate change. Indeed let's not underestimate the interest of policyholders this area. It's bigger than we have seen before. Let's engage them with clear information and help them make informed choices.

And there is more. Insurers will have to consider the impact of their own underwriting practices on the environment as well as the impact of climate change on themselves. Indeed, from a supervisory perspective, climate risk clearly has to be a part of the risk management of any insurer or pension fund.

And so recent work by EIOPA includes the Opinion on the ORSA, the paper on integrating climate risk in nat cat underwriting calibration and the report on the impact and integration of climate change-related risk in underwriting and pricing. This is just the start. EIOPA will continue to work on risk differentials, product disclosure and climate stress testing.

If climate change is top of the agenda, cyber security is not far behind.

The pandemic has accelerated the digital transformation. This is a good thing. But cyber threats are also growing. Hacking, phishing, ransomware – these terms are part of our day to day language and we are always on guard.

Also insurers and pension funds need not only to manage cyber and IT risk within the company and the value chain, but they also need to keep pace with new threats and developments. Here operational resilience testing and cooperation can help and as such EIOPA welcomes DORA and other initiatives in this field and stands ready to contribute.

Like with climate, insurers have another role to play in this area. A sound cyber insurance market is an important measure. The challenge is how to insure and help prevent cyber risk. Especially as these risks are growing in sophistication and intensity.

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 in Europe.

The last challenge that I want to mention here, and it comes in many forms, is digitalization. Technological innovation, new business models and different market players bring new and more possibilities to industry and consumer and that is good news as long as risks are well managed and consumer protection is up to standard.

EIOPA will continue to monitor and motivate innovation, while keeping a close eye on new risks that are emerging, as well as on how consumers are served. Considering the cross-border potential of digitalization, the role of EIOPA will be key to ensure convergence and cooperation in order to safeguard stability and protect policy holders.

ndeed consumer protection focussing on good information, effectively targeted and designed products, appropriate advice, as well as inclusivity will become more important in the near future.

More and more, consumers will buy their products on-line, not knowing (and not caring) where in the EU the insurer is licensed. This is a true reflection of our ambition to create a well functioning internal market. However, this means that when there are issues or complaints consumers will expect to be – and should be – provided with the same levels of protection as domestically. Here supervisory cooperation between home and host as well as convergence will be key. Levels of protection need to improve. Above all, whether in the online world or not, we must make sure all consumers are equally protected and included and where we identify areas of detriment, EIOPA must and should be able to act.

Considering all the possibilities in the market, we also need to keep an eye on what isn't possible, the gaps.

On the non-life side recent cyber attacks, flooding and the COVID-19 crisis made some protection gaps more visible than before. And on the life side of the insurance business the low yield environment is having an impact on products being offered. Moreover, with more people changing the way they work, for example becoming self-employed, the risk of protection gaps is increasing. Identifying these gaps and raising awareness of the need to find ways to deal with them will be part of the EIOPA agenda.

Let me say a bit more on pensions. On a continent with an ageing population, identifying pension gaps (preferably looking separately at men and women) is essential to ensure the adequacy and sustainability of pension systems. EIOPA's work on pension dashboards and tracking services will help to raise awareness at a macro level as well as at the individual level.

But that in itself will not be enough and particularly in the consumer protection area more can be done. The low yield environment has resulted in a shift from defined benefit to defined contribution schemes in Member States. This shift requires EIOPA to consider where most value can be added from a convergence perspective. As the shift to DC means that more members and beneficiaries carry the risk, we will need to pay attention to conduct risk, including ensuring transparency of costs and charges.

There is opportunity too: Cross border activity and simple pension products are underdeveloped. I am convinced that the PEPP, the Pan European Personal Pension product will add value and possibilities to consumers wanting to save for their pension. We need more of these types of products.

A priority for the coming years will be to encourage cross-border provision of occupational DC schemes thereby closing gaps. As well as a careful assessment of the implementation of the IORP II Directive on cross-border activity for the review of IORP II, so that the framework remains robust.

Indeed robustness and a good framework are at the heart of a well-functioning market. We can only meet new challenges if we have a stable starting point and we do. It's called Solvency II. And let me underline that I do not regard Solvency II as a challenge, rather as a success and an opportunity.

Solvency II is the steady foundation on which we rely during challenging times. We saw this during the pandemic. However, there is no time to be complacent, as new challenging times will come. We must make sure that the framework remains fit for purpose.

At the end of last year, EIOPA submitted its Opinion on the review of Solvency II, with our proposals reflecting the ongoing low interest rate environment, the need to foster long-term investment and proportionality. You will not be surprised to hear me use the term 'evolution not revolution'. It is the approach EIOPA choose and it is a good approach. As we all know, the framework was developed around 2012-2014 and included new elements of supervision, like proportionality, internal models and group supervision. The framework and these new elements worked well for insurers and supervisors. We can be proud. However, in order to stay proud, an update reflecting the current economic circumstances as well as fine-tuning some parts of the new elements is needed.

Furthermore, we need to use this moment of review to complete the risk management toolbox, introducing new tools that are needed and relevant. A minimum harmonized insurance guarantee scheme is part of that.

It is true that not all, but many member states have their own insurance guarantee schemes. But the lack of uniformity means that too often policyholders are not treated equally in the event of a failure. This is against our fundamental belief that policyholders can and should expect the same level of protection no matter where they are based or from where they buy their insurance policy.

This is why we believe that there is a strong need for a minimum harmonised recovery and resolution framework and minimum harmonisation in the field of insurance guarantee schemes.

A solid, fit for purpose framework is good for the insurance sector. Solvency II has shown how this is true in Europe and we should strive to achieve this internationally. EIOPA will therefore continue to support the IAIS in its work to set good standards for the insurance sector globally.

With a good basis underpinning the sector, the insurance and pension industry is better placed to meet challenges.

This year, EIOPA celebrated its tenth anniversary. This week, I will mark my 10 days as Chair.

I can say that from these 10 days, I can tell that my agenda – our agenda – is a full one.

We have challenges to face, but we also have opportunities to grow. And if we work together, we can progress in mitigating risk and building resilience and sustainability which can only benefit policyholders and society.

When it comes to opportunity, it's no surprise that the NextGenerationEU recovery plan is built on green and digital transitions. And I believe that the insurance and pension sectors can and will play an important role in making the recovery both strong and sustainable.

So, for far beyond the next 10 days, I am looking forward to working with you – our Board of Supervisor members, colleagues from the EU institutions and our sister European Supervisory Authorities, industry, and of course my colleagues within EIOPA – to take the sector and its supervision forward. If we work together on this, we can be sure that we are building a sustainable future for our society.

Ladies and gentlemen, thank you very much.

Andrea Enria

Chair of the Supervisory Board and Member of the Steering Committee, European Central Bank

How can we make the most of an incomplete Banking Union?

The urgent need for progress in banking integration

Ladies and gentlemen,

I am grateful for the opportunity to deliver this address at the biannual Eurofi Forum. We have finally been able to gather in person and, after such a challenging time, it is a relief and a pleasure to see friends and colleagues once again.

This forum has often played host to discussions on the integration of the European banking sector. Industry representatives have frequently complained about the lack of progress towards a European internal market for banking services that is truly borderless. The debate has traditionally focused on issues related to the euro area institutional framework and legislative reforms. But despite the advances towards a more integrated European institutional and regulatory framework, progress has been underwhelming. For many banking products and services, our market remains deeply segmented along national lines.

Today I will focus on the concrete actions we can take to achieve real progress towards a truly integrated prudential jurisdiction within the Single Supervisory Mechanism (SSM) and within the current institutional and regulatory environment. And by "we" I mean all of us, supervisory authorities and market participants alike. At the ECB we are fully prepared to play our part, but such progress must also be shaped by sound projects and initiatives by banks.

Some argue that, until a fully fledged banking union with all its three pillars is in place, there is very little chance of integrating the European banking sector and we are condemned to a collection of national banking sectors, even within the single prudential jurisdiction.

But just before the summer break we had a timely reminder of the difficulties in achieving immediate political breakthroughs. After years of protracted negotiations, the Eurogroup failed to reach an agreement on the roadmap to complete the banking union.[1] While I am confident that agreement will eventually be found, we cannot simply stand still while complex political negotiations play out.[2]

Moreover, as already mentioned, the political agreement will take the form of a roadmap, with a number of intermediate targets. Completing the banking union, including a fully mutualised European deposit insurance scheme (EDIS), will take some time.

But, in the meantime, we cannot wait. There is an urgent need for material progress towards an integrated banking sector in the euro area. And considering the delicate role the banking sector has to play in supporting a robust recovery from the pandemic crisis, this is a matter of even greater urgency than in the past.

These last 18 months have been extraordinary for a number of reasons. First and foremost, we faced a severe public health crisis which created extreme uncertainty for the trajectory of our economies and the risks facing our banks. But we also had to deal with a whole host of issues in a very compressed time frame. This could have potentially sown the seeds of further fragmentation in the banking union, with uneven national responses. However, I am very pleased that – for the first time – there has been a completely unified European supervisory response to the challenges that the pandemic crisis has posed for euro area banks. We have taken unprecedented

1. The President of the Eurogroup stated: "We've made progress. We need to make more progress. We will agree a work plan, but it will take a bit more time and we will be returning to this later in the year". See Council of the European Union (2021), "Remarks by Paschal Donohoe following the Eurogroup meeting of 17 June 2021". In December 2020 the Euro Summit mandated the Eurogroup "to prepare, on a consensual basis, a stepwise and time-bound work plan on all outstanding elements needed to complete the Banking Union". See Council of the European Union (2020), "Statement of the Euro Summit in inclusive format".

2. Enria, A. (2020), "The road towards a truly European single market", speech at the 5th SSM & EBF Boardroom Dialogue, Frankfurt am Main, 30 January.

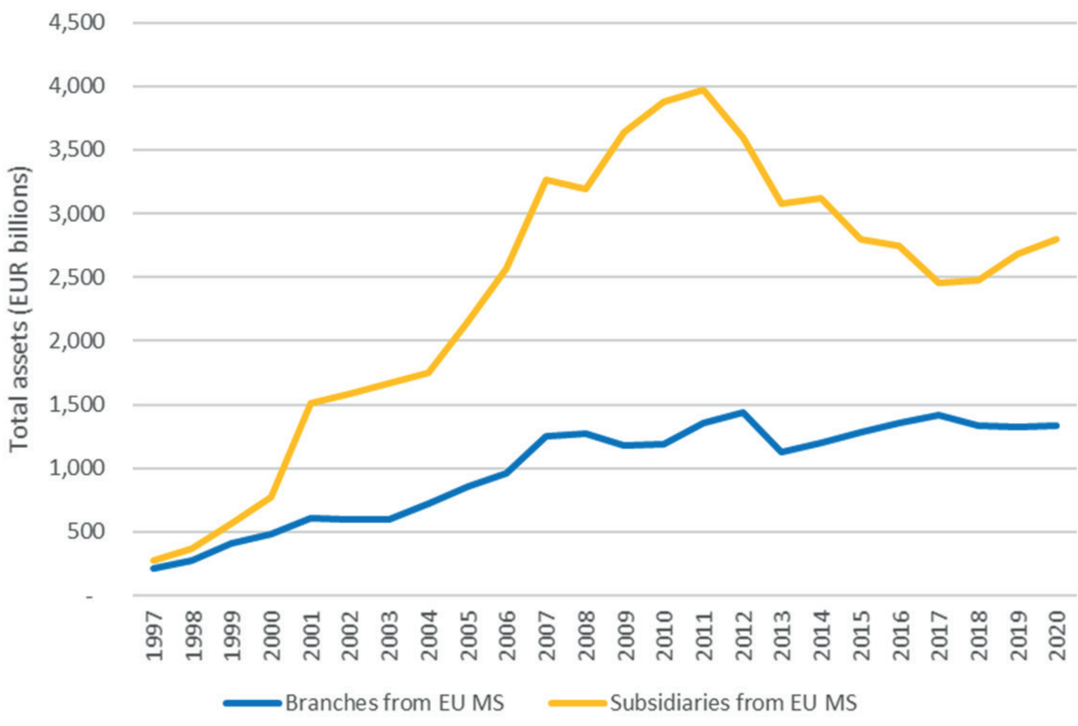
supervisory decisions quickly, in close coordination with monetary policy measures.

We have also seen the banking sector successfully adapt its operations to the unprecedented constraints imposed by the measures taken to fight the pandemic. Banks adjusted to a dramatic increase in the use of technology, in terms of both how they work and how they interact with their customers. This digitalisation also gave banks an opportunity to make their business models more sustainable, increase their profitability and become more attractive to long-term investors. With this in mind, in January 2021 we published a Guide on the prudential treatment of mergers and acquisitions.[3] We clarified how we assess merger transactions so that banks know what to expect from us, and we think these clarifications have had an impact on consolidation in the euro area banking sector. In the past few months, we have directly applied the supervisory principles set out in the Guide to several transactions.

But most consolidation transactions still take place within Member States. The European banking sector remains segmented along national lines, even within the single prudential jurisdiction of European banking supervision.

Looking back, much of the progress in cross-border integration that we saw following the creation of Economic and Monetary Union was reversed in the aftermath of the great financial crisis. And the cross-border integration of the sector has progressed at snail's pace in recent years, even after European banking supervision was established in 2014 (*see Chart 1*). In fact, the measures adopted by national governments in response to the great financial crisis also led to the "repatriation" of many assets that were previously held in local subsidiaries of cross-border groups. The launch of the SSM has not yet reversed this trend. On the whole, subsidiaries currently account for around two-thirds of EU foreign assets in the euro area, while branches make up the remaining third.

Chart 1 Total EU cross-border assets in the euro area



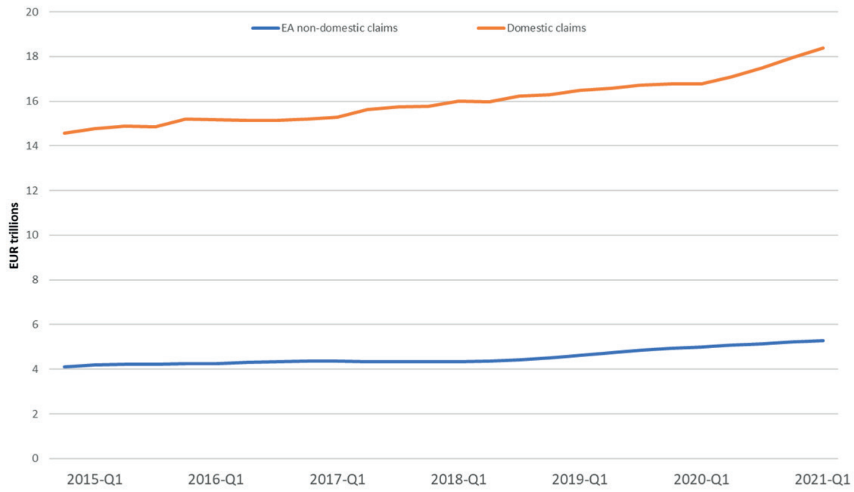
Source: ECB structural financial indicators

When we look at the split between foreign assets and domestic assets held by euro area banks in the years since European banking supervision was established (*see Chart 2)*, there really does not seem to be any significant change in trend. As we also saw from Chart 1, "foreign" assets[4] in euro area banks have not changed significantly since the creation of the banking union. Banking sector integration in the euro area is still an elusive target.

3. ECB Banking Supervision (2021), Guide on the supervisory approach to consolidation in the banking sector, 12 January.

4. By "foreign" assets in Chart 2 we mean exposures of euro area banks towards counterparties in other euro area countries.

Chart 2 Domestic and non-domestic claims in the euro area



Source: Consolidated Banking Statistics and ECB calculations.
Note: four-quarter rolling average of Total Exposures for credit, coounterparty credit and dilution risks and free deliveries.

And we all know why this is so detrimental. It is not only the aspect, though absolutely crucial, of denying economies of scope and scale to European banks that need to compete globally with banks that have a much deeper and more efficient domestic market, as, for instance, US banks do.

But the current limited availability of ex ante private mechanisms of risk-sharing, which integrated financial and banking markets would provide, is of the utmost concern to policymakers. Without such mechanisms, it becomes much more difficult to smooth the asymmetric shocks hitting the single monetary area. The burden falls entirely on ex post public mechanisms of risk-sharing, which reignites contentious political debates.

Former ECB President Mario Draghi convincingly argued that the mechanism of insuring against asymmetric shocks in a common currency area through financial markets "plays a key role in stabilising local economies in a monetary union, in two ways". The first is through financial market integration, which enables firms and individuals to withstand local shocks without sudden contractions of consumption and investment, by holding geographically diversified portfolios of financial assets. It is, of course, also worth mentioning the fundamental importance of the capital markets union in this context. The second is through retail banking integration, as banks with geographically diversified portfolios can offset losses in one region with gains in another. These banks can then continue to provide credit to sound borrowers in the event of a local recession, rather than cutting lending to all customers.[5]

If we listen to those who argue that there cannot be real banking integration without ex post public risk-sharing mechanisms, such as a common deposit guarantee scheme for the euro area, we will get nowhere fast. We will not see indispensable ex ante private mechanisms of risk-sharing until ex post public mechanisms are in place. But the lack of ex ante mechanisms puts too much pressure on the functioning of public mechanisms, making their introduction even more difficult and unlikely. These vicious circles are hindering progress towards completion of the banking union.

That is why we cannot stand still. We need to move forward and make the most of the opportunities that are already available in the current European legislative framework. We need to start from somewhere and I would argue that market players can play a fundamental role here.

In the remainder of my speech, I will outline the main prudential obstacles to banking sector integration that are still embedded in the European legislative framework. I would then like to propose some potential ways of making progress within the current legislative and institutional framework, based on our ongoing discussions in ECB Banking Supervision.

The obstacles to cross-border integration embedded in the European regulatory framework

There are already several excellent analyses of the many shortcomings of the European regulatory framework[6], so today I will focus on the main obstacles to cross-border integration at the legislative level.

5. In his speech, Mario Draghi observed that "around 70% of local shocks are smoothed through financial markets in the US, with capital markets absorbing around 45% and credit markets 25%. In the euro area, by contrast, the total figure is just 25%." The figures are based on European Commission estimates. See Draghi, M. (2018), "Risk-reducing and risk-sharing in our Monetary Union", speech at the European University Institute, 11 May; and Nikolov, P. (2016), "Cross-border risk sharing after asymmetric shocks: evidence from the euro area and the United States", Quarterly Report on the Euro Area, Vol. 15, No 2.

6. See, for instance, Bassani, G. (2019), The Legal Framework applicable to the Single Supervisory Mechanism. Tapestry or Patchwork?, Wolters Kluwer, Alphen aan den Rjin; and Gardella, A., Rimarchi, M. and Stroppa, D. (2020), "Potential regulatory obstacles to cross-border mergers and acquisitions in the EU banking sector", EBA Staff Paper Series, No 7, European Banking Authority, February.

The Basel international standards have traditionally been based on the consolidated regulation and supervision of internationally active banks.[7] The Basel standards also introduced a framework for cooperation between home and host authorities, which is key to determining how capital and liquidity should be distributed across the different entities of a banking group. In general, locally incorporated subsidiaries of international banks are requested to fully comply with the local minimum regulatory requirements at individual entity level. For branches, national authorities often rely on the prudential requirements set by the home authorities.

When the internationally agreed standards were transposed into the European legal framework, prudential requirements in Europe were principally applied at the individual entity level, as well as at the consolidated level. By default, each and every legal entity providing banking products and services needs to fulfil prudential requirements at the solo level.

Intragroup waivers play a key role here. EU banking legislation gives supervisors the option of waiving certain prudential requirements at the level of individual banks and allowing banking groups to meet those requirements on a group-wide or sub-group basis only. Such waivers would in theory make it more attractive for banking groups to reach across borders, as they would make it possible to transfer capital and liquidity resources between legal entities in the same banking group.

But for solo capital, large exposure and leverage requirements, those waivers can only be granted for subsidiaries in the same Member State, and not in a cross-border context, even within the banking union. A similar approach was adopted for the waivers for minimum requirements for own funds and eligible liabilities under the revised Bank Recovery and Resolution Directive, the BRRD2.

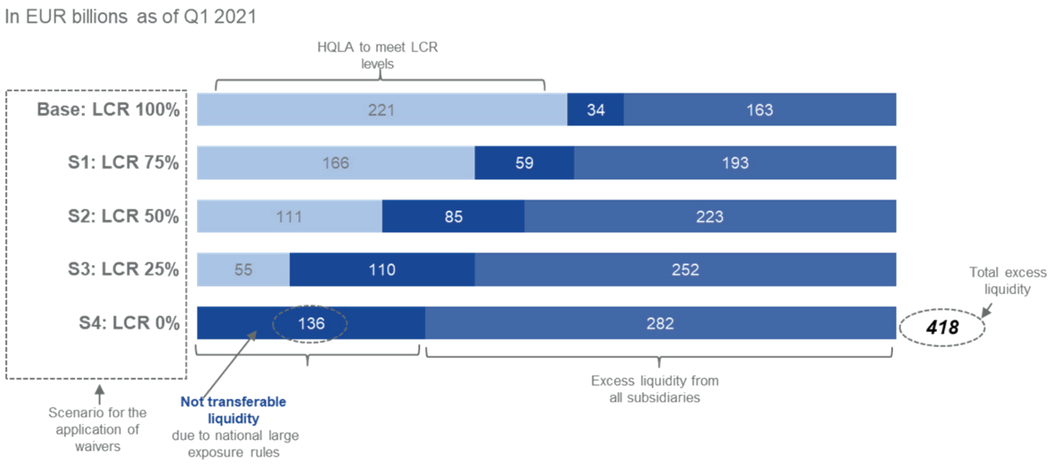
The situation is better for liquidity requirements: the legislative framework does allow cross-border waivers of individual liquidity requirements, creating cross-border liquidity sub-groups. But some Member States, exercising an option that will remain in the legislation until 2028, have imposed limits on intragroup exemptions from the large exposure requirements which, as we have seen, cannot be waived, cross-border, at the solo level. This, in turn, limits the extent to which cross-border liquidity waivers can be used in practice, thereby restricting banks' freedom to move liquidity within their groups.

Calculations by ECB Banking Supervision show that, in the absence of cross-border liquidity waivers – as is currently the case – the combination of these European and national provisions prevents around €250 billion of high-quality liquid assets from being moved freely within the banking union.

But even if a "complete" liquidity waiver (100% of the individual requirement) were to be granted, around €140 billion of high-quality liquid assets would still not be transferable at the system level (*see Chart 3*).

We call those non-transferable liquid assets "trapped" liquidity, which compounds the "trapped" capital created when cross-border capital waivers are not possible. As far as capital is concerned, ECB Banking Supervision's calculations show that the overall amount of risk-weighted assets resulting from the individual non-waivable requirements of cross-border subsidiaries in the banking union is around 25% larger than the amount of consolidated risk-weighted assets attributable to those subsidiaries at the consolidated level.

Chart 3 Excess liquidity held in the euro area by non-domestic subsidiaries of SSM significant institutions



**Excess liquidity defined as difference between high-quality liquid asset buffer and sum of net cash outflows and large exposure towards ultimate parent.*

Source: COREP (C 76.00, C 27.00, C 28.00)

Calculations: DG-OL/CME

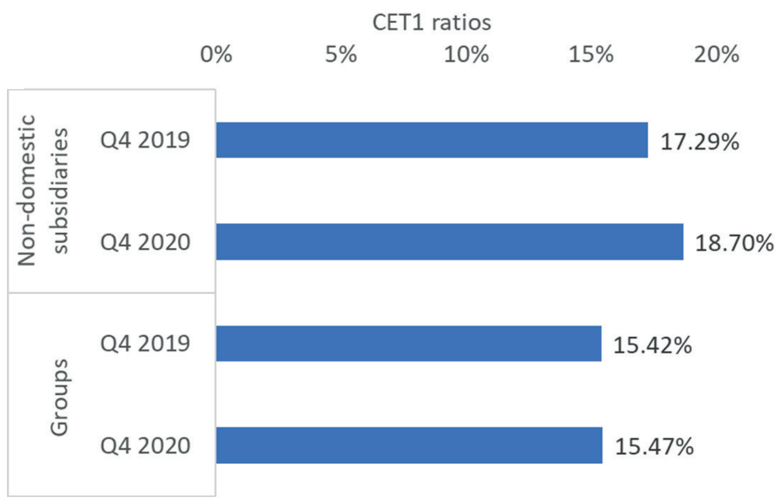
7. See the clear introduction to paragraph 10 of the First Basel Capital Accord: "This agreement is intended to be applied to banks on a consolidated basis, including subsidiaries undertaking banking and financial business". Moreover, as mentioned in paragraph 1 of the Accord, the aim of the Basel Committee was to "secure international convergence of supervisory regulations governing the capital adequacy of international banks". See Basel Committee on Banking Supervision (1988), International Convergence of Capital Measurement and Capital Standards, July.

To complete the picture, we also need to consider macroprudential requirements, for which the European legislative framework contains all the hallmarks of minimum harmonisation. In fact, most of the macroprudential requirements are enshrined in the Capital Requirements Directive, while the most relevant macroprudential provisions in the Capital Requirements Regulation relate to options for Member States. In particular, since the CRD V was enacted, it has been made clear that Member States should be free to implement other "measures in national law designed to enhance the resilience of the financial system"[8] over and above the provisions of EU legislation.

At ECB Banking Supervision, we saw this issue in sharp relief when, during the pandemic, we implemented our recommendation on dividend distribution restrictions.[9] The recommendation specified that it applied only at the consolidated level, given that our supervisory concern was one of preventing capital resources from leaving the banking system in times of extreme uncertainty. Transferring resources from one group entity to another was not – and, I would say, could not be – in our supervisory scope, especially within European banking supervision. But several Member States stopped subsidiaries within cross-border banking groups from paying dividends to their parent entity in line with macroprudential national measures that had been taken to make the national financial system more resilient. In some cases, this led to situations where the restrictions were applied to subsidiaries of foreign banks which already had solvency buffers far higher than the regulatory requirements and any reasonable solvency projections.

Also as a result of the application of those national measures on dividend distribution restrictions, the amount of capital held in national jurisdictions increased even further above the prudential requirements applicable to individual subsidiaries (*see Chart 4*).

Chart 4 CET1 ratios of parent entities and cross-border subsidiaries



Source: Supervisory data.
Note: Weighted average CET1 ratio of 117 non-domestic subsidiaries located in the SSM

The legal framework for macroprudential tools introduced after the great financial crisis entrusted national designated authorities with flexibility so they could cater to local financial and economic conditions and adjust their policies in the light of experience. Within the euro area, a safety valve was left for the ECB to intervene and top-up national measures. But the ECB can only intervene in the case of EU harmonised measures, and many national macroprudential powers are delinked from EU legislation. I would argue that, with the experience gained with macroprudential policies over the last decade, it is now time to move to a more harmonised European framework, with a stronger coordination role at the European level. This should enable the side effects of decentralised macroprudential policies to be mitigated, preventing further regulatory fragmentation along national lines. But until now there have not been specific proposals for major reforms of the macroprudential framework.

On a more optimistic note, let me end this quick survey of applicable prudential requirements with a positive development related to designated or competent authorities being able to consider the euro area as a single jurisdiction within the global systemically important institutions (G-SIIs) methodology[10].

8. See Recital 22 of Directive (EU) 2019/878.

9. For the ECB's first recommendation on dividend distributions in March 2020, see Recommendation of the European Central Bank of 27 March 2020 on dividend distributions during the COVID-19 pandemic and repealing Recommendation ECB/2020/1 (ECB/2020/19) (OJ C 102I , 30.3.2020, p. 1).

10. See Article 131(2)(a) of the Capital Requirements Directive, as introduced by Directive (EU) 2019/878. This legislative change also led to the amendment of Commission Delegated Regulation (EU) No 1222/2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards for the specification of the methodology for the identification of global systemically important institutions and for the definition of subcategories of global systemically important institutions (see Commission Delegated Regulation (EU) 2021/539).

In short, there are numerous legal prudential obstacles to the free circulation of capital and liquidity within banking groups in the euro area. While legislative reforms aimed at removing these obstacles are clearly possible, we are unlikely to see them finalised in the near future, and surely not before a fully fledged EDIS is put in place. If we want to achieve progress now, we need to pursue other avenues, which also require commitment and creative solutions from the banking industry.

Avenues to accelerate progress in the integration of the euro area banking sector

One possible avenue is to continue relying on groups that focus mainly on subsidiaries to expand their business across the banking union. A contractual approach could be developed through intragroup guarantees, which could be made enforceable, and therefore credible, using supervisory tools at the European level.

This is the proposal I developed in a blog post written with my colleague on the Supervisory Board, Edouard Fernandez-Bollo.[11] Authorities in the host Member States may be concerned that, in the event of a crisis, the parent entity might refuse to support local subsidiaries. To allay these concerns, within the banking union group support agreements for subsidiaries could be enshrined in groups' recovery plans and approved by the supervisory authority – the ECB – which would be neutral, pursuing neither a home nor a host agenda. This could facilitate the granting of cross-border liquidity waivers at the solo level to the extent possible within the current legislative framework. Admittedly, this approach would not be an immediate game changer, as the benefits would be constrained by the limits set in the regulatory framework, but it could enable some additional pooling of liquid assets at the group level. And, most importantly, a positive experience with intragroup agreements would foster a more positive attitude at national authorities, creating the conditions for legislative change to happen sooner.

Another avenue that is more radical and challenging, but potentially more promising, would be for banks to review their cross-border organisational structure more actively, while keeping in mind the aim of banking sector integration. I am referring in particular to the possibility of relying more extensively on branches and the free provision of services, rather than subsidiaries, to develop cross-border business within the banking union and the Single Market.

I must stress that ECB Banking Supervision does not favour a specific organisational structure for cross-border banking groups under its direct supervision. These groups are completely free to choose the organisational structure that best suits their business needs, be it through branches or separate legal entities. In fact, I believe that, on a practical level, acquiring a local entity that becomes a subsidiary of the larger banking group may make it much easier to initially enter a new market. It is clearly a matter of using the local expertise and knowledge of the market, not to mention the issue of brand recognition among local customers, especially for retail business.

This notwithstanding, I am puzzled as to why banks have made little use of the basic freedoms of establishment and remote provision of services that were made available with the creation of the Internal Market back in 1992, when the Second Banking Coordination Directive[12] was transposed into national law across the then 15 Member States.

1992 is one of those totemic years in the European integration process that marks the end, or maybe the end of the beginning, of the project started with the Commission's 1985 White Paper on completing the Internal Market[13] and the Single European Act of 1986. It is difficult to overstate the importance of those documents and decisions, including the very first Treaty amendment, for the history of European integration. But the seeds of those milestones had been sown a few years earlier by a seminal judgment of the European Court of Justice in the Cassis de Dijon case of 1979.[14] This judgment established the principle that goods and services[15] "lawfully produced and marketed in one of the Member States" must be granted free access in all the other Member States without requiring other and different requirements over and above those already imposed by the home Member State for the production of those goods and the provision of those services. On this basis, it was possible to establish a truly single, internal market in the European Union, "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured", as enshrined in the European Treaty after the Single European Act.[16]

We are all aware of the inherent limitations of negative integration, even with the adoption of the principle of mutual recognition of national standards. But I can see a parallel between the situation back in 1979 and the situation the banking sector is in today. Back then, a fundamental judicial development helped usher in the most dramatic acceleration in the establishment of

11. See Enria, A. and Fernandez-Bollo, E. (2020), "Fostering the cross-border integration of banking groups in the banking union", The Supervision Blog, 9 October.
12. Second Council Directive 89/646/EEC of 15 December 1989.
13. See Commission of the European Communities (1985), Completing the Internal Market, White Paper from the Commission to the European Council, 14 June.
14. See Case C-120/78, delivered on 20 February 1979. The fundamental statement of that ruling is in paragraph 14: "there is....no valid reason why, provided that they have been lawfully produced and marketed in one of the Member States, alcoholic beverages should not be introduced into any other Member States."
15. For services, and in particular financial and banking services, see the Commission's White Paper, supra footnote 13, paras. 102-104.
16. See Article 26 TFEU.

the Internal Market. And today, I would suggest that a market-based approach to banking sector integration would equally put pressure on political decision-makers, hopefully ushering in the completion of the banking union.

As I said, European banks have made little use of the freedoms that have been available to them since 1992. Branches have seldom been used to enter another country within the Internal Market, and existing subsidiaries have generally not been transformed into branches. Rather, banks have preferred to acquire local credit institutions and integrate them into a cross-border banking group. This has inevitably led to them retaining all the trappings of a separate legal entity: a separate board and support staff, local capital and local resources, separate annual accounts and treasury/finance functions and, of course, a strict application of all the local regulatory requirements on an individual entity basis. But the legal prudential framework still does not facilitate the integration of a credit institution established as a separate legal entity in another Member State. Even the establishment of European banking supervision has not yet changed this. In terms of assets, cross-border branches within the euro area still only represent a minority of intra-EU claims (*see Chart 1*).

All this being said, in the last few years there have been some signs of change, with a few cases of corporate integration within cross-border banking groups. Again, those were free business decisions in which ECB Banking Supervision did not play any role. The basic assumption is that banks made these choices to become more efficient. We merely granted the supervisory permissions necessary to complete the reorganisation, and there was little change in our ongoing supervision – the composition of our Joint Supervisory Teams did not change and national competent authorities continued to be represented.

The first case I would like to mention is the cross-border reorganisation of Nordea. It converted into a credit institution incorporated in Finland after transforming various separate legal entities in different European Economic Area countries (Norway, Finland and Denmark) into branches of a Swedish credit institution, which eventually became a branch of the new Finnish entity. This was a complex process that, from a legal perspective, exploited the opportunities for corporate reorganisations and mobility enshrined in the Cross-border Merger Directive[17], coupled with the freedom of establishment under the European Treaty.

A second related case concerns a Baltic cross-border group, Luminor, which was operating through a holding company and three separate banking subsidiaries in the three Baltic countries. Again, using the opportunities provided by the Cross-border Merger Directive, the two legal entities in Lithuania and Latvia were merged into the Estonian credit institution and are now operating as its branches.

And more broadly in the context of Brexit, there are numerous cases concerning third country groups, in particular Swiss and US groups, which are relocating various activities to the euro area. UBS is a good example, but many US investment banks have also taken the same approach of using the legal tool of the European Company, or Societas Europaea[18], to transform several legal entities in various Member States into branches of a credit institution incorporated in a single Member State (e.g. Germany for UBS and some US banks).

Despite the complexities of such large reorganisations, all the credit institutions contacted reported significant efficiency gains in terms of simplified legal structures and corporate governance, savings related to annual accounts and internal audit and lower overall regulatory requirements, among many others. Certainly, all the legislative prudential obstacles I have mentioned would disappear if, instead of there being separate legal entities in different Member States, capital and liquidity could flow freely within the cross-border group since a branch is structurally part of a single corporate entity.

I am not trying to paint an overly rosy picture by suggesting that those reorganisations did not entail significant costs and execution risks, for example related to IT integration. But our discussions with senior executives of the banking groups involved suggest that these costs and risks are worth it.

The final prize is a truly integrated credit institution, with a unified legal and business structure across different Member States and a return on investment over time that is clearly positive. I found it interesting that the management of one of the banks involved in these reorganisation processes described it as achieving a “one bank” operating model across multiple Member States. Of course, there will always be obstacles to a completely seamless organisational structure across national borders, such as tax rules or legislative provisions for contracts, particularly when it comes to consumer protection laws, which are especially relevant for retail banks. But this is outside the remit of prudential regulatory and supervisory authorities and there will unfortunately always be diversity in such rules across Europe. It is also worth noting that the development of the free provision of services, which should be facilitated by the increasing digitalisation of banking services, can also contribute to a simplified structure, at least for some segments of the market.

One issue that has often been raised in conversations with bank executives is a specific impediment in European banking legislation that particularly affects credit institutions with a large deposit base. I am referring to Article 14(3) of the Deposit Guarantee

17. Directive (EU) 2017/1132, subsequently amended by Directive (EU) 2019/2121.

18. See Council Regulation (EC) No 2157/2001.

Schemes Directive[19], which only allows contributions made in the preceding 12 months to be transferred to a new deposit guarantee scheme (DGS). In fact, all contributions made before that period would be lost when the deposits of a credit institution leave a specific DGS to join another one, for example when a subsidiary is transformed into a branch of a credit institution established in another Member State. This provision seems counter-intuitive, at least from an economic point of view, because the transfer of insured deposits also reduces the overall risk of reimbursement of the original DGS.

ECB Banking Supervision is in favour of a legislative change along the lines already proposed by the European Banking Authority (EBA) in 2019[20], where a regulatory technical standard drafted by the EBA will specify the methodology for calculating the contributions to be transferred, without the strict limitations of the current legislative framework. One potential approach would be to allow the transfer of previous contributions net of the relative share of pay-out events, if any, that occurred during membership of the DGS. But I do not want to pre-empt the technical discussions that need to take place in order to design the most appropriate calculation methodology for the transferable contributions. What seems to be clear is that a legislative change is necessary to incentivise cross-border reorganisations of the type I have described. And, as I said, changing the provision would also make it more aligned with the underlying economic rationale because, in the case of operations through a branch, the deposits are insured by the home country's DGS and not by the host country's DGS.

I know that I have repeatedly said that our analysis would respect a legibus sic stantibus condition, but it is really the only legislative change we are actually looking for. It would also be consistent with the establishment of an integrated European network of national DGSs, as an intermediate step towards a fully fledged EDIS.

Conclusion

Ladies and gentlemen,

Today I have discussed some of the fundamental issues related to establishing a truly single prudential jurisdiction in the euro area, and a genuinely integrated domestic market for our banks. In the history of our Union there have been times when policymakers have driven change and supported leaps forward in European integration. But there have also been times when the private sector has seen business opportunities and structured their operations in ways that foster European integration, and by doing so they have created the conditions for a faster adjustment in the institutional and regulatory framework. I am convinced that serious initiatives taken by banking groups – under the scrutiny of their European supervisor and with the supervisor's support – could be effective in driving positive change while waiting for major institutional overhauls.

I know that a truly integrated banking sector within the banking union is something many of you are looking forward to. But it is important to be aware that progress is in our hands – in your hands. The fundamental Treaty freedoms of movement and establishment are also there for the banking sector. Why they have been so seldom used in the past, especially in comparison with other sectors, is still open to debate. But it is never too late to start using them. As I said, in the past few years we have seen some significant corporate transformations and reorganisations that have provided noteworthy efficiency and regulatory gains for the credit institutions involved.

Within our mandate, we are ready to facilitate sound corporate reorganisations that use the opportunities embedded in the European Regulation on the Societas Europaea and the Cross-border Merger Directive. This would allow us to overcome the strictures of the current legislative framework for prudential requirements. Other pragmatic solutions, centred on intragroup agreements approved and overseen by the ECB, could also be explored for banking groups that prefer not to make use of those fundamental Treaty freedoms and decide to retain their subsidiary structure.

I would like to encourage banks interested in exploring these avenues to liaise with the ECB at an early stage to discuss possible options.

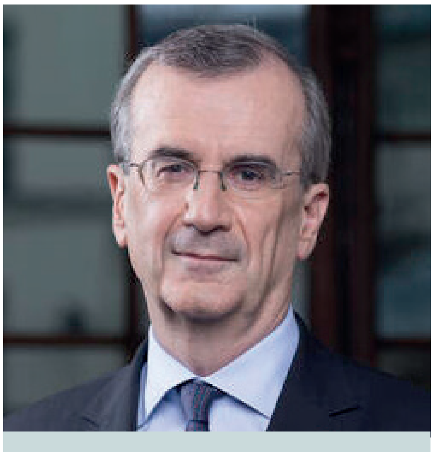
I really think that we all share the same goal here: bringing to life the vision of the European founding fathers – that of a truly internal market, also for the banking sector. At the same time, we should guarantee the stability of our Economic and Monetary Union by establishing ex ante private mechanisms of risk sharing that only an integrated banking sector can provide.

It is a daunting task. But if we do not try, we will never get there. A bottom-up market approach seems to be full of promise, and ECB Banking Supervision is ready to accompany and facilitate this process.

Thank you very much for your attention.

19. Directive 2014/49/EU.

20. See paragraph 7.ii. of EBA (2019), "Opinion of the European Banking Authority on the eligibility of deposits, coverage level and cooperation between deposit guarantee schemes", 8 August. See also pp. 16-25 of the report attached to the Opinion.



François Villeroy de Galhau

Governor, Banque de France

The Banking Union - Time to move forward again

I would have liked to be in Ljubljana today, but I extend my warmest thanks online to David Wright and Didier Cahen for making this event possible. During the acute phase of the crisis, EU governments and the ECB did the right thing in supporting economies, so that we can now bounce back quickly. The European banking system proved its resilience, and contrary to many exaggerated fears, there will be no tsunami of corporate insolvencies, and hence no major rise in NPLs. However, now that firefighters have been successful, it is time to turn to our architects to start building again: Europe must finally unlock the full potential of its Banking Union. This morning I will be in the same vein as Andrea Enria's impressive speech yesterday, which I fully welcome and support. Today, I will first discuss where we stand including the ongoing deadlock in the Banking Union, before elaborating on the pragmatic solutions we can come up with.

I. Banking Union: it is time to move forward again

Where we stand. After a strong initial impulse having achieved an efficient first pillar –supervision –, Banking Union now lacks momentum and remains incomplete. Let us be frank: the project has come to a complete standstill. While the initial ambition was to create a unified area where European banks could operate efficiently, we are still struggling with intra-European borders. The European banking sector remains far too fragmented. In 2019, the market share of the top five US banks was 43% [of domestic consolidated assets], compared with only 23% for the top five in Europe. There are still too many roadblocks to cross-border restructuring: geographical ring-fencing practices prevent groups from managing liquidity and capital efficiently on a consolidated basis. As a result, fewer than ten cross-border M&A deals have been signed since 2014, compared with 180 domestic deals over the same period, a historic low: at present, Banking Union has meant that our banks are actually not more Pan-European. This paradox is intolerable.

Why it remains crucial. The creation of the Banking Union itself was a direct response to the sovereign debt crisis in Europe and its impact on the bank-sovereign nexus in a context of fragmented supervision. Beyond the need to mitigate any future crisis, the achievement of the Banking Union remains of the utmost importance, for both micro and macro reasons.

At the micro level, moving further towards a true single banking market through cross-border restructuring is a matter of strategic autonomy. Genuine Pan-European banking groups could operate more effectively, raise their profitability thanks to scale effects and better face up to foreign competition, especially from the United States. Europe is clearly losing momentum and competitiveness here: the market share of the six major US investment banks in Europe towards their six major European competitors has increased from 44% to 58% in the last seven years. Moreover, larger groups could invest more in the key challenge of digital transformation: as most of the investment costs are fixed, size is a decisive advantage. But not only the largest, all other institutions will benefit from the increased depth of the market, allowing to reap the fruits of their competitive advantages in a larger market.

At the macro level – and I say this as a central banker –, Banking Union would decisively enhance private risk sharing within Europe. The political discussion and energy remain primarily focused on public stabilisation mechanisms, such as a possible common fiscal capacity. Let me stress that private stabilisers are just as important and efficient, and less divisive. Banking Union would enable, in conjunction with progress towards a Capital Market Union, a better channelling of our abundant savings through a genuine "Financing Union for Investment and Innovation".

How to move forward again. The first obvious fact is that we should neither relax now that the banking crisis is mostly over, nor wait for the next crisis to act. It is precisely because we are not in a crisis situation that we should move forward now. First, we have spent too much time and energy on protracted discussions on prerequisites and pre-conditions, such as a full EDIS, itself pre-conditioned by sovereign de-risking. Second, we should not focus on the creation of new instruments and their financing, but start by making existing ones work better. Third, in order to move beyond political divisions, we need to abandon the sequential approach in which the issues are discussed one after another, so that the smallest obstacle can bring the whole process grinding to a halt. I would like to call for simultaneous, parallel movements on several fronts and to broaden the scope of possible action. While welcoming the ambition of the

Eurogroup's "package" and its President, such a pragmatic method of small and parallel steps could help to move forward again. None of these steps is sufficient, but each of them taken separately would be welcome. Or if you prefer a restaurant analogy, call this proposal "à la carte" rather than a "set menu"… bearing in mind that at the end our lunch must be just as substantial and significant.

II. Four pathways towards reigniting the Banking Union

Building on this approach, I would like to share with you four possible and broader pathways towards a stronger Banking Union.

1. Moving beyond home/host issues. On this topic, I would like to start by issuing a wake-up call on the effective implementation of cross-border liquidity waivers within the union, as prescribed by the European legislation. They remain far too limited in practice. The discussions on the completion of the Banking Union are already at a standstill; we need, at least, to fully harness the existing measures! Supervisors must allow the effective implementation of liquidity waivers provided for in the level 1 text. In this regard, the fact that the SSM published guidance mentions the need, in a first phase, to comply with 75% of the liquidity requirements at the individual level in order to grant a cross-border waiver creates an additional obstacle. And we shall not give up on the extension of intra-group waivers to MREL and capital requirements. Let me add three possible ways of making progress: we could first think of a system of workable guarantees between the parent company and its subsidiaries. Backed by the common supervisor, they should provide enough reassurance to host countries, so that they could support waivers in local subsidiaries.

Another step would be to ensure preferential treatment for intragroup exposures within the Banking Union. There should be no cases where there is a difference between the treatment of domestic and cross-border intra-group exposures, be it for liquidity or capital requirements.

To go further, in parallel with the aforementioned options, we also need to explore the possibility of relying more extensively on the branchification of subsidiaries located in other Banking Union countries. This was the core of Andrea Enria's statement yesterday. The branch would then abide fully by the home country's prudential rules. The example of Nordea demonstrates the feasibility of such an option. I am well aware that it raises substantial questions, for banks themselves – for their governance, their brands, their relationships with customers – as well as for deposit guarantee schemes. On this latter issue, the current legislative framework needs to be revised in order to remove the strict limitations on the transfer of past contributions to the new DGS in the case of a branchification. These questions are all the more reasons to seriously investigate this option with the banking industry, as soon as possible.

2. Finding alternatives to EDIS. On the "third pillar" of the Banking Union, we must acknowledge the intractable oppositions to a fully-fledged EDIS, and adopt a more realistic approach. By changing the name and the content, perhaps we could regain momentum and willingness to make progress together. We could call it the "Common deposit mechanism". It would combine a well-known idea with a new one: (i) the well-known idea of a liquidity support system between national DGSs, – and obviously ensuring that each of them is funded as expected – combined with (ii) a renewed approach, in which foreign subsidiaries would be affiliated to the home DGS. The first leg of this new tool would already provide increased funding possibilities. The second leg would provide a serious safeguard to host countries, as they would not bear the cost in the event of an idiosyncratic crisis.

3. Completing the resolution framework. The third pillar – deposits – has been excessively polarising discussions for years. The "second pillar" is seen as more technical while it is at least as important. It currently leaves unaddressed several issues relating to the European banking sector, namely non-viable banks and overcapacities. In this respect, the targeted review of the crisis management framework, which is being carried out by the Commission, should aim at ensuring that the resolution mechanism is more consistent and applies to a larger scope of banks – including small and medium. This does not mean that all banks should be preserved by resolution but that the tools of resolution should also be usable to favor the exit from the market of unviable banks. There is no need to further increase the size of the Single Resolution Fund for this, as we have introduced a backstop by the ESM.

But we shouldn't forget about another subject: how to ensure the provision of liquidity in resolution. Indeed, even if a resolution successfully restores a bank's solvency, the bank may not be able to obtain sufficient market liquidity while it is in resolution. In the case of a systemic bank, the amounts needed could be very significant. A "Eurosystem Resolution Liquidity" could be provided by the ECB at this end as discussed in 2018. This raises the issue of the guarantee framework that should support this facility in order to comply with the European legal framework.

Another difficult but meaningful way forward for the resolution framework is the harmonisation of bank bankruptcy regimes across Europe. I am conscious that bankruptcy regimes, often mentioned in the framework of the CMU, represent a legal challenge. Let us see how we could at least progress on this issue for bank bankruptcies. This work may be focused on the more essential points to facilitate consistency with the resolution tools, like treatment of depositors/creditors hierarchy.

4. The need for an integrated approach to new players. Finally, looking forward now, let me consider broader developments in the financial sphere. Recent trends in financial innovation have fuelled the emergence of a renewed financial intermediation ecosystem, involving new players –including tech companies, be they FinTechs or BigTechs. The associated technological disruptions have resulted in regulatory arbitrage practices, especially on the banking market. Lending activities by non-bank financial intermediaries also circumvent prudential regulation. I wish to stress a major point here: we must avoid repeating the mistakes of the past. Innovation must not translate into further fragmentation. Right from the start we should try to have an integrated supervision at the European level for new players and new technologies.

Regarding innovation, private initiatives do have their role to play in fostering a European integration. Here, let me commend the European Payments Initiative (EPI) project. The EPI will provide citizens with a unified, innovative and autonomous European payment solution, as an alternative to the dominant and extra-European players already established in Europe or the BigTechs in the future. We must support the emergence of such Pan-European projects, in order to preserve and reinforce our financial sovereignty. And we don’t have much time to succeed, in the very next years.

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In conclusion, let me come back to the natural complement to the Banking Union: the Capital Markets Union. We all agree that we badly need it, even more so after Brexit: here in Eurofi, on the Governing Council, and – in principle – around the Ecofin table. But almost nothing, or very little, has been done. One paramount reason for this failure is that our technical product has not so far engaged sufficient political ownership. We need a stronger purpose, a more visible “flag”. Let me suggest one: the implementation of the European Green Deal will require the reallocation of resources towards “green” activities, in a Financing Union for Sustainable Investment. To keep its leadership in the green transformation, Europe must act as a united block in its financing. Moving forward on the Banking Union requires effort, but the rewards will make it more than worthwhile. Thank you for your attention.

Klaas Knot

President, De Nederlandsche Bank

Rebuilding resilience: meeting the challenges beyond Covid

Thank you Didier. It's always a pleasure to speak at Eurofi. Especially today. It is great to see all of you in person again, in the beautiful, ancient city of Ljubljana.

At our last Eurofi meeting five months ago, the situation was still different. Then, I compared the European economy with a patient recovering from a serious accident. I mentioned three phases: the emergency phase, the recovery phase, and the rehabilitation phase: that is to say, rebuilding resilience. Given the circumstances at that time, I focused on the first two phases.

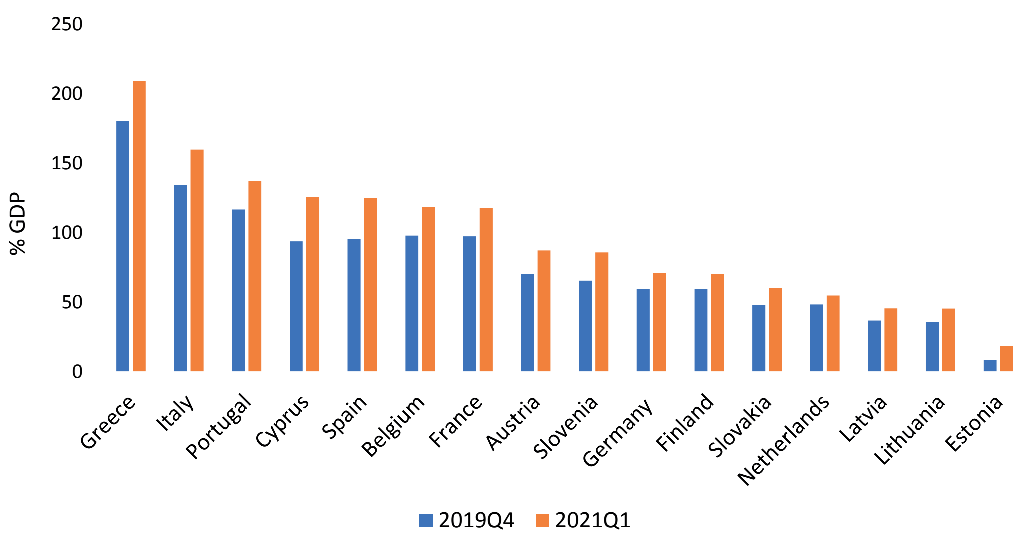
Since then, the economic outlook for Europe has brightened. In most European countries, economic activity is expected to return to pre-Covid levels in the second half of this year.

So now that the patient is recovering, and is slowly getting ready to leave hospital, it is time to look ahead. That's why today I want to focus on the third phase: rebuilding the patient's resilience. The resilience to cope with possible future crises and challenges. For example, the coronavirus is not going away anytime soon. It may never completely do so, and our economy may have to adapt to seasonal flu-like patterns. And then there is perhaps the greatest threat to financial stability of all: climate change. The latest IPCC report once more underlined the urgency of this threat.

When I look at the European economy today, I see that the patient's charts have improved. But I also see some serious underlying vulnerabilities. Yes, Europe handled the immediate economic fall-out of the Covid crisis pretty well. And yes, we now see the fruits of this in the economic data. But let's not fool ourselves. Even before the pandemic, the European economy faced some important structural vulnerabilities. And Covid did not make them go away. On the contrary. The recent crisis highlighted these issues and in some cases exacerbated them.

One of these vulnerabilities is our heavy reliance on debt. Public debt was already high before Covid, and has increased strongly since then, as you can see here.

Chart 1 High government debt has become more pressing

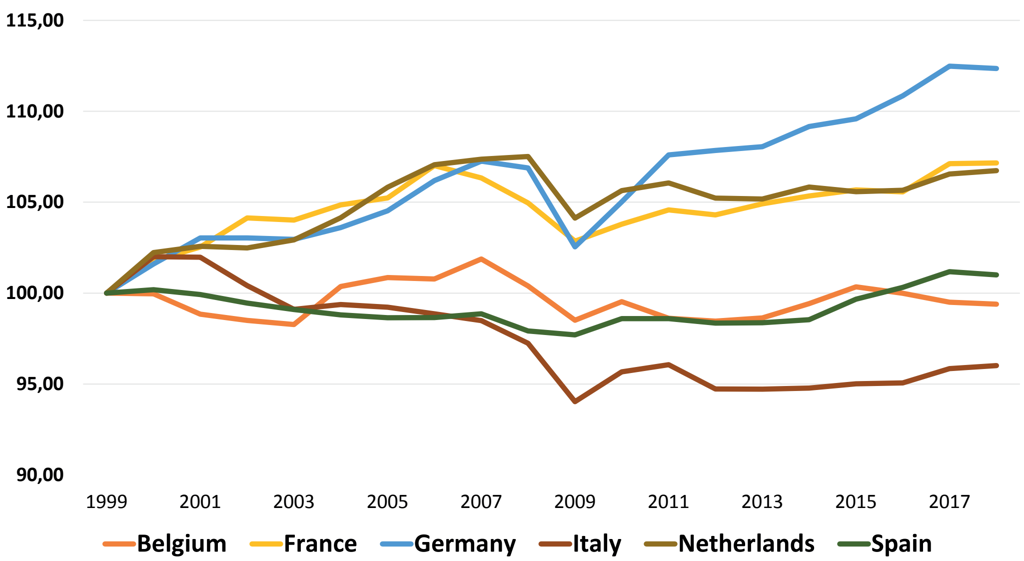


Source: Data Eurostat, DNB calculations

Of course, European government were absolutely right to use deficit spending policies to shield their economies from the worst effects of the lockdown.

But at the same time, it poses new challenges. Especially in some euro area countries, rising public debt has further limited the fiscal space for governments to support their economies and build buffers against future crises.

Chart 2 Productivity follows diverging paths
Total Factor Productivity Growth (1999=100)



Source: Data OECD, DNB calculations

Related to the issue of debt is the long-standing issue of diverging structural economic growth in the euro area. The European economy suffers from several structural imbalances.

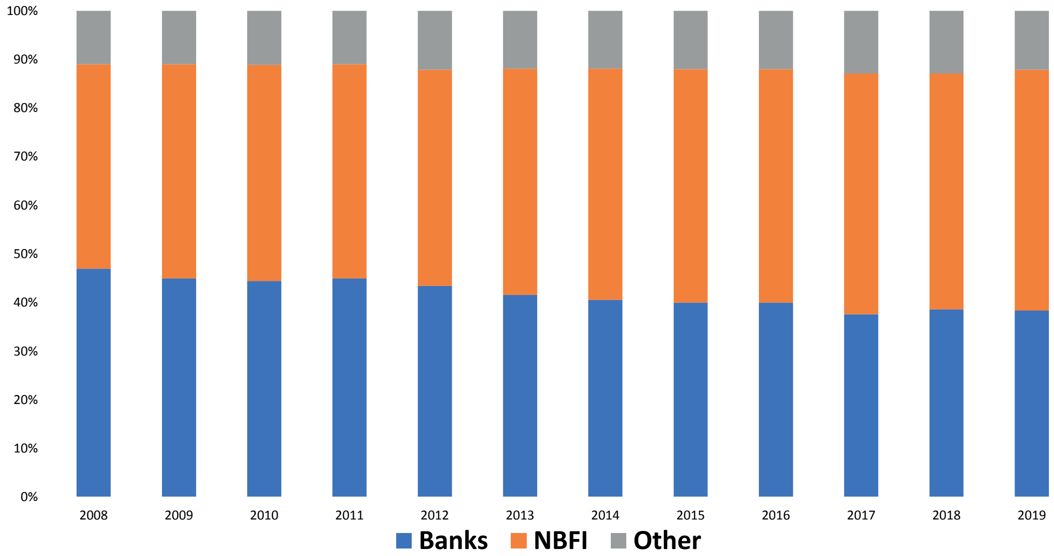
As you can see from this chart, total factor productivity in the euro area has diverged since the start of the EMU. And that has translated into diverging growth paths. Covid has worsened this problem, because some of the economies that have been growing the slowest over the past ten years, are also the ones that were hit the hardest by the Covid crisis. So our economies continue to grow apart. I am concerned about this, because in the long term it threatens the coherence of our Economic and Monetary Union. This was clearly illustrated at the start of the Covid crisis. Concerns about the economic impact of the lockdown led to doubts about the future of EMU. Resilience is about balance. And we all know that if you put more pressure on one leg than the other, you're bound to get some serious health problems at some point. That is not what the patient needs... What the patient needs is some care to wean it from its dependence on debt and to bring back balance in economic growth.

And I would recommend building mental strength too. I used to run marathons and what I learned is that you run those 42k primarily with your head, with your brain. All the training is just to get your body to follow.... The brain of our economy is our financial system. Through its central role in allocating resources, spreading risk and storing wealth, it has an enormous influence on our daily economic processes. Looking at the state of this brain, of the financial system that is, there is room to improve our mental shape.

In Europe, we still have unfinished business. Completing the Banking Union, building the Capital Markets Union, and implementing Basel III. These are more than just nice to have. For one thing, our toolbox to prevent, and if necessary deal with, a future European banking crisis is still not complete. This time we were lucky, because our banking system has been able to withstand the Covid shock pretty well. But that may not be the case next time. And as long as European capital markets remain fragmented, the bias towards bank-based debt financing remains, and the European economy remains too dependent on the fortunes of its banking system, and opportunities for generating venture capital are missed. Capital that we sorely need to fund the green transition, for example.

At global level, the turmoil in financial markets in March last year exposed vulnerabilities in our non-bank financial system. Especially money market funds and open-end funds. Over time it seems investors came to regard investments in these funds to be equal to cash or bank deposits in terms of liquidity and security. Indeed, since 2008, non-bank financial intermediation, or NBFI, has grown much faster than bank intermediation. It now accounts for about half of all financial assets worldwide.

Chart 3 NBFI sector accounts for half of financial assets worldwide



Source: Data FSB, DNB calculations

So, whereas in the aftermath of the previous crisis the emphasis was very much on the banks, we now have some catching up to do when it comes to reducing systemic risk in non-bank financial markets.

So, we know what ails the patient. Now it is time to make a treatment plan to strengthen resilience.

First we treat rising debt and diverging growth in the euro area. I take these two vulnerabilities together because I believe the answer to both problems is the same: to strengthen the structural growth capacity of the euro economies. Higher potential economic growth ultimately generates the capacity to repay debt and it helps to reduce the productivity gap between member states. In other words: the patient needs to become more active.

The question then is: how to strengthen structural economic growth? Here we need two things: economic reform and public investment.

When it comes to economic reform, the key thing here is that all member states must play their part. Weaker economies need to implement reforms that increase their productivity and competitiveness. This is good for exports, for economic growth, for employment, and for public debt. These reforms are more likely to succeed if the stronger economies also do their fair share. For these stronger economies, that means implementing reforms that give households more room to spend, so that they can boost imports and reduce their trade surpluses. This will not only help the weaker economies, but also benefit the stronger ones.

Now when it comes to public investment, not all countries in Europe have the same fiscal space to invest in their economies. Next Generation EU is therefore very important. By relieving national budgets, it enables countries to modernize their economies on a much larger scale than would otherwise have been possible. That includes digitalization and becoming carbon-neutral. It can act as a catalyst for economic reform and private investment. If we succeed in making Next Generation EU work, all countries in the European Union stand to gain.

By reforming and investing we can hopefully stop a further divergence of the European economies and start the process of re-finding our balance.

To support balanced economic growth, we will also have to take a closer look at the Stability and Growth Pact. Policymakers in Europe responded to the Covid crisis by activating the general escape clause. By temporarily lifting all restrictions, governments gained fiscal policy flexibility to do what was needed to support firms and households. That was a wise decision. And we may very well need the general escape clause in the face of another extreme event in the future. But a suspension of all fiscal rules should not be our only tool to achieve a balanced policy mix to deal with economic shocks. To me it showed that the Stability and Growth Pact needs more built-in room for countercyclical fiscal policy. To ensure the rules do not cut short much needed public investment, worsen economic downturns and increase economic divergence between member states. This is even more important in the current low interest rate environment, where, in the vicinity of the effective lower bound, central banks have limited room for maneuver.

Countercyclical fiscal policy is a two-way street: fiscal expansion to support the economy in bad times is only possible if we build buffers in good times. A more countercyclical fiscal framework should therefore have robust and credible rules that ensure national governments keep their debt levels in check. And not only should member states build up buffers in good times. They should also increase potential economic growth that ultimately bolsters debt repayment capacity. So, as we allow for more fiscal flexibility, limiting the level of debt will have to play a bigger role as an anchor for fiscal prudence.

All in all, the Stability and Growth Pact has served an important purpose over the past 20 years and it continues to do so. Therefore we need to review it in the light of the changed economic circumstances.

Time for the shrink, time to balance the mind, time to strengthen the financial system.

At European level, to strengthen the financial system we need to move forward with completing the Banking Union. We need to make significant steps in building the Capital Markets Union. And we should resume the European implementation of the Basel III reforms.

On a global scale, vulnerabilities in parts of the NBFI sector need to be addressed with priority, keeping momentum and ambition in the work underway. Financial institutions, both banks and non-banks, need buffers to absorb losses and liquidity shocks. Regulation needs flexibility in order to allow institutions to use these buffers. And the system needs safety valves, like margining, to prevent too much risk pressure being built up. It is important to advance the comprehensive work program the FSB has developed to enhance the resilience of the NBFI sector while preserving its benefits.

Once, when I was running a marathon I saw another runner with this text on his T-shirt: «Anyone can run a hundred meters, it's the next forty-two thousand and two hundred that count.» During the covid-pandemic we ran over hundred meters, but there is still a long way to go. The biggest mistake we can now make is to think the job is done. There are just too many structural threats to the European economy and financial system we need to address. The most important work is not behind us. It's just ahead of us. So I would say: let's get to the finish!

Roberto Viola

Director General, DG for Communications Networks, Content and Technology, European Commission

Digital Europe: key priorities and the way forward

The COVID-19 pandemic highlighted the importance of digitisation for European society and the importance for the EU to increase its strategic autonomy in tech. At the same time the efficient rollout of the vaccination campaign in Europe, combined with the impressive success of the digital Covid certificate demonstrated that Europe is at the forefront of digital innovation. 450 million certificates have been issued with more than 50 countries about to be connected or already connected to the system. This demonstrates that citizens, institutions and service providers are ready to use digital cross-border solutions.

The pandemic is not over and the work on the digital certificate is still ongoing. However, Europe is already looking ahead while preparing the proposal for the European digital identity framework. The effect of the pandemic accelerated the adoption of new online behaviours and digital transactions, highlighting the need for citizens and businesses to have access to trusted and secure digital identification means to facilitate day-to-day interactions. The European digital identity framework will offer all European citizens and residents a personal digital wallet to identify online and to share a multitude of attributes and certificates (e.g. university diplomas, professional qualifications, digital driving licenses ...). There is also a tremendous upside potential for financial institutions of using digital identity, making it easier and safer for them to on-board customers, among others.

The European Digital Identity will constitute a unified standard for digital credentials agreed with all Member States. It will not replace national eID offered by Member States, however. Where national digital identification systems are successful, they will be strengthened by the European Digital Identity framework, making them recognised throughout the EU.

The other important feature of wallets is that they allow the integration of different services on a neutral basis. There is no 'winner takes all' if everybody agree on the same standard and import different services in an open way. Open credential wallets allow different sectors, such as the automotive sector, the financial sector, public services and health sector, address the same wallet and system by the mean of integrated ecosystem or service. This, in turn, is related to the issue of digital payments.

DG CNECT wants Europe to move quickly into the era of digital currencies and digital euro, working closely with the Department for Financial Stability and Capital Markets (DG FISMA) and the other DGs in the Commission, as well as with the European Central Bank (ECB). The time is right for having a serious discussion around a design of the digital euro that enables the digital economy. The digital Covid certificate shows that when working together, EU can create a solution that is advanced, convenient and privacy-friendly. Europe is at the forefront of the world here.

The European Digital ID is a concrete example of targets of the digital compass. The Digital Compass translates the "EU's Digital Decade: Digitally empowered Europe by 2030" ambitions into four main goals: a digitally skilled population and highly skilled digital professionals, secure and substantial digital infrastructures, digital transformation of businesses, and digitisation of public sectors.

First we need a digitally skilled population. Europe still have a large part of the population lacking basic digital skills and we need more highly skilled digital professionals: doctors that understand artificial intelligence and big data, architects that can use 3D and virtual reality to do their work, artists that can use artificial intelligence. The whole knowledge society has to move up when it comes to digital competencies.

In terms of infrastructure, the goal is for every European to be connected to 5G by the year 2030. The European Commission wants every working European to have a fibreoptic connection when they get home. To achieve that the EU needs to attract investment to be more resilient both in the telecom infrastructure as well as in the manufacturing of technologies. It involves, for instance, production of chips. Currently, European industries are suffering from shortage of chips. The EU strives to double production in Europe by the year 2030. The same applies to edge computing, and cloud systems being much more distributed and integrated, with high computing capacity on demand with high importance for the financial, manufacturing healthcare and the automotive sector. Europe needs an open system without being dependant on a particular vendor. That is why European Commission is championing open cloud systems where users can interconnect with different cloud vendors. The diversity of supply and diversity of solutions will enhance the richness to the offering and give more comfort to the users, especially with respect to the financial sector.

The third element of the digital compass is scaling up and digital transformation of businesses. The small and medium enterprises, being the backbone of the European economy, need to enhance their digitalisation and digital innovation to stay competitive.

It is important to have clear rules when it comes to the digital society and economy. That is why the European Commission is presenting two flagship regulations when it comes to digital platforms: 1) the Digital Services Act (DSA), which regulates all the services and innovates the eCommerce Directive, and 2) the Digital Markets Act (DMA), which looks at the role of systemic actors, being a potential bottleneck for businesses to succeed.

The DSA and DMA, together with the framework for digital identity, are complemented by the Data Governance Act that proposes specific rules on data sharing. Particularly relevant for operators of financial services is, the Framework for Digital Operational Resilience (DORA) proposal. The latter aims to ensure that all participants in the financial system have the necessary safeguards in place to mitigate cyber-attacks and other risks, as the more the society becomes digital, the more there is a risk of cyber vulnerabilities.

One of the large systemic risks for our society comes from cyber security. Therefore, Europe needs to take the protection of critical infrastructure very seriously. The European Commission has identified some critical sectors in the new proposal of Network and Information Security (NIS) Directive, such as healthcare, food supply, drinking water supply and basic supplies.

We also have to take very seriously the emergence of extremely sophisticated and extremely dangerous ransomware attacks and ransomware being diffused to our crucial assets. Here, one of the important elements to combat ransomware is to make sure that we can block the source of financing. That is exactly why, besides simply finding ransomware, regulating crypto assets and crypto currencies, it is crucial to fighting ransomware. A joint cyber unit putting many different components of the European cybersecurity ecosystem together – the security agencies around Europe, European institutions, Europol – will make sure that information exchange is fast and effective.

Finally, I want to stress the sense of urgency and importance that the European Commission attaches to digital as the main tool, together with the greening of society that will lead to recovery and to sustained economic growth and welfare. For the twin transition to happen we need to work together and in partnership as there is the intrinsic link between European overarching strategies and the role of the financial sector, the wealth of the sector and the general wellbeing of the society.

Benoît Cœuré

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

Central bank digital currency: the future starts today

Thank you very much, David. Thank you for your very kind introduction. Thank you for having me here in Ljubljana. We all experienced how the pandemic has accelerated the shift to virtual events, and I guess we are all very pleased to be here in person in Ljubljana, yet the world is not returning to the old normal. Payments are a case in point, and that is what I am going to talk about.

The pandemic has accelerated a longer-running move to digital. Mobile and contactless payments are already part of our daily lives, as we know. QR codes and 'buy now, pay later' options are gaining popularity. Gloves, badges and Olympic uniforms with payment functions are being prepared for the Beijing Winter Olympics. The tech-savvy generation will soon dream about money and payments for the metaverse.

Alongside these developments, the world's central banks are stepping up efforts to prepare the ground for digital cash, or CBDC. They have a job to do, which is delivering price stability and financial stability, and they must retain their ability to do it. Let me explain why.

Central-bank money has unique advantages: safety, finality, liquidity and integrity. As our economies go digital, they must continue to benefit from these advantages. Money is at the heart of the system and it has to continue to be issued and controlled by trusted and accountable institutions which have public policy, not profit, as objectives. Central bank money will have to evolve to be fit for the digital future.

What are the priorities now? First, know where you are going. There is this wonderful quote by Dag Hammarskjöld, who once said, 'Only he who keeps his eye fixed on the far horizon will find the right road.' You have to look at the far future if you want to find you road, and then get going. These are equally important. I am going to elaborate on these two priorities.

First, why do we need to know where are we going? Because, today, the financial system is shifting under our feet. Big techs are expanding their footprint in retail payments. Stablecoins are knocking on the door, seeking regulatory approval. Decentralised finance (DeFi) platforms are challenging traditional financial intermediation. They all come with different regulatory questions, which need fast and consistent answers.

Banks are worried about the implications of CBDCs for customer deposits. Central banks are mindful of these concerns and are working on answers. They see banks as part of any future CBDC system. But make no mistake: global stablecoins, DeFi platforms and big tech firms will challenge banks' models, regardless.

Stablecoins may develop as closed ecosystems or 'walled gardens', creating fragmentation. With DeFi protocols, any concerns about the assets underlying stablecoins could see contagion spread through a system. The growing footprint of big techs in finance raises market power and privacy issues, and challenges current regulatory approaches.

Will the new players complement or crowd out commercial banks? Should central banks open accounts to these new players, and under which regulatory conditions? Which kind of financial intermediation do we need to fund investment and the green transformation, which was a major focus of these two days here in Ljubljana? How should public and private money coexist in new ecosystems? For example, should central-bank money be used in DeFi rather than private stablecoins as a settlement asset?

We urgently need to ask ourselves these kinds of questions—and there are many others—about the future. This is the far horizon for the financial system, but we are approaching it ever more quickly. Central banks need to know where they want to go as they embark on their CBDC journey.

CBDC will be part of the answer. A well-designed CBDC will be a safe and neutral means of payment and settlement asset, serving as a common interoperable platform around which the new payment ecosystem can organise. It will enable an open finance architecture that is integrated, while welcoming competition and innovation. It will preserve democratic control of the currency.

This brings me to my second message: the time has passed for central banks to get going. We should roll up our sleeves and accelerate our work on the nitty-gritty of CBDC design. CBDCs will take years to be rolled out, while stablecoins and crypto-assets are already here. This makes it even more urgent to start.

In the design-thinking methodologies that we use in the BIS Innovation Hub – and other innovators like to use – the ideal product stands in a sweet spot at the intersection of desirability, viability and feasibility. When applied to CBDCs, these translate into three dimensions: consumer use cases, public-policy objectives and technology.

We have to ask ourselves why consumers would want to use a CBDC and what would they want it to do. The recent ECB public consultation showed that consumers value privacy, security and broad usability. In order to meet consumers' expectations, CBDCs need to be made to work most conveniently. Payment data must be protected. Digital functions that are not available with cash can be developed, such as programmability or viable micropayments.

Then CBDCs should meet public-policy objectives. Central banks are there to safeguard monetary and financial stability for the public good. CBDCs are a tool to pursue this through enhancing safety and neutrality in digital payments, financial inclusion and access, innovation and openness. Important questions remain. How can CBDC systems interoperate, and should offshore use be discouraged? These are the questions that are still on the table when it comes to public policy.

Technology opens up design choices. System design will be complex. It involves a hands-on operational and oversight role for central banks and public-private partnerships to develop the core features of the CBDC instrument and the underlying system. These features are ease of use, low cost, convertibility, instant settlement, availability and a high degree of security, resilience, flexibility and safety. Complex trade-offs will be addressed by central banks, including how to balance scale, speed and open access with security, and how to balance offline functionality, which we want to see with digital cash, with complexity and security. These are the kinds of trade-offs that we will have to look into in the coming months and years.

Let me come closer to the conclusion. Across the world, central banks are coming together to focus on their common mission. Charged with stability, they will not rush. They want to move quickly, but not to break things. Consultations with payment systems and providers, banks, the public and a broad range of stakeholders have begun in some countries. As we know, the ECB has started that consultation process. To build a CBDC for the public, a central bank needs to understand what they need, and to work closely with other authorities. The BIS Innovation Hub is helping central banks. We already have six CBDC-related proofs of concept and prototypes being developed in our centres, and more to come.

The EU is uniquely placed to face the future. You can build on a state-of-the-art fast-payment system, on the strong protections provided by the General Data Protection Regulation (GDPR) and on the open philosophy of the Second Payment Services Directive (PSD2). The ECB's report on a digital euro sets the stage.

A CBDC's goal is ultimately to preserve the best elements of our current systems while still allowing a safe space for tomorrow's innovation. To do so, central banks have to act while the current system is still in place, and to act now. I thank you very much for your attention.

Q&A

David Wright

Are there any questions for Benoît?

Participant

You mentioned the competition that is already there between the private providers and potential public providers in terms of central banks. Do you see that there is global competition between central banks? Is it you competing with others like the ECB? It seems that, in the US, the Fed started only because it was afraid that China might be first. Do you see that? Do you see a risk in that the process may be accelerated just because of the fear that others will be first?

Benoît Cœuré

I would say not that much. There is a global technological competition, and CBDCs are part of it, but I do not see CBDCs being primarily led by international competition. I do not even see it as being primarily an international project anywhere, including in China. It is about how the domestic monetary and payment system is organised. In many countries, there is a policy discussion around CBDC. It does not shape up as an international discussion, but more as a conversation on the role of big techs and on the balance between public authorities, banks and big techs in running and controlling the payment system, and in accessing and control payment data. That is very much a domestic discussion, including in China. The notion that CBDC should be seen primarily as some kind of strategic race or contest is, by and large, a myth.

Participant

You mentioned consumer usage, which has a retail element to it. Do you see wholesale in a CBDC context working the same way or would that be a completely different framework that would apply to wholesale?

Benoît Cœuré

You are absolutely right to bring back the wholesale dimension of CBDCs, which is very important. The use case is very straightforward. As you see some critical infrastructures moving to decentralised platforms, you need to find a way to settle on these platforms in central-bank money. You need to find a way to send a central-bank token to these platforms, just to preserve the role of central-bank money as the safest settlement asset in a critical infrastructure, which is a basic principle of oversight for market infrastructures.

If you want to keep it, you will need wholesale CBDC to be used as a settlement asset on these kinds of platforms. That is pretty straightforward and does not create the kind of political complexity, trade-offs and choices that come with retail CBDC. Retail CBDC has a totally different scale. It is about hundreds of millions of tokens or accounts. Privacy will be a key discussion, with different answers in different places, and that does not arise when you discuss wholesale CBDC. It is an important part of the picture but I would say probably less difficult.

Stanislava Zadravec, Banking Association of Slovenia

You mentioned three words that are key in the whole process: digital cash, monetary stability, and technology and new set-ups in payment processing. Looking at these three, I have a few questions, but I will address only two to you this time. What do you think is the difference between instant payment and the envisaged framework for the use of digital currency? What is the role of the banking system? If we are talking about cash distribution and monetary policy and stability, the road is clear, but when we hear statements like private partnerships in payment settlement and processing, the whole picture no longer seems so clear.

Benoît Cœuré

It is an evolving picture when it comes to the different players in this ecosystem. There might be a shift, to some extent, out of banks and towards non-bank players, which has been accepted by PSD2 and by the current framework, but this has nothing to do with CBDC. This cannot be blamed on CBDC. It is a more general shift in the system that comes with new technology and the open philosophy that has been decided in Europe. CBDC will be part of it but not the driver of it.

I would expect banks to remain very much at the heart of the system, particularly when it comes to being the front end of any retail CBDC system. I do not think that any European central banker wants to be in the business of onboarding clients and doing the anti-money laundering/combating the financing of terrorism (AML/CFT) checks on clients. That is not really a line of business in which central banks want to be. That is being and should continue to be done by banks. We have to think of an architecture where most of the front-end will be done by banks, and possibly by non bank payment-service providers, as allowed under PSD2. The central bank, at the heart of the system, will issue the CBDC and have an oversight role. It may have a role in terms of setting the technical standards to ensure interoperability, which is an important feature of the system, but it will not be in contact with clients. That is my personal expectation. We will see what comes out of it.

Finally, when it comes to the difference between retail CBDC and fast-payment systems, fast payment systems are commercial money, so it all boils down to the difference between commercial money and central-bank money. Just as today, if you buy a loaf of bread from a bakery, you can use banknotes, which is central-bank money. You can use coins, which, in many places, is government money. It is the liability of the Treasury. You can use your mobile phone or your credit card, which would be commercial money. We are already living in this system. I do not see the basic principles changing. It is just that, with the use of banknotes for transaction purposes gradually dwindling, you need to keep the option for citizens to use central-bank money, which will be digital cash.

Participant

You insist on the role of central banks in terms of oversight of currency, and you do not need to convince us in the room of that. How do we convince the younger generation, which is already using crypto-assets, stablecoins and all sorts of things, of the beauty of central-bank money?

Benoît Cœuré

It has to be diverse and it has to be an ecosystem, so I have absolutely nothing against the young generation using crypto, provided that it is regulated adequately and that they are aware of the risks. It is a matter of investor protection. If that is about any digital asset being used as a payment instrument, it is about enforcing payment standards and regulations. Internationally, that would mean enforcing the Principles for Financial Market Infrastructures (PFMI), which should really be enforceable on any stablecoin or global payment arrangement.

With that caveat, we need diversity, and there will always be a mix of private and public payment instruments. The beauty of it is that central banks are not in a competitive mindset. They are not for profit, so they have to provide this option to citizens. Some of them will use and some will not, and that is fine.

David Wright

As a non-expert, this seems to me to be an irreversible process. Am I right? Secondly, I see securities and banking regulators beginning to clamp down on various forms of cryptocurrency. Where is that going? Thirdly, what is the timeframe? How do you look at this in terms of timing?

Benoît Cœuré

First, we have to accept and acknowledge that both the answer and the timeline will be different in different jurisdictions, because they are starting from different places in terms of how their payment system works, whether they already have an efficient fast-payment system, and so on and so forth. The likelihood of big tech companies stepping in is different in different countries. There is no single answer to that, but I would very much agree that the train has left the station, and that is the direction into which we are all going.

In terms of the timeline, it has to be a number of years, because these are very complex issues. There are lots of technical choices to be made, and there will be political discussions to be held. These discussions will not be held and decided by central banks. I do not think that they would like that, by the way. If there is a discussion to be had on who is going to access, safeguard and store client data for a CBDC, what would be the threshold for disclosure, or whether there is a threshold below which CBDC holdings can be anonymous, that has to be a political discussion, also because it is very closely linked with the AML/CFT discussion, so it has to be consistent.

This will take time, particularly in Europe, where you have to aggregate 19 different public opinions. It is really for member states and the Commission to lead that part of the discussion, while the ECB leads the more technical part of the discussion. It is a number of years but the whole point that I wanted to make here is not to take too long to do that, because the world is moving around you. If you wait too long, you will face a landscape with market power being locked in by very large players and you might be too late to the party.

Tomoko Amaya

Vice Minister for International Affairs Financial Services Agency, Japan

Global market access challenge and COVID-19

Thank you for kindly introducing me. It is a great honour to participate in this Eurofi forum. Let me touch upon my personal and valuable tie with Europe. Starting from 1996, I spent three years in Brussels serving as financial attaché at the Japanese mission to the European Union, so I had a number of exciting moments to see the launch of the euro and the preparation for EU enlargement. Before starting, I have to make a regular statement of disclaimer. Any views expressed here are my own and should not be understood as ones of JFSA or any body that I am associated with.

Now, I will start with one question. Are there increasing signs of market fragmentation at the global level due to COVID-19 events? A simple answer is yes or no. The uncertainties stemming from the pandemic and from the associated possible paths which economists may take have brought new challenges to authorities across jurisdictions. The magnitude and the shape of the impact caused by market fragmentation on financial institutions, markets and 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 setting 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 consultations. At the onset of the pandemic, precautionary lockdown measures have tested the contingency plans of all financial market participants. Financial institutions as well as we authorities adopted a work-from-home arrangement 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 payments, moratoria and government guarantees for bank loans and so on.

As time progresses, divergence among the industries has been becoming apparent. At the same time, authorities have begun to consider how to phase out the 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.

This leads me to the next question: how have authorities responded in order to avoid unnecessary fragmentation due to COVID-19? How the authorities worked closely and coordinated action to maintain global financial stability is the right place to start. From the beginning of the pandemic, the Financial Stability Board (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 considering.

Authorities also took concerted communication strategies. For example, the Basel Committee on Banking Supervision (BCBS) published a series of statements and papers since March 2020 in order to announce authorities' objective and priorities, provided technical interpretations of the standards and stressed the flexibility embedded in the standards. More generally, in April 2020 the FSB set five principles for official sectors.

Namely; one, to monitor and to share information on a timely basis to assist and address financial stability risks from COVID-19; two, to recognise and use the flexibility built into existing financial standards to support the response; three, to seek opportunities to temporarily reduce operational burdens on firms and authorities; four, to act consistently with international standards rather than rolling back reforms or compromising the underlying objectives of existing international standards; and five, to coordinate on the fit and timely unwinding of the temporary measures taken. These are principles that underpin the official community's rapid and coordinated response to support the real economy, maintain financial stability and minimise the risk of market fragmentation.

Authorities faced the pandemic almost simultaneously. However, the timing and the route to start moving towards exit may differ depending on how the infections are contained, the risk of premature lifting of multiple measures and so on. That is why monitoring is so important now. The current events demonstrate how financial regulatory reforms contribute to the resilience of a financial system. Going forwards, full, timely and consistent adoption of implementation of Basel III is essential.

Next, let me go on to the challenges ahead. In the conventional sense, we have discussed market fragmentation with the assumption that 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 the global stablecoins is a typical example of such new development, as entities within a global stablecoin arrangement may spread in multiple jurisdictions. In addition, a large, globally operating platform easily allows users to perform a financial transaction 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 decentralised 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 benefit. For example, we are still frustrated by expensive, slow and less transparent cross-border payment and remittance, which the FSB and other international organisations are tackling, with guidance from the G20. In addition, the more financial activities migrate to cyberspace, the more important a global response to cyber risks will become. In a broader sense, jurisdictionally fragmented responses to operational incidents would not be enough to achieve a sufficient level of operational resilience of financial service providers.

In short, we are facing a new challenge 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.

The last 18 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 great fact we have confirmed through these difficult 18 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 rapid developing video conference systems. As we are entering a new normal and maybe becoming a world with more borderless financial systems, we need to prepare ourselves for this new reality in a forward-looking manner, and I believe we can.

Having said all of this, although I appreciate the technology of video conference, I strongly miss face-to-face interaction with the international community. I hope I can participate in the next Eurofi forum physically and exchange views with you in person. With this, I conclude my remarks. Thank you very much for your attention.

Emilie Mazzacurati

Global Head of Climate Solutions,
Moody's ESG Solutions

Climate and sustainability risks: implications in the banking sector

Thank you so much and thanks for having me. I am sorry I was not able to be there in person. Climate change has made the news all over the summer again: wildfires and heatwaves in Greece, Turkey and California and hurricanes, storms and floods in Germany, Belgium, New Jersey and Louisiana. The urgency to prevent further climate change is rising on corporate and regulatory agendas. Ahead of COP26 in November, over 50 banks, representing US$37 trillion, the equivalent of almost a quarter of global banking assets, have committed to aligning their lending and investment portfolios with net zero emissions by 2050. These commitments constitute a momentous challenge for banks, but also an opportunity to lower their exposure to climate risk and develop new products. The risks related to the transition to a net zero economy are generally well-understood, although the scale of expected impact varies wildly under different scenarios.

In the best-case scenario, where an orderly transition takes place, supported by rapid technological progress and strong political alignment, banks can expect to see moderate impact of some stranded assets in the fossil fuel industry, higher operational or capital expense and possibly higher energy prices. All of these could lead to corporate asset devaluations or lower profitability and an increasing probability of default of some borrowers. In a scenario where disorderly transition takes place, hampered by lack of political alignment and slow technological progress, the same risks grow exponentially. A corporation could be ill prepared, fail to invest in technology or fail to adjust business models, leading to widespread devaluation, bankruptcy, shock on the economy and lower wealth across the board – a potential climate Minsky Moment.

However, the worst-case scenario is a failure to deliver on the net zero targets all together. Economic models provide but a pale image of the economic cost and the risks to the financial system that may arise because of the physical impact of climate change. The continued increase of temperature rises will drive water and food shortages, extensive flooding, biodiversity loss, conflicts and mass migration, all of which can cause disruption to society, to the economy, and create unmanageable risks for banks.

In this context, net zero commitments emerge as sound net zero risk management policy to present the worst impacts of climate change and protect the balance sheet. Indeed, banks are highly exposed to climate risk but they also hold important levers to lower the risk for themselves, for their clients and society at large. How can banks deliver on this net zero commitment? They are faced with the collective challenge of understanding whether and how their clients are reducing greenhouse gas emissions at a base that is aligned with the urgency and the scale of the problem. Firstly, proper accounting and disclosure of greenhouse gas emissions is critical. Asking clients as a matter of business to report emissions when they apply or renew their line of credit, would help build a much more precise picture of portfolio emissions and transmission capacity in a portfolio. Many smaller companies in their client book may need help in understanding what is expected of them and what technical and market solutions may be available to help reduce emissions, and banks can provide guidance and pointers for these clients.

However, where banks' roles are the most important is in financing the transition. Corporations will need to retro-fit their production facilities to decommission high-emitting assets. They will have to invest in energy efficiency or renewables. SMEs and households can be incentivised with preferential conditions on mortgages, for efficient cars, houses or low interest loans for retrofits. A number of banks have started piloting those mechanisms. Now is the time for the industry to share lessons on what financial products are most effective at reducing emissions so that these problems can be scaled and become embedded into regular lending practices. Banks can nourish their role as key intermediaries to become a driving force in supporting the decarbonisation of the economy. This will lower their individual and collective exposure, create opportunities for new financial products and services, and support a more liveable planet for all of us. Thank you.

EXCHANGES OF VIEWS

Addressing financial stability risks in the current monetary context

Mário Centeno - Governor, Banco de Portugal

Yannis Stournaras - Governor, Bank of Greece

Boris Vujčić - Governor, Croatian National Bank

Boris Vujčić (Chair)

Boris Vujčić (Chair) noted that the crisis has been handled quite well compared to expectations from the beginning of last year, in March and April. The current situation represents a satisfactory outcome in terms of the rapid recovery of the economy. In the spring of 2020, the shape of the recovery was discussed. The recovery at present is probably better than most expectations at that time, in terms of the speed of output recovery and number of corporate bankruptcies. The overall monetary/fiscal-policy mix was successful in that sense.

However, financial stability risks must be considered. This is what central bankers do. Both corporate and government debt are currently higher than they have ever been following the unprecedented fiscal expansion. Financial stability risks in the banking sector have also been exacerbated by easier, covenant-light credit, due to excess liquidity in the banking system. There may be differing opinions on asset valuations, but they are generally very high in comparison to measures of asset valuations in the past, with the new and quite complex credit products that have emerged as a consequence of very high liquidity and very low interest rates. Bank profitability has been affected by a long period of very low and even negative interest rates.

There are probably still a number of zombie firms in existence, given the unprecedented support for the corporate sector during the pandemic crisis. Inflation is rising after many years. Whether it is temporary or whether higher inflation will be present for a longer period of time will be discussed during the session.

Yannis Stournaras

Yannis Stournaras is optimistic about the future. The current coordination of fiscal, monetary and supervisory policies forms a mix quite different, more realistic and flexible, than the one 13 years ago. However, new and old financial risks are still present. In terms of new risks, despite the overall improvement in gross domestic product (GDP) growth, the path to recovery remains somewhat uncertain and uneven across countries and economic sectors. General government primary deficits are now of the order of 7% of GDP in Europe and have to go to zero in about two years' time, or to surpluses in a number of countries. The removal of state aid might lead to a number of corporate insolvencies. It is not expected to be a massive number, but there should be an awareness of the possibility. The pandemic has not yet been beaten and neither have non-performing loans (NPLs) and assets.

Because of the recession and the fiscal measures introduced in response to the pandemic, public debt to GDP ratios have, on average, increased by about 25 percentage points, as have deficits. Especially for very high debt countries, some vulnerabilities are expected to develop. These are not present currently due to the very low interest rates. It is uncertain whether this will continue in the future. A sovereign-bank nexus is also emerging. Mitigating policies include the European Central Bank (ECB) asset-purchase programmes and the forthcoming issuance of EU bonds in the context of the Recovery and Resilience Fund.

Yannis Stournaras also said that the pre-existing risks have not disappeared. First, the very low interest rate environment remains a major challenge for European banks, with clear implications for their profitability and internal capital generation capacity. Second, the non-bank financial sector is continuously increasing in size, generating heightened risks and potentially increasing the procyclicality of financial conditions. Third, climate-related risks, which seemed a distant possibility some years ago, are rapidly gaining importance on the risk heat map. There have been tragic events this summer in both central and southern Europe. Fourth, and perhaps most importantly, the banking system remains largely segmented in the EU, due to the lack of a European Deposit Insurance Scheme (EDIS), a common crisis management framework and a single rulebook.

Mário Centeno

Mário Centeno stated that the crisis that began 18 months ago is a crisis of unique dimensions and nature. There was no playbook to guide decisions. At the start of the crisis, Mário Centeno was finance minister and president of the Eurogroup. It was unprecedented to ask people to leave their jobs unattended. Brave and correct decisions were taken in Europe in response to the difficulties. For the first time, monetary, fiscal, supervisory and regulatory authorities worked in a coordinated way. This should be maintained in Europe.

Mário Centeno commented that the recovery is continuing, despite the Delta-variant and some supply constraints. However, even if there is a return to 2019 levels more quickly than expected, the pre crisis economic dynamics of the European and world economy had a setback. Financial stability was preserved. There should be caution around tail risks, which are latent risks that are not observed. Economic adjustment is typically staggered, meaning that it does not happen at any moment in time in all institutions or firms. As such, the present numbers should be read with cautious.

Mário Centeno stated that financial stability was preserved also because, in the pre-crisis period, there was a very significant reduction in risk in Europe in both public finance and the banking and financial sector. Low profitability in the financial sector and a technological challenge in mainstream institutions are important issues, but Europe is better prepared now. Europe has much better institutions currently compared with 2008, so the institutional risk is not such a concern as in the previous crisis. Institutions in the euro area were incomplete during the previous crisis. Hard lessons have been learned from this and the euro area was better prepared for this crisis.

Boris Vujčić

Boris Vujčić (Chair) asked panellists to comment on the risk of asset-price bubbles, for example real estate prices in their countries. This seems to be more of an issue in Portugal than Greece currently, but there has been a rapid rise in real estate prices all over Europe, including Croatia, where they are increasing very rapidly. Boris Vujčić (Chair) asked if this is a more serious issue from the perspective of financial stability, because much of it is not leveraged. There is an increase in the real estate prices but not so much in terms of leverage, so it should be less of a problem for the financial stability of banks. Another consideration is affordability of housing for young people. Boris Vujčić (Chair) asked panellists to comment on how they expected these risks to evolve.

Mário Centeno

Mário Centeno stated that developments in the valuation of assets, especially residential and commercial real estate, are carefully followed. We definitively cannot conclude that a bubble is developing. There are several mitigating factors, as mentioned by Boris Vujčić (Chair), which are also present in Portugal. In addition, Governor Mário Centeno noted that the current market in Portugal is international as well as domestic, which avoids a concentration of risks in the banking and financial sectors in Portugal. Leaving this crisis with a very substantial increase in debt requires time and economic agents to engage in resolving issues. From an institutional perspective, regulators and supervisors follow this situation very carefully

Yannis Stournaras

Yannis Stournaras noted that the position is similar in Greece. Due to the previous crisis, asset prices and real estate prices have fallen to a very low level. These prices are now rising, reflecting the better fundamentals of the country. The rise is a smooth and steady one, with a 3-4% increase every year in the prices of apartments and commercial and residential real estate.

Yannis Stournaras noted that a positive aspect of this, is that banks now have a lot of real estate, houses and other properties as collateral. As the value of collateral increases, banks balance sheets improve. Also, real estate prospects based on fundamental values attract foreign investors. Interest in the NPL market is, to a large extent, being driven by the increasing value of collateral. This is also good news for the State, since, for historical reasons, the Greek state owns a lot of land. In terms of GDP, the Greek state owns more land than any other country in the Organisation for Economic Co operation and Development (OECD). The trend reflects fundamentals and is not a concern.

Boris Vujčić

Boris Vujčić (Chair) asked what the reason for weak bank profitability is and how risks will evolve. Boris Vujčić (Chair) asked if there will be very low interest rates and compressed spreads, or if there is greater risk of tangibly higher interest rates leading to credit risk materialisation going forward. There are two types of risk for the banking sector at the moment. One is a relatively rapid increase in inflation, and one is that inflation does not return. One would probably mean higher interest rates relatively more quickly and the other would maybe keep rates very low for a prolonged period of time. Boris Vujčić (Chair) asked panellists to comment on these risks.

Yannis Stournaras

Yannis Stournaras commented that medium-term inflation prospects are assessed largely according to data and models. Most models indicate that the current inflation jump is temporary. Whether it becomes permanent will depend on many conditions, including wage contracts. In 2022, inflation in the eurozone is expected to tall below 2%, and even lower in 2023. Hence, these models suggest that inflation is not a medium-term problem. The accommodative monetary policy should continue. This creates a number of problems for banks and insurance companies. The interest-rate margin has fallen. Macro and microprudential measures have been taken to ease the situation, such as tiering.

Yannis Stournaras stated that banks face credit risks. Banks should be transparent and accept the reality that, in two years' time, with the lifting of state aid, there might be a number of corporate insolvencies and new non-performing assets might appear. This should be reflected now in provisions and, if necessary, new capital. However, the elephant in the room in Europe is the lack of an EDIS, which does not contribute to a more integrated banking sector in Europe. This generates, among others, and a number of risks in crisis periods.

Mário Centeno

Mário Centeno stated that very low net interest rates are a concern for banks. Fintech, technological challenges and debt are not specific to this period and are certainly also a challenge for banks. In terms of the way that the recovery is proceeding and considering the support that exists and must be adopted through the crisis, developments must be monitored. Maintaining existing policies could become disruptive because distortions and vulnerabilities may build up. Policies should be adapted to face the challenges from the banking sector.

Mário Centeno commented that, looking ahead, there are good signs and room for policy decisions in line with Yannis Stournaras's comments on inflation. No single sector can handle the recovery on its own. Neither the banking sector, nor the state, nor the non-financial sector, nor households can be exclusively relied upon to drive recovery from the crisis. All sectors must contribute to drive recovery from the crisis. The increase in savings is an important contribution from the non-financial private sector. The flipside of these savings in the private sector was that governments and states increased their debt quite substantially, which also needs attention. Progress should continue with close monitoring and, not by impulse, with further policy decisions and adaptation of existing ones through the crisis.

Boris Vujčić

Boris Vujčić (Chair) asked what would be a sign of sufficient progress in a recovery to enable the normalisation of monetary policy. Boris Vujčić (Chair) asked how the mix of monetary and fiscal policy should then evolve from the point of normalisation of monetary policy.

Yannis Stournaras

Yannis Stournaras explained that the European Central Bank (ECB) renewed forward guidance implies that there should be a steady and sustainable rise in underlying inflation before what is called monetary policy normalisation.This is not the case presently, with inflation expected to fall back to a level well below the medium-term target of 2 percent. The test of the ECB's new forward guidance fails as far as normalisation is concerned, so an accommodative monetary policy is still needed. An accommodative fiscal policy should continue until the pandemic has been eradicated. Europe is very successful regarding vaccination, but continued vigilance is necessary.

Yannis Stournaras added that there are important differences between the current situation and the difficult period between 2012 and 2014, when he served as finance minister of Greece. European institutions have learned not to insist on procyclical fiscal policies. There should be cooperation between fiscal and monetary policy when necessary. This is not anathema and is not against the independence of central banks. It is certainly not fiscal dominance but an effort to achieve favourable financing conditions, a smooth transmission of monetary policy and to prevent monetary and financial fragmentation in the euro area.. Policies should be flexible and realistic, as they are currently.

Mário Centeno

Mário Centeno emphasised the importance of flexibility. The use of different instruments must be balanced due to their characteristics and associated pros and cons. For example, different instruments have distinct impacts on the rate term structure, so care must be taken when moving them. There should be a move to the next stage, looking ahead to some normalisation and taking advantage of the flexibility in terms of monetary policy.

Q&A

Didier Cahen, Secretary General, Eurofi

Didier Cahen noted that public over-indebtedness and fiscal dominance have not been mentioned as potential financial risks. Didier Cahen asked if panellists perceive any vulnerabilities in this area or if they expect that low interest rates will stay forever, and money creation will address the structural problems that EU member states are facing.

Mário Centeno

Mário Centeno answered that interest rates will not remain low forever, but it is unavoidable. Public plus private debt in the euro area increased by 26 percentage points in 2020 alone. 50% of this was public and 50% was private. Two thirds of private debt was from non-financial corporations. There was no way around this. The actions taken at that point were appropriate. Sustainable growth is a precondition for sustainable debt that has to be properly accounted for as the right way to direct the economy. The Recovery and Resilience Facility (RRF) is a great instrument on the public sector side from the European project, which must be considered very carefully. Time should be taken to develop appropriate, well-crafted policies, not on impulse but with patience.

Yannis Stournaras

Yannis Stournaras added that it is important to ensure that the snowball effect (the difference between government borrowing rates and growth rates), remains negative, that is, the growth rate exceeds the interest rate. This is extremely important in order to avoid future public debt vulnerabilities. Despite the fact that public debt to GDP has increased significantly due to the pandemic fiscal measures, forecasts indicate that it is going to fall if, in the following years, realistic and flexible fiscal policies are followed, ensuring the snowball effect remains negative.

Yannis Stournaras recalled that, in Greece, despite three adjustment programmes, despite the primary budget adjustment being the largest in the history of the OECD, at the end of the third adjustment programme, the debt-to-GDP ratio was higher than at the beginning of the crisis. This was so, because the snowball effect cancelled the fiscal effort. This mistake should not be made again. Procyclical fiscal policies should be avoided. Yannis Stournaras reiterated his optimism that the lessons from the previous crisis have been learned.

Participant

A participant commented that the recovery in Europe appears to be proceeding well. Internationally, the Fed and other central banks are openly talking about tapering, but the ECB is not. At the moment, the ECB seems to be quite dovish. The ECB's current forward guidance is to buy assets and purchase government bonds almost until interest rates are about to be raised, closely marrying asset purchases and the rise in interest rates. Christian asked if this is the best approach for the future. If asset purchases and the rise in interest rates are separated, it is possible to ease concerns about fiscal dominance, where asset purchases could be stopped, even though there may be no desire to raise interest rates for a bit longer. Christian asked if the panellists believe that asset purchases and the rise in interest rates should stay closely linked.

Participant

A participant asked if the Phillips curve is alive or dead.

Mário Centeno

Mário Centeno stated that the instruments currently in use must be considered and balanced. Central bankers tend to use a great deal of data on their analysis and decision-making process. Communication is also key and we always send messages of reassurance to the markets and citizens. As such, a problem in terms of managing these two forces is not foreseen within the forward guidance.

Mário Centeno stated that the Phillips curve is alive, but the labour market is working in a very artificial setting presently, given the measures implemented after governments' decisions, for example asking people not to work. These decisions were counterintuitive to social models and had to be accommodated by unique forms of support. The current period demonstrates why the European labour market model is better than others. In Europe, there is less churning through the business cycle and adjustment is more in terms of hours than in terms of bodies. This has severe consequences for wage bargaining, for example. Mário Centeno is optimistic. The European model is proving to be right, which is why Europe is doing so well at this stage of the crisis. Uncertainty is still important also due to some latent variables, and policies should be adapted. The same policies cannot be retained forever. The European institutions and treaties can accommodate the huge responses that all European and national institutions in Europe had to make in 2020 and 2021, which is worthy of praise.

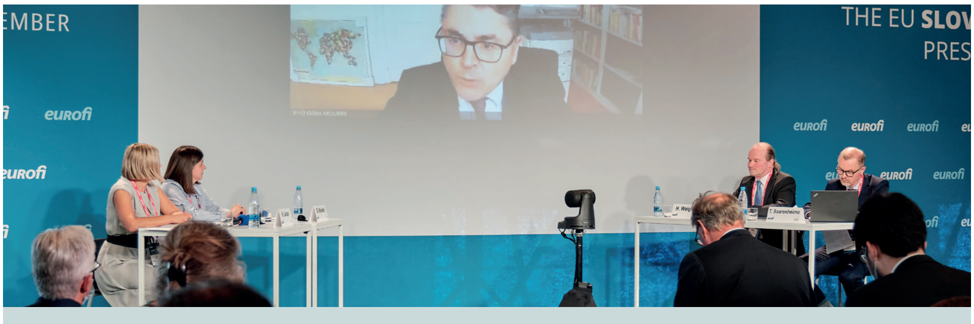
Yannis Stournaras

In respect of the first question, Yannis Stournaras agreed that this particular aspect of the ECB's forward guidance has not changed. It has been useful up to now, but it is certainly not written in stone and could change if circumstances change. He gave an example saying that, to his understanding, the Bank of England follows the opposite path and does not require net asset purchases to finish before it raises interest rates. The new ECB forward guidance has already had positive implications. It has moved expectations about interest rate rises into the future, so it was a successful move.

Yannis Stournaras said that the Phillips curve is not dead, but it needs to be adjusted. Dynamic, Stochastic General Equilibrium (DSGE) models perhaps need some improvement regarding wage and price equations. The international forces that have kept inflation low up till now must be understood better. The dynamics in the DSGE models do not say much about that, because they are constructed around a steady state, which is exogenous. According to pure Phillips curve models, inflation is even lower than ECB forecasts. The Phillips curve is not dead and is a very good instrument.

Boris Vujčić

Boris Vujčić (Chair) thanked the panellists and closed the session.



Reforming the Stability and Growth Pact

Katja Lautar - Secretary of State, Ministry of Finance, Slovenia

Gilles Mourre - Head of Unit, Fiscal Policy and Surveillance, DG ECFIN, European Commission

Tuomas Saarenheimo - President, The Eurogroup Working Group

Gintarė Skaistė - Minister of Finance, Republic of Lithuania

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

Jacques de Larosière - Honorary President, Eurofi

Tuomas Saarenheimo (Chair)

Tuomas Saarenheimo (Chair) opened the exchange of views on reforming the Stability and Growth Pact (SGP). The panel would speak about the review of the Two Pack and Six Pack legislative packages. This has been foreseen in the legislation itself, so it is a legal obligation to go through it. The European Commission was able to launch the consultation that started this review just before the pandemic interrupted the process. While the formal process was interrupted, the pandemic changed the economic realities of life and provided fuel for a fairly active debate on what to do with the SGP. The debate has been ongoing for the last year and a half while the consultation has been interrupted.

Tuomas Saarenheimo (Chair) noted that there are several existential questions around the European fiscal framework but asked the panellists to concentrate their initial remarks on three questions. The first is whether there is a need to rethink the fiscal framework; if so, panellists should describe why, how it should be rethought and what should be changed. The second question is whether the fiscal framework has been properly enforced; if not, panellists should describe how it should be improved and what the role of sanctions and/or incentives is in that process. The third question relates to the present day. The fiscal rules have been suspended through the general escape clause for an extended period of time and will remain suspended for a long time to come. Tuomas Saarenheimo (Chair) asked the panellists how they would reintroduce fiscal surveillance.

Tuomas Saarenheimo (Chair) asked Katja Lautar to answer first and noted that she represents the Presidency of Slovenia.

Katja Lautar

Katja Lautar thanked Tuomas Saarenheimo (Chair) and the organisers. She stated that having rules is certainly better than not having them. This has proved to be efficient in the pandemic with the General Escape Clause, but there is always a 'but'. Katja Lautar has been advocating for many years that one size unfortunately does not fit all. It is necessary to rebuild trust and confidence in future fiscal surveillance due to the obligations that are ahead, especially if there is a desire to boost potential growth and not want hit fiscal objectives for the sake of hampering investment.

The role of fiscal policy should be retained. Katja Lautar would not go into detail about how and why but noted there are certainly some examples of how it can be done. Sustainability of public finance very much depends on country specific factors. Again, equal treatment does not mean "one-size-fits all" rules. It is necessary to look at the countries from a country specific perspective, to avoid being bound by very difficult observables and to stick to the nominal targets. Whether there is already room to discuss thresholds is uncertain.

Katja Lautar stated that she usually says that she is not sure that it is an appropriate idea, if someone is already in a difficult position, to give further financial sanctions. Every sanction needs a reason behind it that has to be objectively proven. There is a way forward with Recovery and Resilience Plans (RRP) because there is the 'carrot and stick'. With reforms and investment going hand in hand, it can serve the purpose well. Katja Lautar suggested waiting for the efficiency to come out of the Recovery and Resilience Facility (RRF) to see how EU fiscal rules can contribute to promote growth on a longer path.

Katja Lautar concluded by noting that the crucial point and momentum ahead is to define an appropriate path for the recovery and gradually reduce the deficit. That is also why the structural reforms and investments play a crucial role. Katja Lautar also suggested finding some kind of flexible solution to support investments because the SGP does not provide sufficient flexibility and the only purpose of the EU rules should not be hitting the measurable observables at any cost.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) thanked Katja Lautar for her contribution. He introduced Minister Gintarė Skaistė from the Republic of Lithuania.

Gintarė Skaistė

Gintarė Skaistė stated that she would try to look at the problems in the three questions raised, all of which were quite broad. She started with the question of whether to rethink the fiscal framework. Gintarė Skaistė stated that it needs to be rethought, but the discussion might be at different levels. It might be necessary to rethink some formal and instrumental points of the fiscal framework. Other countries might try to push through some radical reforms, but Gintarė Skaistė does not support such an approach. The system must be rethought, but it does not have to be rebuilt from the beginning.

We should not limit our discussion to numerical debt and deficit targets. Rather, it is necessary to consider how to ensure the fundamentals of a good fiscal system. Fundamentals that would prevent the build-up of macro imbalances and ensure fiscal sustainability over the medium and long term, as well as transparency, predictability, domestic ownership, and the equal treatment of countries. The system is fairly good but has some fairly specific points that could be improved, such as complexity and ambiguity of the system, element of discretion in formal surveillance procedures, challenges in determining the business cycle, and rules enforcement.

There is space for simplifying the system – for instance by putting more emphasis on observable indicators, such as growth rate and government expenditure. However, it is important to retain the complementarity role for indicators that permit assessing the business cycle, such as structural balance and output gap. The issue sometimes missed in the discussion is that the Stability and Growth Pact (SGP) is about both stability and growth. However, stability without growth may lead to stagnation. In other words, we must not forgo and forget the "G" in the "SGP". That is why it is advisable to consider limited additional flexibility for growth-enhancing productive investments, combining it with appropriate safeguards. The evaluation of the quality of investments would be key in this regard.

Gintarė Skaistė stressed that the Recovery and Resilience Facility (RFF) mechanism is a fairly good example of how to evaluate reforms and investments and ensure their quality. When it comes to implementation of the fiscal rules, the current sanction regime is not viable and has never been used in practice. It is difficult to expect that it could be used in the future This might be due to political considerations or potential negative spill overs at the EU level. This is not a positive situation.

Gintarė Skaistė added that the question is related to discretionary decisions and lack of transparency in rule enforcement. It comes with less predictability and undermines equal treatment of member states. Simplifying the rules and providing a more pronounced role to European Fiscal Board (EFB) in the process could assist in reducing politicisation of the process. Also, we need to think about incentives to follow the rules, for instance while discussing additional flexibility related to growth-enhancing investments.

On the reintroduction of fiscal rules – there is no merit in trying to rush the process to reform the SGP to align it with GEC deactivation. The objectives for the potential SGP reform are much broader than merely COVID related issues and relate to longer-term structural challenges, such as ageing populations and other structural challenges. After the general escape clause is deactivated, it is advisable to come back to the existing rules with all available flexibility, while considering the uneven recovery of the member states.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) thanked Gintarė Skaistė for her contribution. He would 'detour' to Harald Waiglein to complete the set of member states before going to the institutions and the expert.

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

Harald Waiglein stated that he would try not to disappoint because he has been involved in the discussion of the SGP for a very long time. He asked that attendees forgive him if he is somewhat blunt.

Harald Waiglein stated that he would start with a comparison. Everyone has traffic rules in their countries, and yet countries have car accidents. Harald Waiglein asked if anybody really thinks that traffic rules should be abolished or made more lenient to facilitate more ownership. Harald Waiglein stated that he sticks more to principle than to details in the way he thinks about the SGP. However, the principle is important. It is possible to have very positive debates on whether the numbers in there are macroeconomically meaningful, but that is entirely beside the point.

The point of concern came less from a macroeconomist and more from a financial economist. Financial economists know a lot about moral hazards because that is all they deal with in the banking sector. Looking at the state or budget from a certain perspective, it is not very different from that of a financial institution. Another issue of moral hazard is a government always has a clear incentive to shift the burden of consolidation to another government in another term.

The agency problem is even worse because the electorate has the same incentive to shift the burden of consolidation to another electorate in the future. That is precisely the issue that needs to be addressed with a rule. The point is less the figure of 60% or 3% and more the prevention of that moral hazard. Now that those in the European Union have started to mutualise debt, it is a very bad time to put issues on the table that would effectively mean a watering down of the pact or making the obligations more lenient. This is due to the lack of the disciplining effect of exchange rates, which means markets cannot do the job anymore.

Harald Waiglein added that the aforementioned is an even bigger argument for having stringent rules. It is not clear that anyone would argue with that. The eurozone crisis would never have happened if the SGP had been implemented and executed to the letter. If Greece had stuck to the SGP, there would have been no eurozone crisis. However, the SGP had not been implemented and the rules had not been followed. That is something to consider. There is ample room for making the SGP more practical and usable.

Harald Waiglein agreed that the rules are too complicated. However, he remembers why they are complicated. There were nominal targets and the SGP was simple. People said it was simple, but it was also 'stupid' because it was procyclical. Very intelligent people reflected for years on how to make the SGP more intelligent. The more intelligent solution is what is on the table. It is the legacy of intelligent people in the past that intelligent people of the present are unhappy with. That is not to say that it cannot be improved, but, given the history, if the SGP were opened up, the result may not be much more intelligent than what currently exists. Harald Waiglein advised being very careful in starting that discussion.

Harald Waiglein stated that he would stick to principle. He would address the general escape clause in the next round, but the bottom principle is how to deal with the moral hazard issue in a credible way.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) thanked Harald Waiglein for his contribution, noting that he certainly did not disappoint, and turned to the institutions.

Gilles Mourre, Head of Unit, Fiscal Policy and Surveillance, Directorate-General for Economic and Financial Affairs (DG ECFIN), European Commission

Gilles Mourre stated that he was very honoured to take part in the panel and represent Declan Costello. Gilles Mourre began by elaborating on the process and method. In the coming month, the European Commission would have to confirm its intention to deactivate the general escape clause for 2023 based on the economic forecasts. Secondly, it would have to come up with ideas for the future of the EU economic governance (including EU fiscal rules) based on the public consultation that was likely to be relaunched in the autumn. Thirdly, the European Commission would have to provide fiscal guidance to Member States when the general escape clause had been lifted if the discussions around the fiscal rules was still work in progress by that time.

Gilles Mourre stated that the debate had already started in many fora, but he could not help noting the many mischaracterisations of the fiscal rules, even in academic circles. There was an obsessive focus on the 60% level of debt rather than the operational pace of debt reduction. Rules were often regarded as a mechanical straitjacket that had imposed a balanced budget in all countries, a low level of public investment and procyclicality. Some, at the other end of the spectrum, had argued against changing anything in the design of EU rules, focusing only on better enforcing the existing rules. However, the reality appeared much more nuanced than these polar views. Fiscal rules were applied with considerable flexibility since the euro area debt crisis and failed to lower debt before the outbreak of the COVID crisis in some large economies, increasing fiscal heterogeneity in Europe. A real question appeared to be what the realistic ability of the Stability and Growth Pact was to actually influence the behaviour of fiscal sovereigns given strong national preferences.

Gilles Mourre stated that there was a need for consensus on the main challenges lying ahead and the diagnosis on past implementation. In this regard, the detailed review of the economic and fiscal governance published by the European Commission just before the pandemic outbreak should be a starting point, not least because it provided a balanced and evidence-based picture.

Gilles Mourre stated that his second point was to draw the lesson of the crisis. His third and last point was the importance of the RRF. The recovery would be like never before, being much richer in terms of investment thanks to the Recovery and Resilence Facility (RRF). The RRF would provide a supportive fiscal stance, which would allow countries with high debt to run prudent national fiscal policy to improve their debt sustainability. The fiscal effort should focus on current expenditure, preserving nationally financed investment, which would complement investment financed by RRF grants.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) stated that European Commission enforcement is improving by the day. He thanked Gilles Mourre and introduced Jacques de Larosière, who has been an expert with Eurofi for a long time and has recently been active in writing about these issues.

Jacques de Larosière

Jacques de Larosière stated that he was most grateful to have been selected as a member of the panel. A fiscal framework is necessary because not having it would allow negative externalities to play a role. A system without too much moral hazard must at least have strong cooperation. In a monetary union, there should normally be a common fiscal policy, but, if that is impossible, a great deal of cooperation is necessary.

The issue is how to make the aforementioned happen. Rather than relying only on global percentages, like 60% for public debt and 3% for the deficit, a more tailor made and personalised set of rules should consider the situation of each country. Jacques de Larosière advised keeping the 3% deficit rule because it is already very tolerant. He is more sceptical on the 60% one because it does not really consider important parameters like the level of savings or economic potential.

A new standard is absolutely needed. Some countries rely too much on public expenditure, which then deteriorates all their fiscal situation. A precise rule is therefore necessary. According to this, any country that exceeds the 'average normal' of public expenditure to GDP in the eurozone would have to eliminate the difference in the period of five years or less, for example. In order to make it happen, it is necessary to recognise that the present system of sanctions has not been observed. Jacques de Larosière stated that it has not been observed because the figures and norms that were in action were considered as externally imposed.

Jacques de Larosière suggested that there should be a European independent fiscal authority that would help the country in question fix its personalised standards in collaboration with the authority and each member. The rules absolutely must be internalised in domestic frameworks, and the standard that would emanate through each country from this discussion should be a condition for the presentation of the national budget to the national parliament. This, by definition, would be better than pretending to apply sanctions.

This European authority would also be free to establish the fundamental macroeconomic assumptions behind the budget with the assistance of academics. Jacques de Larosière stated that he has spent a large part of his life on article 4s in the International Monetary Fund (IMF). They were an open discussion between the economists of the IMF, which were absolutely independent, and the country in question. Eventually, enlightenment arrived. Figures and realities are just that. The country would agree with the thrust of the article 4 discussion, and then it would be up to the country to apply the programme. Therefore, strong fiscal positions (primary surpluses) and a shift toward quality of expenditure and investment are needed to face the challenge of infrastructure, investments, and ecological policies. Jacques de Larosière advised against abolishing the EU fiscal framework.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) thanked Jacques de Larosière for his contribution. He had four follow-up questions for panellists to choose from. Firstly, there is an idea of excluding some classes of expenditure from the regional rules. There is talk of investments, growth enhancing investments and productive investments. Tuomas Saarenheimo (Chair) asked where the panellists draw the line and what is productive. He asked if education or health are productive and if it is really implementable. He asked if those present can agree on a line to be drawn somewhere.

Second, there seems to be a general tendency towards agreement that the rules should be simpler. At the same time, there is a desire to maintain the countercyclicality of the framework. The President of the European Commission spoke years ago about 'simple and stupid' rules, which did not have the countercyclical element. Countercyclicality was then brought in and made very complicated. The un observables are there to cater for the countercyclicality. Tuomas Saarenheimo (Chair) asked which way to go given the choice between 'simple and stupid' and 'clever and complicated'.

Third, Tuomas Saarenheimo (Chair) asked if panellists believe in the customisation of limits for country specific circumstances, and, if so, on what basis. He also asked what a fair basis on which to set country specific limits would be. Tuomas Saarenheimo (Chair) asked if it is advisable to work from economic first principles or political realities, both of which lead to very different conclusions.

Finally, on Jacques de Larosière's point on fiscal councils, Tuomas Saarenheimo (Chair) asked how much power and what kind of power to give to them, and whether the panellists see a risk of giving too much power to a non elected body. The power could be of a political nature, so this could mean creating a technocratic body doing political work.

Katja Lautar

Katja Lautar stated that there is a chance to have some kind of short term solution for RRF or green investment. There is room to manoeuvre because this does not require changes of the SGP at the moment, although it might be in the future if that is agreeable. It is necessary to define a proper path for recovery. The SGP procedure provides a lot of room to manoeuvre to have clever, but very simple, rules because it is fairly clear. However, a proper path and time after the current crisis are necessary.

Katja Lautar addressed customisation, noting she has been "in the business of path calculations" for many years. If a staff report could customise countries, different kinds of economies, and different kinds of convergence process, the European Commission would have a great deal of knowledge and several ideas on how this could be more customised. This is easy to say from an expert point of view, but much more difficult to say from the political point of view.

Katja Lautar stated that the fiscal council instructions/opinions are necessary. However, it is very difficult to give the Council that type of responsibility in terms of political power and consensus. At least in small, open, and transparent countries, it is a tremendous obligation that always hits within the political and economic cycle, which is not easy.

Katja Lautar stated that really efficient implementation of RRF will have important implications for the future fiscal framework. The European Fiscal Board recommendations are there to be used, while waiting to see what it can improve in terms of un observables.

Gintarė Skaistė

Gintarė Skaistė addressed the question related to the expenditure rule. It should be stressed that the currently available flexibility clause for investment has never been used. Therefore, it is advisable to consider how to broaden the possibilities of using it in practice to support long-term sustainable growth. There is also merit in looking at possibilities for encouraging green investment, bearing in mind the ambitious climate agenda and the amount of resources that will be needed to implement it.

Gintarė Skaistė stated that ensuring the quality of this expenditure is absolutely key. The RRF experience and structure can be used as a model. Every country would have something to say about the RRF: how strict the European Commission is; how they have to talk extensively about concrete milestones and targets, structural reforms and investments; and how they fit with one another. This framework and experience could be used to assess whether expenditures and investments, for which additional flexibility could be foreseen, will lead to growth or not. The RRF has not been fully implemented yet and it remains to be seen what results it will bring, but it could be a useful case point.

Harald Waiglein

Harald Waiglein stated that, excluding investment or some classes of expenditure from the EU fiscal rules would not make sense because it comes from the illusion that financial means are not scarce. Scarcity is an economic concept, so certain priorities must be dropped to invest in others. However, the approach cannot be to say that everything is equally important and to bend the rules for things that cannot be afforded, because the sustainability is also a market fact. It is nowhere in the rules. Investors would not have cared about that if they had been told that it was making use of the flexibility in the case of Greece and that there was not really a debt sustainability problem. It is really a matter of refocussing the priorities.

On simpler rules, Harald Waiglein stated that if he was at a party and wanted to choose a drink, he would go for 'simple and stupid'. However, the situation is real life, so the choice must be 'clever and complicated'. Customisation for countries is a very interesting concept because the macroeconomic circumstances and the debt dynamics are different for every country, so a case could be made. However, the outcome may not always be favourable.

Harald Waiglein noted that Jacques de Larosière mentioned he was suspicious of the 60%. In some cases, simpler rules might mean having a lower debt ratio than 60%. Taking the example of some countries outside Europe, debt sustainability becomes a problem after reaching 30%, so this could be explored. There is a case to be made economically. It would probably mean more difficult categories for some countries, and it would not be possible to agree on a political concept.

Harald Waiglein moved onto fiscal councils being independent. Good independence and guardianship of the greater good is the job of the European Commission. That is why the European Commission has been given that role. However, political reality shows that, once an institution is burdened with such a fundamentally political role, it cannot remain unpolitical. If the European Commission created such a fiscal council, every member state would immediately try and put as many of its nationals in there as possible to influence the decisions and the way it operated. It looks good in theory, but it is much more difficult in practice.

Gilles Mourre

Gilles Mourre first addressed the fiscal council question. He agreed that there was a more general question about the realistic ability of an enforcer – be it the European Commission or the independent fiscal institutions (IFIs) – to actually influence the behaviour of a fiscal sovereign. On the other hand, the IFIs were national bodies, so strengthening their role would increase national ownership. This would also require that they had enough means to fully play their role.

Gilles Mourre moved onto the challenge regarding investment. There was an estimated investment need for the climate and digital transition of over 600 billion per year over a period of 10 years. The issue was how the fiscal rule could incentivise investment. There were many ideas floating around, such as the golden rule. At the same time, it was key to frame the expectation correctly about what the fiscal rules could reasonably deliver since unsustainable public finance is not conducive either to investment.

Gilles Mourre finished with the question on the nature of public investment. There might be a case to make for green investment because green investment not only served a local or national purpose but was also related to the provision of a global common good, namely the reduction of CO_2 emissions.

Jacques de Larosière

Jacques de Larosière thanked Tuomas Saarenheimo (Chair) for his questions and asked to isolate "virtuous" expenditures in terms of investments or ecologically. Jacques de Larosière agreed with Harald Waiglein. If there is a manageable pedestal and someone adds a "virtuous statue" for positive items, such as ecological ones, the addition will create a worse macroeconomic problem than the one that existed before. Therefore, taking more virtuous actions means cutting back some of the less virtuous ones that are presently absorbing the fiscal potential.

Customisation is absolutely indispensable because the 60% and 3% rules are not taken seriously by the nations when they are too general and come from outside. They are considered an intrusion. Therefore, it is necessary to tailor make the system for it to work.

The last question is very good. It is the question of whether, in doing so, political power is given to a technocratic fiscal authority. Jacques de Larosière stated that he diverges from what others have said on that point. He highlighted matters as different as article 4 by the IMF or the way the CEO oversees the budget and criticises executive power in terms of public expenditure in the United States. There is much to glean from these experiences. Jacques de Larosière highlighted Harald Waiglein's point thatcountries would want to staff this organisation with their own nationals. When Jacques de Larosière was at the IMF and one wanted to nationally staff the article 4 matters, he offered his resignation. It is intolerable. Economists have to be there and do the work.

Jacques de Larosière explained that the system is complex, but so is the reality. In order to understand the situation of a country like France in terms of its fiscal compliance, it is necessary to study the subject in a comprehensive way. Therefore, it is necessary to have this dialogue like the one for article 4 with an independent institution. If the country refuses to hear the macroeconomic intelligence behind the discussion at the end of the exchange of views, this is not going to work. The peers of that country will rebel. Therefore, eventually the economic situation dictates political rule. It is a Socratic discussion leading to a quantum of realism. This is a better position than having a few external arithmetical rules that will never be applied.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) thanked Jacques de Larosière for his contribution. He summarised that the rich discussion is not simply about fiscal rules. It is not about the 3% and 60% figures; it is about much more. It is about ownership, the willingness of countries to internalise the European fiscal framework into their own domestic processes and promoting transparent discussion on fiscal issues. It is also embedded in the broader discussion in the future of European fiscal cooperation. Tuomas Saarenheimo (Chair) thanked the panellists and closed the session.

Exchange of views

Bernie Mensah - President of International, Bank of America

David Wright - President, EUROFI

David Wright (Chair)

David Wright opened the discussion and introduced Bernie Mensah. He thanked Bernie Mensah for attending, for his company's support of Eurofi over many years and for being an institutional partner at the event.

David Wright stated that Eurofi attendees are interested in how Bernie Mensah currently sees the economy. Bank of America is a huge global institution. David Wright asked if Bernie Mensah sees a build-up of risks, tapering, and inflation, or if he is looking at an optimistic scenario.

Bernie Mensah

Bernie Mensah stated that the data that Bank of America sees show strong growth that has tapered back in the last month or two. Some analysts call it a speedbump, and Bank of America believes the Delta variant may be a factor. This remains to be seen.

Bank of America revised its full year growth for the US economy to about 5.9%, and it also revised it down in the Eurozone and in China for other reasons. When Bank of America looks at its credit card data and sees expenditure patterns, it is evident that the consumer is in a good place. The consumer's balance sheet is fairly strong from the various government programmes that have been in place; this applies not just in the US, but also elsewhere in the world. That aspect of it is positive.

There are macro worries, including a considerable debate around tapering. This does not just come from Jackson Hole in the US; it is also a debate in Europe and will continue to be. Bernie Mensah worries about what underlying distortions or issues the current low rate environment is building up that might not be evident. The underlying health of the economy looks strong, although this is subject to a strong further vaccine wave.

David Wright

David Wright asked if Bernie Mensah sees any dramatic overall change on non-performing loans (NPLs).

Bernie Mensah

Bernie Mensah stated that he sees no dramatic overall change on NPLs. Some believe that some of this might be seen when some of the programmes fall away; that applies not just to individuals, but also to some of the rent and some of the property restraints that have been in place. Otherwise, Bank of America has not seen it.

If there is a cloud, it is found in the supply chain. There are real constraints in supply chains in both Europe and the US. In some of the ports in the US, the ships are backed up in the huge flow of traffic between Asia Pacific and the west coast of the US for several reasons.

David Wright

David Wright noted that Bernie Mensah's article for the Eurofi magazine makes a very strong case for moving onto global standards, environment, social and governance (ESG) reporting and more. David Wright asked if Bernie Mensah is worried that this is not the current direction. He also asked if this will be a huge cost element for Bank of America. On the previous panel, Xavier Larnaudie-Eiffel gave a figure of 10 million per new reporting requirement. A global firm such as Bank of America must face a fairly large task if there is no convergence.

Bernie Mensah

Bernie Mensah stated that he does not want to relitigate the previous panel. Bank of America spent a great deal of time on the report. For Bank of America, it just helps to move the green agenda along. The financial sector also has its part to play. Bank of America believes that it can be faster, more productive, and more impactful if it has visibility, better measurements, and common data that it can use to measure before impacting. The large institutions have the ability and resources to adjust to what that is. Much of that simplification is used so that small and medium sized companies or individuals who do not consider this the main deal can jump on the bandwagon.

Bernie Mensah noted that he had been to Italy over the last three or four days to see clients and attend another forum. Northern Italy is full of several excellent, incredible global medium sized companies that are very good at what they do. They need to move management resources to tackle this issue. Making it easier for them would be better.

David Wright

David Wright asked if Bernie Mensah is worried about non convergence when he looks at his advisors. Patrick de Cambourg, who is part of the European regulatory framework, commented during the previous panel that he is talking to the International Financial Reporting Standards Foundation (IFRS), but he did not quite say that convergence is happening.

Bernie Mensah

Bernie Mensah stated that this is worrying, and it is interesting that David Wright brought up the IFRS issue. Bernie Mensah referred to discussions at the G7 at which this came up; there was no consensus as to whether the IFRS should be a common standard bearer. Bernie Mensah would prefer to pick on somebody, but it would be worrying if there could be no consensus around that. The panel gave a few notes on where it should be with some caveats, and Europe has its standards.

This is very important for those who play globally. It is particularly important for a firm like Bank of America that America and Europe are on the same page or heading in the same direction as best as possible. The two economies are too large to be heading to separate places.

Much like vaccines, this is an issue on which it is not possible to do everything necessary in just Europe and the US. If India, China, and the emerging markets are not brought along in a fair way, and they are not held responsible for much of the pollution that exists, this will just mean taking the long route to victory.

David Wright

David Wright stated that the US has always had some difficulties with adopting international standards in the sense of making them legal. He believes that the US will rely on the market to drive the standards. David Wright asked if that is correct or if the US will swing behind a global set of standards.

Bernie Mensah

Bernie Mensah stated that he is not enough of a historian to look at where global standards were implemented by Congress. However, the US tends to be fairly practical in all sectors, including the tech sector. As in Europe, many of these sectors are sensitive to letting 'the perfect be the enemy of the good'. They moved forward fairly practically with driving standards in an industry that they went on to dominate.

Those in Europe need to be sensitive to the aforementioned. Bernie Mensah highlighted the underlying work in the US economy. Despite all of the rhetoric from the previous administration, several states, cities, and corporates have driven and are driving huge investments and advances in the ESG space. It is always advisable to be sensitive to the rhetoric and what might be happening on Capitol Hill versus what corporates are doing.

David Wright

David Wright stated that he always likes to ask questions about Europe to leaders like Bernie Mensah. David Wright wrote in his article that he believes there to be a potential EU Brexit dividend: economic reform programmes are going quite well, there has been progress on vaccination and some positive events have happened. He asked if Bernie Mensah is currently more optimistic about the European Union or if he holds that the banking union and the Capital Markets Union (CMU) are not done.

Bernie Mensah

Bernie Mensah stated that he has just come from Italy, where optimism is high. Italy has had a terrific run and has a prime minister who the country is very bullish about. Italy's politics is currently in a positive place.

Bernie Mensah does not believe that the EU has wasted this crisis, whether this means the NextGenerationEU funds or some mutualisation in that regard. There has been a very effective vaccination programme after a slow start, and next steps are being considered. Bernie Mensah is bullish and believes that several global financial institutions have really taken the state of the capital markets in the EU to heart, perhaps more so than in the past. Bank of America believes there is an enormous opportunity for that to grow and to better serve EU corporates and governments. It is very optimistic that that really is a win win, beyond or as a result of the CMU and banking union. As that grows, it will better service an incredibly large economy and drive higher trend growth in the region.

David Wright

David Wright thanked Bernie Mensah for his welcome optimism and closed the session.

Exchange of views

Jean Lemierre - Chairman, BNP Paribas

David Wright - President, EUROFI

David Wright (Chair)

David Wright opened the discussion with Jean Lemierre, Chair BNP Paribas. David Wright thanked Jean Lemierre for attending, for BNP Paribas' support to Eurofi and for being an institutional partner. Jean Lemierre has been one of Eurofi's greatest supporters.

David Wright noted Jean Lemierre's enormous and vast experience of Europe. He asked where Jean Lemierre sees the big issues as he surveys the scene and what the necessary big impulsions and the priorities needed to move the EU forward decisively are.

Jean Lemierre

Jean Lemierre thanked the Chair for organising the Eurofi meeting. He insisted first on the efficiency of the support provided by the official sector during the Covid crisis.

On the question of the deliveries of the 10 last years since the previous crisis, he insisted on the importance of the adoption of the single jurisdiction approach in the Euro zone. It has enabled the creation of a single supervisor for banks, and of a single resolution board. It is the anchor of the Banking Union which still has to be completed. This principle represents a major progress. It must be fully implemented.

The two priorities we may see at the time of the exit from the pandemic in Europe, are the green and digital agenda. They will require massive investments. As it is well known, Europe is a continent of savings, which are largely in life insurance. The question is then to be efficient in channelling these savings in the priorities. This is the reason why Capital Market Union is so important and urgent. One key step would be securitization, helping to put together the skills and the proximity of the banking industry with the long term investing capabilities of the insurance companies. The United States have put this in place more than 50 years ago. Europe should do the same now. Notably at the time the capital requirements at the banks will be impacted by the implementation of Basle III.

For some, "securisation" and "subprime" are linked. Jean Lemierre stated that it should be done in a proper way while avoiding a catch 22 situation in which we seem to be. The discussion in the Eurofi have always been supportive to such a process.

David Wright

David Wright stated that everyone in attendance surely agrees with Jean Lemierre's analysis. However, he asked if enough people understand this at the decisive political level. Endless plans have been on the table and plans are currently on the table. It would not take the Chair and Jean Lemierre long to agree on the measures that are needed to use the savings of Europe. However, the political understanding that the actions that Jean Lemierre spoke about cannot happen unless the capital markets function in Europe is missing.

Jean Lemierre

Jean Lemierre stated that he does not exactly agree with the Chair's interpretation. It is advisable to stop adding preconditions to preconditions. On Banking Union, there is a precondition about the European Deposit Insurance Scheme (EDIS). It is advisable to avoid putting a precondition on securitisation and the Capital Markets Union (CMU). The securitisation process is the first step in the CMU. The CMU is the capacity to mobilise capital, which means savings, for the economy.

David Wright

David Wright noted that this a cross border action.

Jean Lemierre

Jean Lemierre agrees and insists on the need of asset classes in which European savers can efficiently invest.

David Wright

David Wright asked if the narrative needs to change.

Jean Lemierre

Jean Lemierre answered that the Chair made a very fair point. There is a need to explain well the goals and the means.

David Wright

David Wright (Chair) stated that he agrees with Jean Lemierre.

Jean Lemierre

Jean Lemierre added that Eurofi will have a very important job in continuing to insist on this and drafting the narrative.

David Wright

David Wright thanked Jean Lemierre, noting that it is always a pleasure to talk to him and listen to his creative and very relevant thinking, and closed the session.


Exchange of views

Xavier Musca - Deputy Chief Executive Officer, Crédit Agricole

David Wright - President, EUROFI

David Wright (Chair)

David Wright stated that he is delighted to have an exchange of views with Xavier Musca. He thanked Crédit Agricole for all their support of Eurofi over many years, including being an institutional supporter in Ljubljana.

Xavier Musca has had a stellar career. He has been the director of the Treasury; he has served in the Cabinet of the Prime Minister; he has been Directeur de Cabinet of the Minister of Finance; he has been the Secretary General of the President of the République française; and he is now the deputy chief executive officer of Crédit Agricole.

David Wright (Chair) noted Xavier Musca's enormous European experience and asked him for a very crisp view of how he sees the European Union's (EU) main economic and financial challenges. David Wright (Chair) and Xavier Musca would then discuss climate finance and the financing of the environment in the future, which is very important to Crédit Agricole.

Xavier Musca

Xavier Musca stated that it is possible to be positive about what is happening for a variety of reasons. The first is that the recovery is there. The level of gross domestic product (GDP) in France at the end of 2021 will be comparable to the one before the crisis. In all EU countries, growth is booming. It is interesting that the most pessimistic scenario from one year ago has not materialised.

There are also important features that are more structural. During this crisis, the EU has made some progress that has to be underlined. Firstly, there has been real coordination of macroeconomic policies for the first time. There is now an EU recovery plan, NextGenerationEU (NGEU), which is supported by the European Commission and the EU. The objective is to push for structural reforms because it encourages member states to make the necessary investment to raise their growth potential. A significant national resilience plan has been put in place in all member states. It has created a confidence effect that has had very positive consequences on both the confidence of consumers and the solidity of the corporate sector.

For the first time, there is an agreement to raise debt significantly at EU level, which a real change. This policy, together with the European Central Bank (ECB) intervention, helped maintain the spreads between member states at a low level. Divergence between Member States, seen during previous crises, in particular during 2011 12, has not materialised.

The last positive element is the situation of banking institutions in Europe. Before the crisis, voices raised concerns about the high level of non performing loans (NPLs) and European banks being uninsured. However, they have very successfully passed the very demanding stress test conducted by the ECB: On average, the core equity tier 1 of the banks is 9.9% under these hypotheses, which is quite high. Xavier Musca encouraged considering the very bleak scenario against which assumptions were built. This NPL issue is on the way to being resolved. The NPL ratio decreased from 3.2% to 2.5%. In the countries in which the level was the highest, it decreased even more.

The real problem the banking industry is facing is the question of profitability, which was at 6.8% before the crisis. Xavier Musca doubts that it will rebound at a very high level. This is linked to the fact that there has been little progress on the road of cross border consolidation, despite domestic consolidation in Italy and Spain for instance. That has not happened because there are still a lot of hurdles that have not been lifted, notably regulatory ones. In this respect, Xavier Musca is less optimistic because there is not a very strong will to realise a real banking union, and there has been very little progress on Capital Markets Union (CMU).

This is combined with the fact that the translation into EU regulation of the 2017 Basel agreement could require higher capital than was initially promised to the banks. Xavier Musca remembers hearing about a commitment that translation of this agreement should not trigger a very significant increase in capital requirements or threaten long term profitability of the sector. That is not good because this profitability is necessary to address the challenges that will be faced in the future, including digitalisation and the climate change issue.

Despite more concerning long term issues that have not been resolved, Europeans can be proud about the progress made collectively during this period and the improvement that the EU and the eurozone have achieved during the past year.

David Wright

David Wright asked Xavier Musca what his concerns around the climate and related financing issues were.

Xavier Musca

Xavier Musca stated that there has been very strong acceleration of a number of trends that were present before the crisis after the pandemic. These include digitalisation and this issue around climate change. There is very strong demand from civil society to make progress on that. Xavier Musca is very impressed by the strength of the movement. Looking at what happened at shareholders' general assemblies in 2021 shows that concerns on climate have increased quite markedly. For the first time, American firms like BlackRock, Vanguard and others have taken a clear position in favour of more ambitious climate policies for corporates. Climate Action 100+ has also created a coalition of investors that are requesting that companies be more transparent around their climate policies and asking for ambition.

The aforementioned has created an environment in which investors and banks have to answer to this social demand. This message is coming not only from society, but also from supervisors. By 2023, it will be mandatory to disclose environmental, social, and governance (ESG) risk. It is foreseen that it will soon be mandatory to incorporate this ESG risk in the assessment of risk under pillar 2, and maybe later on under pillar 1. That is a very strong and impressive movement.

The real issue is what this means for European finance. It is simultaneously an opportunity and a risk. The opportunity is the fact that Europe is leading the way, and very well placed. The major countries have all issued green bonds in Europe; the last one was Spain at the beginning of the week. The European Commission is planning to issue its first green bond in early October 2021. Some 56% of ESG bonds in the world are issued by Europeans and 70% of the investors in ESG related funds are Europeans. Europe is advancing; it has to keep doing so.

Nevertheless, Xavier Musca is concerned by a variety of issues. The first is the question of data. BlackRock has recently been very eloquent on the need for banks to have the appropriate data in order to assess the risk they are confronted with. Crédit Agricole is not there yet. It knows that it will only be able to get this kind of information through the Corporate Sustainability Reporting Directive (CSRD) so it will wait for the European Commission on this issue. The risk is that banks and investors could be accused of greenwashing, around which issues have been raised recently. It is necessary to engage in the movement, but also to be cautious.

Xavier Musca's main concern is on another level. There is a political impetus towards green finance, but there is little political guidance. The private sector and the banks might be pushed towards acting as subject to government in order to pave the way for a green economy. However, many matters are still unclear and are in the hands of governments.

Xavier Musca asked what the precise European energy mix is. The taxonomy published by the European Commission is a really detailed document, but it is silent on the key issue of the future role of gas and nuclear energy. This silence reflects the fact that there is no agreement on the European energy policy. Xavier Musca does not wholly understand how it is possible to have a transition in this environment without having a deeper political agreement on the energy policy. One key issue is the fact that no one knows yet the central energy scenario against which they are supposed to base their actions and make their commitments.

Finally, investment opportunities are necessary. There is another problem here in that 90% of investment today are not green, according to the taxonomy. Crédit Agricole is supposed to finance investments, but it lacks a real commitment from the other actors to grow in the direction of climate change transition. That is a major difficulty. Xavier Musca is very positive about the movement, but more decisive actions will have to be taken at a political level in order to be successful and for financiers to be able to serve that positive objective.

David Wright

David Wright asked if more political guidance was necessary, particularly on the major types of issues that Xavier Musca raised. He also asked if this meant more granularity in the taxonomy itself or an even more detailed eventual document. David Wright also asked if Xavier Musca worried about the prevalent theme in Ljubljana that the likelihood of global convergence on standards was not very high.

Xavier Musca

Xavier Musca stated that one of his personal worries was corporates and banks needing to determine their financing policy according to rules that are not clear at a European level. They do not yet know if the nature and content of disclosure will be determined by EU democratic leaders or by a constellation of people (funds, investors, NGOs) who have their merits but do not represent political legitimacy. The only way to avoid this uncertainty, is having clearer EU regulation and a convergence of standards at international level.

The only way to avoid this risk is for Europe to be clearer on the big choices. Xavier Musca is not sure that more detail is necessary. Xavier Musca asked what energy is considered legitimate to use in the future and what the path to transition are. There will not be an immediate transition from a brown economy to a green one. It will be necessary to accept that some progress will involve using gas, nuclear or other energies. The way to determine this path is absolutely essential; it will create a consensus among bankers, investors and public authorities that will make the transition as smooth as possible. Otherwise, there could be a very erratic movement and people other than Europeans could tell Europeans what to do in the future. Europeans do not want that future.

David Wright

David Wright stated that Eurofi looks forward to seeing Xavier Musca in Paris. He thanked Xavier Musca and closed the session.

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Birgit Puck
Managing Director Securities Supervision

Autorité de Contrôle Prudentiel et de Résolution
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Publisher: Didier Cahen
Design & Production: Virginie Denis, Initial Production

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.

We thank the **Slovenian EU Council Presidency** and **the partner institutions** for their support to the organisation of the Eurofi September 2021 Forum

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