

VIEWS

THE EUROFI MAGAZINE

FEBRUARY 2022

BRUNO LE MAIRE

Minister of the Economy,
Finance and the Recovery Plan,
France

Europe's sovereignty
is a core objective for
the French Presidency
of the EU



V. ROSS

Strengthening
capital markets
in the EU



I. TINAGLI

The challenge of public
and private investment
in the EU



F. VILLEROY DE GALHAU

A Financing Union to fund
a greener and more digital
post-crisis Europe



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EUROFI POLICY NOTES

PUBLIC AND PRIVATE SECTOR VIEWS

THE EUROFI VIEWS MAGAZINE

FEBRUARY 2022

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

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CHALLENGES AHEAD FOR THE EU FINANCIAL SECTOR



DIDIER CAHEN



MARC TRUCHET



JEAN-MARIE
ANDRES

This new edition of the Eurofi Magazine is published at a time that continues to be very challenging for Europe. Although health and economic indicators are improving, the pandemic is not yet over, the path towards a progressive normalisation of the macro-economic environment has not yet been fully clarified and new threats are appearing, such as inflation.

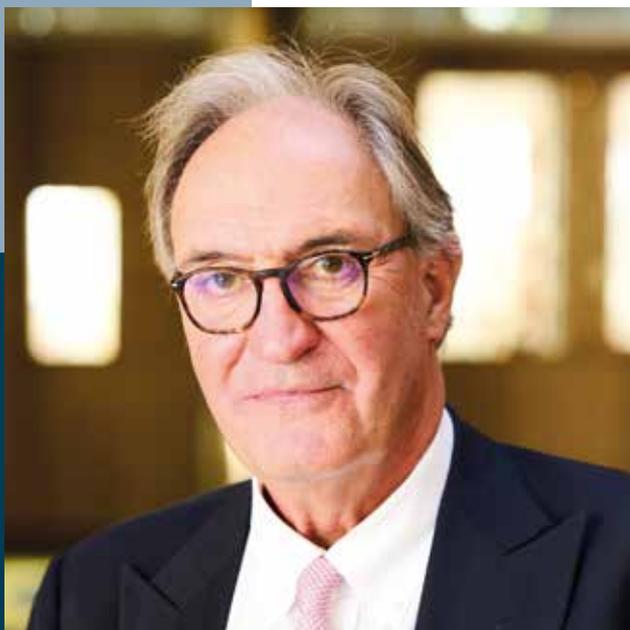
The appropriate ways to relaunch growth in the EU, the role that the financial sector may play in this regard and the policies needed to support this are thus the central themes of this publication, gathering views from a large group of public and private sector representatives. Digitalisation and sustainability trends which are increasingly impacting and driving the financial services sector are also extensively covered.

One particular challenge in the EU is the relaunching of productive investment, which is essential for supporting the post-Covid recovery and the green and digital transformations and is being hindered by lasting low interest rates which have developed a preference for liquidity over productive investment among investors. The “Next Generation EU” Recovery plan will provide significant resources, but money alone will not ensure recovery if the conditions for investment do not improve.

A second major challenge is the so-called “strategic autonomy” of the EU and its financing i.e. its non-dependence on foreign jurisdictions and how to ensure it in a context where post-Brexit fragmentation is potentially threatening the provision of competitive capital market funding to the EU, essential for funding its growing and innovative businesses, and where digital solutions provided by third-party tech players are becoming increasingly structural in the financial services sector.

Many on-going EU initiatives such as the Banking Union, the Capital Markets Union, the sustainable finance agenda and new initiatives such as the Digital Finance Strategy are tackling these issues but they need to move at a fast enough pace and deliver results that match the initial ambitions of these initiatives.

We are grateful to the 180+ public and private sector representatives who have provided us with input on these important questions, and we are sure that you will read their thoughts and proposals with great interest. The Eurofi Secretariat has also published several papers on these topics in the latest edition of the Eurofi Regulatory Update, which we invite you to read.



DAVID WRIGHT

President, Eurofi

Bienvenue à Paris.

Nous sommes heureux de pouvoir nous réunir physiquement à Paris sous l'égide de la Présidence Française du Conseil de l'Union Européenne.

Au nom des membres d'Eurofi, je tiens à remercier la Présidence française ainsi que les institutions publiques de la place parisienne pour leur soutien. Permettez-moi également d'exprimer ma gratitude aux partenaires de cet événement ainsi qu'à tous les membres de notre think-tank sans qui ce Séminaire n'aurait pu être organisé.

L'agenda de cet événement est, comme d'habitude, très chargé. Cela démontre qu'il y a de nombreux sujets économiques et financiers importants sur lesquels il est nécessaire de débattre afin de progresser. Soyons tous constructifs au cours de ces 3 jours de débats et faisons des propositions pragmatiques afin d'aider les décideurs politiques à progresser dans l'intégration économique et financière de l'Union Européenne.

A few brief thoughts for our work ahead.

A helicopter view of political structures around the world today will paint a world of increasing complexity, diversity, dissension and often political conflict. The roots of democratic systems of government are being severely tested. Political extremes are gaining ground and widening, the centre ground fragmenting and decision making becoming more and more difficult and time consuming. Election results are still contested by many in the U.S; some democratic governments today are much less inclined to respect the law, custom, practice and due process; politicised judiciaries are becoming too frequent; and far too much money is swilling around major political systems pushing narrow interests of the rich and powerful and often preventing the public interest being at the heart of policy making.

In this context the European Union, its institutions, its legal bodies, its processes and procedures has significant opportunities to demonstrate to the world at large the right way to make policy and decide. A Union, representative,

democratic, founded and defined by Treaty, based on law, with open, transparent and accountable policy making, underpinned by rigorous economic and societal impact analyses, without fear or favour to sectoral interests or bowing to the interests of a few powerful Member States. In short a European Union working tirelessly to find the centre ground, common ground, convergence where the European public interest lies. An EU acting together, looking to the future, shaping its own destiny with responsible and fair policies that if good, if serious and well thought out, will be subsequently copied around many parts of the world.

There are many recent examples which shows that when the EU acts in a timely and decisive way based on the above principles the results can be spectacular. Some recent examples:

- The EU COVID vaccination programme- the most comprehensive in the world;
- The New Generation Economic programmes to restructure economies post-COVID - cash-on-delivery conditionality resulting in overdue structural reforms happening in many Member States for the first time in decades;
- Common NGEU bond issuance, now over €70 billion, each issuance on average 10 times oversubscribed, including the biggest green bond tranches in the world;
- Global green and climate change leadership even though the taxonomy is not yet finalized.

But in some work areas, EUROFI's focus, covering the European economy and finance, there are 4 gaping lacunae, without which the EU will not be able to sustainably grow over the medium term at a faster rate, nor finance the green transition, nor guarantee financial stability and job creation. Here European decision making is lacking and is far too slow.

They are:

- Banking Union;
- Capital Markets Union;
- A renovated Growth and Stability Pact;
- Managing and reducing, overtime, excessive levels of public debt.

Each is well known. CMU is advancing at snail pace. A top level political delivery timetable is urgently needed within this current European political cycle to accelerate delivery.

The lack of Banking Union is stymying European banking, its competitiveness and needed restructuring to stimulate long-term economic growth.

A new Growth and Stability Pact is badly needed to cement Eurozone stability, including sufficient and workable discipline.

The high levels of European public debt are analysed elsewhere in papers submitted to this EUROFI meeting by Jacques de Larosière and Didier Cahen and I share their conclusions. In particular excessive debt levels are the antithesis of building societal fairness and equilibria.

I hope the French Presidency will be bold in trying to advance solutions on all these fronts, drawing on the strength and integrity of the EU's political institutions. Building confidence with the Member States and the European Parliament and using the inspiration of recent great European successes mentioned above to find agreements.

I wish them every possible success.



Q&A

BRUNO LE MAIRE

Minister of the Economy,
Finance and the Recovery Plan,
France

Europe’s sovereignty is a core objective for the French Presidency of the EU

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

European sovereignty is at the core of the French EU Presidency.

First of all, we Europeans can be proud of the way we collectively faced the worst crisis, since the 1920s’ Great Depression. Thanks to our decisions, to the well-thought coordination of our public policies, and to the instruments we implemented together, at the right time (state-guaranteed loans, short time work schemes, solidarity funds, common debt issuance), we managed to collectively face such a crisis, with success. Such a success is a European success.

We now must show the World that the European Union and its Member states are able to coordinate their economic policies, as efficiently and as ambitiously as they did during the crisis. This is why our Presidency will make sure that the European recovery plans continue to be fully and effectively implemented.

Now the question is, what kind of economic model do we want to build for Europe?

Firstly, a sustainable model. We are the first continent in the World, to draw precisely our path to reach net zero emissions by 2050. Within the Green Deal package, the Carbon Border Adjustment Mechanism (CBAM) aims at fighting carbon leakages outside of Europe, while abiding to WTO agreements. It would be foolish to make such massive investments in reducing our industries’ emissions, while, at the same time, importing carbonized steel and aluminium from abroad. This would have deep negative consequences for our industries, for our citizens and for the World’s climate.

Secondly, a model that paves the way for a fair and an inclusive growth. To this end, the French Presidency of the Council of the EU is committed to establish a fairer and a more efficient tax system. We are determined to succeed in implementing, at

a European level, the agreement on international taxation that we signed at an OECD level, last year. Reaching such a crucial agreement was possible, thanks to the EU and to our countless efforts over the past 5 years.

Thirdly, a model that founds growth on innovation. On Hydrogen, Cloud, AI and Electronics, we need to build leading European competitors. This is why we have decided to develop European industrial alliances (IPCEIs). And this is not only an industrial issue; it is a cultural issue. We Europeans must be incentivised to take more risks, in order to stimulate innovation and to develop the technological solutions we need for the future.

Such an ambition will require massive funding. And such funding does not count in hundreds of millions, but in billions of euros, tens of billions of euros, and even more. Reaching those levels of funding will require both public money and private money. This is why we need a strong and a unified European financial system. This is also why we need to frame our public spending policies. Our discussions on the economic governance review are designed to define a right balance between rules, fiscal sustainability and our investment needs, in order to face the technological and climate transitions.

All these topics will be at the heart of our discussions at the Informal Ecofin and at the Leaders’ Summit on investment and growth, on March 10th and 11th.

How can Europe correct overtime the growing heterogeneity of economic and fiscal performance between euro area countries? What should be the main elements of a reform of the Stability and Growth Pact? What measures would finally make it effective?

The economic governance framework should allow us to follow a double objective: building our economic model

based on sustainable growth, while facing the ecological and digital transitions; and making sure that we have sound public finances. There is no trade-off between sustainability, growth and investment: each issue is similarly important.

To this end, there are several proposals on the table, including the possibility of differentiated fiscal policies between Member States, the necessity to better take our investment needs into account, and proposals in favour of a greater role for Member States in the way they can define their fiscal targets and reforms.

Whichever conclusions we draw, we will need time to examine each proposal and build a consensus on the chosen solutions. Discussions have already started, but it is too early to draw such conclusions.

Modernising our economic governance framework should not only focus on budgetary rules. It will also be essential to think through the way we can better coordinate our economic policies, in order to reduce external imbalances between Member States.

This should be part of the broader discussion on the long-term European economic model, at the informal ECOFIN and at the Leaders' Summit in March.

Does the EU's financial autonomy need to be reinforced and if so for which reasons? How can Europe's financial autonomy be strengthened? What are the prerequisites (e.g. economic convergence in all parts of the Union, positive real interest rates...), the enablers and the priority areas?

I believe we need to reinforce the EU's financial autonomy, in order to increase the resilience of European financial markets.

To reach this goal, firstly we have to build more integrated markets. This requires a Banking Union which fosters the completion of truly transnational banking markets. A genuine Capital Markets Union is also key. We will work during our presidency on developing vehicles that favour pan-European long-term investment, through the review of the ELTIF directive. The review of the Markets in Financial Instruments Regulation (MiFIR) must also contribute to improving the functioning of European capital markets, especially by setting up a European consolidated tape.

Secondly, we need a stronger funding capacity. This means defining the right balance between strengthened financial stability, resilience and the competitiveness of financial actors. We will have to find such a balance in the transposition of the Basel III international agreement into European law: a fair transposition should allow to increase our funding capacity. Similarly, we aim at adopting a Solvency II review which would promote the role of insurers as long-term investors, particularly in equity.

Finally, it is by being able to set its own standards that the European Union will preserve its financial autonomy. This is particularly true when it comes to the ecological transition. Europe has a pioneer role to play in this field. The finalisation of the negotiations on the directive on corporate sustainability reports (CSRD) and on the regulation creating European standards for green bonds (EUGBS) are telling examples.

What are the costs and risks of not addressing ring-fencing practices and therefore not breaking the complete standstill where the "Banking Union" finds itself? How can we move forward?

We need the European banking sector to mobilize large and competitive funding services, in order to support households, firms and projects across the European continent.

To this end, the European financial sector must be less fragmented, so that it can grow, to benefit from scale and scope economies. This means building a Banking Union which paves the way for a truly integrated European banking sector.

Yet, so far, we have clearly failed on delivering on this objective. Before the Great financial crisis, we had more cross-border banking operations in Europe, although supervised by national authorities, than today. Since we started building the banking union, there have been paradoxically fewer cross-border operations and more purely national banks, although now supervised by European authorities. In parallel, the ring-fencing practices rules led European banks to freeze hundreds of billion-worth of excess liquidity at the level of their local subsidiaries.

This more fragmented banking market deeply harms our growth potential. This is why we have to fix this issue quickly if we want to preserve the European financial autonomy. But at the same time, we must continue to take into account the concerns on "host" jurisdictions.

A way to overcome the current situation is to develop appropriate safeguards, through a credible and an efficient European resolution regime and through European safety nets, such as the Single Resolution Fund and the project of EDIS.

From a supervisory point of view, such power transfers from home and host supervisors to a central authority will ensure a more neutral treatment. From a bank crisis management perspective, such a resolution framework would create a strong intragroup solidarity between home and host entities. Combined to the deployment of large amounts of mutualised safety nets, which are mostly funded by home sectors, this should ensure the right level of safeguard for host jurisdictions. France is supportive of the Eurogroup president's attempt to unlock such political discussions. We must take ambitious actions to complete a truly integrated European banking market, while ensuring that we design strong crisis management and depositor insurance frameworks.



Q&A

VALDIS DOMBROVSKIS

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

Europe’s economy: building back strength, moving forward for the future

How can we explain the low level of growth of Europe over the last few years - particularly in comparison with the US and China - while savings in EU countries are particularly abundant and investment needs are significant?

The economies of China, the European Union and United States, while broadly similar in terms of size of their economic output, are structurally very different.

China’s average real income per person, for example, remains at about a quarter of the living standards in Europe. Its sustained and rapid growth is largely driven by a catching-up process.

The comparison between the US and EU is more appropriate.

If we look at the recent past, it is clear that the initial economic impact of the COVID-19 pandemic was greater in Europe. This largely reflects the degree of the health shock and more stringent containment measures. In addition, the fact that the EU is a more open economy left it more exposed to the collapse in global trade.

Both the US and the EU have taken very sizeable support measures, which contributed to a rapid recovery on both sides of the Atlantic.

In Europe for example, we were quick to activate the general escape clause of our fiscal rules and deploy the SURE job retention scheme.

As a result, the labour market remained more resilient in the EU than in the US. With NextGenerationEU, the EU has also provided a strong incentive to support public and private investment in the post-crisis phase, along with ambitious reforms. The transformative nature of green and digital investment should have a lasting positive impact on economic growth.

While this bodes well for the EU’s economic prospects, one has to recognise that the US traditionally has a more dynamic economy, with a stronger capacity to adjust and rebound more quickly than that of the EU.

In the two decades before the COVID-19 crisis, euro area GDP increased by an average 1.4% per year in real terms, while US GDP increased on average by 2.2% per year.

This underscores the need to combine the short-term EU response with longer-term supply side policies. The Recovery and Resilience Facility will play an important role here.

It will be crucial to improve the functioning of product, labour and financial markets.

This will also require continued progress in deepening the single market, completing the Banking Union and deepening the Capital Markets Union.

How will economic recovery be accelerated and supported by the EU Recovery and Resilience Facility? What contribution is expected from private investment and capital markets?

Europe’s NextGenerationEU (NGEU) recovery package will significantly boost the EU economy in the post-crisis phase and beyond.

Just in terms of the investment it will generate, we expect NGEU to increase GDP by up to 1.5% and create up to two million jobs during the years of its active operation.

This expected growth will boost consumer demand and create more business opportunities, helping Europe get out of the crisis stronger and more resilient than before.

National recovery plans also contain reforms designed to affect supply side conditions. These are likely to increase the GDP growth and job creation even further.

In addition, our simulations show that positive spillovers account for around one-third of the estimated growth impact for the EU average. This means that even those EU countries that receive a small allocation of funds will indirectly benefit from RRF investments in others.

Private investments and capital markets will play a large role in the recovery and modernisation of our economies, as well as in the green and digital transitions.

For the Recovery and Resilience Facility (RRF) specifically, the European Commission is raising funds on capital markets on behalf of the EU – to date, more than €70 billion raised in long-term funding – with strong demand seen for all our bonds so far.

The first NGEU green bond was issued in October 2021 and raised €12 billion to be used exclusively for green and sustainable investments across the EU. It is the world's largest green bond issue.

Issuing these high-quality assets also contributes to EU financial stability, as well as providing a new asset for banks and a new opportunity for other investors. This is also important given the scarcity of AAA bonds in financial markets.

On implementation, RRF funds are being released gradually as Member States reach the milestones and targets for the investments and reforms identified in national plans. The plans set out a clear trajectory for the economy, which should encourage more private investment.

The investments and reforms will improve the business environment, reduce regulatory barriers and administrative burdens for businesses.

It shows that we want to make our economies fit for the future and send a clear sign to the markets that the time to invest in Europe is now.

What are the fiscal and economic priorities for achieving sustainable growth in the European Union in the context of over-indebtedness of most Member States and a resurgence of inflation?

The EU economy rebounded strongly in 2021, although the pace of the expansion has moderated towards the end of the year. The current wave of infections, supply bottlenecks, soaring energy prices and rapidly rising inflation rates are creating a drag on economic activity.

In 2022, the overall fiscal stance should remain moderately supportive so that the recovery can build traction. Since debt levels are high in several Member States, it is important that the support is well targeted and does not create a permanent burden for public finances.

We have called for support to come from higher investments, both from those funded by the EU and from national budgets. Higher investment will contribute to raising productivity and thereby potential growth. It will also reduce the risk of sustained inflationary pressures compared with an expansionary fiscal stance fuelled by higher current expenditure.

It will remain important to continue close coordination of fiscal policies in the period ahead.

On one hand, the persistent uncertainty requires fiscal policy to remain agile.

On the other, we need to create clarity and predictability on the general course of our policies beyond the immediate future.

That is why we will very soon provide guidance on fiscal policy for 2023. It will reflect the global economic situation, the specific economic and budgetary situation of each Member State and also the discussion on reviewing the EU's economic governance framework.

A key priority will be to reduce high and divergent public debt ratios in a gradual, continuous and growth-friendly way, considering the importance of investment.

What are the costs and risks of not addressing the ring-fencing practices that explain the complete standstill in which the Banking Union finds itself? How can we move forward?

Banks remain the main funding source for EU economies. We need them to be well capitalised and resilient, but also efficient in managing their costs, operations and cross-border resources.

In this respect, an integrated and completed Banking Union would bring benefits through more efficient management of resources and economies of scale.

It would increase the ability of the private sector to absorb shocks at a time of crisis and allow banks to diversify their exposures to different regions, sectors and sovereigns.

Deepening and diversifying sources of funding remains a key element of our Capital Markets Union project. At the same time, banks play an important role in financing local economies.

They need to be able to provide credit anywhere in the EU to households and businesses, including SMEs – particularly in smaller markets with less availability of other funding sources.

Since banks of different sizes with different business models can respond to a wide range of financing and risk management needs, we have made sure that our regulatory framework respects the diversity of the EU banking sector.

By completing the Banking Union, we can create the confidence and trust needed to remove ring-fencing practices while protecting financial stability. In turn, this would help us to progress with achieving more cross-border consolidation and reduce the risk of market fragmentation within the Banking Union.

As we emerge from the crisis, risks may come with the phasing out of support measures for the real economy – along with new challenges such as the green and digital transitions and cybersecurity threats.

We cannot properly address these challenges without a complete Banking Union.



Q&A

MAIREAD MCGUINNESS

Commissioner for Financial Services,
Financial Stability and Capital Markets Union -
European Commission

**Spotlight on EU financial policy developments:
Capital Markets Union and Basel III**

How important are capital markets for the post-Covid economic recovery, the green and digital transition and ensuring Europe’s financial autonomy? How is the Commission approaching the next steps of the CMU initiative?

The Capital Markets Union is vital for the EU’s economic agenda. Especially in the current circumstances, making progress on the CMU will help us deliver our economic policy goals.

Strong and well-integrated capital markets are essential to help firms access wider sources of financing. They can also help channel savings into productive investment. The CMU can mobilise huge investment to tackle climate and environmental challenges and to support the digitalisation of the EU economy. Crucially, the CMU and the Banking Union can together build a strong, competitive and integrated European financial system.

That in turn can strengthen the EU’s global economic role and open strategic autonomy, including via a stronger international role of the euro.

We do need to recognise that the CMU is a long-term project and we need patience and perseverance. It is a structural reform project that addresses deep-seated differences across Member States. Building the CMU requires ambition and strong political commitment from Member States and the European Parliament.

By the end of this Commission’s mandate in 2024, we hope the co-legislators will have adopted most of the measures proposed, including on the more structural proposals such as corporate insolvency law and withholding tax.

I want to help make sure that the financial sector can rightly be seen as a driver of growth and an accelerator of the transition to a green and digital economy by the end of my mandate.

How is the Commission approaching the next steps of the CMU initiative? Will the action plan¹ published in November 2021 allow a step change in terms of development and integration of EU capital markets?

Companies need access to more diverse sources of funding to grow and innovate. People need better returns on their money. And we need to break down the remaining barriers between European capital markets to build the CMU.

In September 2020, we presented a new CMU action plan to accelerate our work. On 25 November 2021, we took a major step forward on that plan by adopting a package of four legislative proposals. First, we are increasing market transparency by reviewing MiFIR and introducing a European consolidated tape for trading data. Second, we are creating a European Single Access Point, which will put information at investors’ fingertips while giving companies more visibility to investors. Third, we are reviewing the rules for European Long-Term Investment Funds to make them more attractive. And fourth, we are making targeted changes to the Alternative Fund Managers Directive to help asset management work more efficiently.

More work is to come in 2022. A Listing Review will encourage more companies to list on EU public markets, particularly SMEs. We will make a targeted legislative proposal to harmonise some corporate insolvency rules. Making it easier to predict the outcome of insolvency proceedings across the EU is particularly important for cross-border investors. And we will also focus on financial education, so people can ask the right questions and know what products work for them. Last month we finalised a financial literacy framework together with the OECD which will help Member States, financial companies, businesses, civil society and educational institutions design effective financial education programmes. Finally, we will set up an open finance framework to allow data to be shared and re-used by financial institutions to create new products and services for consumers and companies – while keeping people in control of their own data.

How is the clearing landscape evolving in Europe one year after Brexit and what are the key issues remaining to be tackled in terms of financial stability and competitiveness?

In September 2020, the Commission adopted an equivalence decision for UK CCPs set to expire on 30 June 2022 to avoid the financial stability risks entailed by an abrupt disruption in the access of EU market participants to UK CCPs. In this equivalence decision, market participants were urged to reduce their exposures to UK CCPs. This over-reliance on UK-based CCPs raises concerns for our regulatory and supervisory autonomy and implies financial stability risks for the European Union, notably in the event of stress in these CCPs. The move of derivatives from London to the EU so far has been marginal and the over-reliance on those CCPs – and associated risks – persist. ESMA confirmed in its assessment that some of the services provided by UK CCPs are systemic but that forcing relocation at this juncture would be too costly for EU market participants. In addition, the Commission conducted work in 2021 with European public authorities on how to build strong and attractive central clearing capacity in the EU that showed we need to encourage infrastructure development and reform supervisory arrangements. But it was clear that June 2022 was too short a deadline. This is why I recently announced that we plan to extend the equivalence decision by another 3 years. Nevertheless, this extension does not address our medium-term financial stability concerns. We will soon launch a public consultation on the best way to achieve our goal. In the second half of the year, I intend to come forward with measures to make the EU an attractive clearing hub. I will propose ways to increase liquidity in EU CCPs and expand the range of clearing solutions on offer. If the EU is to increase its capacity for central clearing, it is essential that risks are well-managed and the EU's supervisory framework for CCPs is strengthened, including a bigger role for EU-level supervision.

To what extent can the Basel III package effectively improve the comparability of the risk-based capital ratios of banks in the EU and globally?

The banking package proposed by the Commission last October addresses the remaining shortcomings of the prudential framework identified in the aftermath of the financial crisis, including the lack of comparability of risk-based capital ratios. The proposed measures will constrain and frame the use of internal models to calculate capital requirements while increasing the risk sensitivity of standardised approaches. For operational risk and credit valuation adjustment risk, models will no longer be available. For credit risk and market risk, their use will remain possible for assets where there is reliable data, subject to input and output floors. To effectively improve the comparability of risk-based capital ratios and restore their credibility, all parts of the final Basel III reform need to be implemented. The Commission's legislative package would achieve just that.

Is the increased granularity of the proposed framework leading to improved proportionality and simplicity?

The banking package will increase the granularity of the framework in a targeted manner and only in the few areas required for robust risk measurement – for instance when it comes to the modelling of certain trading activities or the standardised treatment of equities or specific forms of mortgage lending. Most of the proposed measures, however, will simplify the rulebook by removing or better framing the more complex approaches that banks can currently use to calculate their capital requirements. So the package carefully balances comparability, risk sensitivity

and simplicity. It will lead to more proportionate outcomes with less administrative burden.

Can international standards adapt to the specificities of different regions in terms of financing, notably those such as Europe where banks play an important role?

An open, global financial system requires global standards for safety and soundness. Without them, any single jurisdiction neglecting financial stability can result in spillover effects for other jurisdictions, as the global financial crisis vividly demonstrated. Global regulatory cooperation is therefore essential for global financial stability. But global cooperation does not mean full harmonisation of prudential regulations. Instead, the Basel framework is designed to serve as a minimum level playing field, a common baseline that reflects differences among jurisdictions. If domestic transposition processes of international standards show that certain specific features need to be accommodated, then there is room to do so without compromising the integrity of the overall framework. Our banking package respects the international agreement while taking into account the EU economy's specific characteristics. In the EU we support multilateral approaches to address important global issues, so we must faithfully implement solutions agreed at international level. Only then can we expect our international partners to do the same.

Is the Basel Framework well fitted for addressing sustainability risks?

To some extent, the Basel Framework already captures sustainability risks. Work by the ECB/European Systemic Risk Board (ESRB)² suggests that climate risks manifest through traditional risk types. Nevertheless, the Basel Committee identified relevant areas where climate risks may not be adequately captured by the existing framework. It is currently exploring options to close these gaps. As observers in the Basel process, we are closely following this work and providing our input. In the EU, we have already started to incorporate sustainability risks in the prudential framework for banks. In 2019, CRR II introduced disclosure requirements for ESG risks. The recently adopted Banking package went even further by proposing to hardwire ESG risks in banks' risk management processes, supervisors' SREP processes, and stress tests.

What is being envisaged to tackle the concerning points (e.g., physical risk underestimation, difficulties to approach the very long term, ...) unveiled by the stress tests?

Stress tests are a powerful tool to assess the non-linear and unique features of climate risks. They are useful for supervisors to assess whether banks are resilient enough to withstand financial and economic shocks, in the short, medium and long term. The banking package we adopted last October would empower supervisors to incorporate ESG risks in supervisory stress testing and in the supervisory review of banks' risk management practices, and require stress testing by institutions. The outcome of those exercises – and any points of concern they may reveal – may then influence the review and evaluation process (SREP) of each bank and allow supervisors to take action through Pillar 2 measures.

1. [*Action plan*] should be corrected and read '*package*'
2. ECB/ESRB Project Team on climate risk monitoring (2021), "*Climate-related risk and financial stability*", ECB/European Systemic Risk Board, July.



Q&A

PASCHAL DONOHOE

President of the Eurogroup
and Minister of Finance of Ireland

Completing the Banking Union will be key to drive economic growth and fund the twin transitions

What have been the lessons learned from Europe's economic response to Covid-19? What is the appropriate policy mix for the euro area given current headwinds on the outlook?

The euro area economy performed remarkably well in 2021 and growth prospects for 2022 remain robust despite the difficulties created by the pandemic. Evidence suggests that the euro area response was well calibrated - sufficient to preserve productive capacity but not creating other imbalances, which could hold back growth in the coming years.

Budgetary and monetary policy have worked hand-in-hand since the onset of the pandemic and the benefits and effectiveness can be seen in employment and GDP data. The supportive monetary policy decisions were coupled with swift, decisive and coordinated actions by governments to cushion the impact of the pandemic at both national and EU level, not least with the implementation of the ground-breaking Next Generation EU recovery plan. Together with the rollout of vaccines and the easing of restrictions, it enabled the euro area to rebound strongly from Covid-19.

Output is rapidly returning to pre-crisis levels and at a much faster pace than previous crises. Latest GDP forecasts indicate that it will take approximately 8 quarters to return to pre-pandemic levels of output in the euro area. In contrast, it took the euro area about 29 quarters to recover lost ground from the financial crises. So while these shocks were inherently different, the recovery from Covid-19 - which had a bigger impact on GDP - looks like being approximately four times quicker than the financial crises.

Perhaps the most tangible evidence is in terms of our labour market performance. The latest data shows that the unemployment rate in the euro area fell for a seventh consecutive month to just 7.2 per cent in November - slightly below the unemployment rate when Covid-19 first hit. In contrast to the financial crises when we had stubbornly

high unemployment rates - in double digits - of between 10 and 12 per cent for several years - this time around, we have protected jobs.

This data is encouraging as our focus progressively shifts from dealing with an emergency to ensuring a sustainable recovery.

Uncertainty remains high, and we are alert to the evolution of the health situation, the rise in inflation as well as other headwinds to the economic outlook. That is why we agreed at Eurogroup on the need for our budgetary policies to remain supportive, agile and coordinated whilst being increasingly targeted.

At the same time, we are all too aware of the uneven impacts of the pandemic. That is why we must continue to invest heavily and sustainably in our people, infrastructure and institutions. Next Generation EU will have a key role to play in helping repair the immediate economic and social damage brought about by the pandemic. It will also address our longer-term challenges by supporting reforms and investments to tackle the climate emergency and the digital transition.

How can the private sector complement public policy efforts to tackle the investment needs related to the green and digital transition?

In the wake of the financial crisis we implemented many economic, structural and financial reforms.

We benefited from this resilient banking system during the pandemic. Banks' risks continue to decline, with broadly stable capital and leverage positions, an improvement in their liquidity position, a decline in NPLs and a decrease in MREL shortfalls.

Loan moratoria, public guarantee schemes, borrower relief and liquidity support all contributed to the mitigation of

the impact of the pandemic on balance sheets. Of course, the impact of the pandemic will be revealed over time, as forbearance measures are wound down and public supports become more targeted.

The impact on banks' balance sheets will largely depend on the strength of the broader economic recovery. But as a result of the political and institutional strides we made in the early days after the financial crisis, we are now in a position to ensure that the banking sector can contribute to the recovery.

There are new challenges to face, in terms of financing the green transition and the increasing digitalisation of the sector and the wider economy, which will require enormous investment. For example, Europe will need an estimated EUR 350 billion in additional investment per year over this decade to meet its 2030 emissions-reduction target in energy systems alone, alongside the EUR 130 billion it will need for other environmental goals.

Governments cannot provide all of the funding for these transitions. We need to mobilise and direct private investment, through Banking Union and Capital Markets Union, to provide the majority of this funding. Well-functioning financial markets are critical to the future of our monetary union - as a shock absorber, to support the economic recovery and to drive the twin transition.

What are the missing pieces in the Banking Union? How can we move forward on this project?

All Member States agree that the completion of the Banking Union is important to drive economic growth and fund the green and digital transitions. As President of the Eurogroup, I am aiming to build consensus on the next steps take this project forward. We are aiming to agree on a work plan for Banking Union, which will be the political framework for holistic, stepwise and time-bound progress on our Banking Union.

This is a good opportunity to reflect on why the Banking Union we currently have may not suffice, and what we need to complete it.

Crisis management

- The establishment of a common European framework for the handling of large EU banks in a crisis - less than ten years ago - was a powerful outcome of the last financial crisis. To date, this EU crisis framework has only been applied once to resolve a bank. Mid-sized banks are considered not systemic enough to be resolved at EU level, but too big to be liquidated in an effective manner at national level. There is a gap in the framework here, which leads to different outcomes and use of public money depending on the country: this creates a risk for stability and distortion.
- There is broad consensus on the need to revamp the crisis management framework. The key questions relate to the scope of European resolution versus the national handling of failing banks, and to the common rules for the use of funds.

Integrated banking markets

- There is no single market for banking services today. Banks cannot allocate resources in a flexible manner across their entities, and deal with different corporate, tax and

employment laws, and differences in consumer protection and insolvency laws.

- This weighs on banks' cost structure, their governance and their ability to offer efficient, cheaper and better services to customers. There is a low level of bank consolidation in the EU, and they lag behind in size, profit and innovation compared to global peers.
- However, as important as promoting market integration and bank consolidation is, it cannot come at the price of financial stability, neither at EU nor at national level. Strong safeguards have to be in place.

Depositor protection

- The protection of deposits is handled at Member State level today. In case of a severe bank crisis, the existing national funds, financed by banks, could be depleted. This is also an element of fragmentation for the banks, which have to deal with multiple funds. Finally, there are divergences in the use of national funds for measures other than direct payout to depositors in the event of bank insolvency which again risks an uneven playing field.
- A broader European safety net would offer a larger liquidity pool to absorb shocks. This is key to strengthening citizens' trust - to avoid bank runs and contagion in other Member States. It is also justified by the fact that a significant part of responsibilities for defining the rule book and carrying out supervision has been transferred to the European level.

Sovereign exposures

- The financial crisis highlighted that the feedback loop from banks to sovereigns can endanger the stability of the euro area. This loop between banks and the sovereigns was at the very heart of the Banking Union project. Sovereign concentration in banks could be further addressed in our assessment of bank risks. Again, steps to help mitigate the feedback loop should not disrupt sovereign bond markets in the EU, especially in times of crisis where there are high funding needs.

In conclusion, we need to get the framework right for EU banks to be competitive and in a position to support a thriving economy. All the missing elements to complete the Banking Union are closely linked.

I expect my colleagues to work in a constructive and compromising spirit over the coming months. I think there is a path for collective success and a window of opportunity to act now, to set out a political framework so that the Commission can bring forward legislative proposals and deliver tangible change.



Q&A

IRENE TINAGLI

Chair of the Committee on Economic and Monetary Affairs - European Parliament

The challenge of the public and private investment in the EU

Latest forecasts by the European Commission paint a positive picture for investment. After a sharp fall in 2020, total investment are clearly recovering. However, we should not be overoptimistic in believing the picture will stay like this for long easily. The road ahead of us is hard and full of obstacles.

As we move forward, a number of economic and financial factors may induce the financing conditions to be not as easy as they are today. Private businesses will have to face deteriorated balance sheets, due to losses absorption and consequent higher leverage ratios, and therefore will tend to cut or delay investments. Governments' fiscal space will shrink, as they will be confronted to unprecedentedly high level of public debts and (hopefully new) fiscal rules will come back in the picture.

This potential adverse scenario will come at a time where the European Union will be mostly in need of investment. By 2030, the EU should reduce its greenhouse gas emissions by 55% (with respect to 1990 level), should have at least 40% of renewable sources in its energy mix and should increase its energy efficiency by 36%. According to the Commission estimate, the EU would need to invest approximately €595bn per year to achieve that (€470bn per year for the ecological transition and €125bn per year for the digital one).

The above-mentioned objectives are valuable in themselves, but they also have geopolitical and social implications. The digital transformation is vital to make sure Europe stays at the technological frontier, and not dependent on foreign countries. Furthermore, medium to long-term growth depends on today's level of investment. If private investments remain at a standstill, this will hamper future growth potential and EU's economy risks entering in a vicious circle. Lower growth potential would make fiscal rules imposed to governments tighter, leaving them less space to spend and forcing them to cut on investments, thus sustaining growth even less. In the meantime, higher rates of bankruptcies would generate higher levels of unemployment, making social expenditure more important and generating even more pressure on public productive investments. In addition, this

rise in unemployment would produce a loss of human capital and hence hampering even more the economy's growth potential, and so on and so forth. Overall, this ultimately poses a serious risk for the tenure of our institutions and for democracy.

We need to act fast and we need to act now.

National public budgets cannot bridge this huge investment gap on their own. Although there now seems to be growing support for the idea that green, digital and social investments should be favourably treated for the purposes of the constraints of the Stability and Growth Pact - which clearly cannot come back as it was pre-crisis - the issue of substantial indebtedness of the Member States is there, and poses an evident economic constraint. Therefore, it is clear that the public initiative will have to be accompanied by even more substantial private funding.

Despite the numerous reforms initiated or even completed in the last decade, European financial markets are not yet ready for this challenge. European finance is still largely segmented along national lines, with savers and investors depending heavily on national banking systems. The problem of nationwide fragmentation of the banking sector is not new on the European political agenda. The Banking Union was a response to this problem. Unfortunately, after a strong initial impulse having achieved an efficient first pillar (supervision) and an important but still improvable second pillar (resolution), Banking Union now lacks momentum and remains incomplete. Yet, the completion of the Banking Union is key for tomorrow's challenges.

Moving towards a true single banking market through cross-border restructuring is above all 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. At the macro level, Banking Union would decisively enhance private risk sharing within Europe and, in conjunction with parallel progresses towards a Capital Markets Union, would enable a better channelling of our abundant savings toward

the important targets of the EU in terms of digitalisation and green transformation of our economies.

The project of the Banking Union can be brought forward only within an holistic approach. However, some work-streams should be prioritised in light of their greater urgency in relative terms and the more essential role they play to complete the Banking Union. I am referring to the introduction of a European insurance scheme on deposits and to the crisis management framework. Such reforms are strictly interlinked and are pivotal in limiting market fragmentation and creating a true level playing field across the euro area.

As for the former, the reason for its prioritisation is straightforward. In order to accomplish a real Banking Union, depositors across the Euro Area need to be sure that they can rely on the same safety net. Such a result will be ensured only by an insurance scheme on deposit providing full loss-coverage. Any work plan on the completion of the Banking Union must explicitly acknowledge this element as the end goal, and indicate a clear-cut timeline to achieve such goal. Hybrid solution are acceptable only a first step towards a fully mutualised mechanism, with clear loss-absorbing features and a pre-defined timeline.

The adequacy of the EU banks' crisis management framework is the other main issue that should be addressed quickly. Everyone recognizes that the creation of the Single Resolution Mechanism represented a big step towards facilitating the orderly resolution of significant institutions with minimal or no taxpayer involvement. However further improvements should be discussed also in line of the considerations made both in the European and international fora on the shortcomings of the current framework. In this regard, one of the main issue is whether the BRRD framework is suitable for handling the crisis of small and medium-sized banks. The experience of recent years does not appear to be encouraging. Indeed, most medium-sized banks (not to say smaller ones) are not equipped to tap capital markets to issue MREL-eligible instruments. It is therefore of utmost importance to introduce a harmonised framework for the crisis management for these institutions.

This would ideally be achieved via the implementation of a European framework for an orderly liquidation regime of banks failing the public interest test, financed by the national deposit guarantee schemes. The positive example of the Federal Deposit Insurance Corporation (FDIC) is often mentioned in this regard. However, it should be heard in mind that FDIC not only manages orderly liquidation or preventive measures. One of the key success factors of the FDIC is the possibility of combining resolution and deposit guarantee functions for all US banks. A European insurance scheme on deposits is the only element that can ensure consistency between the responsibility of the crisis management and the level where costs are borne. This is the reason why these two reforms are strictly interconnected.

A common insurance scheme on deposits is also the essential element to move beyond home/host issues. On this issue, we should start from the effective implementation of cross-border liquidity waivers within the Union, as prescribed by the European legislation. Moreover, some additional efforts should be done as regard the extension of intra-group capital and liquidity waivers. So far, the main obstacle to these waivers was exactly the absence of and European insurance scheme on deposit, since this created a discrepancy between the place where the resolution decisions are made and the place where the material disbursement of the funds takes place. This once again proves how important it is to start from the third pillar of the banking union to find a solution to the other problems.

A stronger and integrated banking system is key to contribute to the financing of the digital and green transformation of our economies.



Q&A

VERENA ROSS

Chair - European Securities and Markets Authority (ESMA)

ESMA Chair's perspective: opportunities and challenges for strengthening capital markets in the EU

What are the key priorities for ESMA in 2022 and the challenges ahead?

As I get into my first calendar year as Chair of ESMA, I can see both a challenging and exciting time ahead. While the EU economy is now on a path to recovery, uncertainty over the speed and resilience of that recovery persists. On top of this, financial markets are changing rapidly through digitalisation and the need to support the sustainability transition. These developments present big challenges, but also opportunities, not just to the markets themselves but also to the EU securities regulatory and supervisory community.

ESMA has a highly ambitious work programme for 2022. Developing rules for both sustainable and digital finance, and supporting their convergent implementation, remains a key priority. The legislative frameworks and market practices in these areas are evolving fast, so it is important that we are on the front foot. Another ESMA priority is to support the development of effective EU capital markets, for the benefit of companies and investors, and in that context, we have an important role to play on various CMU initiatives and associated reviews of EU legislation. For example, the creation of the European Single Access Point (ESAP) and consolidated tapes for various financial instruments will be essential steps forward to increase transparency in the EU markets.

Finally, ESMA's more established tasks continue. Our supervisory convergence agenda remains as busy as ever, with the aim to ensure a risk-based and outcome-focused, consistent, and coordinated approach to supervision across the whole EU market.

This is all about building a common supervisory and enforcement culture in the EU, protecting investors, and supporting orderly and stable financial markets. And last but by no means least, our direct supervisory responsibilities remain a fundamental priority. There are high expectations on ESMA to directly supervise on a day-to-day basis an

increasing range of entities, based on an effective risk-based and data driven supervisory approach.

How is the role of ESMA expected to evolve in the coming years? Are we going towards a stronger operational role for ESMA and an increase of direct supervisory responsibilities?

In an ever-changing world, I believe we can expect that ESMA's role will continue to evolve over time. ESMA was a very different organisation when it was established 11 years ago. With financial markets continuously transforming (e.g., the rapid digitalisation of finance and related innovation in new products), it is vital that the authorities overseeing these markets have the tools to ensure stability, credibility, and investor protection in tandem.

There is no doubt that ESMA's supervisory capacity has grown significantly, based on new mandates in the revisions of ESMA's founding regulation and sectoral legislation. Since January this year, we have assumed supervisory responsibilities for critical benchmarks and data reporting service providers. Before that, securitisation repositories and significant non-EU CCPs came within our supervisory scope.

Of course, these all came on top of our original supervisory responsibilities for CRAs and Trade Repositories. ESMA's reputation as a credible and effective direct supervisor means that we are well placed and prepared for further duties in the future, if and when such direct supervision at EU level is merited.

Outside of supervision, ESMA's roles and powers continue to evolve as the EU pushes forward on key initiatives such as sustainable and digital finance and in developing the CMU. Our proposed roles in relation to the ESAP and the consolidated tapes are just two examples of where ESMA will

have substantial responsibility in the delivery of important EU-wide projects that will make a difference to the EU capital markets.

The operational implications of these new duties are challenging, as we must manage the seamless implementation of new tasks with staffing and budgeting constraints. In this context, it is vital that the EU supports new initiatives with appropriate resource allocation so that they can be credibly delivered on. ESMA has built up its skills and experience over the last decade, but at its core remain the national authorities. The effective cooperation with them is of immense value and contributes directly to ESMA's success.

Has significant progress been made in the building of an effective EU capital market since the launch of the CMU initiative? What can be a reasonable ambition for Europe in this regard?

From my perspective, progress has been made, but more needs to be done to increase the role of market-based funding sources, especially considering the urgency to channel private capital flows towards sustainable economic activities. Improving access to a diverse range of funding possibilities for European companies, and improving the overall attractiveness of EU capital markets, continues to be a priority as we seek better ways to finance the recovery and the necessary changes to the EU economy.

Overall, further initiatives are needed to allow financial markets to play a more central role and ensure investors can engage in the capital markets in a well-informed and safe way. Therefore, I welcome the extensive and ambitious package the Commission presented in November 2021.

Looking ahead, building an effective EU capital market requires further work to boost retail participation. The picture of citizens' involvement in capital markets across Europe is now very divergent. As an example, in Greece around 85% of household savings are held in bank deposits with the remainder in financial investments. If we look to countries such as Sweden and the Netherlands, we find almost a mirror image with 81% of savings invested, either directly or indirectly.

The Commission's retail investment strategy, which is due to be presented in the first half of the year, will be an important opportunity to reflect on how to streamline investor protection rules, strengthen the support investors can get, and tackle the benefits and risks stemming from digital innovation.

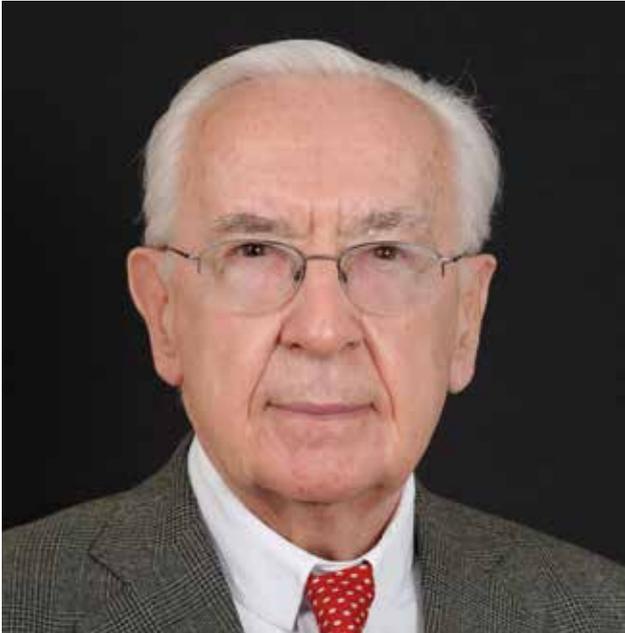
In addition, a pre-requisite to a strong CMU is a common supervisory approach by national authorities, based on a harmonised set of rules. Achieving convergent supervision will lead to a true level-playing field that will foster aligned outcomes across the EU for both firms and investors.

Will the CMU action plan published in November 2021 and the MiFIR review proposals allow a step change in terms of development and integration of EU capital markets?

The CMU package published by the Commission in November 2021 is in my view an extensive and ambitious set of proposals and a step in the right direction.

MiFID II has not met its objective to deliver a consolidated tape. I therefore find it very encouraging that the Commission is now proposing measures to address this. ESAP will enhance investor protection by improving the accessibility and usability of information, notably for sustainable investing. The proposals regarding funds are important to help promote long-term investments, which are key to the recovery, the sustainable transition and to digital infrastructure.

While these are all important steps to help foster retail participation and ensure an appropriate regulatory environment for businesses, there are broader obstacles to capital market integration that need to be resolved at the same time. For example, different national fiscal and insolvency rules continue to contribute to market fragmentation. Aligned ambitions and coherent reform across the entire EU capital markets ecosystem is a must to achieve a successful CMU.



JACQUES
DE LAROSIÈRE

ECB needs to change gear

During the Lehmann Brothers, EU sovereign debt and Covid crises, central banks and fiscal policies played a crucial role and intervened on an unprecedented scale to keep financial markets liquid and stabilize the financial system.

Meanwhile central banks have been overly involved during the past years. No well-functioning economy should operate with real interest rates that remain negative for too long: capital is then misallocated and growth impaired.

Can money creation indefinitely outpace the pace of economic growth? Can we ignore the financial vulnerabilities created by zero interest rates, the inexorable rise in global debt and the “search for yield” when productive investment has performed poorly over the past 15 years? Does the resumption of activity in Europe require the extremely accommodative stance of monetary policy? Can we stop inflation in Europe with increasingly negative real interest rates and continued QE programmes? Is the priority mission of central banks to protect States from fiscal difficulties by financing their deficits rather than to protect the purchasing power of citizens by fighting inflation, even if it means risking a social crisis to avoid a financial crisis?

The continuation of very low interest rates in the euro area would intensify already negative consequences for financial stability, growth and employment. As the Eurofi monetary scoreboard (February 2022) demonstrates, pushing too hard and too long on the monetary pedal has severe negative consequences: the lasting excessively accommodative monetary policy enhances incentives to borrow more and increase financial leverage, disincentives governments to undertake structural reforms since borrowing “no longer costs anything”. Persistent low or negative interest rates induce a fatalistic mindset that lowers, not raises, propensity to invest. Under what J.M. Keynes called the “liquidity trap”, investors play safe by placing savings in very short-term instruments rather than deploying them longer term when low interest rates bring them inadequate returns for higher risks.

The social significance of persistent very accommodative monetary policies should not be underplayed. Did they help reduce societal inequalities? In fact, the opposite is

true; they tend to make societal disequilibria worse because the beneficiaries have been those who have the income and capital to profit from inflated financial and asset markets. Not poor people.

Thinking that monetary creation can notably solve the problems arising from excessive debt is an illusion. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that will inevitably pose systemic risks to financial stability and therefore to future growth. Actually, the huge monetary and fiscal stances of the last decades have not led to investment or higher growth. In other words, supply-side obstacles cannot be resolved by throwing conjunctural money at problems.

Monetary policy can erase spread differentials in the euro area but cannot relaunch capital flows from the North to the South. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita-capital countries (Spain, Italy, Portugal, Greece). This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between the eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area reflect the persistent doubts of investors in Northern Europe about the solvency of states and companies in other countries, as well as the lack of a genuine Banking Union and integrated financial markets.

Policy makers need to rebuild safety margins. As stated by the BIS in its Annual Economic Report (June 2021), “an economy that operates with thin safety margins is vulnerable to both unexpected events and future recessions which inevitably come. These margins have been narrowing over time. Rebuilding them means re-normalising policy”.

Inflation has risen sharply in recent months and could be more persistent than thought which would endanger the economic rebound: indeed, inflation is lowering notably real revenues and the earnings of companies with negative consequences not only for consumption, but also for investment.

Easy money policies have become even more accommodative because of rising inflation, which has caused negative real rates to fall still further. It is rational to believe that wage-earners will react substantially to higher prices. Trade unions will insist on some form of compensation or indexation to adjust wages. In theory if inflation abates, price adjustments should disappear. But experience shows that it takes a long time to get rid of indexation, because it comes a habit and even a social right.

Central banks are behind the curve and need to move more quickly. In such a context, Federal Reserve Chairman Jerome Powell has announced an accelerated ending to the Fed's quantitative easing through massive government bond purchases. This delivers an urgent message worldwide. If central banks fail to act now, the economic rebound could be running into severe problems. Inflation will lower real revenues, prompting destabilizing wage demands, from income-pressed workers.

The world should move gradually and cautiously towards monetary normalisation, in order to avoid a cliff effect. Central banks should pursue without compromise their primary objective of monetary stability, especially without taking governments' funding costs into consideration as well as the kind of addiction and dominance of markets that is hard to give up, markets regularly challenging central banks with instability and the threat of correction as an — even modest — tightening in monetary conditions approaches in the end acting as inhibitors.

As W. White stated, “until now, central banks have been lured into a “debt trap” where they refrain from tightening, to avoid triggering the crisis that they wish to avoid, but that restraint only makes the underlying problems worse”.

Normally, central banks policies should tighten when inflation threatens, and overheating is apparent. Instead, we see the opposite: a significant de facto loosening. The climbing of inflation from 1% to 5% in Europe with still no significant upward adjustment in interest rates results in a huge further monetary stimulus. Responding this with assurances that price pressures are ‘transient’ is not sufficient.

Waiting too long will not make life easier: neither for central banks nor for the economy. Indeed, the risk is that hesitation could force central banks to tighten credit far more abruptly later on, causing more pain than if they acted in timely fashion. Preparing for European interest rates to return to more normal levels would not only be a signal of central bank independence on both states and markets, but also be the first step to a more productive post-pandemic period of higher growth and productive investment.

Fostering a sustainable path to stronger growth is essential, notably in the current indebtedness environment. Raising long term potential growth requires structural reforms, an appropriate remuneration of risky investments and sustainable fiscal policies designed to deliver a flexible and competitive economy. Lost competitiveness due to postponed reforms in many EU countries, has led to the deterioration of the potential growth which cannot be improved by cyclical policies. Monetary policy cannot do everything; and more productive investment does not require more redistribution by budgets: only domestic structural - supply side oriented - reforms can resolve structural issues and foster productivity and growth. The Next Generation EU package, if well implemented, should be useful in this respect.

In over-indebted countries, governments must take corrective actions to ensure a path of primary fiscal balances and reduce unproductive and inefficient public spending. Reforming the Stability and Growth Pact is an urgent necessity.

Only productivity enhancing, and productive investment can create sustainable increases in productivity, neither negative rates, nor QE.

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POST-COVID ECONOMIC PROSPECTS AND REFORMS

ISSUES AT STAKE

The euro area economy is recovering as vaccine rollouts accelerate although the pace of recovery is uneven across EU member States. Funds from the NGEU recovery package have begun to flow, providing further resources to EU countries.

The Covid-19 crisis and the supportive measures that have been put in place have increased the heterogeneity of fiscal performance across EU Member States and led to a substantial increase in debt levels, which is a source of under competitiveness. In addition, inflation has increased sharply in recent months and could be more persistent than thought which would endanger the economic rebound. Indeed, inflation is lowering notably real revenues and the earnings of companies with negative consequences not only for consumption, but also for investment.

Raising long term potential growth requires structural reforms, an appropriate remuneration of risky investments and sustainable fiscal policies designed to deliver a flexible and competitive economy. Central banks need to move quickly to avoid sharper correction later. In over-indebted countries, governments must take corrective actions to ensure a path of primary fiscal balances and reduce unproductive and inefficient public spending. Reforming the Stability and Growth Pact is also an urgent necessity.

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POST-COVID PRIORITIES



FRANÇOIS VILLEROY DE GALHAU

Governor - Banque de France

“Look up”: a Financing Union, at last, to fund a greener and more digital post-crisis Europe

Two years ago, the Covid crisis broke out and called for a strong response from public authorities, for which the financial sector acted as an efficient transmission belt to the real economy. However, despite its resilience, our European banking and financial markets remain deeply fragmented. As we can now reasonably hope to exit the pandemic, it is time for firefighters to hand over to architects.

The Banking Union and the Capital Markets Union (CMU) would both enhance risk sharing within Europe and improve private stabilisers, which are just as important and efficient as public ones – and less divisive than this common fiscal capacity – in addition to our successful monetary Eurosystem, a financial Eurosystem should now see light.

The Banking Union is crucial to create large pan-European banking groups, raise their profitability thanks to scale effects and better face up to foreign competition. And yet after a strong initial push in which we built an effective first pillar (supervision) and achieved important work on the second pillar (resolution), Banking Union is now on hold. We need to move forward again, breaking the “EDIS deadlock”, with simultaneous and parallel movements on several fronts. We should not focus on the creation of new instruments, but rather try and make existing ones work better.

First and foremost, we have to move beyond home/host issues, for instance via the broader use of cross-border liquidity waivers as currently allowed by the regulation, and ideally new waivers for intra-group MREL and capital requirements. A system of workable guarantees between the parent company and its subsidiaries, a preferential treatment for intragroup exposures, and / or a more extensive recourse to branches rather than subsidiaries are other paths to explore.

In designing future solutions, we naturally have to foresee worst-case scenarios including the possibilities of a bank's resolution or insolvency. This entails finding realistic alternatives to EDIS, for instance a scheme where foreign subsidiaries would be affiliated to the home deposit guarantee scheme. Resolution tools could be used for small and medium banks too, without increasing the size of the Single Resolution Fund. Liquidity in resolution could be provided by the Eurosystem, intertwining with the issue of the guarantee framework that must support this facility.

The CMU is the natural complement to the Banking Union: capital markets and banks together provide diversified sources of financing, offering both safety and flexibility to economic agents. From a central bank point of view, a deeper and more integrated financial system is desirable, as integrated capital markets help absorbing asymmetric shocks and improve the transmission of our single monetary policy to all parts of the euro area.

The good news is that the euro area has abundant savings: the surplus of domestic savings over investment structurally exceeds to EUR 300 billion. Yet the world's largest pool of savings is not sufficiently channelled to productive investment, and the EU keeps lagging behind Asia and the United States in terms of innovation. We can measure this lag in venture capital – the most suited way to finance and accompany the development of young and innovative companies. Over the last decade, fundraising by the ten biggest European funds (including the UK and Switzerland) represented only 15% of the ten biggest US funds.

Rather than a collection of segmented national markets, Europe has to transform – at long last – into a seamless single market.

The Commission launched a new CMU action plan in September 2020, with several items that are all welcome and relevant. The main issue at stake now is to ensure its concrete implementation. More broadly, the success of CMU and BU does not depend on an ever-improving technical agenda; it depends on a much stronger political impetus. To this end, we should rebrand the CMU in a way that better reveals its goals: financing the digital and ecological transformations.

Rather than a collection of segmented national markets, Europe has to transform – at long last – into a seamless single market.



NADIA CALVIÑO

Vice-President and Minister for Economy
and Digitalization, Spain

A renewed EU fiscal framework for the future

There is a growing consensus on the need to reform the EU economic governance framework. The review process was launched before the pandemic, in view of the clear shortcomings of the system in terms of complexity, coherence and alignment with economic reality. Since then, the unprecedented shock and its deep impact on the economic, social and fiscal stance of most countries has made it clear that we need to update our rules and procedures in order to make them future proof.

This review can build on the historical response to the pandemic, which has opened a new outlook on how to reinforce our policy coordination and improve its effectiveness. We have deployed an unprecedented coordinated response at national, European and global level that has been key to preserve financial stability, to protect businesses and employment and to allow for a fast recovery. Our economies and societies have also undergone a significant transformation and new challenges have emerged.

Discussions are expected to intensify in the upcoming months and, to succeed in this crucial task, we will need to avoid the divides of the past. There is an important lesson from the experience of this crisis that we should bear in mind as we move forward: we are all on the same boat, and united we are stronger. Entrenched positions will not get us far. This is a future-oriented discussion and we need a forward-looking approach based on the broad consensus emerging. Certain elements will be particularly important going forward.

First, our starting point is one of substantially higher debt-to-GDP ratios than before the crisis. In order to be ready for the next shock, we need to create fiscal space. In fact, a responsible fiscal policy in Spain has allowed for an important reduction of deficit and debt to GDP ratios already in 2021. We will continue on the same track of fiscal responsibility in the coming years, benefitting from strong GDP growth. However, in a context of higher debt levels across EU Member States, we should reinforce public finances in the long term with a realistic and pragmatic fiscal framework. We need a pragmatic and country-specific approach for fiscal consolidation to be credible and effective. Debt reduction should be realistic, gradual and sustained, compatible with economic growth and job creation in order to ensure fiscal sustainability.

Second, in the coming years, we will also need to undertake an unprecedented investment effort to drive the necessary green and digital transitions. In previous crises, public investment and other growth-enhancing expenditure were the first victims of fiscal consolidation policies. Spain is a case at hand, as public and private investment dropped in the six years following the outbreak of the last financial crisis and it

never recovered, dragging potential growth and prosperity for several generations. These strategies proved to be ineffective, leading to a protracted underinvestment, weakening potential growth and social welfare and jeopardizing fiscal consolidation efforts.

The ambitious objectives of EU Green Deal and the EU Digital Strategy will require an unprecedented amount of public and private investment by 2030. While indeed Next Generation EU will partly cover these needs during the first years of the transition, nationally financed public investment will also increase. The fact that we are all on the same boat is particularly relevant in this regard. When it comes to climate change, for instance, our citizens would not understand that necessary investments are delayed in some countries because of insufficient fiscal space. This is a shared challenge and an issue of intergenerational fairness that requires a decisive common response. Moreover, leading and succeeding in these structural transformation processes is an essential element of our strategic autonomy and our future role in a fast changing and challenging international context.

**“We should reinforce public finances
in the long term with a realistic and
pragmatic fiscal framework.”**

Third, we need to draw lessons from recent experience. Contrary to the controversial approaches of the past, the national ownership of investments and reforms of the Recovery and Resilience Facility and its multiannual approach can be a very useful source of inspiration to promote a virtuous circle with improved enforcement and impact of fiscal strategies.

Fourth, timing is crucial. We need a renewed framework by 2023 and we have no time to lose. We cannot go back to the old rules. They were not fit for purpose before the pandemic and cannot be applied as such in the new reality.

All in all, by 2023 we need a growth-friendly fiscal framework that reinforces financial stability, supports the recovery and job creation and is adjusted to the specific circumstances of different countries. Spain will continue to contribute active and constructively to this fundamental process, that will determine the scope of the post-pandemic economic cycle and the standing of the EU in the new geopolitical landscape.



KLAAS KNOT

President, De Nederlandsche Bank (DNB) & Chair,
Financial Stability Board (FSB)

The global impact of European regulation

After the global financial crisis, the Financial Stability Board (FSB) coordinated a comprehensive reform program. These reforms, which promoted close cooperation and strong international standards, strengthened the financial system and made it more resilient to withstand the economic shock from Covid-19. Economic developments and structural changes will continue to pose new challenges in the coming years. In its work program, the FSB will focus on the pandemic recovery as well as long-term structural changes within the financial system. This article discusses how the regulatory agenda of the EU could play an important role in these discussions and catalyze further reforms to enhance global financial stability.

When the Covid-19 crisis erupted, financial institutions were in a much better position compared to 2008/2009 to absorb losses and continue lending to the real economy. As a result, the financial system did not create the same amplification effects that we saw during the global financial crisis. Nonetheless, the vulnerabilities experienced within the non-bank financial sector provide new lessons for the regulatory framework. In addition, the pandemic accelerated fundamental trends such as digitalisation. Moreover, the necessary extraordinary fiscal and monetary support measures have increased underlying vulnerabilities associated with search for yield, economic divergence and public and private indebtedness. From its cross-sectoral and global perspective, the FSB plays a central role in monitoring these developments and coordinating the international response. The EU can contribute to these objectives in various ways.

First of all, the EU has always been – by nature – a strong partner in fostering international cooperation and high-quality minimum standards among jurisdictions. The EU should aim to lead by example by implementing reforms in a comprehensive and consistent manner. A harmonized approach can sometimes involve a trade-off with practical challenges in specific regional circumstances. However, any differences need to be balanced against the need for a global perspective and keep in mind the objective of maintaining a level playing field. In this context the EU could make further progress in implementing the Basel III standards in accordance with the internationally agreed framework.

Second, the EU can play an active role in implementing the lessons from the recent crisis. The immediate challenge is to facilitate an orderly exit from the different support measures without creating shock effects or scarring the economy and bearing in mind the risk of spillovers to other countries from uncoordinated actions. In addition, supervisors need to strengthen the regulation of non-bank financial intermediation (NBFi), which experienced a short, but intense period of stress in the initial phase of the pandemic. The FSB is coordinating international policy

efforts to make the NBFi sector more stable and to mitigate liquidity risks that can emerge during stress. In addition, the economic divergence within Europe during the Covid-19 crisis has once again highlighted the unfinished agenda of completing the European banking union and breaking the interconnectedness between governments, the domestic banking sector and non-financial corporates. Additional measures are also needed to develop the European Capital Markets Union and facilitate private risk-sharing.

How can the regulatory agenda of the EU catalyze reforms to enhance global financial stability.

Finally, the EU can play a leading role in supporting the transformation of the financial system. For example, the EU is ahead of the curve with the development of a green taxonomy and incorporating climate risks into day-to-day supervisory activities and stress tests of the Single Supervisory Mechanism (SSM). The financial sector can play an important role in combatting the effects of climate change. Another challenge of a clearly global nature, is the crypto-asset market, which is growing fast and becoming increasingly connected to the traditional financial sector. The FSB will examine both unbacked crypto-assets and stablecoins to monitor risks to financial stability and to identify regulatory gaps. Experiences within the EU with the development of the Markets in Crypto-Assets Regulation (MiCAR) can provide valuable input for these discussions. More broadly, the digitalisation of the financial sector will bring new risks to financial stability worldwide and will require new and harmonized regulatory approaches among jurisdictions.

I am convinced that an ambitious EU approach that builds upon ongoing international efforts will strengthen the European financial system and reinforce global financial stability. From an FSB perspective, I would therefore encourage continued close interaction and cooperation to meet these new challenges.



MÁRIO CENTENO

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

Post-pandemic monetary and fiscal policy and EMU deepening

Over the coming years, the policy action must combine short-run stabilisation with a robust long-run institutional setup. In the euro area, despite the improvement in the crisis response apparatus since the financial crisis, fragilities persist. Coupled with the scars from the pandemic and its uneven effects across sectors and economies, the institutional fragilities may hamper economic growth and limit financial integration.

Monetary policy should safeguard the transmission mechanism, while pursuing the primary objective of price stability. It should make use of the flexibility enshrined in the purchase programmes, guaranteeing a gradual pace for the future normalisation. This is not to say that monetary policy should abstract from the recent surge in inflation, but there are strong reasons for keeping a steady-hand.

First, it is hard to argue that its drivers are “monetary”, imprinting inflation expectations and contributing to disanchoring.

Second, despite excess demand in some markets, we are witnessing a natural process of relative price adjustments, reflecting relative scarcities, and adjustments towards a decarbonized economy. Still, well-identified and arguably temporary supply bottlenecks are part of the story.

Third, although a strong recovery in demand would eventually call for a policy response to restrain demand and refrain the surge in inflation, there would be welfare costs and, foremost, unsurmountable coordination aspects beyond the reach of monetary, and I dare say, fiscal policies. Such response could delay the adjustments in supply and hence to inflation. Embarking in a generalized restrictive loop, when we face exogenous shocks, will not help the economy overcome these challenges. Overall, the review of the ECB’s monetary policy strategy has just confirmed its medium-term orientation, as “the appropriate monetary policy response to a deviation of inflation from the target is context-specific and depends on the origin, magnitude and persistence of the deviation”.

Fiscal policies should address possible asymmetries in the recovery. However, it is important to start a gradual transition towards a neutral stance. Whereas the current environment of low interest rates may favour the effectiveness of expansionary fiscal policy, it remains important to strike the right balance between stabilisation and sustainability, ensuring a sound interaction with monetary policy. The fiscal strategy should be prepared for a transition towards the normalisation of monetary policy. In this context, it is reassuring that initiatives taken under the NGEU instrument offer ample opportunities for a sustained recovery process.

Their effectiveness will depend on channelling funds towards high quality and productive investment. It is now up to the Member States to deliver upon this extraordinary moment of European integration and solidarity. Failing would weigh on the future of Europe.

The milestones of an agenda for a long-run institutional setup are known, but lack consensus on their relative importance and prioritization. Evolving conditions and challenges shift priorities, but the main features are consensual. Climate and digital transitions will influence implementation, but, above all, will benefit from it. The establishment of a complete banking union in all its three pillars, the review of the crisis management framework and the implementation of the capital market union should continue to be part of the financial agenda. Progress should accommodate worries and concerns from all sides, but must be steady. On another front, fiscal risk-sharing is also desirable. Coordination of fiscal policies among member-states is insufficient.

**[...] policy action must combine short
run stabilization with a robust long-run
institutional setup.**

It is fundamental to build on the NGEU and aim for common debt and budgetary instruments that have proved their success. The approval of the Budgetary Instrument for Competitiveness and Convergence before the pandemics was a huge step, reflected already in the NGEU framework and financing. We should not rest on these glories, but make further progress towards a truly European institutional landscape, without dead-ends or rough cliff edges.

One of the lessons of this crisis is that monetary and fiscal policy can coordinate naturally, and hence mutually reinforce each other. Preserving the autonomy of both policies while contributing to the welfare of our citizens is possible and desirable.



VITORIO GRILLI

Chair of the Corporate and Investment Bank EMEA
J.P. Morgan

EU financial integration through the CMU and Banking Union

Over seven years have passed since the European Commission's Green Paper on Capital Markets Union (CMU), and ten years since the launch of the Banking Union. JPMorgan has been a strong supporter of the goals of both since their inception, which is about developing a more diversified financial system with deep capital markets complementing healthy bank financing. This should enable cross-border investment without barriers, and allow businesses to more easily raise funds. I have personally invested in both initiatives, during my time as Italian Finance Minister and as a member of the Commission's CMU High-Level Forum.

The EU has made strong progress on both, having finalised legislation on securitisation, covered bonds and private pensions, and with the creation of the single supervisory and resolution mechanisms.

A report last year from AFME shows that there was record levels of capital markets funding supported EU businesses in the first half of 2021, reflecting significant recapitalisation needs in response to the pandemic and favourable conditions for raising capital. In particular, European primary capital markets continued to expand during the first half of last year for the third consecutive year, with the proportion of markets-based funding for EU corporates rising to 16.8%. Capital markets funding to European SMEs has also grown at a record rate.

Considerably more banking activities that used to be conducted from London are now conducted from the EU27. For example, at JPMorgan, we have recently completed the consolidation of our EU presence into a single legal entity, known as J.P. Morgan Societas Europaea (JPMSE), which operates a network comprising 14 branches across the EEA and the UK, making us among the top 20 ECB supervised banks with a total capital base of around €34 billion.

Aggregating across the whole industry, this built-out is considerable. The thinktank NewFinancial has produced research showing that more than 440 firms in the banking and finance industry have relocated part of their business, that banks have moved more than £900bn in assets, and insurance firms and asset managers have transferred more than £100bn in assets and funds. This roughly tallies with the €1.2 trillion in banks assets (£1.05tn) that the ECB says banks have agreed to move. Final numbers will likely be larger.

But more work is needed to improve EU financial market integration. Last November, we had a "mini-CMU" package, which included legislative proposals to reform ELTIF and to create a European Single Access Point which would establish a European-wide company data registry system. These could help move the needle. We are also expecting further proposals

in the coming months on securitisation, which we think is a bridge between the CMU and the Banking Union. When developed in such a way as to be responsible, prudentially sound and transparent, securitisation can be an important vehicle to increase the capacity of banks to lend, especially to SMEs, and also for investors to have access to European credit products.

Going forward, it will also continue to be important that the EU remains open to international financial markets. The participation of global firms in the EU system brings added competition and market depth, to the benefit of EU clients. Non-EU firms increase diversification and resilience of financial services provisions in case of disruption affecting EU firms. JPMorgan, for example, increased its lending by over 20% between 2019-2020, indicating our commitment to Europe in a time of difficulty.

More work is needed to improve EU financial market integration.

It is reassuring that recent initiatives from the European Commission recognise the importance of international cross-border practises, such as third country branches and the delegation of portfolio management to third countries, which has contributed to the success of UCITS on a global scale. We are hopeful that this same approach will be adopted when it comes to the use of so-called national access regimes, which EU corporates use to optimise their capital raising and financing.

There will unlikely be a moment when the CMU nor the Banking Union are declared "complete". Instead, they will be ongoing processes, with progress depending on incremental steps, continued political momentum as well as the avoidance of 'pitfalls' that could be detrimental to cross-border market financing. We will continue to build.



LUIGI FEDERICO SIGNORINI

Senior Deputy Governor and Member of the Governing Board
Banca d'Italia

Highlights of the G20 Work in the financial area under the Italian Presidency

Italy took up the G20 Presidency in the midst of the pandemic crisis, when global economic activity while recovering was still far below its pre-Covid level. Thanks to the extraordinary public support extended to households and firms and to the prompt coordinated reaction of monetary and other financial policies to the crisis, in 2021 the world experienced a strong recovery. The rapid roll-out of vaccines in developed countries led to a gradual lift-off of restrictions to economic activity and to a resumption of investment and consumption, with much fewer bankruptcies than expected.

Many advanced countries have reached or are close to pre-crisis output levels although the recovery remains vulnerable to risks owed to an evolving pandemic, persisting supply-side bottlenecks, and diverging economic outcomes.

Under the Italian Presidency the G20 took actions to help the weakest economies hit disproportionately by Covid-19. It provided support to multilateral mechanisms ensuring wide access to tests and vaccines. It established a new Panel on prevention and preparedness which advanced proposals to improve the mobilization of funding and enhance coordination between Health and Finance Ministries and international organizations. Work to deliver a shared solution will continue in the next months.

The G20 also agreed to suspend debt service payments for 50 countries and to make available 650 billion dollars in additional reserves through a general SDR allocation. Follow-up work aims to develop actionable rechanneling options which will allow low income countries to receive further support.

On international taxation, to address fairness issues posed by globalization and digitalization the G20 endorsed an important agreement which sets rules for the reallocation across jurisdictions of taxes on excess profits of multinationals and introduces a minimum level of taxation. Work on implementation will be completed by 2023.

The Italian Presidency also focused on longer term economic drivers, in primis the fight against climate change, giving priority to the issue of sustainable finance. It promoted the creation of the Sustainable Finance Working Group under the leadership of the United States and China as a permanent mechanism for coordinating the mobilization of resources to finance the transition and mapping future G20 work through its Roadmap. In 2021 it concentrated on strengthening the approaches for aligning investments to sustainability goals and on overcoming informational challenges by improving reporting and disclosure. A further initiative is the request to the IMF and other international organizations to consider climate-related data needs in preparing a new Data Gap Initiative.

The growing digitalization of payment and financial services during the pandemic offers opportunities but brings risks for financial inclusion. Under the Italian Presidency the Global Partnership for Financial Inclusion co-chaired by Italy and Russia focused on these risks and developed a menu of policy options for enhancing financial consumer protection and financial education; its work also targeted the facilitation of remittance flows and the reduction of transfer costs. A related workstream concerns the Roadmap for enhancing cross-border payments. In 2021 the G20 achieved consensus on a set of ambitious targets for costs, speed, access and transparency of these payments that will help measure progress in the main areas of intervention. The implementation of the Roadmap will be taken forward according to its milestones and timelines.

**Sustainable finance and NBF
resilience were among the priorities of
the Italian G20 Presidency.**

The Italian Presidency focused on two further issues concerning financial stability. One relates to the outcome of the analysis of the performance of the financial system faced with its first test of resilience since the global financial crisis which shows that the regulatory reforms of the past decade have made the financial system more robust, although some issues and gaps remain to be addressed. The other concerns the efforts to strengthen the resilience of the non-bank financial intermediation sector (NBF): the G20 achieved a consensus on an agreement to assess and address money market fund vulnerabilities in their jurisdictions, using the framework and policy toolkit set by the Financial Stability Board. Further work will be conducted to improve NBF risk monitoring and mitigate liquidity risks in open-ended funds.

OPEN STRATEGIC AUTONOMY: IMPLICATIONS FOR FINANCE



EMMANUEL MOULIN

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

European financial autonomy after and beyond Brexit

With Brexit, the European Union de facto lost its main financial center. It raised again the question of our financial autonomy, in particular when it came to market-related activities. We all became aware of the need to reduce our dependence vis-à-vis external players, in other words to develop the financial centers of the European continent.

I believe that we have made some progress in this regard. European equity trading has been massively relocated within the block. Our clearing business is gaining market share. The relocation of financial institutions and staff has also been significant: almost half of London-based financial services firms have moved or plan to move some operations and staff to the European Union since the Referendum. We see an original model taking shape in the European Union with several integrated financial centers,

each with its own specificities and comparative advantages.

That being said, the issue of European autonomy in financial services extends far beyond Brexit. We must not lose sight of the essential. The real challenge is whether our financial system is agile and powerful enough to back our most promising entrepreneurs and businesses, to invest in the rest of the world, to deliver strong returns to savers and to remain at the frontier of innovation. From this point of view, the current situation is not fully satisfactory. We are yet to build a European financial system up to the task of financing the twin green and digital transitions.

Indeed, we have a formidable stock of financial savings which still does not sufficiently finance the productive economy. For example, too many innovative European companies still rely massively on American capital for growth financing, whether for late-stage funding rounds or initial public offerings. Only 28% of investors in the top 20 European growth companies are Europeans. There is still ample room for the Capital Markets Union to support the development of European financial markets, which is why we adopted and strongly support the Capital Markets Union action plan.

**The challenge is whether
our financial system is
agile enough to back our
best entrepreneurs.**

How can we further increase our autonomy in matters relating to financial services? I see three important directions. First, there is an issue around data. To be attractive and efficient, a market requires easy access to information by current and prospective market participants at a reasonable cost. Our data ecosystem remains heavily reliant of non-EU players. This is why the new Capital Markets Union package, which we are starting to negotiate under the French presidency, foresees to implement two centralised data platforms: a database consolidating financial and ESG data published by European companies and a consolidated tape for each of the

main asset classes aggregating in real time financial transactions carried out across European trading venues.

Second, there is an issue around investment tools available to savers. Expectations of younger generations are high in terms of transparency, ease of use and access to financial products. New behaviours are emerging with the development of online applications. I strongly believe in the power of financial education to improve capital allocation. We expect the upcoming Retail Investor Strategy to trigger a positive dynamic from that respect. Besides, with the ongoing revision of the ELTIF regulation, we intend to facilitate the emergence of pan-European funds easily accessible to retail investors to allocate more capital to real assets including critical infrastructure for the green transition.

Finally, there is an issue around regulations which must encourage innovation and integration. The banking and insurance sectors must be able to fully play their role in financing the European economy. European banks keep losing market shares to international peers and are 4x less profitable than their US competitors. We need more innovation, integration and digitization in this sector. A balanced transposition of Basel III will be essential. Similarly, the revision of Solvency II should allow insurers to allocate a larger portion of their balance sheet to equities.

Last but not least, our financial landscape is being disrupted by digital technology. To further strengthen the position of the EU as a breeding ground for FinTech, we will soon adopt a "pilot regime" which creates a sandbox to test and develop blockchain-based applications. We send a strong signal about our willingness to make Europe a place where digital transformation is encouraged and used to improve the financing of the economy. In addition, the creation of a digital euro will contribute to the euro area sovereignty and leadership in digital payments.

A strong, autonomous financial system is key to the prosperity of the EU economy but also for its influence throughout the world. In this perspective, we have to ensure that we give priority to three objectives that are the development of strong EU-based financial actors, the deepening of EU capital markets and the ability to attract foreign investments.



JOHN BERRIGAN

Director General,
DG for Financial Stability,
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Capital Markets Union,
European Commission

Financial openness and autonomy: rising to the challenges of a multipolar world

Does the EU's financial autonomy need reinforcing and if so for which reasons?

The introduction of the euro, combined with important reforms spearheaded in the aftermath of the last financial crisis, means that the EU has a large, sophisticated and stable financial system, much safer and better supervised now than it was ten years ago.

It is also very open internationally, with strong links to other major economies and financial markets, most notably in the United States and the United Kingdom. Several EU banks and other financial companies are global players, and third-country financial institutions and markets provide important services in the EU through subsidiaries, branches or from their home countries under the equivalence regime. Above all, our openness has spurred greater competi-

tion and innovation of financial products and services, as well as access to a broader set of investment opportunities and capital.

We firmly believe that openness is an advantage for the EU, and we do not want to retreat from that. However, there is a need to reinforce the EU's strategic autonomy by addressing some vulnerabilities linked to that enduring commitment to openness.

The global geopolitical situation and the EU financial landscape have dramatically changed in the last years, and we need to take action in order to continue to reap the benefits of our openness and mitigate any associated risks. For example:

- The departure of the United Kingdom from the EU has meant that London, once the EU's largest financial centre, is now offshore. This situation implies financial-stability risks for the EU, as some critical services and products are now subject to a third-country jurisdiction and outside the framework of EU co-ordination. It cannot be assumed that the needs of the EU and the United Kingdom will always be aligned in all circumstances.
- We have witnessed increasing departures from international multilateralism. By imposing sanctions and restrictions related to the use of their currencies or access to their markets, third countries can have extra-territorial impact and thereby diminish the sovereignty of, and potentially causing economic damages to, the EU.

We need to take action in order to continue to reap the benefits of our openness and mitigate any associated risks.

What is the degree of financial autonomy possible in a world where the dollar is the international benchmark currency and dollar liquidity is the key to financial stability?

We are aware that the US dollar is the international benchmark currency, and dollar liquidity is key to financial stability. However, the euro is the second most used currency, and there is room for further strengthening its position. By doing so, the EU can not only strengthen the global monetary system, but also benefit from lower cross-border transaction and funding costs. Moreover, it may reduce funding

and investment needs in non-EU currencies, thereby lowering reliance on foreign-currency funding.

This gradual process will depend on many factors, including on changing market practices (e.g. commodities pricing and cross-border invoicing), and on further developing EU capital markets. We are on a good track in this respect, and the issuance of NGEU bonds, or some reforms to our securities markets regulation have given a further boost to the euro in the international arena.

How does the European Commission's "Open strategic autonomy" agenda translate in the financial sector?

The financial sector is a key area in which open strategic autonomy can be ensured. The euro is not the only means through which the EU can achieve greater financial sector autonomy.

We need to complete the Banking Union and advance on the Capital Markets Union in order to increase the attractiveness of our financial institutions and markets and to widen financing and investment opportunities for businesses and individuals.

Moreover, we need to strengthen our financial-market infrastructures and create the conditions for building onshore capacity to provide critical financial services. With a view to discouraging third-country measures that interfere with EU legitimate business, we are also reviewing the Blocking Statute regulation. We are considering the establishment of mechanisms that could facilitate financial transactions and trade with third countries in case of market failures.



FLORIAN TONCAR

Parliamentary State Secretary -
Federal Ministry of Finance,
Germany

Enabling European financial markets fosters the Union's autonomy

Fundamentally, “open strategic autonomy” encompasses the Union’s freedom to act sovereignly and independently on the world stage: as advocate of a rules-based multilateral system, defendant of a resilient and open global economy, and supporter of well-functioning financial markets.

Macro-economic stability is a crucial prerequisite for such sovereignty. This entails not only growth, – supported by investments in the green and digital transition – fiscal sustainability as well as price and financial stability, but also the ability of governments to act in times of crisis, which requires building fiscal buffers in economically good times. But while stable macro-economic conditions are necessary, they are by themselves not sufficient. To maintain the EU’s financial sovereignty, we need to ensure that European financial markets are resilient, dynamic and well-integrated. In this, it is vital that policy makers set the right framework to enable a flourishing financial market ecosystem. Strong, innovative and resilient European banks, insurances and asset managers as well as central-

counterparties, payment providers, stock exchanges and FinTechs – all have an important role in maintaining Europe’s financial autonomy.

Against this backdrop, we welcome the intention of the French Presidency of the Council to focus on the EU’s economic and financial strategic autonomy and work on respective Council Conclusion. The Council can build on important work of the Commission which has set out its vision with a set of important policy goals for financial markets last year:

- i) strengthening the international role of the Euro,
- ii) deepening the European Capital Markets Union, ensuring the strategic resilience of financial markets infrastructure
- iii) enhancing the Union’s ability to shield the functioning of financial markets infrastructure from unlawful extra-territorial application of unilateral sanctions. [This was put into perspective in the 2021 Strategic Foresight Report.]

The international role of the euro is first and foremost determined by the strength and the stability of the economic and monetary union. Strengthening the Euro therefore means strengthening the EMU. We will continue our stabilisation efforts to recover strongly from the pandemic-induced crisis and aim to create momentum for an even more resilient Union in the future.

**We need to ensure that
European financial
markets are resilient,
dynamic and well-
integrated.**

However, a strong currency in the international arena also depends on the stability and depth of the EU’s financial sector and the international position of European economic and financial players. We are pursuing this goal with a multitude of initiatives.

A broadly usable digital Euro, would act as a visible sign of European sovereignty and strengthen the international role of the Euro. However, such an ambitious project could only be successful when Member States are adequately involved from the very beginning.

With the Capital Markets Recovery Package, we introduced changes

needed to develop euro-denominated derivatives for energy and raw materials. Moreover, the euro is on a path to become the default currency for the denomination of sustainable financial products in line with the EU’s development as the prime global hub for green finance and the world’s largest carbon market.

With the European Capital Markets Union project, we will deepen and further integrate financial markets, supporting the financing of the real economy while increasing markets’ resilience to shocks. The large amounts of derivatives, including contracts denominated in euro, that are currently cleared outside the EU show a high exposure of EU market participants and raise financial-stability concerns for the EU. It is therefore of strategic importance for the EU to enlarge the clearing base in the EU in order to increase liquidity in EU CCPs and to make clearing in the EU more attractive to reduce its exposure to offshore clearing.

To further protect financial market infrastructure, the Commission has proposed several measures, such as creating a sanctions database or a system for anonymous reporting of sanctions’ evasion. These proposals seem generally viable to strengthen the coherent implementation and enforcement of EU sanctions, but need to be elaborated further. In this regard it is crucial that Member State’s competences in sanctions implementation would not be weakened.

These ambitions will not only increase the EU’s financial autonomy by strengthening European financial markets. They will also have the potential to shape forward-looking and rules-based policy internationally, known as the “Brussels Effect” - itself evidence of Europe’s capacity to act open, strategically and autonomous on the global stage.



MARKUS FERBER

MEP - Committee on Economic
and Monetary Affairs,
European Parliament

Gaining financial autonomy through increased competitiveness

In many aspects, Brexit has been quite the disaster for the British people and the British economy. Despite this, the most liquid and most highly developed capital market in Europe remains London. While some business has moved over to Paris, Frankfurt, Amsterdam and other European financial centres, the financial services ecosystem in place in London that consists of significantly more than just a share-trading venue remains mostly unchallenged.

The European Commission has voiced the aspiration for the European Union to achieve a status of 'strategic autonomy'. If the European Union wants to play in the international Champions League, it needs the financial system to match this aspiration. What needs to be done to get there? Apart from some structural factors such as a stable currency, a reliable banking system and overall macroeconomic stability, there are three steps to take that would get the European Union onto a sensible road.

Firstly, completing the Capital Markets Union: The Capital Markets Union

has long been one of the European Commission's flagship projects, yet progress remains painstakingly slow. There is no lack of good ideas, but rather a lack of meaningful execution. The Commission's latest CMU package that revises certain aspects of MiFIR, AIFMD, ELTIF and introduces a European Single Access Point for company data is certainly a step in the right direction, but only a modest one. Once again, the big-ticket items such as a harmonisation of insolvency law and a further harmonisation of taxation rules are missing. Without these key aspects, that are famously difficult to resolve in the Council, the Capital Markets Union and thereby the integration of European capital markets will remain incomplete.

Secondly, repatriating crucial services such as Euroclearing to the European Union: While the European Commission has been hesitant to grant any equivalence status to the United Kingdom, there is one area that is noticeably different: clearing. Many European businesses make good and frequent use of the services of UK CCPs. For that reason, the European Commission has clearly been hesitant to enforce the relocation of clearing business to the Union. While cancelling the equivalence decision might come with financial stability risks, extending the equivalence status time and time again, certainly does not provide any incentives to moving clearing business into the Union, either.

The Union's attractiveness as a financial centre depends on its competitiveness.

If the end goal is to build a strong European financial services infrastructure along the entire value chain, the Commission needs to step up its game and tie the next equivalence decision to a firm and credible deadline for when European clearing business is expected to move back to the continent. Particularly when it comes to the sensitive matter of the clearing of euro-denominated derivatives, this is ultimately also a question of financial stability for the European Union.

Thirdly, revise European listing rules: The best financial markets infrastructure is worth little if there is no demand to make use of it. The European financing model is still heavily skewed towards bank financing. Too few European companies go public

and if they do, they often chose venues outside of Europe. That is of course an unsatisfying finding and indicates that European venues are less attractive than their international competitors.

Consequently, we need to consider whether European listing rules are indeed fit for purpose. The United Kingdom has done just that with the listings review performed by Lord Hill. The review has come up with some noteworthy recommendations such as lowering the disclosure requirements for subsequent financing rounds, recommendations on dual-class share structures and the free float requirement. Such changes can be understood as an attempt by the UK to snatch away business from European venues by offering more flexible and more attractive listing rules.

In order to remain competitive, the European Union would be well-advised to take a close look at those recommendations for the next iteration of the prospectus directive.

The example of the listing rules illustrates a bigger point though: ultimately, the Union's attractiveness as a financial centre depends on its competitiveness. The more competitive the EU's financial centres are, the bigger our strategic and financial autonomy. Fortunately, increasing the EU's competitiveness in financial services is firmly in our own hands and we should make good use of that opportunity. The three steps outlined above could be a starting point.



STÉPHANE BOUJNAH

Chief Executive Officer and Chairman of the Managing Board - Euronext

From finance takers to finance makers

The concept of strategic autonomy has emerged as a key policy objective of the EU to protect the European way of life. Initially limited to defence and security issues, the concept of strategic autonomy has found echoes in all EU policies.

In the area of finance, Brexit was the trigger for this growing awareness and has highlighted a fundamental question: can our continent be satisfied with being an importer of financial services developed and produced outside the EU or should it build some form of strategic autonomy in finance?

When the main financial centre of the EU was London, the status quo was both comfortable and inevitable. The situation has changed dramatically with Brexit. The EU depends on – and should remain open to – global capital but can no longer rely massively on intermediation which has also become non-European. We must all respect Brexit, but Europeans cannot accept in resignation the excessive dependence on third countries that it has engendered in critical areas such as derivatives, FX trading, clearing and asset management.

Building European strategic autonomy in finance means improving the

competitiveness of EU capital markets, promoting a CMU based on European champions and a decentralized model as well as reducing our dependency on third countries by strengthening our EU capacities.

The EU is the home of leading companies in the areas of insurance, asset management, banking and market infrastructure. This rich ecosystem must be supported by legislation that allows it to compete on a level playing field. The European Commission must put in a place a systematic “competitiveness test” to focus, before introducing new rules, on whether such new rules will weaken or strengthen European companies. Attention to unwanted consequences must increase. The recent proposal to create a consolidated tape via MiFIR is a striking example of a form of unilateral disarmament of the EU for the benefit of non-European actors.

Simplification must also be an overarching principle of our strategy. Euronext is supporting several proposals to simplify rules via the proposed European Listing Act. To build an integrated primary market for equities, the Prospectus Regulation should be amended urgently to ensure its unified application across Europe to create a proper single European prospectus. This will be critical to accelerate the transfer of substance triggered by Brexit on international IPOS. Since 2021, a significant number of international companies have chosen to go public on Euronext in the EU, while in a pre-Brexit world, these companies might have otherwise considered London. This is the case of the Spanish Allfunds, the Polish Inpost, the Universal Music group, originally from the United States, the Franco-British investment fund Antin IP which all have chosen the Euronext markets to go public.

It is up to the European companies to concretely build the strategic autonomy of the EU.

There is a European momentum, with the gradual replacement of a single financial centre, the City, by a group of more specialized, deeply interconnected and fully integrated financial markets. Operating across eight countries in the Single Market, Euronext has a long track record of building a pan-European federal

model connecting local economies to global markets. This European decentralized model will have to be supported by further initiatives to promote supervisory convergence at the EU level.

But it is up to European companies to concretely build the strategic autonomy of the EU. As part of its new strategic plan “Growth for Impact 2024”, Euronext has taken two major decisions in that perspective.

Euronext is so far the only significant market infrastructure that does not directly manage its clearing activities, which are operated by a company controlled by the London Stock Exchange Group. Since April 2021, with the acquisition of Borsa Italiana Group, which operates CC&G, the Italian clearing house, Euronext now has 100% control of a multi-asset clearing house. Euronext has therefore decided to transform CC&G, into “Euronext Clearing”, to offer clearing services to all European Euronext markets.

The impact of this development for European strategic autonomy is significant. The ultimate decision-making centre and the definition of the Euronext flow clearing strategy, as well as the development in the coming years of the associated technology will be transferred from a UK-headquartered Group to the EU.

Similarly, Euronext has decided to move its main data centre from Basildon, near London, to Bergamo, in Italy. This decision stems from a strategic, operational and financial logic. In the post-Brexit world, Euronext has chosen to relocate its main data centre in the EU.

These two examples, which, beyond Euronext and the market infrastructure sector, will surely be followed by others, illustrate the choice facing Europeans: supporting initiatives to build the strategic autonomy of the EU or seeking to preserve the status quo ante of a distribution model of global finance long considered immutable, but which belongs to the world of yesterday.



FABRIZIO CAMPELLI

Member of the Management
Board – Corporate Bank
and Investment Bank -
Deutsche Bank Group

Strategic autonomy requires joint efforts

Achieving strategic autonomy is top of mind for every European policymaker right now, from those in the Commission to the Council and MEPs. At Deutsche Bank we too support EU Strategic Autonomy and the European Commission's efforts to strengthen our financial services sector.

This should mean lifting Europe's financial framework up to the level of our peers. More specifically, building a European banking sector that is more sustainably profitable, open and competitive, but no less stable. Banks must refocus their business models and further strengthen their balance sheets while bolstering their systems and infrastructure.

Strengthening European financial markets -- like addressing environmental issues and rolling out new data economy initiatives -- works best when there are the fewest possible geographical frictions. We should therefore strike the right balance and avoid "autonomy" being translated into ringfencing of activities.

However, European banks do not currently operate in an efficient Single Market for financial services.

This is where policymakers can play a decisive role.

First of all, as Europe is still heavily dependent on bank funding, the impact of the final Basel III framework will not just be felt by banks, but also by clients. Originally, European finance ministers had issued a mandate for "no significant increase in capital demand". Even though the proposals from the European Commission provide relief for impacts, the vast majority of this is only temporary. European banks will therefore likely still see significant capital impacts in 2030.

With US regulators indicating a capital-neutral approach for US banks, there is a risk that European implementation in its current form may weaken the competitive position of European banks. This would undermine the strategic autonomy agenda.

Second, the Single Resolution Fund threatens to impede EU banks' ability to finance the transformation of European economies and to invest in their own future digital strategies. The SRF has grown beyond its initial target size -- not because of additional risks in the banking sector, but because the methodology links the fund volume to deposits which have been inflated in an unusual way during the pandemic.

**The right balance means
avoiding "autonomy"
being translated
into ringfencing.**

By now the fund has gathered bank contributions of more than 52 billion euros, and these funds are sitting unused rather than supporting the economic recovery. This limits the capacity of EU banks to lend and invest. It also places them at another competitive disadvantage: our non-European peers do not have to contribute to a national resolution scheme.

Third, we must complete both the Banking Union and the Capital Markets Union. A full Banking Union would strengthen individual institutions and enable much-needed consolidation, another requirement for keeping European banks globally competitive. A developed Capital Markets Union is vital to more effectively financing the recovery from Covid recovery and transformation of the economy.

The question therefore is not so much where Europe has its financial

centre, or centres, but rather how to develop one rulebook, and no national divergences, so the EU can be really treated as one market. The sums needed are vast and the EU Green Deal, for instance, will not succeed without stronger European capital markets, complemented by appropriate local financial sector expertise.

Lastly, more generally, we would urge policymakers to avoid adding regulatory complexity to the European framework. The policy themes of the future do not fit into the traditional rulemaking boxes of "banking" or "insurance" any more. Instead, the policy areas of sustainability, data economy, new payment structures and digital assets will impact a wide array of institutions and corporates.

Regulatory proposals on these policy areas, which impact the financial sector among others, are now being developed across several policy units within the Commission, discussed in various Committees of the European Parliament and reviewed in various working groups of the Council. There is a risk that processes involving so many participants eventually produce standards that do not work in practice or achieve their intended goals. This again would place the EU as a whole at a disadvantage compared to jurisdictions that have a less complex policymaking setup, such as the US, the UK or parts of APAC.

Knowing that we have shared goals, we look forward to continuing working with policymakers on how to ensure a smooth regulatory implementation that enhances our capacity to finance the economy and the competitiveness of our home region.

RELAUNCHING PRODUCTIVE INVESTMENT IN THE EU



WERNER HOYER

President - European Investment Bank (EIB)

Supporting the economic recovery in the light of high uncertainty

Less than two years after the pandemic hit Europe, EU real GDP is back to pre-crisis levels. The immediate rebound in investment has also been encouraging. Real investment got back to its pre-pandemic level in less than two years. To put that into perspective, it took more than a decade for investment in the EU to reach its pre-crisis level after the 2008 financial crisis.

This crisis has been tough, but the economic policy response has been quite remarkable. Working together, the EU and its Member States have achieved a rapid emergency policy response, which has been well-coordinated, targeted and commensurate to the enormous task of preventing the initial shock from multiplying into a full-blown systemic crisis.

According to the EIB Investment Survey, an annual survey among 12,000 firms in the EU, more than half of firms in Europe benefited from some kind of policy support since 2020. Most

companies confirm that this support was crucial to weather the shock and adapt to a new reality.

I am convinced that it is, in no small part, due to these bold efforts that Europe is in such a strong position today.

However, we have to remain cautious in our outlook. The Bank's annual Investment Report highlights a series of fault lines to pay attention to as we start the new year. One such fault-line is the pandemic itself, which is still not over. About 4 in 5 firms say that they are holding back on investment activities due to 'high uncertainty'.

High energy prices - and how policy makers will respond to them - constitute a second fault line. A major risk in this regard is that some will be tempted to blame the climate transition for the high energy prices, but this would be a terrible mistake! The green transition should be seen as part of the solution to the problem of high energy prices.

Of course, we need to pay close attention to the burden on vulnerable consumers, but we must avoid interventions that reduce incentives for green investment including by increasing uncertainty about climate policy going forward!

The risks of an asymmetric recovery is a third fault line that we need to be aware of as we start to scale down our crisis support measures. We still do not know what economic scars this pandemic will have left behind once it is over and how resilient will firms be once the exceptional policy support measures are fully removed.

What we can say is that severe impacts on firm revenue have been quite concentrated in terms of sectors, and uneven in terms of geography, but there still is significant uncertainty as to how much asymmetries will emerge once the economy recovers, and whether this may pose systemic risks in some locations.

Public investment has played an important stabilising role over the past two years. It also plays an irreducible role in creating the enabling conditions to catalyse action by the private sector. Our research shows, for example, that where digital infrastructure was better, firms have been more likely to digitalise as a response to the pandemic.

Going forward, it is, therefore, important that we keep the positive momentum going. The Recovery and Resilience Facility promises to be essential in that regard. The initial, impressive commitment, however, now needs to be followed up by effective implementation. Building up a pipeline of high-quality projects, as well as European coordination, will be key for this.

At the EIB, we stand ready to support Member States in this endeavour.

But no matter how impressive public investment is in the EU, we will not be able to close the enormous investment gaps, if we do not manage to bring private sector on board. Think about the green transition: the Bank's engineers estimate that about 50% of the emission reductions needed by 2050 depend on technologies that are at the prototype or demonstration stage, i.e., not yet available in the market.

It is critical that - irrespective of whatever need for transition solutions - we keep on pushing more high-impact, private sector investment in this area. This is not just a matter of good climate policy, but also key for our strive towards more energy independence, as well as for the EU's competitiveness more generally.

A similar argument can be made for the digital transition, which depends squarely on strong firm-level investment in innovation, technology adoption and workforce skills.

The crisis has shown us an effective way of mobilising more private sector investment: the same risk sharing instruments that have been used to safeguard investment under extreme uncertainty at the outset of the crisis, can be used to unlock risky investment activities also in areas of strategic importance such as innovation, new climate technologies as well as their large scale deployment. And they can do so at very low fiscal costs.

Europe has weathered the crisis well. It is now time to make it ready for the future. To do this, accelerating public and private investment in the light of high uncertainty will be key.



ODILE RENAUD-BASSO

President - European Bank
for Reconstruction and
Development (EBRD)

NextGenerationEU has an ideal partner in the EBRD

The future must be green and it will be digital. As economies recover from the Covid crisis, the NextGenerationEU Programme can seize the historic opportunity we now have to promote sustainable growth and prosperity in the EU. The challenge is to move from planning to implementation. For that, the EU needs high quality projects that deliver impact, as well as reliable partners.

In Central and Eastern Europe (CEE), the EBRD – with its strategic focus on the green and digital transitions and promoting equality of opportunities – is an ideal partner. The RRF green target in particular aligns perfectly with the EBRD’s own objective of ensuring that, by 2025, over half its annual investment is in climate and environmental finance, a goal already achieved in 2021.

NextGenerationEU is a unique investment and reform programme, one which not only heals the scars of the current crisis but also encourages continuing economic transition and convergence. The programme will leverage much needed private sector financing and funding to achieve lasting sus-

tainable impact beyond the temporary response to the pandemic’s economic impact. Overall, early signs are promising, with 22 EU-approved national recovery plans, triggering over €52 billion of pre-financing disbursed by the EU to 17 member states.

The EBRD is very active in the EU member states in the CEE region and especially in those countries where productivity is lowest and which are among the largest recipients of EU recovery funds as a percentage of their Gross national income (GNI), notably Greece, Croatia, Bulgaria and Romania. Last year the Bank invested € 2.9 billion in its 12 countries of operations in the EU, almost 100% of it in the private sector.

Nevertheless, the implementation challenges NextGenerationEU faces remain huge, particularly in CEE.

First, the region’s capital markets, anticipated to play a major mobilisation role under the programme, are still fragmented and illiquid. They need further streamlining to channel the additional private sector funding required to finance necessary infrastructure projects. A robust green recovery and improved access to finance for under-served sectors will be less effective without better technical and digital solutions and further significant capital market reform.

The RRF green target
in particular aligns
perfectly with
the EBRD’s
own objective.

Given its experience, the EBRD is well placed to support capital market development and efficiency. For example, the Bank is assisting countries in CEE in strengthening capital markets infrastructure, diversifying the local investor base, crowding in private sector investors, and promoting the expanded issuance of securities in domestic markets and in local currency.

In the Baltic countries, the EBRD supported the consolidation of the local stock exchanges and the creation of a Pan Baltic Capital market. In Poland, the EBRD supported the design of a Capital Market Strategy and worked with the Warsaw Stock Exchange to develop new ESG Guidelines for companies that want to list on it.

The second main challenge NextGenerationEU faces is the reality that the transition to low-carbon economies will be particularly acutely felt by CEE countries which are highly reliant on coal and fossil fuels. Energy intensity in the CEE region is almost twice as high as the EU average. The main priority and challenge for these countries - as well as for the EBRD - will be supporting a transition that is not only ambitious but also Just. Policy as well as financing will be critical to achieve this. For example, in CEE – where close to 80% of EBRD’s investments support the green transition - the Bank supports the shift of one of Poland’s largest energy firms from coal to renewable energy sources, thereby helping transform a coal-reliant region and providing new employment opportunities.

The third challenge is the lack of suitable candidate projects. To be successful, NextGenerationEU must also be an opportunity to tackle key priorities such as institution building to develop project preparation, absorption capacity of the public administration and the need to adapt regulatory ecosystems to create an enabling business environment. It is equally important that EU resources are channelled towards the most innovative and riskier technologies that require concessional funding and avoid distorting markets.

The EBRD is well equipped to support this effort thanks to the scaling up of its digitalisation work and the leveraging of the digital transition as an enabler of economic transformation. This includes: building the foundations for digital transformation through investment in infrastructure and developing the right legal, regulatory and institutional frameworks; adapting enterprises and governments to the demands of the digital era; and fostering innovation.

NextGenerationEU represents a once in a lifetime chance to deliver a Europe transformed, one ready to address the challenges of the future. In the EBRD, the EU has an ideal partner to look to for support and expertise in doing just that.



HARALD WAIGLEIN

Director General for Economic Policy, Financial Markets and Customs Duties Directorate, Federal Ministry of Finance, Austria & Member of the Board of Directors, European Stability Mechanism

NGEU and private investment: how to ensure crowding in

Total investment in advanced economies is typically around 20% of GDP. Public investment accounts for a relatively small share (between 2% and 4% of GDP), while the bulk of capital is formed by the private sector. In a crisis, an increase in public investment can (partially) compensate private demand shortfalls and generate income and employment. This can prevent the emergence of hysteresis, i.e. persistent demand weaknesses that undermine the productive capacity of an economy.

Against the background of an unprecedented recession, the investment needs related to the EU's Green Deal agenda, and over-indebtedness of a number of EU Member States, EU leaders agreed on an 800bn Recovery Instrument. NGEU was the response to a symmetric shock with heterogeneous impacts on Member States, new political priorities and unresolved legacies from the past crisis. The Recovery and Resilience Facility (RRF), which

is at the heart of NGEU, is rooted in cohesion policy and defines as its primary objectives to avoid an increase in divergences following the COVID-19 crisis and to stimulate the green and digital transition.

Spending money is a relatively sure path of fuelling short-term growth. According to Commission estimates, EU GDP in 2026 will be some 1.2% and employment 1% higher than without NGEU. Yet a temporary increase in public investment does not automatically cure structurally low private investment, nor does it generate the long-term growth needed to repay the debt incurred. The permanent impact on potential output depends on the type of spending and accompanying structural measures.

Reforms targeted at the frictions that hold back investment are key. According to the EIB 2022 investment survey, the most important long-term barrier is the availability of skilled staff. This is followed by uncertainty, business and labour regulation and energy costs. By contrast, the availability of finance, access to digital infrastructure and adequate transport infrastructure are major obstacles for less than 20% of firms. With regard to green investment, firms require first of all clarity on the decarbonisation path at the national and EU level.

The effectiveness of NGEU is a function of the quality of reforms.

What does this mean for the NGEU impact on investment? Beyond the short-term impact, the potentially largest effect may come from investment in education and training. In addition, the reform angle of Member States' Recovery and Resilience Plans is promising: reducing obstacles to doing business and reforms of labour markets and social protection systems. NGEU should also help reduce energy price volatility (via investments in renewables), but not necessarily the cost of energy (as this would conflict with the green objectives).

About 60% of the RRF funds are directed towards green and digital investment, consistent with the main aims of the Facility. Investments in renewable energy, energy efficiency, electric charging stations or high-speed internet to remote areas will stimulate GDP via their impact on demand, but the medium- to long-term effects

remain to be seen. The results from the EIB investment survey suggest that expectations towards the more permanent growth impact from the green and digital transition may be too optimistic. Moreover, the fact that only very few Member States committed to structurally change incentives for the green transition, e.g. via the introduction of CO₂ taxation, suggests that there remains room to attract private investors into green activities.

Beyond an ambitious implementation of Member States' Plans, additional steps may be needed to crowd in private investment, notably with a view to addressing skills gaps and inefficiencies in labour and product markets and the public sector. Mobilising private capital through further developing equity and venture capital markets and increasing the efficiency of insolvency systems is also important. And finally, clarity on the path towards CO₂ reduction and appropriate tax incentives are key to capitalise on the stimulus from NGEU.

To conclude, the 800bn envelope from NGEU will not automatically relaunch productive investment in durable manner. NGEU can only be a game changer if it changes the conditions for private investment. Thus, the effectiveness of NGEU is a function of the quality of reforms. Catalysing private investment with a view to raising GDP permanently is a joint duty of all EU Member States. It is a key determinant of the EU's repayment capacity in the next decades, and as such, it should be prioritised over the speed of pay-outs from the Facility.



PHILIPPE HEIM

Chairman of
the Executive Board -
La Banque Postale

Banks play a key role in achieving the green transition

As climate change is a tangible reality, organising the transition is an economic and social priority for all of us. As the stakes are high, financing needs have to be up to this unprecedented challenge.

The EU Commission estimates financing requirements for green and digital transitions at €650 Bn per year until 2030, the former requiring €520 Bn alone. The Commission's Recovery and Resilience Facility, the largest component of Next Generation EU (NGEU), is intended to be supported by private sector investment by an appropriate mix of market and bank financing.

Indeed, certain large or mid-sized companies will find resources on the market (green bonds and private placements in particular), and the Capital Market Union's completion will be instrumental to shift the trillions to this end.

The finalisation of the taxonomy, the upcoming EU Green Bond Standard, the building of a "European EDGAR" – a centralized access point to financial and non-financial information – as well as a possible alleviation of listing rules will undeniably enhance the shift towards green projects.

However, the main bulk of financing, that of SMEs and households, will come from banks. Their ability to provide funding will depend on the available liquidity, the profitability of green investments and their capital treatment, as well as on a globally conducive regulatory environment for such investments.

As illustrated by the latest ECB stress tests, European banks have robust balance sheets and have accumulated savings. Combined, these two elements should ensure credit supply. There are also significant income opportunities in green investments: according to a report by Oliver Wyman (2021), the financing of the energy transition could provide up to 25 or even €50 Bn revenues to banks over the next 5 years. As regards the opportunity of a "green" incentive or a "brown" penalising factor, the forthcoming assessment to be performed by the EBA will be a decisive milestone. This work will also be contingent on the standardisation and reliability of non-financial data, which will allow exposures to be differentiated. Part of the solution lies in the future reporting rules for corporates (the so-called CSRD) that will hopefully soon be adopted.

**At La Banque Postale,
the energy transition
is at the heart of our
strategic plan.**

On the demand side, companies have been asked to better formalise their long-term transition strategy to convert macroeconomic estimates into precise financing needs. It might be useful to focus, at European level, on the interactions between the EU taxonomy framework and sectoral transition plans for activities that are not considered as "green". To support this effort, in October 2021, La Banque Postale committed to an ambitious decarbonation trajectory, which was validated by the Science Based Target Initiative (SBTI).

In many Member States, ecological and digital transitions are also addressed through specific policies and resources. The French recovery plan provides a substantial amount for ecological transition (30%). Its first assessment report illustrates that households' incentives have reached their targets in transportation and dwelling improvement. However, due to more demanding long-term investment cycles, some industrial

companies find it difficult to give priority to environmental projects. This is precisely where banks have a paramount role to play.

At la Banque Postale, supporting the energy transition is at the heart of our strategic plan, an objective that we also incorporated directly into our articles of incorporation. We aim to transform our banking model into an impact-driven one, notably by developing the necessary tools (such as an Impact Weighting Factor) to ensure that each of our financial and investments decisions meet environmental, social and territorial criteria. We provide all our clients with a diversified range of products and offers, for enhancing home's energy efficiency, the purchase of a greener vehicle or to provide our local and corporate clients with respectively green loans and green bonds.

Moreover, financing is not the only driver of business transformation. A study carried out by BPI France in 2021 identifies four drivers to help SMEs manage their own transition: developing a strategic vision, leveraging innovation and R&D to improve competitiveness, mobilising employees' skills and commitment for achieving change, and using the corresponding financing resources.

All in all, there is clear need to help corporates realising their transition projects. But such transformation should also be viewed from a holistic standpoint, incorporating the social impact of what should be a "just" transition. A globally more conducive and supportive ecosystem for economic players is therefore needed, and banks are instrumental to this end, not only through their funding role.



ALFRED KAMMER

Director, European
Department - International
Monetary Fund (IMF)

A decisive European policy response to the crisis: investing for the future

The decisive European policy response to the COVID-19 pandemic has led to a strong rebound in growth, an unusually fast labor market recovery and a sharp uptick in investment. A key pillar of the policy response, and an important demonstration of European solidarity, has been the 750 billion Euro Next Generation EU (NGEU) package. The NGEU offers a unique opportunity to push ahead with structural reforms and fill investment gaps, especially those that will support the green and digital transitions. On average, countries are planning to devote nearly 40 percent of the spending in their Recovery and Resilience Plans (RRP)—the largest part of the NGEU package—to climate change-related investments. IMF staff estimates that, over the next decade, national RRP are expected to expand EU's GDP by 1.4 percent and reduce greenhouse gas emissions by 2.1 percent compared to 2019 levels.

As is common during recessions, investment fell during the initial phase of the pandemic, further reducing the investment rate in the euro area that had never fully recovered from

the global financial crisis. In fact, net public investment was negative in several European countries, including Italy and Spain during 2013-17, which implies an erosion of the public capital stock. Deep cuts to public investment tend to deprive the private sector of much-needed common infrastructure and adversely affect growth. The NGEU boost to investment thus comes at a crucial moment.

But more is needed to meet the huge investment needs, especially those related to the green and digital transitions. Estimates point to public investment needs for the climate transition of 0.5-1 percent of EU GDP per year until 2030, of which national RRP cover about 0.2 percent of GDP annually for 2021-26.

Public policy is key to boost public investment and set the right incentives for private investment—through policies and regulations. Given the magnitude of the investment needs, it is clear that private sector investment will need to be significant. Public investment should focus on projects with high social returns and that provide key infrastructure needed to increase private sector investment.

**Public policy is key to
boost public investment
and set the right
incentives for private
investment.**

Correctly pricing carbon is a necessary step to provide the private sector with the right incentives. As the IMF is arguing, carbon pricing provides across-the-board incentives to reduce energy use and shift to cleaner fuels, and it is an essential price signal for redirecting new investment to clean technologies. Guaranteeing that private investors have access to transparent and clearly defined information on the sustainability of different investment products, is also important to appropriately channel capital. In that context, improving and harmonizing climate-related disclosures and taxonomies would be a useful step. And given the importance of bank financing for the European economy, including climate within broader bank risk assessments—as is increasingly the case—is key. These are only a few concrete steps, and, clearly, a broad holistic approach is needed. Labor and product market policies which facilitate the transition of

workers and capital to a new climate-friendly and more digitalized economy, including training to reskill and upskill workers, are just as important.

Coming back to the role of public investment, the creation of an EU Climate Investment Fund (CIF) could help countries meet their common climate goals. The EU CIF could help finance some of the additional spending needed as the benefits of reducing carbon emissions are felt across national borders. Such an EU fund should be well placed to identify and coordinate projects requiring cross-border investments to achieve the fastest carbon reduction at the lowest cost, while internalizing the effects of and interactions with other emissions reduction policy instruments, such as the emissions trading scheme. In addition, an EU CIF would eliminate the incentives to free ride on emissions reducing investments of other members. Given the need to frontload climate investments, the EU CIF could have a borrowing capacity. Borrowing would not be to provide for cross-country transfers, but based on the need to arrest the flow of greenhouse gas emissions into the atmosphere as quickly as possible.

The climate challenge we face is historic. There is little time, and the transition will impact all aspects of the economy. It will be essential to maintain a societal consensus as policies move ahead, including to provide the necessary support to impacted segments of society.

Climate change is a global challenge that will need global solutions. In this regard, the EU will have to continue playing a crucial leadership role.

This article has been co-written by Asghar Shahmoradi & Frederik Giancarlo Toscani, International Monetary Fund

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NORMALIZING MONETARY POLICY



**BORIS
VUJČIĆ**

Governor

Croatian National Bank

How to keep inflation unnoticeable?

Central bankers know very well that the best level for inflation is when people do not notice it. We cannot always tell in advance where that point is, but we can certainly see with the benefit of the hindsight if inflation diverges too far from that level. Indeed, inflation has after a quite long period exceeded the point when it becomes palpable. This is largely due to prices of energy and food – components of inflation that are usually the most volatile, but also the least responsive to monetary policy. However, standard measures of core inflation – those that strip off volatile components out – are now also elevated across the globe. A consensus view attributes such developments largely to pandemic-related “supply chain bottlenecks” combined with increased consumer demand in reopened global economy, further boosted by switching of demand from high-contact services to goods. On top of that, we have also observed instances of severe weather conditions fueling food inflation, potential speculation in markets for

some commodities, greening efforts and a touch of geopolitics in the area of energy prices.

Although analysts largely concur on diagnoses of economic forces behind the observed price swings, there is a remarkable lack of consensus on expected duration of current inflationary environment. To some extent at least, there is also a disagreement on the particular mix of economic shocks underlying it. The willingness of central bankers for phasing out QE (“tapering”) and increasing policy rates to fight elevated consumer inflation crucially depends exactly on these “controversial” characteristics of the current inflation. Monetary authorities are usually reluctant to react when elevated inflation is driven by recessionary supply side shocks.

**We need to constantly
re-evaluate incoming
data and weight risks
to price stability.**

Policy actions, in essence, depend on demand side shocks. In practice, however, separating between different types of shocks has proved awfully complicated. Take an oil price shocks for example. These shocks are often considered temporary supply side shocks for a net oil importing country, usually ignored by central banks. Recent literature, however, rather convincingly challenges these views and argues that most of the variation on real price of oil is in fact demand driven. Green transition may additionally complicate our ability to characterize drivers of oil prices properly – both in terms of sources and duration of underlying shocks – possibly asking for a different monetary policy reaction to swings in oil prices.

Prevalent view until recently was that elevated consumer inflation is only temporary in nature – energy prices are expected to stabilize this year, while easing of supply constraints would allow them to better align with growing demand. Under such a scenario, monetary policy tightening could be postponed – so called “looking

– through” higher inflation. European central bank, for now, seems to be comfortable with such a wait and see strategy and is willing to tolerate a transitory period with inflation moderately above the target. On the other hand, FED has recently diverged from that narrative and adopted the view that inflation may last longer than initially expected, creating room for faster monetary policy normalization. These differences in policy actions are relatively well grounded in different economic conditions on the two sides of the ocean as cyclical recovery of the euro area is lagging behind that in the US at the moment, with muted wage growth leading to somewhat weaker inflationary pressures.

Duration of inflationary episode crucially depends on second round effects that operate through inflation expectation channel. Once consumer inflation remains elevated for an extended period of time, especially if prices of frequently purchased items, such as food or fuels for our vehicles, continuously increase, they may feed into inflation expectations and trigger self-fulfilling inflationary spiral. We need to take such a risk very seriously, even though inflation expectations remain anchored as well as at any time in past decades.

Over the last year we have seen a uniquely expedient recovery, but also reemergence of inflation that almost no-one saw coming. As emergence of inflation in itself was a surprise, we need to constantly re-evaluate incoming data in order to disentangle sources of shocks hitting our economies and weight risks to economic outlook. Our narrative needs to remain flexible in the face of those risks and adapt to changing circumstances. Likewise, our monetary policy guidance should be based on a specific set of conditions rather than fixed time-frames.

Only by acknowledging uncertainty and adapting to circumstances, we will be able to return in the least painful way inflation to the point where it is not high enough for people to notice.



ROBERT HOLZMANN

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Secular trends in interest rates - when and how of normalizing monetary policy

Secular trends in interest rates, and the when and how of normalizing monetary policy

Central banks are often charged that unconventional monetary policy is responsible for low interest rates. Savers certainly do not appreciate zero interest rates. Why are interest rates so low, what might climate protection imply for interest rates, when and how should monetary policy act in the shorter run?

Why are interest rates so low?

The key reason for low real interest rates is not central bank policy, but structural factors which have driven down equilibrium real interest rates over recent decades to or even below zero. Most probably, population aging, an overhang of savings over investment and declining productivity are responsible (Brand et al., 2018; Borio et al. 2017; Summers and Rachel 2019). In stabilizing output

and inflation, monetary policy moves policy rates around this structurally determined natural rate of interest. Given the low level of this so-called r^* , a “normalization” of monetary policy would not raise interest rates back to the high levels seen a few decades ago. At the same time, monetary policy rates should not persistently deviate from r^* , as this can create asset price bubbles, accentuate wealth inequality, and damage productivity growth by facilitating the survival of unproductive, otherwise non-viable firms.

What might climate change imply for r^* ?

A key challenge of our time is climate change. The necessary transition to a carbon-neutral economy might help to reverse the trend decline in r^* since it is the most fundamental transformation program since industrialization in the 19th century. If handled successfully, climate transition will bring forth new, innovative and fast-growing businesses – in line with the notion of “creative destruction” coined by Joseph Schumpeter.

The key reason for low real interest rates is an equilibrium real interest rate driven down to zero.

Climate protection can trigger a gigantic economic investment and growth program. It has the potential to increase the demand for capital and to structurally increase r^* over many decades. Climate protection avoids productivity losses from overheating; cheap renewable energy will in the long run provide a lasting boost to productivity, growth, and welfare.

The shorter-term: when and how should central banks act?

Corona has held the world in its tight grip for the past two years. In terms of growth and employment, the pandemic is almost over. The flip side: Inflation is back. While the ECB projects that the rise in inflation will be temporary, there is a risk that it may not decline as quickly and by as much as projected. So, when should we scale back the generous monetary stimulus? When should we not only scale down but stop net asset purchases? When should we start raising policy rates? When should we gradually scale back existing central banks’ asset holdings? The answer is: “It depends”.

Given prevailing uncertainties, monetary policy must keep its options open and “drive on sight”. Many central banks, including the ECB, have reassured the public that inflation will soon fall back to or even slightly below target soon. But let us be humble given the repeated failure to anticipate the extent and persistence of the current surge in inflation. While many of the factors driving this surge are beyond central banks’ control, they must also assure the public and markets that they will not allow inflation to get out of hand. Fighting inflation too late would be very costly.

Summing up

The secular trend towards low real interest rates is driven by fundamental factors. Reversing this trend requires big policy changes. These include (i) reforms to keep older workers in the labor force, making sure they stay healthy, skilled and engaged; (ii) a deep energy transition that offers productivity gains by drastically reducing clean energy prices and driving system transformation; and (iii) capital flows from the global north to the global south to fund infrastructure and green production.

In the short run, it will be for central banks to judge on time and correctly whether the current sharp rise in inflation is indeed temporary or more lasting. In the latter case, central banks must not shy away from acting fast and decisively to fulfil their primary mandate of preserving price stability.

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Lessons from Stagflation for Monetary Policy

“Stagflation” was popularised in the 1970s and early 1980s. It came to be identified with sustained periods of slow, or even negative, economic growth, high levels of unemployment and high inflation. Although central to the U.S. economy, this experience was mirrored in all other industrial economies.

The main causes of the stagflation episode were two successive waves of oil-price increases by OPEC. Those oil price shocks made life difficult for central banks because they were strictly supply-side phenomena. For almost 10 years, policy makers faced a dilemma. Tighten monetary policy to bring down inflation that would raise the unemployment rate further, or ease monetary policy to reduce the unemployment rate that would bring inflation even higher. Many central banks chose the latter.

Today’s situation is very different. Oil prices have risen in the past year, but at a rate far below anything experienced in the 1970s. In fact, they are near or even below their levels of a decade ago. Moreover, today’s economy is more service-based and less manufacturing-

based than in the 1970s. Services require less energy than manufactured goods. Therefore, it would take a much larger oil-price change to have the impact on the economy observed during the 1970s.

Euro area inflation reached very high levels early this year, but is expected to come down as pandemic-related supply disruptions and product and labour shortages unwind. The combination of supply and demand shocks is expected to dissipate. Contrary to the 1970s stagflation, unemployment is at historically-low levels. Economic activity is expected to pick up again later this year and moderate at close to historical levels in 2023 and 2024.

Furthermore, during the 1970s most central banks had not established credibility, with few exceptions, like the Bundesbank. In the U.S. the main weapon to fight inflation was wage and price controls. In the mid-80s inflation had fallen to low levels but long-term interest rates remained high, because the Fed had still not earned credibility.

Today, despite the recent surge in euro-area inflation, the yield on the 10-year euro area benchmark bond stands near zero, indicating that the markets believe that this rise is transitory. The 5y5y forward inflation linked swap rate is anchored close to the 2 per cent target. Underpinning this situation is that markets expect that the ECB will deliver on its commitment to achieve 2 per cent inflation in the medium term. For the same reason, no second-round effects have been generated by rising prices; wages’ growth remains rather contained. Unlike the 1970s, wage indexation schemes are largely non-existent today, as wage earners trust that the ECB will deliver price stability.

Today, inflation has risen but long-term interest rates have remained low because central banks, in our case the ECB, have earned credibility.

The ECB needs to assess whether the rise in inflation will be short-lived or persistent. Unlike the 1970s, there are good reasons to believe it will be short-lived. That is why medium-term indicators show that inflation will fall back to near – or below – the 2 per cent level.

It is essential that the ECB maintains its credibility, which brings me to the issue of the way forward for monetary policy.

Monetary policy faces high uncertainty, reflecting, in part, the erratic path of Covid-19, geopolitical tensions and the unknown impact of green transition policies on future inflation.

Policy makers need to see through this cloud of uncertainty. Our objective is price stability, and our compass comprises the information, such as price expectations, that shows if that objective is achieved.

Presently, our compass tells us that a steady course is warranted. An abrupt tightening could lead to recession, damage credibility, especially in the aftermath of the too-low inflation outcomes in the previous decade, and trigger financial stability risks and fragmentation.

Therefore, the ECB’s monetary policy stance should stay the course, as long as the available information points that inflation will remain below our target over the medium term. A gradual and cautious unwinding of the monetary policy stimulus over the coming period could continue to be pursued, based on the further improvement in the economic environment and the inflation outlook.

Monetary policy should learn from the lessons of the past

However, the risk that current high inflation rates may become entrenched in long-term inflation expectations should not be overlooked. We have to remain vigilant and prevent that risk from materialising. If signs of a sustained presence of inflationary pressures emerge, we should act in accordance with our mandate.

Monetary policy implementation should learn from the past. It needs to see through price developments that are expected to be short-lived and focus on price stability in the medium term. It will thus maintain its credibility, continuing to support the smooth functioning of the economy in the euro area.



MĀRTIŅŠ KAZĀKS

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Monetary policy normalization in the euro area: better safe than sorry

The world economy has recently seen the return of inflation. After years of struggling with below target inflation, the policy challenge has shifted towards finding the right balance between “looking through” the pick-up of inflation that is viewed to be largely transitory, while keeping the underlying price pressures in check.

Almost all major central banks have revised their medium-term policy outlook. The ECB has decided to end the active phase of its emergency pandemic asset purchase programme (PEPP) in March, while the purchases in its more “traditional” asset purchase program are boosted slightly raised to smoothen the end of PEPP. With respect to possible changes to our current interest rate policy, no immediate commitments are envisaged for the time being. Which might beg the question – are there risks of the ECB falling behind the curve?

To some extent, this assessment will always be in the eye of the beholder. But it helps to have a common framework

to evaluate the policy course. And in the case of the ECB, the forward guidance on interest rates (and implicitly on the remaining asset purchases) provides an explicit and clear guidepost.

Our forward guidance consists of three conditions that must be met before we decide to act on rates: inflation must be reaching our target well ahead of the end of the projection horizon; inflation must remain at this level durably for the rest of the projection horizon; and we should see sufficiently advanced progress in the observed underlying inflation. And we would not cherry-pick just one or two of these elements; all three must be met for us to act.

Inflation has recently exceeded our projections on a regular basis. We constantly update our projections, but even the most recent inflation forecast of December 2021, comes with upside risks. So, after years of undershooting our 2% target, the current inflation projections are close to it. And even though they come with a high degree of uncertainty, the probability of being at or above 2% over medium term has not been this high in a very long time.

**Forward guidance
provides an explicit and
clear guidepost – so, be
ready and be prepared.**

This does not mean downside risks to inflation have disappeared. High uncertainty equally implies future inflation may be lower than we anticipate. Moreover, if a significant part of the current inflation surge comes from rising energy prices and supply side bottlenecks, this can be seen as the evidence of high inflation for the wrong reasons, as it may dampen economic activity, and therefore also future inflation. So, the possibility of inflation falling below our target should not be discounted altogether.

Yes, forecasting inflation is complicated. Therefore, we do not rely entirely on a mechanical link between projections and policy, and we have deliberately included in our forward guidance the condition of advanced progress in underlying inflation, which requires using judgement as a complement to the more technical analysis.

The broader picture of the euro area economy shows us strong short-term price pressures, but also generally positive developments in the real sector.

Labour market figures continue to be robust, with unemployment rates declining (which is one of the reasons we are not currently debating the stagflation scenario). But for a persistent inflation push we also need a robust wage growth, which is not there yet in the data. The Phillips curves for the euro area have been rather flat over the last years. This, of course, can change in the future, and wage growth may accelerate significantly, but we first must see it to believe it.

The long-term inflation expectations in the financial markets have not climbed above 2%. If anything, they still imply long-term inflation slightly below our target. So, if market expectations are for the ECB to raise rates soon, yet the long-term inflation expectations are below 2%, then this is clearly not consistent with the conditions we have laid out in our rate forward guidance. Unless the expectations are that inflation will fall back below 2% because of premature tightening. And this is exactly what we want to avoid!

The roadmap for central banks is much clearer when the inflation is high, as opposed to when it is persistently low and the risks of an effective lower bound are looming. This calls for a cautious approach to monetary tightening, and that is the idea behind our rate forward guidance. But it only works well when it is credible.

That is why we take the commitments embedded in our rate forward guidance seriously. It is clear on what needs to happen for us to change policy. We are getting closer to all three conditions being met, but we are not there yet. But make no mistake, when all three conditions are met, we will act without delay. We do not want to be behind the curve, nor do we aim to be ahead of the curve. We will be at the curve. So, be ready and be prepared.



BOŠTJAN VASLE

Governor and Member
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Transition from crisis mode to a gradual normalisation of monetary policy

Less than two years into the pandemic, the euro area economy has returned to the pre-crisis level of activity, though the recovery has been incomplete in some sectors and countries. With a rapid and comprehensive response of monetary, fiscal and other policies to a once-in-a-lifetime shock, we prevented the free fall of the economy and helped to preserve financial stability and protect productive potential. As our interest rates were near the effective lower bound, the Eurosystem has resorted to unconventional monetary measures, launching tailor-made instruments to leave no one behind.

With the roughly simultaneous reopening of economies and relatively robust household incomes, backed by fiscal and other measures, regional and global demand rebounded strongly. This led to supply-chain bottlenecks and shortages of different goods, ranging from energy and construction materials to computer chips, and brought about soaring prices. The pick-up of inflation in the euro area and elsewhere was not unexpected, considering the low reference base

in 2020 and the impact of pandemic-driven one-offs and other presumably short-term factors. In an effort to secure the uncertain recovery, we last year had good reasons to tolerate supply-driven spike of inflation - after a decade of it falling short of the target set.

However, Eurozone inflation prints kept surpassing our projections in recent months. Energy inflation and consequently headline inflation exceeded their highest levels since the introduction of the euro. Global supply chain disruptions have proven more sustained, while Europe also grapples with the energy supply crunch, aggravated by geopolitical developments and the EU's own climate-related policies. With the persistence of these factors, price growth has been gradually spilling over into a wider range of products, bringing core inflation rate on par with its previous 20-year peak.

**We need to start
rebuilding the monetary
policy space to be ready
for the next business cycle.**

Elevated inflation is set to persist well into 2022, longer than previously expected. The development of the pandemic and thus the duration of disruptions in supply chains are still uncertain. At the same time, various structural policies and geopolitical disputes indicate no immediate relief in energy prices. Longer spell of higher inflation increases the danger of it becoming more entrenched and broad-based. Studies show that euro area economies tend to be at risk of price hikes leading to increased wage pressures. In addition, expectations of future inflation, an important determinant of inflation, are highly state dependent and tend to react strongly to current inflation. Higher inflation, even if caused by external factors, could therefore result in a feed-back loop through higher wages and increased inflation expectations. Our monetary policy focus should therefore be on identifying early signs of increased wage pressures or the de-anchoring of inflation expectations above our target.

In addition to the surge in consumer prices, some of the unintended consequences of our policies are also weighing heavily on our decisions. In a low-yield environment investors are seeking yields in riskier segments of the markets, or are pushing the prices

of some investment possibilities, like housing, into levels where abrupt repricing could pose a threat to the macroeconomic environment. Furthermore, our maintaining of favourable financing conditions across all sectors and jurisdictions during the pandemic has contributed to increased debt levels in these sectors, hence inducing refinancing risk. Macroprudential policies with capital- and borrower-based tools are an important line of defence, but they focus primarily on the banking sector and are not all powerful. The longer the highly accommodative policy is maintained, the more pronounced these risks become, and the more painful the normalisation process may have to be.

Given these considerations, the time seems right for our monetary policy to move out of crisis mode and start the process of gradual normalisation. With the return of economic activity to the pre-crisis level, looming labour shortages and in part structural pressures on energy prices, our monetary policy needs to start rebuilding its space to be ready to respond to the next business cycle. However, this has to be a gradual and predictable path, in order not to pull the rug from underneath a more complete recovery in the context of an enduring pandemic. The decisions at our previous monetary policy meetings have laid the necessary groundwork to implement such an approach.



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Inflation is ushering in a new and uncertain phase of monetary policy

A heated debate is raging about the causes of high inflation, and how persistent it will turn out to be. In short, I think we ended up in a sort of perfect storm, where a number of factors contribute to intensified price pressures. These include transitory factors such as clogged supply chains, stress on energy markets, and buoyant demand stimulated by government aid packages (particularly in the US).

If inflation is transitory, central bank action may not be needed and in any case is unlikely to help bring down inflation. A central bank rate hike won't move containers faster from Shanghai to Rotterdam, nor will it help making energy cheaper to come by.

But there is reason to at least be on the alert for more persistent inflation pressures. Labour shortages may be longer lasting, with a view to demographics and demand for specific labour skills needed for e.g. the energy transition. Inflation, transitory or not, may translate in higher wage demands. One round of wage increases doesn't make inflation structural, but central

banks will be weary of a repeated back-and-forth between prices and wages.

I haven't mentioned one factor as possible cause of high inflation: monetary stimulus. Indeed central banks have been stimulating for many years already, while consumer price inflation only recently roared back to life. In that sense, a direct link appears implausible. Indeed, there is a broad consensus that negative rates and central bank asset purchases (Quantitative Easing or QE) have contributed to inflation not of consumer prices, but of financial and real estate assets. Wealth effects may have bolstered consumption, but the propensity to consume among households with financial assets tends to be relatively low.

So is there really no urgency to stop monetary stimulus in order to tame inflation? Well, let's look at this from another perspective. The economy is healthy, the impact of Covid-19 appears to be receding, unemployment is low, vacancy numbers are high. Inflation is running above the central bank's target. Is that an economy where you'd expect negative rates and asset purchases? Of course not. Indeed central banks have been changing their narrative. The Federal Reserve will conclude its asset purchases shortly and has signalled multiple rate increases for this year.

**Is today's economy one
where you'd expect
negative rates and
asset purchases?
Of course not.**

The ECB, too, has quickly rotated from warning against too-low inflation to warning against upside risks to price stability. Unlike the Fed, the ECB is not dealing with a potentially overheating economy warranting a strong rate hike cycle at this point. But with inflation running above the ECB's target, the case for asset purchases has all but disappeared. Tapering, followed by ending the negative ECB deposit facility rate would be a clear signal that the era of monetary stimulus is over. This would also be welcomed in the banking sector. Seven and a half years of negative rates and a flat yield curve are increasingly calling into question the sustainability of banking in the Eurozone. Maintaining negative rates and preventing the yield curve from steepening will weaken banks and impair their ability to lend. Given

Europe's high dependency on banks for credit, this is a scenario to avoid.

But ending monetary stimulus is hard to do. For several years, the ECB conducted asset purchases targeting the longer end of the yield curve, thus helping to maintain price stability. But QE neatly also served to bring rest to the Eurozone's sovereign and financial markets. This happy concurrence of goals is breaking down, now that the economy no longer needs the ECB's asset purchases.

A big question mark has emerged how bond markets will respond to the phasing out of asset purchases (tapering). One major effect of asset purchases on financial markets has been the compression of risk premiums. Moreover, since the outbreak of the pandemic, the ECB has indirectly but effectively financed governments' (very welcome) deficit spending. It will be a precarious exercise to escort issuers and investors back to more normal market circumstances, where risk is adequately priced in absence of the ECB as the dominant buyer. At the same time, the ECB should not delay its monetary policy changes for fear of financial market reactions. It should avoid any impression of "fiscal dominance", a situation where the central bank's (in) action is guided by the effect it might have on governments' budgets.

In the end, the mandate of the ECB is about managing price stability in the real economy with risk-free rates as prime instruments. The mandate is not about financial markets or risk premiums.



DINO KOS

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Where does inflation go now?

The high inflation readings of 2021 caught everyone by surprise. At the beginning of the year, inflation looked well contained and some central banks – such as the Federal Reserve – were aiming for inflation that was “above target” to make up for earlier periods when prices rose less than the two percent target. As the year progressed and inflation rose, investors were reassured by the authorities that higher prices were “transitory”. By year-end inflation rates were rising globally and the arguments of “team transitory” were ultimately abandoned even by some of the biggest proponents.

This evolution was not supposed to happen. Inflation targeting regimes – typically aiming for 2 percent – were thought to help anchor expectations at or near the target. For many years that seemed to work. However the combination of strong stimulus and resurgent demand has sent prices rising by 5 percent in Europe and even higher in the United States. Even excluding energy prices, eurozone inflation is running just below three percent, distant from the “below, but close to, two percent” target that has anchored the ECB’s approach for many years.

Why did inflation rise so much? Three factors are at work. Firstly, fiscal policy loosened massively and stimulated demand almost everywhere except China. Secondly, central banks eased

monetary policy further, including massive asset purchases that inflated equity and fixed income prices. So, consumers had more money from the government and felt wealthier from rising asset prices. Third, the pandemic disrupted supply chains that created shortages of some key components (e.g., semiconductors) and subsequent spikes in prices of those goods. In other words, as demand was rising, supply was being disrupted, creating a classic mismatch that could only be resolved with higher prices.

The troubling aspect was that higher prices began to feed into higher labor costs and the possibility that a “wage-price spiral”, a term not common since the 1970s, could be unleashed. To be fair, we must acknowledge the impact of the pandemic and if it recedes in 2022, then inflation should start coming down as the COVID-related disruptions are corrected and supply chains once again rebalance.

reassure markets that they will not permit inflation to get out of hand. That will require clear communications and a credible message that (1) real rates will need to rise, and (2) that inflation rates will be capped and then guided down gradually over time. For several years central banks were overly focused on inflation rates they viewed as “too low”. Now they need to pivot to both safeguard their credibility and re-set investors’ views that inflation will be contained, even if it means a period of higher volatility in asset markets.

**As high inflation
continues to rock global
economies, how can
central bank monetary
policy control what
may not just be a
temporary trend?**

However, there is no guarantee that will happen so neatly and quickly. In addition, the contagion of inflation from the supply chain to other parts of the economy is already happening. With real interest rates still deeply negative, central banks should carefully map out their strategies with a view to normalizing monetary policy. That implies both gradually raising rates and ending asset purchase programs. Even with that, monetary policy will still be deeply accommodative. Nonetheless, it would be a beginning of what is likely to be a long and uneven process. Not doing so risks a more serious inflation outbreak that would necessitate much harsher medicine later on.

That prospect of less friendly central banks already has the attention of global investors. During the first few weeks of 2022 many equity indices declined by 10 percent – a large amount given the short time frame. While geopolitics and COVID are factors, it is higher inflation and the risk of more aggressive tightening that is pushing investors to reprice valuations. It also raises the stakes for central banks to



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Oliver Wyman

Structural convergence, not more debt, is the key to success for the EU

Nobel laureate Robert Mundell defined the characteristics of an optimum currency area: It is all about factor mobility and risk sharing. Unfortunately, the Eurozone still is some distance away from meeting these criteria as defined by Mundell.

Firstly, labour mobility, the most important aspect of factor mobility, remains imperfect due to language and cultural barriers within the Eurozone. Fragmented social security frameworks also make it rather unattractive for workers to move.

Mobility mostly moves into one direction, i.e. from the economically weaker countries to the stronger ones, causing demographic and skill imbalances. The freedom of movement could be witnessed during the European sovereign debt crisis when young people from crisis-hit countries found opportunities in other EU member states.

More, but not enough progress has been achieved on capital mobility. The capital union has unified financial

regulation across the Eurozone and created a common supervisory landscape. However, many differences remain. For example, insolvency frameworks remain highly fragmented, leading to challenges when dealing with legacy assets. Deposit insurance has been harmonized across the EU, but no mutualisation has been agreed. We lack truly European banks mainly for strategic considerations, but the current policy framework does not necessarily help either.

The third criterion, a fiscal risk-sharing framework within the Euro area, remains the elephant in the room. The Eurozone was created with the understanding that such a risk-sharing framework was not required as the Stability and Growth Pact (SGP) would prevent Euro area economies from diverging too far from each other.

In hindsight, the desired result has not been achieved. Neither was the SGP ever enforced nor did it prevent the European sovereign debt crisis. Unfortunately, the economies of member states have diverged rather than converged. Debt-to-GDP ratios in some member countries are well above SGP limits and will likely remain there for some time. Although everybody agrees that the ESM is hugely important for the Eurozone, it is predominantly a safety net in times of stress with limited power to address structural issues. The same is also true for the NextGenEU program.

Rather than increasing EU debt limits the ECB must be relieved of its role as „buyer of last resort“.

The ECB stabilised the situation significantly as it kept borrowing costs low for all European member states. While the Eurosystem's balance sheet has more than quadrupled since 2008, the "cost" of doing so was limited as the extensive purchasing programs did not prevent the ECB from fulfilling its primary mandate: price stability. On the contrary, they played a key role in preventing the Eurozone from falling into recession.

This comfortable situation may now be a thing of the past. While current inflation is indeed partially due to temporary effects, structural factors could well constrain the ECB's room to manoeuvre should it not want to

accept a protracted overshooting of its 2 percent target. The green transition, for example, is likely to exert continued upward pressure on energy prices.

With the ECB holdings of Eurozone sovereign paper approaching 40 percent and with the ECB continuing to buy a significant share of new Eurozone public debt, its actions largely determine the financing conditions within the Eurozone. The development of spreads in recent weeks shows which countries have more fiscal space than others.

The discussions on reforming the SGP have only started, but good ideas seem scarce. Simply lifting the debt limit is not sufficient, perhaps even premature and outright dangerous. While somewhat higher debt levels could indeed be sustainable in an interest rate environment substantially lower than when the 60 percent limit was defined, this would commit the ECB to keep rates low - whatever it takes.

It may make sense to approach the problem differently. While Eurozone leaders can raise debt levels, they cannot compel private investors to buy this debt. The ECB stepped in as the „buyer of last resort“, keeping interest levels low. To attract private investors, structural reforms are needed to increase competitiveness and productivity. Such reforms pay off only in the medium run and require political will. A revised SGP may put more emphasis on growth-enhancing reforms than purely on fiscal indicators.

The continued success of the Eurozone will depend on achieving the economic convergence that was always at the heart of the European project. Simply increasing debt levels cannot be the solution as it would only put more burden on the ECB. The times when the ECB was able to take on that burden without cost are coming to an end.

The future of the Eurozone is not to be determined in Frankfurt but in the European capitals and in Brussels.

2

FINANCIAL STABILITY CHALLENGES AND VULNERABILITIES

ISSUES AT STAKE

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

Liquidity issues experienced by some money market funds and open-ended investment funds in March-April 2020 have moreover revived the debate about fund liquidity risks and more generally about the resilience of non-bank financial intermediation (NBFII), although the sector generally demonstrated resilience during this period in Europe. Improvements to the MMF framework are being considered at the global and EU levels in order to address the vulnerabilities associated with these funds, as well as a harmonisation and greater availability of liquidity management tools at the disposal of open-ended funds.

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

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Q&A

MICHAEL WEST

President - Moody's Investors Service

Risks to the financial sector becoming increasingly complex and interrelated

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

There are three areas I would highlight in terms of financial stability risks are: the banking system, the corporate debt markets, and sovereign debt.

The European banking sector has come through the pandemic in reasonable health. Capital has increased rather than declined, asset quality has continued to improve rather than deteriorate (in view of NPL ratios), liquidity is abundant, earnings are strong. While yields are rising at the long end in response to higher inflation expectations, we don't expect policy rates to budge any time soon. While this creates an element of continued earnings pressure, it also supports asset risk. As a result, we see credit risk in the banking system as well contained.

In the public debt markets, and also in the fast-growing private debt markets, it's a different story. Although corporates have tended to hoard cash, meaning net debt has not increased much, there has been rapid expansion of lower grade corporate credit, with weak contracts and covenants. These risks are better handled outside the banking system, and paradoxically push default risk out, but still result in greater risk for investors. It's government balance sheets that have seen the biggest change, bearing the brunt of the pandemic response. This creates a political challenge, but it's not yet a major financial one. This is thanks in part to those low interest rates which mean that debt service has continued to improve even while debt has increased.

The key financial stability risk could be a sudden risk aversion resulting in a correction in financial markets, spilling over into real assets like property and ultimately the real economy.

From Moody's analysis and conversations with CEOs/ market participants/ investors, how well do you think the financial sector is prepared to face these vulnerabilities?

Overall, the financial sector has come through the pandemic in much better health than it did following the Global Financial Crisis. We believe the European banking sector is well placed and any deterioration in asset quality and capitalisation should be modest. Given the critical role of banks in funding businesses in Europe, this gives us confidence that the private sector recovery should continue as public health measures ease and normal business activity resumes. At the same time, however, more progress is needed to boost disintermediated finance in Europe, and more broadly to drive the Capital Markets Union agenda.

Globally, there is a continuing shift towards disintermediated finance, which gives businesses access to a wider range of funding sources. However, Europe remains heavily reliant on banking. Boosting disintermediated finance presents significant opportunities for Europe as a whole; given that the EU is a net exporter of capital, it could be a stronger incentive for the private sector to keep funds in Europe, driving private sector investment and tangible increases in living standards. Such private funding flows would complement the planned Next Generation EU initiative, amplifying the benefit for businesses and citizens alike.

Beyond pure financial risks and vulnerabilities, a major focus for the financial sector more specifically, and corporate sector generally, is the transition to net zero. This will be an enormous undertaking for many companies. Do you think the financial sector has the

capabilities to meet these transition commitments and how can the financial sector support the transition to net zero of other sectors as well?

We have a collective responsibility when it comes to supporting the transition to net zero. Companies and governments worldwide are increasingly aligned around the goal of addressing the climate crisis. The financial system has a significant role to play in repricing climate risk and supporting sustainable investments that align with a lower carbon future and enable solutions to climate change.

Few issues are poised to multiply risk – or opportunity – more dramatically in capital markets than climate change. The economic benefit from the transition to a climate resilient, zero-carbon economy could amount to nearly a 25% cumulative gain in GDP over the next two decades alone, compared with a scenario in which the world fails to act. This is equivalent to adding the current Italian or Canadian economy to the global economy each year over this period and creates a €40 trillion investment opportunity for those able to take advantage of it. When it comes to financial institutions, first they need to know where their customers are on the net-zero journey, and then they can assess how they can help customers along the way.

More disclosure will provide better data which will ultimately drive better decisions. Proper accounting and disclosure of greenhouse gas emissions is foundational, with regular reporting to track changes in emissions for every borrower.

Where banks' role will be most important, however, is in financing the transition. Corporations may need finance to retrofit production facilities, decommission high-emitting assets or invest in energy efficiency.

The faster the transition to net zero, the lower the costs will be. Across the G-20, financial firms hold around €20 trillion in loans and investments subject to carbon transition risk. Over the coming years, they will need to ramp up climate risk assessments and set clear goals for reaching net zero in their financed emissions. They will need to invest in green businesses and new technologies. They will have to fund the capital needs of companies in carbon-intensive sectors who are aligning their business strategies with low-carbon business models. A delayed and disorderly carbon transition poses the greatest risk to financial firms.

Cyber security and cyber resilience are themes that are preoccupying the financial services sector as much as any other type of risk. How do you see this category of risks from the perspective of a global risk assessment company? What are the most significant vulnerabilities in this regard and how well set up do you think the financial sector is?

These are real concerns and we have seen that cyber risk is increasing in frequency and severity. We have identified 13 industry sectors as facing medium-high or high risk to cyber, which account for total rated debt exceeding €17 trillion.

The four most at-risk sectors are banks, securities firms, market infrastructure providers, and hospitals – all of which

rely heavily on technology for operations, content distribution, or customer engagement. The financial services sector handles extensive customer and proprietary data, are custodians of customers' wealth, and facilitate transactions across critical financial infrastructure. All of this makes them ripe targets for cyberattacks. However, these firms also have fairly strong cyber-preparedness, an essential risk mitigant, and have been leaders in enhancing cyber strategy and investing in cyber defences, processes and talent, as detailed in the findings from our recently published survey of 88 rated banks across the globe.

From a cyber risk perspective, we see vulnerabilities directly or indirectly related to banks. Changing behaviours pose new cyber risks - remote and hybrid work arrangements have made cyberattacks easier and more attractive for cybercriminals. Greater demand for and dependence on digital banking technology has increased the risk of successful cyberattacks. Cybersecurity talent gap is growing, vulnerabilities to supply chain attacks highlight the need for deeper assessments of supplier cyber risk, and finally, cyber insurance is poised for change as premiums continue to climb, while the scope of coverage narrows.

From a resilience perspective, banks report having sound cyber governance practices. In addition, regulatory scrutiny will continue to help mitigate cyber risk and mandates around disclosure rules will increase.

A key issue with cyber risk is the fact that financial markets have very little ability to quantify cyber risk. And in the face of future unknowns, resilience is probably more essential than preparedness. Cultivating resilience involves building capabilities within an organization to navigate cyber-attacks. Widening the aperture on cyber security from working to prevent attacks to building greater resilience for when the attack happens will be crucial.

OVER-PUBLIC INDEBTEDNESS CHALLENGES FOR GROWTH AND STABILITY



SYLVIE GOULARD

Second Deputy Governor
Banque de France

Cinderella and the Covid crisis

Coming (slowly) out of the sanitary crisis, it is difficult to identify what the “new normal” could be. Compared to the management of the previous crisis the response to the COVID choc was definitely quicker, of a larger magnitude, and more coherent.

In March 2020, the ECB decided to intervene in a massive way to preserve financial stability and avoid the collapse of European economies. The Pandemic Emergency Purchase program consisted of an unprecedented injection of liquidity (1,8 trillion euros). Access to liquidity was secured for private banks. Prudential buffers were released.

On the fiscal side an unprecedented expansionary policy mix was implemented. This support helped economies to go through brutal lockdowns, kept companies alive, saved jobs and supported purchasing power. In July 2021, EU Member States agreed to a common debt issuance to finance the recovery; the 800 billion € recovery fund is intended to help relieve the

economic pain due to the crisis. NGEU disbursements will amount to around 0.8% of Eurozone GDP per year in 2021 and 2022. Two new features, NGEU conditionality and assessment process led by the Commission, should contribute to increased efficiency in national reforms and mutual trust.

All these decisions took place in an exceptional context, where the stability and growth pact rules were suspended as well as state aid rules. And now? Like Cinderella, we may face another situation when the night is over... Several issues are at stake:

- **rising inflation:** in the Eurozone, the annual inflation rate was estimated at 5% in December 2021 when, since the strategic review, the new inflation target of the Eurosystem is a symmetric 2%. According to the ECB previsions, inflation is expected to fall slightly below 2% by the end of 2022 (1.8% in 2023);
- **accumulation of public debt:** at global level, public debt-to-GDP ratio increased on average by 15 pp between 2019 and 2020; for the Euro area, it is estimated to reach 100% in 2021, however with great disparities;
- **pre-existing structural vulnerabilities:** economic performances of euro area countries are heterogeneous. Though the creation of the “macro imbalances procedure” in the revised Stability and Growth Pact (SGP) in 2011 meant to give the Commission a monitoring power, spill overs between states still exist.
- **new long-term challenges:** all EU countries are committed to net zero which requires huge investment (estimated at €360 billion per year for the three coming decades); digitalisation is also key and costly, without even considering the possible need for more military spending in a troubled geopolitical environment.

Should inflation be more persistent and higher than anticipated, the ECB will act according to its mandate. Higher interest rates could both affect the European Union’s recovery and increase the interest burden of public debt. Fiscal authorities will have to include the risk of higher nominal interest rates in their budget plans.

The Commission has launched a consultation on the current EMU rules. As long as states remain in charge of economic and social policies and the

ECB of a unique monetary policy, this “social contract” is key.

EU fiscal rules are often considered too complex and even not applicable. It is true that the revised SGP and the “fiscal compact” (TSCG treaty) were adopted in a short period of time (end of 2011 / 2012), in a context of very high spreads and mutual distrust. To revise these rules, it is not enough to criticize their complexity, their insufficient counter cyclical or limited enforcement. These are the consequences of remaining cultural divergences, which need to be worked upon in depth. Whatever the outcome of the current revision, reduction of debt will require effort, in particular in countries used to high levels of debt, long before Covid.

Cinderella holds her fate in her own hands.

New rules are not a silver bullet nor will they create convergence if governments and public opinions are not convince that these efforts, accompanied by well designed productive investments, are in their interests. Some ideas currently discussed such as the exclusion of some expenditures in the calculation of the deficit and debt, were also already envisaged in the past, with little success.

A common EU central fiscal capacity should be investigated, as part of a optimal currency area, and to cover the financing needs of the green transition while ensuring convergence across Members-States on the transition path. However, the best method to get such a budget one day is to make the best possible use of the NGEU.

Any future “budget” dedicated to common priorities driven investments and growth-friendly public spending requires not only the revision of rules but other behaviours. Cinderella holds her fate in her own hands.



EDWARD SCICLUNA

Governor - Central Bank of Malta and Member of the Governing Council of the ECB

One instrument for one objective

Nobody needs to explain why high inflation is undesirable. It robs people on fixed incomes. It starts the dog chases tail wage-price spiral between unions and employers. And yet, nobody would like inflation to return to negative territory, where interest rates can get stuck at very low levels for long periods.

Hence the accepted 2% inflation rate target, which gives adequate elbow room to monetary policy makers to keep the ship steady and allow economic growth to flourish. Hence too the symmetry principle which the ECB has embraced for the future.

That said we are presently faced with relatively high rates of inflation which were last experienced more than a decade ago. Indeed, the rates in the European Union countries and elsewhere, notably in the US and Canada, are exceptionally high.

The knee-jerk reaction response from media to raise interest rates is understandable. But proper evaluation needs to enquire about the source of this inflation, and how it has been in hibernation for so long and after proven itself unresponsive to the barrage of monetary instruments over the last decade, appears all of a sudden.

Of course, it has to do with the pandemic. No doubt the pandemic has upset persons, institutions, and whole economies. Many people stayed at home for various reasons. Like a war period both supply and consumption were seriously interrupted. Like war it has interrupted the modes of work, encouraged persons especially the elderly to withdraw from the labour force, affected heavily people's wellbeing and self-worth, while making others to rethink their life-plans and undertake a reset as well.

The aftermath of the pandemic found the economy with previously pent-up demand pouring out and finding supply short. Industry found much of their staff missing due to sickness imposed quarantine, absences to look after children whose schools were closed, or even inadequate vaccination.

The logistic problems affecting cargo shipping, combined with the tight oil production and ensuing energy prices affected the prices of a wide range of goods, including food and housing cost. Each price surge is explainable, has a beginning, and an end. In short, the price burst is not expected to be permanent. Inflation is transitory.

Many questions arise. What do we mean by transitory? What about the reactions of firms, unions and consumers in the face of such price increases? Will they react? Inflationary expectations are of material interest to the medium term anchoring of the inflation rate.

**... an agreement
on a renewed fiscal
pact for the sake of
containing inflationary
expectations.**

In all this we cannot ignore the fiscal side. In this pandemic, government support took a central role and may be described as the elephant in the room. Definitely more so in the US where no less than a 3 trillion US dollar stimulus package was laid out.

On this side of the Atlantic the pandemic-related public expenditure was likewise justifiably generous, though not as much as in the US. But judging by the increasing deficits and debts which averaged over 13 percentage points for the euro area it was indeed significant and without precedent.

This public assistance was intended to ensure some element of continuity

which was missing during the 2008 financial crises and its aftermath. Wage supplements and business support schemes were meant to provide liquidity to revenue-starved firms and ensure the labour force would remain on the firms' payroll. This was supplemented at the EU level by various schemes with the largest being the RRF. Definitely, one cannot overlook this as a potential source of inflationary pressure.

In comparing the global financial crisis to the pandemic crises another difference stands out. The aftermath of the former crisis was marked by stringent EU wide fiscal rules and relentless consolidation where EU governments saw a marked reduction of their deficits and their debts. In the current situation the fiscal rules had to be suspended and a new fiscal framework is still being discussed. Its future is not yet clear. It is expected that deficits will come down but definitely slower than before.

What is relevant for inflationary expectations is whether consumers, firms and unions believe that governments are really committed to bring down the crisis related deficits and debts. If that is the case then indeed inflationary expectations would be eased accordingly.

If on the other hand the taxpayers believe this will not happen, inflationary expectations may not become anchored at the required rate for price stability. They will argue that since governments do not do their part to see the debt burden falling to pre-pandemic levels through growth and fiscal rectitude then inflation will be left to reduce the debt burden through its known taxing method.

The principle of using one instrument for one objective here applies. That part of inflation which is caused by fiscal largesse must be mainly addressed by fiscal means. For now it is imperative for MS to reach an agreement on a renewed fiscal pact for the sake of containing inflationary expectations.



DECLAN COSTELLO

Deputy Director-General,
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Europe's recovery from the crisis: facing new headwinds

The EU economy is rebounding from the recession caused by the COVID-19 pandemic faster than previously expected. Thanks to a successful vaccination campaign and a forceful and coordinated policy response, most Member States returned to its pre-pandemic output level by the end of 2021, according to the Commission's latest economic forecast of November 2021. The Commission projects GDP growth in the EU at 4.3% in 2022, in line with strong domestic demand dynamics and a positive labour market outlook. The economic expansion is set to continue, with GDP growth expected at 2.5% in 2023.

The uncertainty around these projections is high and headwinds to the economic outlook are mounting. Whilst recent developments are positive in Europe, new waves of infections and containment measures remain a downside risk to the outlook. More pressingly, we also see that the supply side is struggling to keep up

with buoyant demand as supply chain disruptions and shortages of raw materials and intermediate inputs hamper production, while pockets of labour shortages emerging. In addition, a sharp spike in energy prices fuels inflationary pressures.

Whilst our economies have coped better than expected and worst potential impacts in terms of scarring have been avoided to date, vulnerabilities over the medium and long-term have increased. Highly valued equity markets and the recent surge in house prices, to levels above their fundamental value in many Member States, carry the risk of sudden corrections. At the same time, high corporate and public debt levels accumulated during the crisis imply additional exposure to changing financial conditions. While the substantial liquidity support, public loan guarantees and debt repayment moratoria have helped keeping businesses afloat during the pandemic, the overall low insolvency rates suggests that bankruptcies are due to catch-up to some degree, with possible ramifications on public finances.

In this challenging macro-economic environment, the right policies and effective economic policy coordination will be crucial to support a broad-based recovery that is consistent with the green and digital transition while ensuring macroeconomic stability.

**Whilst our economies
have coped better than
expected, vulnerabilities
have increased.**

With the Recovery and Resilience Facility (RRF), the EU has created a once-in-a-generation opportunity to transform our economies in light of an unprecedented crisis. By providing large-scale financial support to high-quality investments and enabling reforms in the Member States, the RRF will help lift their growth potential and thus support the sustainability of public debt.

Now is the time to turn the Member States' ambitious recovery and resilience plans into tangible results on the ground. We should see it as a strong and positive signal that the euro area Member States with high deficits and debt levels are frontrunners in the implementation. Spain has already received its first disbursement under the RRF based on the successful implementation

of the first milestones of its plan, and France is expected to follow suit soon. Greece, Italy and Portugal have formally submitted payment requirements which are under active consideration by the Commission.

Beyond the swift implementation of the RRF, we need to reach a swift agreement on the direction of our economic governance. The reform of the fiscal rules should help put fiscal policy on a credible medium-term path that strikes the right balance between macroeconomic stabilisation and fiscal sustainability. A credible anchor for fiscal policy will foster market confidence and support the ECB in ensuring that the monetary policy stance remains consistent with inflation stabilising at the target rate over the medium-term, in line with an eventual normalisation of interest rates.

Finally, and as part of this debate, economic governance should pay attention to the quality of the budgets and protect public investments that are crucial for the green and digital twin transition. The EU has chosen to be a frontrunner and to embrace the opportunities found in environmental protection and the fight against climate change, which is the biggest challenge we collectively face. In addition, the pandemic has further accelerated the digital transition. Supporting the development and uptake of digital technologies and equipping the workforce with the right digital skills will be key to lift the growth potential of our economies.

The fiscal rules should take due account of these objectives. In this regard, the RRF grants will help to adjust to the structural changes underway without jeopardising fiscal sustainability.



SARAH CARLSON

Senior Vice President
Sovereign Group -
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Next Gen EU offers opportunity for debt-laden countries to address challenges

In Moody's view, the Next Generation EU (NGEU) economic recovery programme is a once-in-a-generation opportunity for some of the EU's most indebted countries because of its size and the way in which it links disbursement of its funds to the enactment of structural economic reforms that could address root causes of weak growth potential.

Four South European countries — Greece, Italy, Portugal, and Spain — will receive almost half of all grants and loans available under the NGEU's Recovery and Resilience Facility (RRF). The European Commission has stated that if fully utilized, the funds available for all EU countries would total €806.9 billion in current prices, or around 4% of EU GDP, over the 2021-26 programme period. In the case of Italy and Spain, the RRF funds are several times the size of what these countries receive under the regular multi-year EU budget.

In all, EU funds from the RRF and the current EU budgeting cycle will

effectively double public investment in these four countries over the next five years. Public investment spending in these countries has been falling since the euro area sovereign debt crisis and was among the lowest in the EU in 2019. Since 2015, the four countries had accumulated a public investment gap—in other words, the investment needed to maintain the stock of public assets net of depreciation—that averaged 2.4% of GDP, with Portugal and Italy having accumulated the largest investment needs.

The NGEU recovery funds give recipient countries the space to reduce pandemic-era deficits while supporting economic growth. Moody's estimates that this funding, if fully absorbed, could add 0.7 percentage point to real GDP growth in these countries between 2021 and 2027, which in turn could help to activate positive debt dynamics. If these funds mobilise further private investment, this could have additional benefits for economic growth.

Moody's views the structural reform component of the NGEU programme as being at least as important as the investment funds themselves in boosting longer-term growth potential, and in many cases the reforms and investment priorities are mutually reinforcing. For example, substantial funds that are being channelled toward digitalization will aid reform of the public administration. If implemented effectively, this could generate significant efficiency gains and ease spending pressures in areas such as healthcare, which will be under pressure in the coming decades because of population ageing.

The NGEU recovery funds give recipient countries the space to reduce pandemic-era deficits.

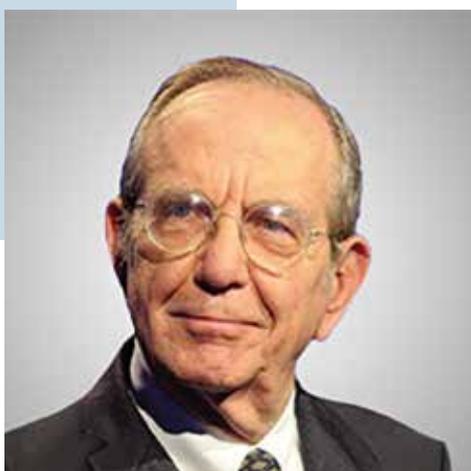
In fact, subdued investment spending is only one key driver of weak growth in the EU's most indebted countries. The most acute challenges vary by country, but relatively low productivity growth, low labour force participation, and slowing population growth have often played an important role, too, in driving the low level of economic growth in Europe's most indebted countries. Among the advanced economies, Europe is not unique in facing growth challenges—for example, South Korea also faces significant demographic challenges and the US has difficulties with productivity growth, weaker

participation rates for some segments of the labour force, and high levels of income inequality. However, in both South Korea and the US, high levels of technical innovation mitigate these challenges to a greater degree than in Europe. This contributes to keeping their growth potential higher.

Many challenges remain for the EU, but if they can be overcome there is further upside potential to Moody's growth expectations, which if realized would be credit positive for the countries concerned. One key area of uncertainty is whether the large recipient countries can absorb large amounts of investment funds in such a short time frame and use these funds effectively to support the process of structural reform. This has been a challenge in the past, and if previous absorption rates were to be applied here, Moody's estimates that the growth impact of the recovery funds would, on average, be 0.2 percentage point lower each year. Whereas the incentives that the NGEU's governance process has created are a strength of the programme, it will be difficult for governments to maintain political momentum around the structural reform process. It could also be challenging for the European Commission to enforce commitments to deliver on reforms.

Nevertheless, NGEU has the potential to mark not just an institutional milestone for the EU, but also an important step towards addressing the twin challenges of low growth and high debt that many of the EU's most indebted member states are confronting.

If NGEU can realise its potential, this would increase the resilience of the entire monetary union, with meaningful benefits for the stronger member states as well.



PIER CARLO PADOAN

Chairman of the Board of Directors - UniCredit S.p.A.

The need to create fiscal capacity and a true capital market in Europe

The US economy is probably the best reference for a comparison on EU growth, while China has a completely different structure. In 2010-19, per-capita GDP growth in the EU underperformed the US by an average of 1pp a year, due to an unfavorable mix of demographic factors and slower productivity. This was exacerbated by the fact that the EMU remains an incomplete project, with lack of fiscal integration and slow progress on the banking union.

Consequently, before COVID-19, the euro area was not adequately equipped to counter cyclical shocks via fiscal policy and placed an excessive burden on monetary policy as a stabilization tool. After the Great Recession, austerity that was intended to reassure financial markets backfired, leading to tighter conditions and severe recessions in the weakest eurozone countries, ultimately leaving the responsibility of sustaining the economy entirely on the ECB.

Against this background, the main reform priorities for European policymakers are the creation of a central fiscal capacity and establishing a true European capital market.

European policymakers need to create a common fiscal capacity to attain a more adequate aggregate fiscal stance than what a coordination of national policies has managed to achieve before the pandemic. NGEU has been a major step forward. Several European leaders have recently expressed their support in favor of the set-up of a permanent fund to increase common investments in strategic areas (such as defense, research, infrastructure, and digitization) and the proposal is expected to be discussed in March on the initiative of French presidency of the Council of the EU.

The need of more investment in “common goods” is highlighted by the weakness in public investment over the last decade. In the eurozone, public investment fell from 3.5% in 2010 to 2.8% of GDP just before the COVID-19 crisis, with Italy and especially Spain recording large declines. In fact, the debate on the reform of fiscal rules and the discussion on a central fiscal capacity should be seen as complementary and mutually reinforcing in strengthening Europe’s resilience to shocks and place the recovery on a fairer and more sustainable path. Driving the rules’ reform proposals is the aim of encouraging growth-friendly expenditure, such as green and digital investment, and enabling member states to pursue a gradual and realistic reduction in debt to avoid stifling the recovery.

Creation of a central fiscal capacity and establishing a true European capital market.

Policymakers need to step up efforts toward integrating European capital markets and thereby channeling towards investment the large pool of European private savings (whose stock exceeded EUR 4tr last year) irrespective of home-country considerations. This is particularly important as the COVID-19 crisis risks increasing economic divergences within the euro area. Increasing cross-border ownership of stocks and debt securities and cross-border business financing would be an important way of sharing risks and by this means stabilizing the real economy over time. It would also be critical to achieve the substantial investments in digital and green infrastructure that are needed to meet the bloc’s medium to longer term objectives. The goal to cut greenhouse gas emissions by at least

55% before the end of the decade will on itself require about EUR 500bn per year in additional investment, compared to the previous decade. And the bulk of these additional funds will have to come from the private sector.

The implications of above-target inflation will depend on the causes of high inflation and the response of monetary policy. If high inflation mainly reflects an improvement of economic fundamentals, namely activity exceeding the pre-pandemic trend-line sooner than expected, a closing of the output gap and stronger labor markets and wage developments, big negative consequences for financial stability are unlikely. The ECB would stop net asset purchases and, probably, lift interest rates out of negative territory. However, the increase in market rates would feed through to the average cost of debt over a number of years, while public debt/GDP ratios would continue to decline thanks to sustained nominal growth.

The situation would be different if high inflation were to mainly reflect supply bottlenecks and persistently high energy costs. In this context, economic activity would suffer because the inflationary shock would erode the purchasing power of households, with negative consequences not only for consumption, but also for investment and intra-area exports. However if inflation expectations remain well-behaved, the ECB should refrain from tightening monetary policy and this would help stabilize market sentiment.

A more challenging situation would arise if the recovery of eurozone countries proceeds at markedly different speeds with highly indebted countries lagging behind. In this environment, the ECB would probably need to tighten policy to some extent, which might lead to wider sovereign spreads and a higher risk of renewed financial fragmentation.

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SUSTAINABILITY RISKS IN BANKING



ALESSANDRA PERRAZZELLI

Deputy Governor
Banca d'Italia

Banking sustainability risks: central bank and supervisory authority perspective

The transition towards a sustainable growth requires strong commitment by all stakeholders: public and private actors, international bodies and national governments as well as financial regulators and supervisors. Indeed, the financial system can play a key role in such a process. As a central bank and supervisory authority, the Bank of Italy is fully committed to facilitate the smooth development of sustainable finance; as an investor, it has been integrating ESG criteria into its equity investment policy since 2019.

On the banking side, intensive work is underway at national, EU and global levels to assess whether new prudential rules are required to address sustainability risks. In particular, the recent proposal of the European

Commission of a review of the Capital Requirements Regulation and Directive aims at strengthening the Pillar 3 disclosure and the management and supervision of ESG risks (Pillar 2), in line with the Sustainable Finance Strategy.

Notwithstanding the regulatory debate is still open, two milestones lead global works for the time being. First, regulation must remain risk-focused: the financial system can play an important role in driving the transition but its success should mainly lie on national governments' responsibilities. Second, climate-related financial risks are nothing but additional sources of well-known risks, which the current regulatory framework seems to be in the condition to manage. However, their distinctive features (i.e. forward looking nature, far-reaching impact, irreversibility) require further analyses to assess whether and how the three Basel pillars could, or should, be enhanced.

**Intensive work is
underway to assess
whether/how the three
Basel pillars could /
should be enhanced.**

Indeed, filling the data gap and strengthening international coordination are among the main priorities of authorities. The Italian G20 Presidency had a pivotal role to this regard, including the fight against climate change among its top priorities. The Presidency reinvigorated the Sustainable Finance Study Group, which was eventually elevated to a permanent G20 working group; promoted the development of a global baseline for disclosing and reporting sustainability information and climate-related data.

As part of our drive to foster the development of new technologies and sustainable finance, last year the Bank of Italy and the Bank for International Settlements Innovation Hub launched a new G20 TechSprint. This international hackathon received about 250 draft proposals and 99 full applications from teams in 25 countries. The three winners developed innovative applicable solutions addressing the challenges concerning green and sustainable finance.

The impact of sustainability risks on the financial sector still needs to be properly assessed. Relying on the knowledge gained in the economy-wide climate stress test run last year by the ECB and the experience gathered so far, the SSM is launching in 2022 a specific micro-stress test on climate risk for banks under its direct supervision, together with a specific thematic review on risk management practices. Given the data and methodological challenges, both projects will be a learning process for both banks and supervisors.

Environmental risk is a top priority also for the Bank of Italy. We are implementing a pragmatic and gradual supervisory approach, expecting all intermediaries, including small and medium-sized ones, to fully understand the impact of ESG-related risks on their exposures, as well as the threats and opportunities for their business models. As part of a broader thematic review on the governance of Less Significant Institutions (LSI), a first round of targeted interviews to board members of a large sample of banks was conducted last year, in order to gather insights about their degree of awareness towards environmental risk. First evidence shows an increasing awareness in this area, even though material differences across intermediaries still emerge. A more structured thematic review on a sample of LSI will follow in the coming months, as part of an ECB project.

Finally, drawing on the ECB Guide on climate-related and environmental risks, the Bank of Italy will shortly issue a public document containing a first set of supervisory expectations targeted to both LSI and asset managers under its direct supervision, designed according to a proportionality principle.

The journey is still long, especially for smaller players. Banks' vulnerability will depend on a number of drivers, such as business model, sectorial exposure as well as risk concentration. However, it is clear enough that their ability to define new strategies integrating ESG components and targets into the risk management practices and corporate culture will contribute to make their business models more efficient and sustainable in the coming years.



FERNANDO RESTOY

Chair - Financial Stability Institute (FSI)

The prudential treatment of climate-related financial risks: the challenges

There is an absolute need for authorities to review their prudential frameworks as to fully incorporate the implications of climate-related financial risks for financial stability. Physical and transition risks constitute relevant threats to the safety and soundness of individual banks and the stability of the financial system. Accordingly, there is merit in expanding existing prudential regulatory frameworks to ensure that banks have an adequate climate-related risk management processes in place that are consistent with their risk appetite, risk profile and operating environment. In addition, changes to the prudential framework should involve, as the BCBS is envisaging, an assessment of whether capital requirements already adequately capture such risks or if adjustments are needed to address any relevant gaps as to ensure sufficient loss absorbency capacity.

Yet, the operationalisation of such prudential approach for climate-related financial risks entails substantial operational challenges. First, given the longer time horizons and the high degree of uncertainty

associated with the materialisation of climate-related financial risks, standard Pillar 1 instruments such as capital requirements might be ill-suited to address such risks. In particular, requiring banks to set aside capital today to cover losses for risks that may only materialise long after the maturity of most of their current exposures and only if their investment strategy remains unchanged over long time-horizons is inconsistent with the construct of the prudential framework.

In contrast, the intrinsic flexibility of the Pillar 2 framework makes it the natural candidate to ensure that banks effectively manage climate-related financial risks and have sufficient loss absorbency capacity against such risks. For examples, supervisors can use scenario anal to increase banks' awareness about potential deficiencies in their risk management framework as well as require management actions and additional loss-absorption capacity, if needed. Having said that, the same flexibility that makes the Pillar 2 framework such a powerful and effective approach may give rise to level playing field issues. Guidance on the application of Pillar 2 to address climate-related financial risks would therefore be a welcome development.

Need of a bold response by regulators, but fully anchored on their safety and soundness mandate.

There is no obvious scope for a macroprudential framework aimed at containing systemic climate-related financial risks. First, because the microprudential regime, and in particular, the Pillar 2 framework, through stress tests and scenario analyses, seems to be a more suitable approach to ensure that banks have sufficient loss absorbency capacity against systemic climate-related financial risks. Second, the application of tools such as imposing a capital add-on as a function of aggregate brown exposures are likely to be ineffective and potentially detrimental for financial stability.

Indeed, empirical evidence shows that changes in capital requirements have a small impact on banks' investment policies unless they are calibrated at very large levels. More importantly, macroprudential actions aimed at reducing exposures to carbon-intensive firms and sectors may not always be conducive to reducing aggregate

climate-related financial risks. In particular, unlike in the case of standard macroprudential actions, measures aiming at containing brown exposures may not necessarily contribute directly to a financial stability goal, as they might exacerbate transition risks.

Similarly, a green-supporting factor, consisting of alleviating prudential requirements for green exposures is unlikely to contribute to financial stability policy objectives. A reduction in capital requirements for green assets would cause a break in the fundamental relation between risks and capital requirements as there is no conclusive evidence that green investments are less risky than other exposures.

Swift action by governments to steer the transition to a greener economy could fruitfully interact with a financial-stability-focused prudential regulation to ensure an effective contribution by the financial sector to the economic transformation. By deploying a combination of carbon taxes and subsidies as well as guarantees, public authorities should seek to meet that emissions reductions targets and, also, to facilitate an orderly transition to a more sustainable economy.

At the same time, this policy mix would contribute to a reduction in the overall exposure of the financial system to both physical and transition risks. That combined with a well-designed climate-related microprudential framework could make the banking system more able to manage these risks and, therefore, to contribute effectively to the economic transformation.



FRANÇOIS-LOUIS MICHAUD

Executive Director - European
Banking Authority (EBA)

Closing the data gaps to allow for an orderly climate risk transition

Financial institutions generally acknowledge the urgent need to take into account the growing importance of Environmental, Social and Governance (ESG) risk factors. Data collected by the EBA show that banks recognise ESG risks as drivers for traditional financial risk categories, credit risk in particular, and start integrating ESG risk considerations into their risk management^[1]. However, significant progress remains to be made, including in areas such as business strategies, governance arrangements, risk measurement and monitoring.

Data gaps represent a critical challenge to the development of methodologies to identify, assess and monitor ESG risks. This is fully acknowledged by the public sector. Pro-active actions by banks are also needed, leveraging on available public disclosures, bilaterally engaging with counterparties, and assessing the need to have recourse to external data providers.

Facilitating the transition to a more resilient and sustainable European banking sector is a key objective for the EBA. To that end, the Authority is currently very active complementing

the single rule book in the areas of disclosure, supervision, stress-testing and prudential treatment, in collaboration with key stakeholders both inside the EU and internationally.

Firstly, the implementation of a well-defined disclosure (“Pillar 3”) framework for ESG risks is needed to facilitate access to meaningful and comparable information, allowing stakeholders to assess institutions’ ESG performance and risk profile, and to allow for an orderly transition. The recently published EBA disclosures standards define granular templates, tables and instructions, with quantitative disclosures on climate-related risks and qualitative disclosures on broader ESG risks^[2]. These standards can help establish best practices and encourage progress at international level.

Secondly, as reflected in the EBA Report on ESG risk management and supervision, institutions need to further embed ESG risks into their business strategies, risk management frameworks and internal governance arrangements. The EBA expects banks to manage these risks as drivers of financial risks in their risk appetite and internal capital allocation process. The EBA also advises institutions to develop methodologies and approaches to test their long-term resilience against ESG factors and risks, including the use of scenario analysis. Additional guidance was provided with regard to internal governance and remuneration,^[3] as well as loan origination.^[4] More will come on risk management. Similarly, ESG risks need to be incorporated into supervisory practices.

Regulatory enhancements will best support banks and supervisors in addressing ESG risks.

Climate stress-testing and scenario analyses are also being introduced by banks and supervisors. In 2021, the EBA published the results of its first pilot exercise on climate risk^[5], mapping banks’ exposures and shedding light on data and classification challenges banks confront. This provided a robust foundation to the work ongoing at supervisory authorities and banks in the area of climate stress tests. The first such exercises will in turn prove very useful to the EBA when embedding climate risk in the EU wide stress testing framework in the coming years,

which will also benefit from the work of the Network for Greening the Financial System on climate risk scenarios.

Last but not least, environment risk drivers should also be properly captured into the prudential regime. This should be grounded in measurable facts, as prudential regulation should remain geared towards ensuring the safety and soundness of institutions. A risk-based approach includes assessing whether there is evidence of a risk differential between specific exposures, and whether the peculiarities of environmental risks necessitate to amend the existing rules. The EBA is working on this, and is closely involved in the related Basel Committee initiatives in this area as international coordination is of the essence.

Overall, the materiality of ESG risks is more and more acknowledged and there is a clear willingness of all stakeholders to make progress. While the existing regulatory framework provides a strong foundation for banks and supervisors to address these risks, regulatory enhancements are necessary to best support their efforts and facilitate an orderly transition to a more sustainable economy.

[1] See *EBA Risk assessment of the European banking system* (December 2021)

[2] See *EBA Implementing Technical Standards*

[3] See *EBA Guidelines on internal governance and remuneration policies*.

[4] See *EBA Guidelines on loan origination and monitoring*

[5] See *EBA Report: Mapping climate risk: Main findings from the EU-wide pilot exercise*



SHINSUKE TODA

Chief Executive Officer for
Europe, Middle East and Africa -
Mizuho Financial Group,
Inc. / Mizuho Bank, Ltd.

International collaboration to ensure sufficient funding for a just transition

Globally, governments, corporations and other market participants are accelerating their efforts to achieve sustainability. Although moving towards the same goal, they are neither moving in tandem nor yet speaking the same language. An example is ESG ratings, where various rating agencies and data providers use different methodologies and definitions to evaluate a corporation. This lack of consistency devalues transparency and provides less meaningful information for investors and other users to assess risk.

A review of sustainability disclosures across Europe and Japan will quickly reveal that although the direction of travel is similar, the pace and approach differs. Most European and large Japanese banks have committed to achieving carbon neutrality or alignment with the Paris Agreement. They have started integrating climate change risks into their governance and risk management frameworks, and have taken steps to conduct scenario analyses. There is wide participation in international initiatives, such as the

Net Zero Banking Alliance. However, in areas affected by local government policies, they are taking different approaches. Sector-specific policies, arising out of balancing economic, industry and energy interests, have a significant impact on banks' approaches to transition plans in different jurisdictions.

Climate stress testing is another area that European banks lead, as supervisors have provided clear guidance from an early stage. Japan is currently planning to introduce sustainability disclosure requirements for corporates and considering its supervisory approach to banks' management of climate risks.

As a global bank, our focus is on bridging corporate clients and investors on a cross-regional basis: providing funding opportunities for European corporates by inviting Japanese and other Asian investors, supporting European multinationals to conduct business in Asia, and supporting Japanese companies entering EMEA markets. Those businesses consider the ESG impact of their activities and investments, with transition risks and divergence in the pathways to carbon neutrality across different jurisdictions being key client concerns.

**...avoid short-termism
and facilitate sufficient
funding to achieve a
just transition.**

Firstly, in respect of transition risk, the energy sector is striving to shift from fossil fuels to renewable energy, which requires unprecedented levels of investment. Transition pathways should be appropriately managed to avoid disruptive events such as commodity price surges. The recent spike in natural gas prices in Europe shows that the world needs fossil fuel energy until there is sufficient investment in renewable energy sources for them to become suitably widespread and reliable. The pace of transition should be carefully managed to balance the drive towards sustainability with ensuring that the associated risks to the economy are properly considered.

Secondly, transition pathways vary both globally, between jurisdictions, and locally, depending on the industry and activities being carried out. There is a risk that capital will flow towards green assets and industries, and although this

is desirable in the long-term, in the short-term it will divert vital funding from the industries that need it most, increasing their ESG transition and associated funding risk. Therefore, we urge regulators and policy makers to closely monitor the flow of capital, both locally and globally, to mitigate this risk. As energy transformation requires enormous investment, it is essential that companies appropriately profit from existing business and reinvest for the transition.

The policy measures introduced to meet carbon neutrality targets are intended to facilitate long-term transition pathways to green. However, there is a material risk that some of these could effectively, and unintentionally, function as a penalty and prejudice a just transition. Taxonomy and disclosure requirements will help companies visualise the pace of transition, which may unfairly create a negative impression for companies that have not yet had the opportunity, funding or know-how to transition, or operate in a regulatory environment that has not yet imposed the same measures as the EU.

Achieving carbon neutrality is a universal goal, but implementation is still at an early stage and various challenges remain. Regulators and policy makers should collaborate to ensure a coordinated approach to rule making to reduce global fragmentation, particularly where rules will have extraterritorial effect, so we have a common understanding of our fundamental goals and standards. Even if transition pathways and regulatory frameworks must ultimately differ between jurisdictions due to their varying political and economic sensitivities, the fact is that companies operate globally.

We therefore urge policy makers to ensure that the risks of unintended distortions in the cross-border flow of capital are appropriately monitored and controlled, to avoid short-termism and facilitate sufficient funding to achieve a just transition.



EMMANUEL VOLLAND

Global Sector Lead -
Financial Institutions
S&P Global Ratings

Greater transparency is key to addressing climate risks for banks

ESG factors can materially influence the creditworthiness of a rated entity when S&P Global Ratings has sufficient visibility and certainty to include them in our credit rating analysis. However, environmental factors currently only have a limited impact on our bank credit ratings because many public policies on climate have yet to take effect. If policy changes are implemented, we expect climate risks to increase over time and believe they could negatively influence the credit ratings of banks most exposed to sectors with significant greenhouse gas (GHG) emissions.

Addressing climate change is a top priority for European governments and policymakers. The EU's Green Deal sets out a path toward a transition. In addition, the EU's Taxonomy, Sustainable Finance Disclosure Regulation, and Corporate Sustainability Reporting Directive are setting new sustainability standards. Regulatory bodies across the world are already working on supervisory frameworks to address climate-related risks for banks, including through the Network for Greening the Financial System (NGFS). European regulators and banks

are the most advanced on this front, although the U.S. is catching up rapidly.

For example, the European Central Bank's guide on climate-related and environmental risks released in November 2020 intends to enhance the industry's awareness of and preparedness for managing these risks. At the global level, the Basel Committee's principles-based approach for the effective management and supervision of climate-related financial risks is consistent with the ECB's approach.

The regulatory frameworks applied to banks in their jurisdictions are an important element that S&P Global Ratings considers when we assess their creditworthiness. While the regulatory initiatives listed above are positive developments, most banks have not yet fully integrated climate risks into their risk management framework. In its recent assessment of the most significant eurozone banks, the ECB notes that about half of them expect climate and environmental risks to have a material effect in the short-to-medium term; with credit, operational, and business model risks being the most impacted. Despite that, only a few institutions have put in place climate risk practices in line with supervisory expectations. Integrating climate risks across the full spectrum of risk management activities will require major efforts for banks in the years to come.

**Over time, banks
will need to navigate
the risks and
opportunities created
by the climate transition.**

This will be particularly challenging as banks continue to face several roadblocks in assessing and addressing environmental risks. Disclosures and the quality of data about their customers, especially small and midsize enterprises, are still poor. The risks themselves, which may be nonlinear and have long time horizons, may be difficult to quantify and do not yet have track records. More banks are adopting negative screening policies (such as excluding companies with high carbon intensity) with the immediate benefit of a smaller carbon footprint for their portfolios. However, this breaks the relationship with revenues from these companies and risks are only shifted to another creditor. This is the reason some banks instead prefer to engage with these companies to support their

transition. Finding the right balance between these two approaches is an important decision for banks, the results of which might only be known in the long term.

We understand the Basel Committee is exploring the use of the Pillar 3 framework to promote common disclosure standards for climate risks. This positive step would provide investors with more data to compare and differentiate among banks. At this stage, however, we do not expect the Basel Committee to introduce Pillar 1 capital requirements to cover climate risks. We believe this could be possible only with an improvement of data availability and consistency, which will not happen overnight. Also, regulators may proceed gradually because of the consequences any changes might have on the climate transition process of some economic sectors.

We expect supervisors to continue focusing on climate risks. In particular, the ECB's upcoming bottom-up climate stress test may help reveal vulnerabilities of the banking sector, provide greater transparency, and increase the quality and the quantity of data available for our credit rating analysis. For instance, more climate-related data on banks would be useful for our credit loss estimates at both system and individual bank levels. More comparable disclosures of banks' exposures to these risks would also help us further differentiate between banks.

At this point, S&P Global Ratings sees climate stress tests as a valuable first step. However, we recognise that there is significant uncertainty about the pace and impact of climate change, which will be highly influenced by public policies. Over time, banks will need to navigate the risks and opportunities created by the climate transition and adapt their tools, risk appetite, and business models accordingly.



MARIE-DOMINIQUE GORDON

Chief Compliance Officer
Bank of China (Europe) S.A.

Sustainability landscape in China

Environment Social and Governance (“ESG”) is the essential part of human development, among which the response to environment and climate change is the most urgent and the fundamental challenge for the future. Indeed, this response may dramatically impact the economic development and human being’s way of life. It is also recognised that the transition to climate neutrality could create significant opportunities, such as the potential for economic growth and technological innovation.

Many countries and major international organizations have reached the consensus of the need for more concrete efforts for environmental protection, and have over time issued important pieces of legislation and national strategies. EU is playing a leading role in reducing carbon emissions, and responding to climate changes and the protection of the environment. CRD and CRR have set the rules, and ECB and EBA have issued technical standards and guidance. In Luxembourg, the financial sector regulator, the Commission de Surveillance du Secteur Financier has issued Circular 21/773 in June 2021^[1] which detailed the expectation for banks to take adequate account of climate

and environmental change factors in their strategy, risk appetite, risk management, internal governance etc. As a major channel of financing, banks indeed have an important role to play in addressing environmental and climate changes.

To fulfill its international sustainability obligations, China has set out its “30-60 Targets”^[2], which are not only on carbon neutrality goals, but also set the timetable for China’s energy revolution. New goals and requirements have been put forward for China’s financial industry. The “30-60 Targets” include the following:

The capital market should make adaptation to sustainable development

Mr. Jianfeng MA, deputy director of the China Securities Finance Research Institute of the China Securities Regulatory Commission, pointed out that the disclosure of environmental information by listed companies is of great significance to mitigating climate change, which will help investors to effectively identify green companies and allocate funds to green and low-carbon listed companies. Chinese regulators have continued to strengthen the supervision of listed companies’ environmental and social responsibility information disclosure, and are currently formulating measures for listed companies to disclose environmental information in the form of ESG reports.

To fulfill its international sustainability obligations, China has set out its “30-60 Targets”.

Financial institutions shall take more actions on sustainable development

From the perspective of regulatory authorities, the China Banking and Insurance Regulatory Commission has put forward requirements for financial institutions’ strategic planning to be based on the digital transformation, and green and low-carbon transformation. From the point of view of supervised banks, Mr. Jiandong Liu, Chief Risk Officer of Bank of China Group, said that financial institutions should actively respond to the goals of the state, transform asset allocation, and play a key role in China’s carbon neutral vision. Commercial banks need to adjust and optimize asset structure and allocation in combination with their own development strategies.

Commercial banks should also conduct stress tests on environmental and climate risks, actively identify and respond to risks, and make adjustments in asset allocation. Carbon emission reduction projects often have problems such as maturity mismatch, higher information disclosure requirements, cost-benefit mismatch, and difficulty in quantifying external effects. Incentives and supporting policies are needed to offset business costs

Introducing a carbon pricing mechanism and improve the top-level design

Mr Zhang Xiliang, director of the Institute of Energy and Environmental Economics of Tsinghua University, said that to achieve the “30-60 Targets”, China’s energy system needs to undergo a profound transformation. The main measures include the introduction of a carbon pricing mechanism, the setting of floor price/cap trading quantity for the national carbon market, and the floor price level should be gradually increased to shift to a more reasonable and effective price.

In summary, we believe China could learn from the experience of sustainable development in developed economies, China could build a state carbon emission control mechanism and emission trading operation paradigm through carbon pricing. China could promote the formation of technical screening standards for sustainable development and accumulate comparable and reliable database for environmental and climate risk analysis purposes, as well as for meeting climate-related disclosure requirements. Finally to effectively implement the China-EU green partnership, and introduce low-carbon technologies from Europe.

[1] *On the management of climate related and environmental risks*

[2] *China’s commitment to hit peak emissions by 2030 and carbon neutrality by 2060*

SUSTAINABILITY RISKS IN INSURANCE



ALBERTO CORINTI

Member of the Board of
Directors - Italian Insurance
Supervisory Authority (IVASS)

Integrating sustainability considerations in risk management

Currently, integrating sustainability considerations in the risk management is one of the most challenging objectives of insurers. Sustainability considerations could affect the company's performance and value, especially in the long-run. Achieving this objective certainly requires significant adaptations to how insurers manage their risks and business. This is not an easy task.

Difficulties mainly arise because of the complexity of the nature and impact of sustainability risks. These can affect both assets and liabilities and can include the mitigation of the risks influencing the value and performance of the company (outside in) as well as the impact of the company's activity on sustainability issues (inside out). The latter, in turn, could affect the value of the company given their reputational consequences.

Most of these challenges obviously depend on the uncertainty about a clear classification of sustainable activities. The EU Taxonomy, together with the consequent enhanced transparency of financial entities and markets, is going to shed light on that, but more work is needed to complete the classification and to provide indications on how to apply the classification in practice. The level of alignment between what is classified as sustainable and its actual riskiness, in terms of expected losses for the insurers, also remains to be considered.

Sustainability risks, in general, do not materialize as specific risks, but affect the profile of other, more traditional risks. Climate risk, for example, affects market risk on the asset side via transitional risk, through the potential change in value of "brown" assets, as well as underwriting risk on the liability side, due to the increase of damages resulting from natural events. This implies a change in the approach and methodology used up to now to manage those risks.

**It is a long journey,
to approach
with perseverance
and balance.**

The challenges on the identification of these risks add to the inherent difficulties to measure them. The historical data that are necessary to produce estimates are still lacking and, very often, estimates require a forward-looking approach. The measurement and management of sustainability risks, in general, do not follow the logic and metrics of traditional risks and sometimes build on factors that are not under the control of insurers, or are even unknown to them. This is the case, for example, of transitional risks, which depend on the modalities and pace of the public policy actions for a transition toward a sustainable world.

It is understandable that those challenges are limiting the insurers' capability to identify, measure and mitigate sustainability risks and to set a strategy and a governance to drive the business accordingly. The integration of sustainability considerations is a work

in progress and a lot of work remains to be done.

Climate risks are now the focus of attention and, in this context, transitional risks seem to be the most addressed. Organizational and governance safeguards within companies are heterogeneous and mainly dependent on the size of the insurers. The measurement of the specific effects of climate change on expected losses is still difficult. Pricing of relevant coverages relies mostly on the annual repricing in order to consider the long-term effects of climate risk.

As in the case of the introduction of the risk culture in the management of insurers, which the implementation of Solvency II has enhanced, the regulation itself could be a catalyst of the integration of sustainability considerations in risk management. Regulators and standard setters are working extensively in this field, even if at the moment this is mainly limited to environmental aspects and, among those, climate change considerations.

The work of EIOPA in relation to climate change, for example, spans from Pillar I aspects (e.g. NAT CAT capital charge), to risk management enhancement (e.g. scenario analysis in ORSA), from disclosure (e.g. KPI) to business considerations (e.g. "impact underwriting"). IAIS has also set an ambitious work plan. However, also in terms of regulations and standards, further work remains to be done.

What is important, I think, is that both regulators and the industry remain committed to sustainable objectives, but using risk based regulations and practices, supported by a proper cost-benefit analysis. They should openly cooperate to cross fertilize the knowledge of these risks, develop methodologies, collect relevant data to measure them, and enhance transparency in the market.

It is a long journey, to approach with perseverance and balance. We should avoid that the mitigation of sustainability risks leads to reducing the accessibility of coverages and increasing the protection gap, which in some regions is already too wide. This would limit the widely recognized contribution that insurance should make in the path toward a more sustainable world.



VICTORIA SAPORTA

Executive Committee Chair -
International Association of
Insurance Supervisors (IAIS)

Maintaining resilience: supervisory responses to climate change

The effects of climate change are already being observed across the globe and we can expect the risks will only increase further in the future. Every year new records are being broken, not only in climate terms, but also in economic terms. In 2021 worldwide insured losses from natural catastrophes exceeded USD 100 billion, continuing a trend of more than a 5% rise in losses seen in recent decades.

Insurers' business models are particularly impacted by climate change, both in their role as underwriters and investors. Members of the international insurance supervisory community, represented by the International Association of Insurance Supervisors (IAIS), are committed to urgently addressing climate risks. Insurers have a key role in climate change adaptation and risk mitigation.

Supervisory focus is on integrating climate risks into insurer governance and risk management frameworks

and public disclosure of material climate-related risks. We are currently conducting a gap analysis of our global insurance supervision standards to consider whether changes are needed to take account of growing climate risk, including whether further supporting material is needed to help supervisors apply these standards in practice. Additionally, this year we will add specific data on climate-related risks into our annual data collection for financial stability monitoring purposes to better understand how climate change impacts both the assets and liabilities of the insurance sector.

Importance of risk assessment and scenario analysis

Scenario analysis is a key tool for assessing climate risks to the insurance sector. It provides supervisors and firms with a framework by which they can assess the different climate pathways and the resilience of the sector.

Last September, we published such an exercise in a special report on climate, which assessed how insurance sector investments are exposed to climate risk. The report represents the first global, quantitative analysis on insurers' investment exposures and supervisors' views on climate-related risks and confirmed the benefits of an orderly transition towards internationally agreed climate targets.

Compared to an orderly transition, a disorderly transition, or a scenario whereby climate targets are not met at all, would have a two to six times greater adverse effect on sector-wide solvency.

Supervisory focus is on integrating climate risks into insurer governance and risk management.

For example, under a "disorderly transition" scenario, results show an absolute drop in insurers' solvency ratio of more than 14%, increasing to almost 50% under a "too little, too late" scenario. Nevertheless, considering the solid overall solvency position of the global insurance sector, the sector as a whole appears to be able to absorb investment losses from all scenarios tested. However, more analysis will be needed, both to increase the scope of insurers' investments covered by the analysis and to extend the assessment to consider the physical risk impacts of climate change on insurers' liabilities.

We learnt many things from this exercise, as have many insurers that have undertaken similar exercises. In particular, the lack of a globally consistent framework for measuring climate risk-related financial information, the difficulties with translating climate change risks into financial risks and the long-term horizon over which climate impacts materialise all present challenges for our work.

Building on the lessons learnt from this analysis, the IAIS will continue to improve data availability and analytical tools for monitoring climate-related financial stability risks as well as to support the development and sharing of good supervisory practices among IAIS Members. For example, we have just finished a stocktake of our members' work on scenario analysis. This will help us identify where the IAIS can bring most value in developing guidance on supervisory practises. As we take this work forward, we will seek to learn from best practices; develop tools and further guidance; and, importantly, promote global consistency to help reduce market fragmentation. Our members, and the insurers they supervise, are at different stages of developing scenario analysis and this will be recognised in our work. We are collaborating with a range of partners, including other international bodies (BCBS, FSB, NGFS), and our implementation partners at the Sustainable Insurance Forum and the Access to Insurance Initiative.

Prudential supervision involves constant reassessment of risks to understand whether effective mitigants are in place. New information and approaches to assessment of climate risk continue to emerge. As this work evolves, supervisors will focus on whether and how insurers are effectively embedding climate and other sustainability risks into their governance and risk management frameworks and public disclosure.



FAUSTO PARENTE

Executive Director -
European Insurance and
Occupational Pensions
Authority (EIOPA)

Solvency II: leading the way in managing sustainability risks

Sustainability risks are of growing relevance for the investment and underwriting activities of insurers, as they can materialize, for example, through investment losses related to stranded assets, increased insured losses or reputational risks. In order to tackle climate change, insurers have set up important initiatives regarding their investment and underwriting activities, for example the Net-Zero Asset Owner Alliance and the Net-Zero Insurance Alliance, both focusing on the decarbonisation of economies to limit global warming.

EIOPA's work on sustainable finance reflects the important role of insurers as long-term investors and risk managers of a wide range of society's risks, ensuring that the prudential framework reflects sustainability risks in the areas of solvency, consumer protection and financial stability in an adequate and risk-based manner.

As a risk-based forward looking framework Solvency II is capable of managing climate risks alongside the other

risks faced by insurers. The tools used to measure and mitigate risks can for the most part also be applied to climate risks. For example, in 2021, the Solvency II framework has been adopted to include the prudential treatment of sustainability risks. The adopted amending regulations require the integration of sustainability risks in the risk management and governance of (re)insurance undertakings. Sustainability risks will need to be reflected in the investment and underwriting strategies of insurers and be monitored by the risk management as well as the actuarial function. As part of the prudent person principle, insurers will also need to take into account the potential long-term impact of their investment strategy and decisions on sustainability factors.

As sustainability risks, and climate change in particular, materialize in the insurers' investment and underwriting activities, further steps towards a more sustainability-related framework need to be taken. EIOPA welcomes the two additional mandates on sustainability risks proposed by the European Commission as part of the review of the Solvency II Directive.

**Solvency II sets
the pace when it
comes to reflecting
sustainability risks.**

The first mandate requires EIOPA to explore by 2023 the potential for risk differentials related to assets or activities associated substantially with environmental and social objectives or harm to such objectives. The existence and quantification of sustainability-related risk differentials is part of an ongoing debate and has attracted a lot of interest among politicians, supervisors, industry experts, NGOs and academics. The continuous improvements in the sustainability-related data disclosures by firms, for example through the Non-Financial Reporting Directive in the EU, widespread carbon-pricing schemes like the EU's Emissions Trading System (EU ETS) and the increasing awareness of societies, firms and investors about sustainability risks, provide an increasing potential for climate-related risk differentials to become quantifiable. EIOPA will focus its analysis on specific asset classes that are substantially relevant for insurers' investment decisions and, based on available data, findings and exchanges with the other ESAs, conclude whether a dedicated prudential treatment

in Solvency II is justified. Given the expected increase in physical risk exposures due to climate change, EIOPA will also explore the potential for a dedicated prudential treatment of insurers' underwriting exposures related to climate change adaptation.

The second proposed mandate requires EIOPA to regularly re-assess the appropriateness of the scope and the calibration of parameters of the standard formula with regard to natural catastrophe risk, and if necessary, provide an opinion on potential changes to the prudential framework. Given the continuous and evolving impact of climate change on the frequency and intensity of natural catastrophes, a regular re-assessment of the capital requirements for natural catastrophe risk is an important step to integrate the latest considerations on climate change with regard to perils and countries affected, and thereby to ensure the solvency of the insurance sector against rising physical risk exposures.

Moreover, EIOPA published in 2021 an opinion to include climate scenario analysis in the ORSA. It is essential to assess climate risks both in the short term, and also in the long-term using forward-looking scenario analysis to inform strategic planning and business strategy adequately. Recently proposed amendments to the Solvency II Directive by the European Commission reflect these considerations and as a next step, EIOPA will publish application guidance to facilitate the implementation of materiality assessments and climate change scenarios in the ORSA.

The Solvency II framework has made important progress to address sustainability risks. However, as these risks continue to materialize in different ways, it is essential that Solvency II also continues to evolve to ensure that future sustainability risks challenges are appropriately captured.



DAVID ALTMAYER

Commissioner - Florida Office of
Insurance Regulation

Managing and addressing climate and sustainability risks holistically

While the focus on ESG and sustainability initiatives in finance may appear, to some, to be a recent trend, these issues have long been a key focus for the insurance sector given its exposure to weather-related and other environmental risks. Addressing this challenge is a collaborative effort between insurers and insurance supervisors.

Insurance supervisors should take a holistic view to effectively address climate and related risks. The National Association of Insurance Commissioners (NAIC) and state insurance supervisors have been laying a proper foundation in the U.S. to address sustainability risks by focusing on three key areas:

- 1) climate financial risk analysis;
- 2) availability and affordability of insurance; and
- 3) stakeholder risk awareness and engagement.

The insurance sector faces potential risks both on the asset side of the balance sheet through their investments and on the liability side through the risks insurers underwrite.

As part of our insurance solvency regulatory framework, regulators collect information from insurers to monitor their exposure to both their underwriting and investment portfolios. This process includes forms such as the NAIC's Own Risk and Solvency Assessment (ORSA), which highlights insurer risk exposure and how it is managed; quarterly and annual insurer financial data, which includes critical information on insurer investments; and the Insurer Climate Risk Disclosure Data Survey, which helps supervisors assess and evaluate industry risks along with insurer actions to mitigate climate risk.

While analyzing insurers' financial risk and exposure is important in managing climate and sustainability risks, access to affordable insurance remains critical, especially as losses to consumers rise. Maintaining the vital balance between insurer solvency and reasonable rates can be challenging, particularly in certain areas that insurers view as presenting a greater risk of loss, such as flood zones. Through data collection, the NAIC has supported states' efforts to measure affordability and availability of residential coverage following extreme weather events.

Part of these holistic efforts include the promotion of mitigation and resiliency, especially in areas most vulnerable to climate risks. The NAIC provides education and outreach materials on numerous topics to promote mitigation across its membership and proactively conducts research to drive discussion and advance understanding of insurance issues among policymakers, regulators, and industry leaders.

Insurance supervisors should take a holistic view to effectively address climate and related risks.

Access to technology is imperative in this process, and to better inform the work in all these areas, the NAIC has an initiative underway to enhance the level of information received regarding potential and emerging risks by updating its Catastrophe Computer Modeling Handbook. We are also considering establishing a Catastrophe Model Center of Excellence to provide resources for state insurance supervisors, including access to modeling documentation; technical education and training;

and applied research to proactively address regulatory climate risk and resilience priorities.

The tools noted above will complement lessons being drawn from stress testing and scenario analysis. Efforts undertaken by individual jurisdictions and at the international level, such as the 2021 analysis and report by the International Association of Insurance Supervisors, are helpful in assessing the level of exposure insurers have to climate-impacted investments and how these exposures could affect insurer solvency and the financial system more broadly. The NAIC is in the process of planning a quantitative and qualitative climate scenario analysis on the asset side of domestic insurers.

In addition to potential risks, work to date in this area has highlighted a variety of opportunities for insurers. It has also flagged a need for greater consistency in measuring climate-risk-related financial information. To that end, the NAIC is reassessing its climate survey to maintain valuable historical information while better aligning it to the Financial Stability Board's Task Force for Climate-Related Financial Disclosure (TCFD).

Ultimately, our work continues to evolve. We are confident the holistic approach the states and the NAIC are taking will fortify the insurance sector and help ensure policyholders are better protected from the devastating costs of climate risks.

We look forward to continuing our discussions from the local to global level as we keep refining and strengthening our system and our industry.



STÉPHANE DEDEJAN

Chief Executive Officer
CNP Assurances

Climate-related stress tests: lessons learned by a life insurance company

The insurance sector is exposed to risks related to climate change through its investment activity, its insurance activity and its internal operations. They can take several forms:

- Physical risk, resulting from damage directly caused by meteorological and climate-related phenomena;
- Transition risk, resulting from the effects of a transition to a low-carbon economic model. It includes in particular regulatory, technological, social, market, liability and reputational risks.

Aware of the effects of climate change, CNP Assurances set up a climate risk committee in 2019. It brings together the risk department, the investment department, the actuarial department, the general secretariat and the CSR department, and was extended in 2021 to monitor the progress of the subsidiaries on the management of climate risks.

The ACPR organized in 2020 a climate stress test exercise dedicated to the French financial sector, in order to raise

awareness of vulnerabilities to climate change. CNP Assurances simulated the potential consequences of 3 scenarios:

- Efforts to comply with the Paris Agreement take place in an orderly manner between 2020 and 2050;
- Efforts to meet the Paris Agreement kick off sharply in 2030, reaching the targets in 2050;
- Efforts to meet the Paris Agreement kick off sharply in 2025 and targets are met quickly.

The impacts of the climate scenarios were assessed according to 3 metrics: the Solvency 2 balance sheet, the income statement and the valuation of the investment portfolio. For personal insurers such as CNP Assurances, the scenario of a sharp rise in temperatures leads to an increase in claims, caused by an increase in pollution and vector-borne diseases, which would impact:

- Death guarantees and work stoppage guarantees of protection and creditor insurance policies;
- Health care cost guarantees of protection insurance policies.

**Increase in claims
could be offset by a
wide mutualisation and
the decarbonization of
the portfolio.**

As regards CNP Assurances, the potential increase in claims induced by the occurrence of physical risk could be offset to a certain extent by an increase in the pricing of protection insurance and creditor insurance, wider pooling of risks and the development of private-public frameworks (like the French natural catastrophes regime). The use of behavioral studies (by measuring risk appetite and sensitivity to incentives of the consumer base) is also a leverage to mitigate climate-related risks.

During the annual renewal of its reinsurance cover, CNP Assurances is also exposed to various risks related to climate change: increase in the price of reinsurance and/or decrease in the capacity for reinsurance of climate-related perils, inadequacy between the duration of the cover of reinsurance - generally annual - and that of insurance coverage - sometimes multi-annual.

Regarding the insurance business, CNP Assurances could be impacted by various transition risks, in particular:

- changes in the savings behavior of our customers which would impact the net inflow of retirement savings;
- stricter environmental regulations which could disrupt the real estate market or household incomes and consequently impact the borrower insurance or mortgage surety business.

Regarding investment activity, in 2015 CNP Assurances adopted a low-carbon strategy in favor of the energy transition, then committed in 2019 to aiming for carbon neutrality of its investment portfolio by 2050 by adhering to the Net-Zero Asset Owner Alliance. In order to achieve carbon neutrality, CNP Assurances has set ambitious new targets for 2021 for 2025 in line with current scientific knowledge, in particular to reduce the carbon footprint by an additional 25% between 2019 and 2024 (scopes 1 and 2) of its directly held corporate equity and bond portfolio and an additional 10% between 2019 and 2024 of the carbon footprint (scopes 1 and 2) of its directly held real estate portfolio.

In order to limit the risk of stranded assets in its investment portfolio, in 2020 CNP Assurances adopted a plan to definitively phase out thermal coal : to this end, it has undertaken to achieve zero exposure to thermal coal in its investment portfolio by 2030 in the countries of the European Union and the OECD, and by 2040 in the rest of the world. These commitments were supplemented in 2021 by a policy governing its investments in unconventional oil and gas.

To go further, CNP Assurances finances an academic research program on emerging risks, created in January 2020 for a period of 5 years, the Chair of Excellence in Digital Insurance And Long-term risk (DIALog). One of the lines of research is dedicated to the study of future impacts related to the evolution of environmental factors in insurance. It will make it possible to carry out prospective reflection work aimed at understanding the major transformations underway while integrating the long-term dimension.

The expected results should improve the prospective vision, in particular the impacts of environmental risks on insurance claims and health (climate change, pollution, pandemic risk).



FRANCESCO MARTORANA

Group Chief Investment Officer -
Assicurazioni Generali S.p.A

Insurers as a force for good in achieving net-zero

More than ever, we know that public investment will not be sufficient to cover the investment required to complete the green transition, against the backdrop of the Paris Agreement, recently renewed at COP26.

Within the financial world, which is playing a leading role in redirecting private capital towards a more sustainable future, large insurers are making an increasingly decisive contribution.

Insurers play a double role: they have huge firepower in terms of financial assets to manage – European insurers manage over EUR €10 trillion of assets – and they have a deep knowledge of all the business sectors from the risk management point of view, being the enabler of most economic activities, enhancing their resilience and guarding them from potential failure.

Insurers are accelerating their reading of the climate challenge through the lenses of double materiality. Through the risks we incur, insurers must be able to measure and manage transition and physical risk on their assets. This remains a challenge as data and models are in a development phase. Insurers are confronted with the following

challenges: how to assess physical risk for a multinational? How to factor in transition risk for an energy company which committed to a significant transformation of its business model? Given that asset allocation is mainly represented by bonds, how to differentiate the risk for an issuer across its capital structure?

It is estimated that the EU needs c. €180bn in extra yearly investment over the next decade to meet the Paris targets. In the last few years, the Commission has taken important steps to ensure that institutional investors effectively play their role – for example, with the EU Taxonomy Regulation – and it is now more than ever the time for large private investors to start contributing to the sustainable recovery post-pandemic.

This is why Generali has committed to carry out up to € 9,5 bln in new green and sustainable investments by 2025 and has also launched an investment plan of €3,5 bln supporting the sustainable recovery in Europe, financing the most impacted sectors, such as SMEs, healthcare, education and sustainable housing via direct lending and private equity. These two commitments show, with the size of our assets, that we can provide a real and effective contribution to a green and sustainable economy.

The regulatory framework influences the integration of sustainability in our investment strategy.

Insurers are long term, liability-driven investors, which represents both opportunities and risks. We invest our assets according to a well-defined regulatory framework, which influences the way in which we integrate sustainability aspects in our strategy. In this sense, we welcome the proposed revision of Solvency 2, to ensure that sustainability risks are accounted for in the risk management framework of insurance companies.

The commitment to decarbonize the investment portfolio is crucial and must be linked to factual and measurable targets. In 2020, Generali joined the Net-Zero Asset Owner Alliance and has set out a target of decarbonizing its corporate investment portfolio by 25% by 2024, and to align its real estate portfolio to 1.5° pathway,

as intermediate step to reach net-zero greenhouse gas emissions by 2050.

Given the relevance for insurers of fixed income portfolio with low turnover, we are convinced that engaging with companies is a more effective lever than the simple divestment, which can be more easily applicable to an equity portfolio. In addition, it can be more difficult for insurers to influence companies directly through voting – and engagement provides a tangible alternative to steer our investees towards a more sustainable path.

It is also worth mentioning the relevance of underwriting activities and the liability side. Generali pioneered the issuance of the first ever green catastrophe bond and is one of the founders of the Net-Zero Insurance Alliance. The Group is committed to increasing its share of insurance products with social and environmental value, which exceeded 23% of gross written premiums in 2020. The shift to a resilient, low-carbon economy will increase prosperity and will be a net driver of job creation. However, there will be transitional challenges for workers, communities, and countries while this shift is happening. A rapid green transition will have social consequences, and we believe that we must ensure an inclusive and just transition.

Implementing a just transition does not mean slowing the path to a low-carbon economy, but rather incorporating the social risks management related to workers and local communities into the insurance activities associated with implementing the strategies stemming from the Paris Agreement. If not managed, unemployment, community discontent and lack of labor skills could jeopardize the decarbonisation process. With this in mind, the transition must also include improving growth, generating net new jobs and reducing inequality.



MIREILLE AUBRY

Director Prudential Regulation
Standards & Foresight - Covéa

With climate & sustainability risks, Solvency II does and should remain sensible

Solvency II possesses adequate tools, granularity and scope to embrace climate and sustainability issues at a sensible pace. With a demanding risk-based approach and structure the Solvency II prudential framework is robust and well equipped to address the multi-dimensions of climate and sustainability risks.

The three pillars of Solvency II, the micro and macro monitoring of risks, the quantitative and qualitative approaches, the forward looking stance and the economic valuations and calibration of the risks remain most valid and useful to monitor and supervise these new risks that are not so much new classes or categories as such but rather new drivers that modify the risk exposures of the different risks and perils already identified in the prudential framework. The attention drawn to these changes to embrace has been reinforced by Commission Delegated Regulation (EU) 2021/1256 amending Delegated Regulation (EU) 2015/35 as regards the integration of sustainability risks in the governance of insurance and reinsurance undertakings which shall apply from August 02, 2022. We

deem it more a reinforcement of the focus on these issues in the heat map than an innovative change. We rather acknowledge that the Solvency II regulation was no short of compelling (re)insurance undertakings to identify, analyse, assess, manage, monitor and report each and every risk they are facing as well as to investigate their trends and evolutions.

Physical and transitions risks can both be captured in the components of the solvency ratios computed in Solvency II pillar 1 quantitative requirements. Impacts can be tracked under both assets and liabilities.

On the assets side, with the help of the Non-Financial Reporting Directives and Regulations enhanced data reporting, sustainability information will flow in consistently across all stakeholders. The European Commission's proposal for a Corporate Sustainability Reporting Directive will fill the data gaps that exist by establishing a European sustainability reporting standard. This new framework aims at ensuring alignment of reporting requirements for companies with the overall legal framework for sustainable finance in the EU. Sufficient and standardised data is crucial. Notably requirements will be amended by extending the scope of reporting entities, introducing common reporting standards and clarifying the principle of "double materiality", where an entity considers how its activities affect sustainability and conversely how sustainability matters affect the entity and its performance. With these advancements, together with other stakeholders and investors, insurers will be able to better assess the overall performance and risks of their assets.

Solvency II possesses adequate tools and granularity to embrace climate & sustainability issues.

On the liability side, the amended Article 260 of the Commission Delegated Regulation (EU) 2021/1256 and Article 29 of the Commission Delegated Regulation (EU) 2015/35 require to take environmental developments for the calculation of the Best Estimate into account. Again, that adds to a focus that was already underlying the computations of best estimates and which was pertaining to the forward looking approach of the best estimate valua-

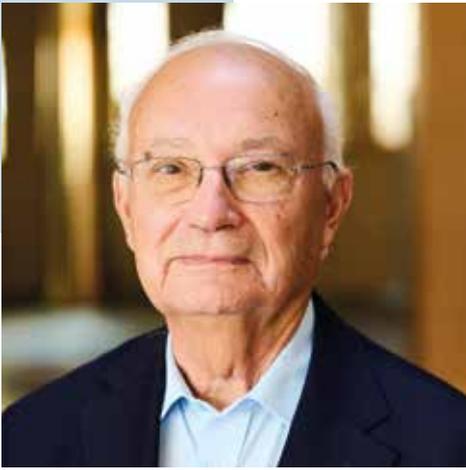
tions including the trends and evolutions of the risk drivers that could be assessed.

Generally, climate change issues are not particularly significant in the best estimate of reserves estimations. The insurance field most exposed to climate change is non-life. Yet, climate change does not play an important role here because the claims have already been occurred. In the estimation of the best estimate of premiums, climate change is taken into account via the evolution of future premium and future claims in the light of the trend insurers identify with historical data and other additional prospective insights.

Although best estimate methodological approaches allow to factor climate issues as just explained, we identify a weakness for the mid to long term trends in non-life due to the contract boundaries. We would support the introduction of equalization reserves to help contributing to climate change adaptation and playing an interesting role in maintaining an affordable and available insurance market.

With regards capital requirements under the capital requirement SCR measure, premium risk implicitly takes into account climate risks since the computation is using actual premiums as a key driver, the latter being directly impacted by adaptation measures. For natural catastrophe risks and as proposed by EIOPA regular reviews of the coefficients are foreseen every 3 to 5 years which will enable handling the impact of the climate change.

Under Pillar 2 the risk management is deeply rooted in the governance of (re) insurance undertakings and a steeper forward looking approach is undertaken with full going concern approaches that are enriched and challenged under adverse entity specifically suited stress scenarios. As risk experts, insurers are particularly well placed to inform about climate risk.



JEAN-JACQUES BONNAUD

Treasurer - Eurofi

Leveraging the insurance sector on the way toward a carbon free economy

In addition to the role of the Insurance sector on the financing of long-term investment needs of the economy notably those related to an unprecedented investment intensive transition required to address the general warming, the sector has also to respond to the increasing risks accompanying climate change, which will translate in a durable accumulation of catastrophes in the world.

The insurance sector, including of course reinsurance, is already addressing this problem. It has set up various types of responses adapted to the various geographical specificities of those risks as well as to the levels of compensation cost, which depend on the level of economic development. Indeed, economic development entails higher values of real estate and maintenance needs, higher wages, developed legal dispute culture... The cyclical inflation we are witnessing also compounds the challenge.

In France some studies on the projected increase in the cost of the climate change related disasters at the 2050 horizon, show that the « development

impact » on the cost could reach more than 50% of the anticipated increase of disasters' costs.

All things being equal, this means that on average the citizens will only be able to shoulder half of the additional charge, which corresponds to climate related claims.

All these evolutions will naturally confront the insurance and reinsurance companies to a need to increase their capital and trigger some important moves on the structures of the sector. But it is clear, as we can see it already, that the private sector will not be able to have the clients to accept certain increases on the cost of the premiums. Part of the surplus would thus eventually be supported by states, i.e., taxpayers.

Due to the impact on insurance costs of the level of development, climate related burden sharing mechanisms should be envisaged on a regional basis homogeneous economic development wise.

This should also help to consider that the impact on the theoretical pricing of the premiums which should be required from the insured clients, will be very dependent to the regional rhythm of climate change and its variability, e.g., in one region drought will concern agriculture as well as housing.

The same applies to marine submersion and storms and hurricanes and related damages, or to pandemics from which the western economies have recently felt the brutal effect on businesses losses and the costs of healthcare.

Public private partnerships appear unavoidable but they need to adapt to regional climate related risks.

Even before the current pandemic, some solutions have already been successfully experimented notably regarding pollution risks, terrorism, or natural catastrophes as well as agricultural disasters like hailstones.

In addition to professional pools or mutualisation mechanisms, for some of those risks the burden is shouldered by the state while the insurance sector provides both expertise and servicing, sometimes as it is the case for medical insurance the sector this provides an additional level of co-ventures.

The French natural catastrophe regime, created in 1983, shares the financial burden between public and private sectors. A specific tax on housing insurance premiums provides part of the financing to a public reinsurance company. The other part comes from the state. In addition, the insurance company will only afford part of the costs of reinsurance.

The likely increase of the costs of disasters in Europe and the fact that those threats have no national limits, should lead to a coordinated European long-term view in these issues. Perhaps it should lead to a European reinsurance facility addressing at least the risks arising in the less developed EU areas,

Similarly, in emerging economies in other regions in the world, although the reinsurance sector already operates and brings its expertise in evaluating the costs and managing the files, it will be more and more necessary to erase the excessive inequalities stemming from a probable lack of insurance and to address related social risks.

This should lead to a World Fund _ a private public regional partnership supported by regional development banks, the World Bank or the IMF - which would give birth to a public global reinsurer.

The world will have the choice between massive social and migratory conflicts and solidarity on facing up the long-term unavoidable climate change.

MMF LIQUIDITY RISKS: POLICY PRIORITIES



DIETRICH DOMANSKI

Secretary General
Financial Stability Board (FSB)

Enhancing the resilience of Money Market Funds

Money market funds (MMFs) are managed with the aim of providing stability of principal, daily liquidity, risk diversification and returns consistent with money market rates. They are important providers of short-term financing for financial institutions (especially dollar funding for non-US banks), corporations, and governments. They are used by retail and institutional investors to invest cash and manage short-term liquidity needs. MMFs' shares are redeemable on demand and many investors tend to treat MMFs as cash-like. It is therefore important to monitor and, where needed, address vulnerabilities in the MMF sector that may affect financial stability.

MMFs are subject to two broad types of vulnerabilities that can be mutually reinforcing: they are susceptible to sudden and disruptive redemptions, and they may face challenges in selling assets, particularly during periods of market stress. The extent of these vulnerabilities in individual

jurisdictions may depend on market structures, use and characteristics of MMFs.

The first type of vulnerability arises from the fact that MMFs engage in liquidity transformation, are used for cash management by investors, and are exposed to credit risk. These features can contribute to a first-mover advantage for redeeming investors in a stress event and thus make individual MMFs, or even the entire MMF sector, susceptible to runs. The second type of vulnerability arises because the secondary markets for the underlying short-term instruments in which MMFs invest are typically not very active. Investors tend to buy and hold these instruments to maturity. As a result, there is limited demand for dealer intermediation services.

The March 2020 market turmoil underscored the need for further action to address MMF vulnerabilities.

In practice, these vulnerabilities have been more prominent in non-public debt MMFs, as illustrated by the large redemptions (and runs) on those funds in the US and Europe in 2008 and 2020. In 2008, redemptions were triggered by a credit crisis following the bankruptcy of Lehman Brothers, and the loss of principal at a large prime MMF in the US that "broke the buck." In contrast, in 2020, pandemic-related uncertainties resulted in a "dash for cash" by corporations and other investors. MMFs in other jurisdictions have also not been immune from stress. For example, MMFs in Japan encountered problems in 2001, following the Enron scandal; as did South African MMFs following the collapse of a bank in 2014.

While some MMF reforms were introduced following the 2008 financial crisis, the March 2020 market turmoil underscored the need for further action to address MMF vulnerabilities. To this end, and following a public consultation, the FSB published policy proposals to enhance MMF resilience in October 2021. These proposals form part of the FSB's work programme

to enhance the resilience of non-bank financial intermediation, which is intended to ensure a more stable provision of financing to the economy and reduce the need for extraordinary central bank interventions.

The FSB report describes policy options to address MMF vulnerabilities and their potential effects on MMF investors, fund managers and sponsors, as well as on short-term funding markets. Policy options are grouped according to the main mechanism through which they aim to enhance MMF resilience: imposing on redeeming investors the cost of their redemptions (e.g. through swing pricing); absorbing losses (e.g. through a minimum balance at risk or a capital buffer); reducing threshold effects (e.g. by removing ties between regulatory thresholds and the imposition of fees or gates, and the removal of the stable net asset value); and reducing liquidity transformation (e.g. through limits on eligible assets and additional liquidity requirements).

FSB member authorities are assessing MMF vulnerabilities in their jurisdictions and will address them using the framework and policy toolkit in the report, in line with their domestic legal frameworks. The FSB recognises that individual jurisdictions need flexibility to tailor measures to their specific circumstances. At the same time, international coordination and cooperation on policy reforms is critical to mitigate cross-border spill-overs and avoid regulatory arbitrage. The FSB will, working with IOSCO, review progress made by member jurisdictions in adopting MMF reforms. The review process involves a stocktake by end-2023 of the measures adopted by FSB member jurisdictions, followed by an assessment in 2026 of the effectiveness of these measures in addressing risks to financial stability.

IOSCO also plans to revisit its 2012 Policy Recommendations for MMFs in light of the FSB's framework and policy toolkit. Finally, the FSB and IOSCO intend to carry out follow-up work, complementing MMF policy reforms, to enhance the functioning and resilience of short-term funding markets.



JEAN-PAUL SERVAIS

President - Financial Services
and Markets Authority,
Belgium (FSMA)

Towards a more resilient MMF industry

Money market funds (MMFs) play a key role in the short-term funding markets (STFMs). They bring investors with excess cash together with financial institutions, corporations and governments with short-term funding needs.

Although the regulatory framework for MMFs was strengthened in the aftermath of the global financial crisis, the March 2020 market turmoil at the onset of the COVID-19 pandemic revealed that MMFs remain subject to vulnerabilities.

On the liability side, MMFs are susceptible to sudden redemptions. Although MMFs are not homogeneous they share some features, such as the aim to offer capital preservation and daily liquidity, which often cause them to be considered as cash-like and therefore cause them to be used as cash management tools.

In periods of stress, investors may reassess the cash-like nature of their MMF investments and have incentives to redeem, which may be amplified when first mover advantages are present. This vulnerability is not prominent

for all MMFs, however. It depends, among other things, on the extent of the liquidity transformation, the extent to which investors use the MMF as a cash management tool, its exposure to credit risk, and the consequences of crossing regulatory thresholds.

On the asset side, MMFs may face challenges in selling assets, particularly under stressed market conditions. This holds in particular for MMFs investing in commercial paper and certificates of deposit, instruments traditionally held until maturity and for which secondary market liquidity is therefore relatively limited.

The FSB, in cooperation with IOSCO, has identified a set of policy options to mitigate MMF vulnerabilities, as well as an assessment framework with regard to the effects of each of these policy options.

MMF vulnerabilities could be addressed through a number of mechanisms, including by passing on costs to redeeming investors, by reducing threshold effects, and by reducing liquidity transformation.

FSB in cooperation with IOSCO has identified a set of policy options to mitigate MMF vulnerabilities.

In this respect, swing pricing, or economically equivalent mechanisms, are key policy measures as they make it possible to impose the costs associated with redemption on redeeming investors, and thereby better align the liquidity offered by an MMF to its investors with the liquidity of its assets.

Another option involves the removal of ties between regulatory thresholds and the imposition of fees and gates, which would mitigate threshold effects by diminishing incentives for pre-emptive redemptions.

Other options include limiting eligible assets by requiring MMFs to invest in more liquid instruments or shorter-term instruments, or by requiring a minimum holding in certain instruments deemed to be more liquid; such an option would reduce liquidity transformation and thus help in turn to mitigate the impact of large redemptions.

A final important option to be considered is eliminating the stable NAV MMFs.

The policy options are a toolkit for jurisdictions to assess and decide on their own reforms. As the characteristics of MMFs and the prevalence of their vulnerabilities vary considerably across MMF types and jurisdictions, flexibility is needed in tailoring measures to existing legal frameworks.

It is now up to the different jurisdictions to draw on the toolkit to adopt reforms that mitigate MMF vulnerabilities. The legal framework should be strengthened in order to enhance the resilience of MMFs, limit their financial stability risks and minimise the likelihood of central bank interventions in the STFM.

In Europe, the EU Commission will start to review the MMF Regulation in 2022. ESMA has already consulted on potential reforms, taking into account the vulnerabilities that were revealed during March 2020.

In particular, in line with the policy toolkit, ESMA has consulted on proposals to decouple regulatory thresholds from suspensions and gates, to require MMFs to use swing pricing or certain equivalent mechanisms, to increase or modify liquidity buffers, to remove or reduce the types of stable NAV MMFs, and to assess the role of sponsor support. The consultation document and the feedback ESMA has received on it will inform ESMA's opinion on the review of the MMF regulation.

The next steps for IOSCO and the FSB on MMFs will include a progress review, which will first encompass a stocktake of the measures adopted by jurisdictions, by the end of 2023, followed by an assessment of the effectiveness of the measures in addressing financial stability risks.

IOSCO may also revisit its 2012 Policy Recommendations for Money Market Funds, taking into account the policy toolkit. In response to the feedback from the public consultation on the FSB's policy proposals to enhance MMF resilience, the FSB and IOSCO also intend to carry out follow-up work to enhance the functioning and resilience of the STFM.



FRANCESCO MAZZAFERRO

Head of the Secretariat -
European Systemic
Risk Board (ESRB)

The European Systemic Risk Board's recommendation on money market funds

The 2020 financial market turmoil showed that the regulatory changes after the global financial crisis (GFC) had not sufficiently mitigated systemic risk in the money market fund (MMF) sector. The 2017 MMF Regulation¹ set out rules to limit the contagion channels that appeared during the GFC and to make MMFs more resilient to shocks. During the market turmoil at the onset of the COVID-19 pandemic, MMFs investing in private debt instruments experienced acute liquidity strains due to large investor redemptions and lack of liquidity in the markets for those instruments. It was not until central banks took exceptional monetary policy measures that the functioning of short-term debt markets improved and liquidity strains in MMFs eased.

The events of 2020 revealed the underlying tension in the liquidity transformation performed by MMFs. As they offer on-demand liquidity to investors, MMFs are often perceived to

be cash-like instruments. But they also invest in financial assets that are not reliably liquid – particularly in times of stress, when MMFs face redemption requests. Liquidity mismatch can be particularly acute for MMFs investing mainly in commercial paper and certificates of deposit, as the market for these instruments is fragmented. This tension between the “deposit-like features” and the “fund-like features” of MMFs remains a source of systemic risk.

The policy response has to ensure MMFs' resilience while reducing the need for central banks to step in during crises. MMFs perform two main functions in the real economy and the financial system: they provide short-term funding to issuers (mainly banks and non-financial corporations) and are used by investors (notably institutional investors and corporate treasurers) to manage liquidity. After the forthcoming regulatory reform, they should continue to act as the key intermediaries in the financial system, while being able to absorb potential shocks instead of amplifying or spreading them.

Policy has to ensure MMFs' resilience while reducing the need for central banks to step in.

Against this backdrop, the European Systemic Risk Board (ESRB) has issued policy recommendations to address persisting MMF vulnerabilities. The Recommendation on money market funds², addressed to the European Commission, reflects policy discussions at the international level, including consultations by the European Securities and Markets Authority³ and proposals from the Financial Stability Board⁴. It reflects the spirit of the ESRB's 2012 Recommendation⁵ to reduce the “deposit-like features” of MMFs and to increase the features that make them similar to other investment funds. This is why the ESRB has not proposed measures such as own funds requirements to increase the loss-absorbing capacity of MMFs.

The aims of the policy recommendations are as follows.

Recommendation A aims to reduce threshold effects embedded in regulatory requirements that might provide first-mover advantage and provoke runs. It proposes that low volatility net asset value (LVNAV) MMFs have a fluctuating NAV. It also advises removing regulatory trigger ef-

fects (using liquidity fees and redemption gates) when MMFs breach liquidity requirements.

Recommendation B aims to reduce liquidity transformation. It calls for higher liquidity requirements for variable NAV and LVNAV MMFs, as well as mandatory public debt holdings alongside daily and weekly maturing assets. To encourage MMFs to use liquidity buffers to meet redemptions, the Recommendation suggests that MMFs could hold less liquidity in times of stress than normally required.

Recommendation C aims to impose redemption costs on redeeming investors. It proposes that all MMFs have at least one liquidity management tool (LMT) that passes trading costs on to departing and incoming investors (anti-dilution levies, liquidity fees or swing pricing for MMFs with a fluctuating NAV). To facilitate the use of LMTs, the Recommendation calls for criteria to be established for their application in all market conditions.

Finally, **Recommendation D aims to enhance monitoring and stress-testing frameworks.** To provide national and EU bodies with better information to identify the systemic weaknesses of MMFs, it proposes system-wide stress tests, higher reporting frequency and wider data collection and sharing.

The Recommendation will contribute to the upcoming MMFR review. No single measure can address all systemic vulnerabilities of MMFs: the reforms proposed need to be assessed as part of a package that will increase resilience in the MMF sector and reduce systemic risk.

1. Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds (OJ L 169, 30.6.2017, p. 8).
2. Recommendation of the European Systemic Risk Board of 2 December 2021 on money market funds (ESRB/2021/9).
3. See “EU Money Market Fund Regulation – legislative review”, Consultation Report, ESMA, March 2021.
4. See “Policy Proposals to Enhance Money Market Fund Resilience”, FSB, October 2021.
5. Recommendation of the European Systemic Risk Board of 20 December 2012 on money market funds (ESRB/2012/1).



GABRIEL BERNARDINO

Chair - Portuguese Securities Market Commission (CMVM)

Building a resilient and proportional regulation for Money Market Funds

Money market funds (MMF) are an important instrument for a sound financial system and real economy as they provide short-term funding for issuers and are used as cash lending vehicles by investors as an alternative to other financial instruments, such as bank deposits.

This means that MMF can act as substitutes - both to issuers and investors - to banking intermediation instruments. However, there is an underlying tension between the different objectives of MMF, in particular between providing principal stability and offering daily liquidity - and this tension, as we have seen recently, might result in systemic risks under severe market stress situations.

The MMF liquidity resilience was tested in March 2020, since several funds, particularly those with low volatility net asset value (LVNAV) faced significant outflows. Intervention from public authorities and in particular central banks prevented traumatic outcomes such as funds breaking the 'collar' that would result in a variable net asset value disadvantageous conversion.

On another front, MMF that invested in private debt experienced particularly acute liquidity constraints caused by a combination of high-level redemptions rates and lack of liquidity in money markets. This led to concerns that those liquidity constraints could in fact amplify the effects of the pandemic shock to other parts of the financial system.

In this scope, it was globally acknowledged that the financial market turmoil revealed several systemic vulnerabilities that called for a thorough reassessment of the MMF market functioning and rules in the context of a post-global financial crisis regulatory reform. This was done in record time and we are now facing the moment for decisions.

I believe the key objective should be to enhance MMF resilience while preserving their useful functions. This includes addressing the structure and functioning of the sector and of the underlying short-term funding markets, as this would minimize systemic risks and the need for future interventions from central banks and other public authorities.

Our objective should be enhancing resilience, while preserving MMF's main functions in the economy.

For that matter we should begin by recognizing some challenges. For example, the specific nature of MMF's assets and liabilities, and the maturity and liquidity transformation that they embrace, can pose challenges to financial stability. Despite this, targeted and efficient amendments to MMF regulation could be used to minimize such risks, while maintaining some (but not all) cash-like beneficial features of MMF.

First, removing first-mover advantage is of paramount importance. In this way, changes should be introduced to make MMF less procyclical, especially in market stress situations. In addition, measures such as decoupling regulatory thresholds from imposed suspension of redemptions or gating mechanisms would be welcomed.

Second, the implementation of additional liquidity management tools, such as increasing liquidity buffer requirements and allowing its usage

in times of stress, could also be used as relevant countercyclical measures. The composition of that buffer could allow efficient diversification of liquid instruments, without minimum exposures to public debt - similarly to other prudential requirements in the financial sector.

Third, all MMF should have the possibility to use a liquidity management tool appropriate to a fund's concrete situation allowing it to reflect redemption costs for departing investors and avoid dilution.

Moreover, I believe we should take this opportunity to promote a paradigm shift: eliminate constant or low volatility net asset value funds that are sustained on the valuation of amortized costs. The current paradigm simply does not reflect market value best practices. Liquidity and credit risks associated with the MMF's assets would be better reflected through changes in their net asset values to match mark-to-market value of their respective assets. Additionally, such a change could also reduce current investors' incentives to redeem when they perceive that the underlying value of the assets has fallen below the stable net asset value and is at risk of falling below a threshold at which the fund must change its valuation and reprice its shares.

Additional measures outside the specific MMF domain could also be considered, namely those that aim at better understanding the characteristics of MMF's investors and the regulatory regime in which they operate. Management companies should have such data available upon request by supervisors.

In conclusion, I believe that the full package of measures to be adopted should be proportionate and chosen with caution. We must avoid MMF becoming unviable instruments, which would force capital to flow to other less transparent alternatives. Importantly, the measures should incentivize MMF to become more resilient in stress situations without hampering their very important economic role in normal times.



GERRY CROSS

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Money market funds – a case for reform

Following a period of unexpected fragility in the money market sector in the early days of the COVID 19 pandemic, it is important that resilience is strengthened.

The period of intense market turbulence in March-April 2020 was characterised by a flight to safety. This dynamic gave rise to significant liquidity pressures including in the short-term private debt markets where MMFs play a large role. The stresses that developed and fears of contagion prompted central bank intervention.

Money market funds have regulatory daily and weekly liquidity thresholds linked to liquidity management features such as gating, imposition of fees or suspension, all of which are designed to protect the MMF in the face of significant outflows. One dynamic revealed by this period of marked stress was that these thresholds – combined with the perception of potential cliff effects - served as a pinch point which fuelled redemptions at the height of the crisis as investors sought to liquidate MMF positions before liquidity management features were invoked.

The outflows experienced by European private debt funds and Prime MMFs

in the US appear to have resulted in corresponding inflows to the perceived safe-haven of European and US government MMFs, which are structured as constant NAV (CNAV) funds.

Globally, there is an emerging consensus on the need for reforms to enhance MMF resilience, with the FSB having issued its final report identifying potential areas for improvement in October 2021 and the European Commission set to conduct a review of its legislative framework in 2022 following on from work by ESMA and the ESRB.

Care should be taken to avoid identifying “silver bullet” solutions. Reform needs to be multi-faceted given the broad impact of the 2020 stresses across private debt fund types.

In the first instance, the unforeseen consequences of features built into the current MMF regulatory framework need to be addressed. One is the need to decouple thresholds for MMF daily and weekly liquidity from any rigid imposition of gates and fees. These features were designed to diminish the potential for stress within a MMF, rather than serve as an aggravating factor.

**There is an emerging
consensus on broad
parameters of changes
necessary to enhance
MMF resilience.**

There is also a need to enhance the quality and composition of liquidity buffers held by MMFs. Whilst the calibration in terms of precise levels of liquidity and portfolio composition remain subject to debate (including the extent of public debt holding in private debt MMFs), the necessity to have a more resilient buffer is apparent. The potential negative impacts of holding additional low yielding assets could be mitigated somewhat by building an element of cyclical releasability into buffers, albeit subject to clear rules on usage and replenishment and the maintenance of sufficient minimum levels through the cycle.

The role of liquidity management tools, such as swing pricing or anti-dilution levies is also garnering much attention. It is important that investor incentives to be early to withdraw money from MMFs – the so-called “first mover dynamic” is removed, or at least significantly reduced. It is appropriate

that those investors redeeming from MMFs should bear the transaction costs, including liquidity premia, associated with redemption. This not only helps to address any misalignment in the incentive for withdrawing, but it is also in the best interests of remaining investors in the MMF. This fulfils objectives both of investor protection and the financial stability concerns of public authorities.

Increased reporting on key areas from MMFs as well as developing more system-wide approaches to stress testing should enable authorities to have a better understanding of the potential spillover risks from different sectors, as well as the second-round effect of asset disposals, including the likelihood of further redemptions and adverse pricing impact in a stressed market environment.

Implementation of these reforms will significantly enhance resilience across all types of money market funds. What was clear from the period of market turbulence in the March-April 2020 period was that the different types of private debt money market funds – including both variable (VNAV) and low volatility NAV (LVNAV) funds – were significantly impacted. While further measures may be needed to reflect differences amongst fund types, these should remain proportionate and should seek to retain the benefits to European capital markets and its economy that are provided by its well-developed and differentiated money markets sector.

In that context the policy objective is to ensure that MMFs are reformed, so as to permit them to fulfil their economic function in a way that is resilient to shocks and which minimises the need for extraordinary central bank intervention in markets.



DALIA BLASS

Head of External Affairs
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Executive Committee -
BlackRock

Improving the European MMF regulatory framework to enhance resiliency

The COVID-related market events of March 2020 present a unique opportunity to reflect on a live stress test of all segments of global financial markets and draw conclusions about how to improve the resilience of market structures and participants alike. Money Market Funds (MMFs) are one of the first areas of focus by international regulators in this reflection. BlackRock supports efforts to ensure that the regulatory framework for MMFs is robust. MMFs play a critical role for many end-investors; reforms must enhance their resilience, while preserving their utility.

In March 2020, European MMFs experienced varying levels of outflow pressures across currencies and fund structures, but none breached regulatory thresholds. This is despite the fact that the ECB and Bank of England asset purchase programmes had minimal impact on MMFs, as they focused on ensuring that non-financial corporate issuers (a very small segment of European MMFs' investment universe) were able to access primary

markets, unlike the US Federal Reserve's dealer support programs which were aimed at providing liquidity in secondary markets for all types of commercial paper and certificates of deposit.

We believe that reforms should be based on observable vulnerabilities and calibrated to reflect the real strains European MMFs faced in these market conditions.

We are pleased to see that many regulators have identified the linkage between redemption gates and fees and MMFs' Weekly Liquid Asset (WLA) buffer as a vulnerability. De-linking these provisions is one improvement in the regulatory framework that seems to be widely agreed upon in both the industry and regulatory community. This will reduce procyclical pressures on MMFs by removing the key incentive that drove asset sales in many MMFs in both the US and Europe in March 2020.

Further reforms to improve the liquidity buffers in MMFs are also important areas for focus. In considering how MMFs can meet outflow pressures, cash on hand and Daily Liquid Asset (DLA) levels are most relevant. That is because MMFs, unlike other kinds of mutual funds, are designed to meet net redemptions from cash, rather than by selling assets – this is also why swing pricing, a critical liquidity risk management tool for many open-ended mutual funds, is inappropriate for MMFs.

**March 2020 was a
test for European
MMFs; they performed
well in challenging
circumstances.**

Ensuring all types of MMFs have minimum DLA levels commensurate with potential daily outflow levels ensures MMFs can meet redemptions in market stresses. Calibration could be based on historic flow patterns across a variety of market conditions. This is a more direct way of addressing MMF resilience than, for example, minimum government debt buffers. Such buffers, while they may be designed to achieve the same result, do so in a less direct way, requiring the holding more cash-like securities rather than holding more cash. They can also have unintended consequences, such as exposing the MMF to price volatility risks due to the limited amounts of high-credit-quality,

short-dated government debt in Euro and Sterling, forcing MMFs to turn to secondary markets.

However, raising DLA levels across the board will not be as straightforward in Europe as it might be in the US. Euro and Sterling markets, in particular, suffer dislocations around quarter- and year-end which prevent many users (not only MMFs) from placing cash overnight on and around these dates. Finding a solution to this problem would allow the most direct, and appropriate, policy response to promote MMF resiliency.

Finally, as the debate also coincides with the scheduled review of the MMFR framework in 2022, there has been considerable focus on one of the key new fund structures created by the Regulation in 2018, the Low-Volatility NAV (LVNAV) MMF. These funds have worked well since their creation, with none breaching regulatory levels in March 2020 despite the stressed conditions, and they are valued by many different types of end-investors.

Looking at data around outflow pressures versus mark-to-market price deviations in LVNAVs, there is no clear evidence from March 2020 to support the hypothesis that the 20bps 'collar' accelerates redemptions or creates 'cliff-edge' effects. In fact, in Europe, the two kinds of MMFs that experienced the most significant outflows in March 2020 were Euro-denominated Standard VNAV funds, and US Dollar-denominated LVNAV funds (where some of the most significant MTM deviations were actually above the rounded share price of the fund).

March 2020 was a strong test for the European MMF sector and for the MMFR regulatory framework; for the most part, they both performed well in challenging circumstances. Drawing on this experience, it is clear that targeted improvements to the regulatory framework for MMFs can be made, but it is also clear that short-term funding markets overall should be made more resilient.

Without addressing market structural problems, MMF reforms could further disintermediate the investor base, reduce transparency and increase the potential for systemic risk.



DENNIS GEPPE

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Money market funds and the sound functioning of the money market ecosystem

Any potential reform to money market funds (MMFs) should be fully supported by data and be designed to enhance their safety and resilience. In considering the events of March 2020 it is important to remember that the stresses observed were not due to the vulnerability of MMFs but by a global economic shock to the system, resulting from the decisions of governments around the world to shut down their economies to prevent the spread of Covid-19.

In its Investment Funds Statistics Report, the International Organization of Securities Commissions (IOSCO) analyses the reasons for the US Treasury market dislocation in March 2020 and cites: *“general widespread uncertainty of the economic impacts of COVID-19; regulation that has limited banks and dealers’ ability to warehouse asset inventory; liquidity impact of the “working from home” environment, which impairs the networks that traders rely on to execute trades; and the role of leverage*

in the system.” IOSCO advises that “any assessment of the role of individual players in the marketplace during this stress event needs to be viewed through the lens of market-wide interactions”.

This is why, in addition to certain critical enhancements to MMFs globally (especially removing the improper linkage between liquidity fees/gates and liquidity levels) Federated Hermes agrees with the Financial Stability Board’s (FSB) recognition of the critical need to improve the functioning of the short-term funding markets (STFMs). These are an integral part of the money market ecosystem and need to be designed so that they remain open even in stressed times.

While the FSB is right that a review is warranted, it is vital that a full STFM reform is conducted alongside, not subsequent to, any reform of MMFs.

In addition to focusing on improving the STFM, the FSB, the European Securities Market Authority (ESMA) and now the U.S. Securities and Exchange Commission (SEC) has identified that delinking liquidity and the potential imposition of fees and gates must be a top priority. This linkage has proven to be an unintended negative consequence of the regulations. However, we continue to observe a lack of appreciation of the benefits delinking will have on money market funds and the positive impact delinking would have had during the March 2020 liquidity events.

**It is vital that a
full STFM reform is
conducted alongside,
not subsequent to, any
reform of MMFs.**

Removing the improper link between the liquidity thresholds and a fund’s potential imposition of fees and gates would remove one of the major incentives for artificially high redemptions that were observed in March 2020. In addition, delinking would have freed 30% or more internal liquidity that MMFs could have utilised to meet all redemptions with no market consequences as they held levels of liquidity more than sufficient to cover the redemptions experienced by MMFs during March 2020. With this link removed, there is no need to require MMFs to hold higher amounts of liquidity, as an additional 30 to 40% will have been made available simply by delinking.

The other policy options the FSB and SEC advance are either unnecessary or inappropriate. In particular, swing pricing, whilst applicable to non-MMF products, has never been applied to a MMF (whether in the U.S., EU, or any other jurisdiction), and any requirement to implement it would be a de facto elimination of MMFs as a viable product for investors. Investors have been clear that they will not invest in a MMF with swing pricing, as this would eliminate the fund’s ability to provide intraday and same-day settlement.

As a result, any future “dash for cash” or credit crisis would not be mitigated – but rather shifted away from highly regulated, transparent MMFs to unregulated, longer dated and less transparent vehicles which would certainly have far greater effects on financial stability. Swing Pricing is also entirely redundant should MMF Boards retain the ability to implement a targeted and well-timed liquidity fee designed to pass on the cost of liquidity to redeeming shareholders in times of stress.

It is critically important that MMFs remain a viable product available for global investors and, for that to occur, MMFs must retain their ability to provide investors with daily liquidity, a market yield and a high quality, diversified investment portfolio.

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EU AML / CFT AUTHORITY: SUCCESS FACTORS



**GEDIMINAS
ŠIMKUS**

Governor - Bank of Lithuania

AML is an essential step towards transforming and enhancing AML/CFT supervision

Massive technological innovation is rapidly changing the face of the financial sector. Cross-border payments these days can be made instantaneously any time of the day and week, with the number of payment providers and the overall complexity of the financial system growing. The Financial Action Task Force reports that multiple jurisdictions are facing increased vulnerabilities, particularly due to a rise in remote transactions. The COVID-19 pandemic accelerated the pace of change in customers' financial patterns - more people work from home and conduct more online transactions than ever before.

With such a transformation taking place, sound, prudent and accurate AML/CFT procedures must be a top priority for financial market participants. Even though AML frameworks are improving, substantial

amounts of money involved in suspect financial activity are still being detected. Europol assesses the annual cost of money-laundering to the European economy at well over 100 billion EUR. Therefore the EU Member States must take action. Besides efforts to improve efficiency of the national AML/CFT frameworks, a further push is needed to implement more uniform AML supervision across the EU Member States and to establish an effective EU AML Authority (AMLA).

Money-laundering and terrorism-financing activities are not contained within national borders. Accordingly, a truly effective framework for AML/CFT must be international. Completing the Single Market for services requires a well-functioning financial sector, and a well-functioning financial sector requires AML/CFT compliance at the very heart of financial companies, with uniform rules for compliance across the EU. To ensure this, we need a harmonized AML/CFT supervision framework.

Extensive information exchange and deep cooperation are central for the EU AML/CFT framework.

Currently, AML/CFT regulatory and supervisory system is too country-centric and therefore application of the rules for compliance vary depending on the country. The recent proposal of the Commission introduces a Single Rulebook for preventing the financial system from being used for the purposes of money-laundering or financing terrorism. Such a Single Rulebook in place at the EU level will stop regulatory arbitrage and provide a basis for an effective supervisory practices. Furthermore, the Commission proposes to expand the rules against anti-money-laundering or terrorism financing regarding crypto-assets and related service providers - a crucial step, given the mounting evidence from research of illegal activities involving such assets.

At the center of such an EU-wide supervisory framework for AML and

CFT should be a competent AMLA. A capable AMLA has the potential to improve the resilience of the European financial system, reduce the likelihood of systemic errors, and allow individual cases to be handled with greater efficiency. To this end, it must be ensured that AMLA has a broad mandate, covering a range of players in the financial sector, and its staff have thorough knowledge in all areas of financial services. In addition, there must be clear and objective criteria for determining which institutions fall under AMLA's direct supervision, ensuring an appropriate balance between AMLA and national AML/CFT supervisors, in both the overall supervisory framework and the day-to-day operations.

Last but not least, it is of utmost importance for AMLA to have a good overview and knowledge of the EU Member States' markets, as well as to promote the convergence of supervisory practices. Therefore, at least one entity per Member State should fall under direct AMLA supervision.

AMLA should work in close cooperation not only with national AML/CFT supervisors, but also with other institutions - ESAs, for example - to ensure the flow of all necessary information. Currently, we lack a well-defined common structure to support such cooperation at the EU level. This shortage of common tools and resources leads to situations where too few cross-border joint analyses by AML/CFT and non-AML/CFT supervisors are carried out, hindering the capacity to detect money-laundering and terrorism financing early on. Creating an EU-wide AML/CFT data hub, administered by AMLA, that integrates data from all sides is vital, as access to reliable, accurate, detailed and real-time data is crucial for an effective AMLA.

Building up an EU-wide AML/CFT framework with an AMLA at the center of it is not an easy feat. However, we are sure to succeed, as we start from vast experiences of AML/CFT coordination at the national level and recognize prevention of money-laundering and terrorism financing as our top priority.



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Let's make the AML A a giant leap forward in the EU's AML/CFT policy

When considering how to combat money laundering and terrorist financing even more effectively, we should be aware of the indisputable starting point: money laundering and terrorist financing are global phenomena, often with a transnational and cross-border character.

Why is this the case? The EU's internal market has brought us all many freedoms: goods, services, capital and people can move freely, citizens can freely choose their place of residence as well as pursue a job, education or entrepreneurial activity in a Member State of their choice. At the same time, however, the internal market has also facilitated the free movement of laundered money across borders. The fact that proceeds can be moved across national borders makes traceability more difficult, offers an opportunity to disguise the origin of the money and allows the funds to be laundered where preventive requirements are lowest. The consequence of these findings is that we need to mirror the

freedoms achieved by the internal market with safeguards that prevent abuse of these freedoms for money laundering purposes.

Considerable progress on harmonisation has already been achieved with the EU's AML directives – a single rulebook within the upcoming directly applicable AML Regulation will now make the necessary complements to achieve a real level playing field. What is still missing, however, are measures that enable authorities to take EU-wide action at the same pace and within the same mindset as transnational money launderers. Only by doing so can we prevent criminals from exploiting the freedoms of the single market by taking the path of least resistance for their money laundering activities.

With the proposal for a European Anti-Money Laundering Authority (AMLA) in particular, we are pursuing the goal of ensuring uniform application of the EU legal framework and establishing common supervisory practices. The latter will be accomplished by means of standard-setting and coordination of supervisory activities, as well as direct supervision of (small numbers of) obliged entities from the financial sector who, due to their cross-border activities, fall under the jurisdiction of several supervisory authorities, thus creating a special coordination burden. In addition to designing strong powers for the AMLA, our attention should also focus on how the governance is designed. In this regard, we should re-examine the governance we have designed for other agencies, while

We should not let the opportunity pass us by to build up the AMLA from scratch and install custom-made decision-making processes.

bearing in mind it was often developed for their primary role of standard-setter. The guiding principle in the re-evaluation of existing decision processes should be that it is critical to design a customised decision process for each of the authority's powers, because the strongest powers cannot be exercised efficiently in practice if they do not mesh with the decision-making processes.

The Commission's proposal has been already guided by this idea and, with regard to the AMLA's internal decision

making process, differentiates between whether the AMLA takes directly binding measures vis-à-vis individual obliged entities in the area of direct supervision, or acts in the area of standard-setting. This approach is to be thoroughly welcomed due to the fact that for standard-setting, which the AMLA will undertake in many areas of money laundering law, we urgently need common ownership and broad support from the supervisory authorities that will be tasked with consistent implementation of such standards. In this way, know-how from day-to-day supervisory practice can best feed into new standards, given that authorities are conscious of where problems lie.

In contrast, a different decision-making structure is required for the powers within the framework of direct supervision, where action has to be swift and targeted. Here, the day-to-day supervisory work will be carried out by the respective national supervisory authorities together with AMLA staff in joint supervisory teams, again with the aim of using existing knowledge and experience. However, a body that is independent and impartial – the envisaged Executive Board – should then make the final assessment as to whether directly binding measures need to be taken against an obliged entity.

In this way, we will ensure that the AMLA decides – especially in constellations where the AMLA has direct supervision because national supervision has proven insufficient – without being exposed to the delays and potential conflicts of interest associated with too large a forum of national supervisors. In addition, such governance will allow the AMLA to be perceived externally as a body with indisputable integrity and objectivity in combating money laundering.

We should not let the opportunity pass us by to build up the AMLA from scratch and install custom-made decision-making processes. In doing so, we can achieve decisive progress for the institutional set-up of the EU's AML structure, comparable to the establishment of the SSM in prudential supervision.



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Equipping the EU with a fit-for- purpose AML/ CFT regime and architecture

As a follow up to its 2019 report on the assessment of recent alleged money laundering cases involving EU credit institutions and subsequent 2020 action plan, the European Commission unveiled its AML/CFT package in July 2021. With this package, the EC seeks to address shortcomings in the existing EU AML/CFT regime notably in the EU cross border context.

The AML/CFT package includes a new AML/CFT regulation and a regulation establishing an EU AML/CFT authority. There is much to command in the EC's proposals, which would thoroughly improve the EU's ability to tackle the threat that money laundering and terrorism financing (ML/TF) poses to the integrity of its economic and financial system and, ultimately, its social fabric. Still, further improvements could be envisaged by the EU's co-legislators.

The current AML/CFT directive embodies one of the strongest set of AML/CFT rules in the world. Yet, it

requires transposition into national law. This is conducive to divergent interpretation; fragmentation in national rules and sometimes delay in implementation ensue. The proposed new regulation includes directly applicable rules that obliged entities would have to comply with. Harmonized rules would bring greater convergence in practices across the EU. However, for that objective to be fully achieved, the rules have to be detailed enough.

Among other issues, two sets of requirements would gain to be further developed in the new regulation. First, customer due diligence (CDD) requirements need to be fleshed out in a granular way to prevent inconsistent implementation or, worse, regulatory arbitrage occurring within the internal market. This is especially true for identification and identity verification requirements, all the more so in a context of growing remote customer relationships. After all, a suspicious transaction report with incorrect identity information has scant value if at all. Second, for groups of obliged entities with significant cross border activity, both within the EU and in non-EU territories, comprehensive risk-based requirements at groups' level would address ML/TF cross border and trans-sectoral nature. This would help ensure that transactions carried out by non-EU subsidiaries or branches of EU-based groups comply with EU rules.

AMLA's direct supervision scope needs to be crafted so that it adds value to the existing framework.

Having the right AML/CFT regulation in place is not enough; supervision and enforcement have to follow suit, including on a cross-border basis. Recent initiatives, such as the European Banking Authority's guidelines on AML/CFT colleges for cross-border financial groups and on cooperation and information exchange between prudential supervisors, AML/CFT supervisors and financial intelligence units (FIUs), have greatly improved the coordination of competent authorities within the EU. Yet, the EC's proposal to set a new EU AML/CFT Authority (AMLA) would lead the EU AML/CFT architecture to a quantum leap.

AMLA would have a two-pronged role in supervision and in FIUs' coordination. In the supervisory realm,

AMLA is set to become the center of an integrated system of national AML/CFT supervisory authorities, with direct supervisory power on a subset of financial obliged entities deemed to be exposed to the highest ML/TF risk. Getting that subset right is not easy; indeed, gauging an entity's ML/TF risk exposure and benchmarking it to that of other entities is not as straightforward as measuring the size of its balance sheet.

Additionally, ML/TF risk exposure is not always commensurate with an entity's volume of clients or activities. Against that background, two areas of the EC's proposal require further consideration.

First, the scope of AMLA's direct supervision needs to be crafted so that it adds value to the existing framework. Current selection criteria are mainly EU-oriented; the inclusion in AMLA's direct supervision of entities with non-EU-based parent entities would bring greater EU-wide supervisory leverage—especially so in the cryptosphere in which the geographical location of activities is less relevant. Current selection criteria also hint at focusing on a few banking groups, possibly headquartered in a limited number of member states; consideration should be given to a broader set of financial activities and to giving to AMLA's direct supervision a meaningful stake in each and every member state.

Second, AMLA's indirect supervision would be instrumental in bringing consistency in the supervision of both financial and non-financial activities and levelling up the EU's defense against the ML/TF threat. The AMLA regulation needs to empower it with sufficient tools to help ensure its effectiveness.

Other thoughts could be given to information sharing and synergies between AMLA's supervisory and FIU parts. Yet, overall, the EC's AML/CFT package is a robust proposal, which, once adopted, will equip the EU with a much-awaited modernized and more integrated AML/CFT regime.



DERVILLE ROWLAND

Director General Financial Conduct - Central Bank of Ireland

AMLA's role in delivering enhanced convergence, coordination and cooperation

The flow of illicit funds contributes to and sustains serious societal harm, including drug dealing, terrorism, and modern slavery, not to mention risks to financial stability. The UN Office on Drugs and Crime estimates that between 2 and 5% of global GDP is laundered each year. According to Europol, this equates to between €715 billion and €1.87 trillion annually.

Recent scandals have shown that the current EU framework to fight financial crime and money laundering is not as effective as desired. The proliferation in new technologies creates new opportunities for criminals and terrorists to launder their proceeds or finance illicit activities.

The weaknesses in the framework and inconsistent approach to supervision require structural and legal changes combined with the coordinated effort of a broad coalition of actors comprising regulators, FIUs, law enforcement, policy makers and legislators across the EU.

The AML/CFT Package represents a radical overhaul of the framework and has the potential to strengthen our collective defences. The ultimate success of the Package will depend on our ability to act collectively and in the spirit of solidarity to realise the full potential of the proposals.

The divergent application of the existing AML/CFT rules hinders the EU's ability to prevent the financial system being used for illegitimate purposes. The creation of a single AML/CFT rulebook by means of a directly applicable Regulation will prevent inconsistent application of the rules across Member States, close regulatory loopholes and reduce regulatory arbitrage, all of which criminals have exploited.

The establishment of AMLA is at the heart of the framework overhaul. AMLA will be charged with raising standards in supervision, delivering a common understanding in supervisory practices and driving increased alignment and coordination with other EU and international authorities.

A credible methodology for assessing EU wide ML/TF risk and identifying the firms that pose the greatest ML/TF risk to the Union will be imperative to AMLA's success. AMLA must also embrace an intelligence-led approach to its direct supervision ensuring that its resources are concentrated on the areas of greatest risk. Information-sharing with ESMA, the ECB, NCAs and FIUs will be essential to this intelligence-led approach.

Enhanced convergence, co-ordination, and co-operation between the broad coalition of actors is vital.

AMLA's Joint Supervisory Team approach to direct supervision is welcome. NCAs with in-depth knowledge of national AML/CFT risks must be engaged and empowered in this structure. This will inevitably require meaningful cooperation and a continuous feedback loop between AMLA and the NCAs.

In order for AMLA to have a meaningful impact in the fight against money laundering, it will have to work closely with NCAs to ensure that firms not directly supervised are complying with their AML/CFT obligations. AMLA must foster with the NCAs an effective and responsive risk culture. AMLA must be

effective in its own threat response and capable of requiring NCAs to respond, where required, to address the threat of money laundering.

In its role as AML/CFT supervisor, AMLA will identify emerging ML/TF risks and trends across the Union. Its role in developing Regulatory Technical Standards that reflect real-time developments will ensure that the single rulebook remains relevant, agile and capable of responding to evolving threats.

AMLA's mandate to coordinate FIUs across the Union provides it with the opportunity to revolutionise how financial intelligence is shared and analysed. AMLA's interaction with law enforcement will be key to ensuring that financial intelligence results in prosecutions.

AMLA's indirect supervision of the DNFBPs has the potential to be a powerful tool in the fight against money laundering as lawyers, accountants and trust and company providers act as gatekeepers to the financial system. The DNFBPs are uniquely placed to prevent criminals gaining access to the financial system and represent a rich store of intelligence for both AMLA and FIUs.

The success of the Package is not dependent on any single factor. The drivers of success are multifaceted. A harmonised rulebook, overseen by a single supervisor that raises standards and delivers increased alignment and cooperation across the regulatory landscape, will be transformative. No legislative package can, however, contemplate every ML/TF risk and totally eradicate money laundering.

Success will ultimately be measured by how well the Package enables the Union to reduce money laundering and its detrimental impact on the financial system.



DUNCAN DEVILLE

Global Head of Financial Crimes
Compliance - Western Union

Anti-money laundering: making the new EU framework a reality

In July last year the European Commission published its ambitious package to reform the anti-money laundering/anti-terrorism financing (AML) framework for the EU. Western Union is a very strong supporter of these proposals. Compliance with AML is one of the largest investments made by Western Union and one of the most significant barriers to the emergence of efficient cross-border payments both within the European Union and internationally. This has also been recognized in the G20 Roadmap for enhancing cross-border payments.

At the heart of the European Commission's proposals are two elements:

- harmonization of the rules via a single rulebook by moving parts of the current AML framework from a Directive, which is not directly applicable, to a Regulation, which is directly applicable across the EU;
- more centralized supervision via the new EU authority on AML.

Together these measures are expected to lead to significantly higher harmonization across the EU. Harmonization brings legal certainty, reduces frictional

costs in implementing the rules across 27 jurisdictions and most importantly allows companies to develop and roll out a single compliance program for the Single Market as a whole.

The proposals by the European Commission recognize that financial services institutions, and in particular payment services providers, are increasingly offering their services and products to clients in an online environment, be it through mobile or other non-face-to-face applications. Harmonizing the AML rules allows companies to develop technology solutions to on-board clients by using electronic identification tools. Technology also allows companies to better identify, track and act upon suspicious transactions. All of this should contribute to making Europe a safer place for doing business, while not disrupting the innovative and seamless customer experience which Western Union and its competitors aim to deliver.

The legislative proposals are now with the European Parliament and the EU Member States. As the co-legislators elaborate on the legislative texts, we at Western Union believe there are a number of aspects that still deserve further consideration and would help make the revised EU AML framework a real success.

We believe individual companies should have the right to opt in to the sole and direct supervision by the AML authority.

We welcome that the proposals aim to clarify how AML reporting obligations interact with the General Data Protection Regulation. In the absence of legal certainty in this regard many financial institutions rightly err on the side of caution, potentially depriving law enforcement of information that could solve, or even prevent, crimes. A further improvement would be to require the new AML authority and the national Financial Intelligent Units to swiftly agree on common suspicious transaction report templates. This would streamline the reporting process and allow for the use of modern analytical tools to report suspicious transactions.

Even though we are strong proponents of a harmonised AML framework,

Western Union also believes the EU AML framework should allow companies to rely more on risk-based approaches when it comes to AML prevention and detection. This means that the EU framework should not be overly prescriptive but should allow individual companies to develop and implement their own risk mitigation techniques, appropriate for their own respective business models.

This brings us to the question of direct supervision by the EU AML authority. The European Commission's proposal suggests that high-risk activities should be directly supervised by the authority. These are defined by their cross-border nature, as well as the nature of the underlying activity. We are critical of any regulation whereby cross-border financial services institutions would automatically be deemed riskier than exclusively domestic financial services institutions. Why otherwise promote a Single Market in the EU? Any assessment of a respective financial institution's risk profile should instead take into account the average size of the transactions, the nature of the transaction and most importantly the risk mitigation techniques and past supervisory track record of the respective financial institution. It is important to avoid a potential blacklisting of directly supervised financial institutions.

Western Union has one final suggestion. Independent of the designation process we believe individual companies should have the right to opt in to the sole and direct supervision by the AML authority. This would make them subject to only one AML regime within the EU, thereby reducing the compliance burden for pan-European companies, but most importantly leading to more effective and efficient AML supervision in the European Union. It would also help address any concerns when it comes to de-risking.



JESPER BERG

Director General -
Danish Financial Supervisory
Authority (Finanstilsynet)

Technology and public private partnership are the greenfield opportunity for AMLA

Combatting and preventing money laundering remains one of the key challenges we face – as an industry, as regulators, as supervisors and as society. This seems unlikely to change anytime soon.

We are all struggling to improve the effort, procedures, and systems. Much has been done and much is being done. Banks and authorities have stepped up. Few banks and no authorities want to fail. Failure is not an option, and could also cost you dearly on your reputation. There is still work to do. A very large part of crime is undetected, and criminals are getting better and better at hiding and masking their illicit proceeds. It is a global and a local problem. The Financial Action Task Force has done much to solve the global issue by issuing recommendation and by assessing the individual jurisdictions. The question remains, where should we focus on the plethora of options for improvements to the framework put forward?

In the European Union, the Commission has put forward a proposal for an AML

package. The package includes more stringent and more harmonized rules.

The package also includes a proposal for a new European AML Authority, the AMLA. The task of the AMLA will be to supervise the largest and most risky financial institutions in the AML/CFT area, to supervise the supervision in the member states (to police the police, so to speak), and to issue standards for supervision.

Nobody questions the need to keep up the pressure on both supervisors and the supervised, but it deserves discussion, how the AMLA will give maximum value for the money spend.

Being close to financial institutions, local law enforcement authorities and the judicial system will continue to be crucial for efficient supervision. National supervisory authorities should still play a central role in supervision, also in the largest and riskiest financial companies.

However, supervisors are at best a supporting actor in the fight against money laundering. The key battle to win is taking place in the nexus between financial institutions, the FIUs and the police. The Greenfield opportunity for the AMLA is to contribute to the winning of that battle.

Technology and Public Private Partnership is the Greenfield Opportunity for AMLA

Increased cooperation and enhanced room for exchanging information has great potential, both within the private sector and between the private sector and authorities. And, building on such initiatives, technology has the potential to enhance the quality and efficiency of efforts further.

The criminals' methods are becoming ever more complex and more international. Banks therefore need to have better access to data on transactions made by the criminals in order to detect them in their own system. Crucially, banks must be able to cooperate closer in their transaction monitoring and investigation of suspicious transactions.

Legislators and authorities, both on EU level and on national level, must support banks by closer cooperation, not least via a close public-private partnerships.

Authorities shall augment their efforts through closer cooperation and exchange of information on suspicious transactions and on suspected noncompliance by banks and other obliged entities.

There are both high- and low-hanging fruit here. Technology holds great potential for both CDD-procedures and transaction monitoring. Developments within electronic identity solutions can enhance security when verifying identities, while access through APIs to for example validated beneficial owner registers can make necessary customer information readily available. Advanced technologies such as machine learning can increase the quality of existing transaction monitoring systems and facilitate the identification of criminal networks spreading their activities across multiple financial institutions in more extensive transaction monitoring systems. A fundamental premise for efficiently exploiting technology is, however, that comprehensive, informative, and high quality data is readily available.

Increased use of data and data sharing does not come without risks obviously. I believe it is important to have an up-front in-depth discussion of just how far we want to go down this road. It is important that we find the right balance between the worthwhile fight against financial crime on the one hand, and on the other ensure that we do not encroach on basic human rights and data privacy rules.

Both authorities and the private sector play a crucial role in fighting money laundering and terrorist financing. Increased cooperation, exchange of information and usage of technology must necessarily go hand in hand with making our common efforts more efficient.

3

BANKING AND INSURANCE POLICY PRIORITIES

ISSUES AT STAKE

European banks entered the Covid-19 pandemic with stronger capital positions, higher liquidity buffers and better asset quality than the 2008 financial crisis. So, this time European banks have been part of the solution. The EU banking crisis management framework however needs reviewing to ensure that the banking system can face future episodes of stress. In addition, European banks suffer from a persistent low level of profitability caused by excess capacity, low interest rates and insufficient efficiency that need tackling for preserving their capacity to support the post-Covid recovery going forward.

Further challenges include the competition from non-banks and tech companies, significant digitalisation costs and the implementation of additional Basel III standards. How the European banking sector may preserve its current diversity, which is beneficial for the financing of the EU economy with on-going evolutions in the EU regulatory framework is a further question to be considered.

Policy changes are also needed for supporting the role that insurers play in the long-term financing of the economy. In this perspective, the European Commission has launched a review of Solvency II aiming to adapt it to new risks such as cyber risks, climate and environment-related ones, and to the new opportunities offered by digitalization, AI and the EU green deal, while preserving the soundness of the European insurance sector.

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Q&A

JEAN LEMIERRE

Chairman - BNP Paribas

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

Even if the pandemic is not behind us, what are the key lessons for banks that you draw from this crisis?

First of all, even if the health crisis is not behind us, we can already say that the massive coordinated fiscal and monetary response to the pandemic has been very successful, to minimize the impacts on the economy, and to preserve jobs. This has helped businesses and households to weather the crisis, which has allowed a very robust rebound in 2021, compared to previous crisis.

Second, the crisis has brought to the forefront existing vulnerabilities, such as supply chains, and accelerated structural changes in behaviors, such as work from home, digital shopping, awareness to climate change.

In this context, banks have shown their resilience, and their pivotal role to continue to finance the economy in times of stress, also helped by targeted temporary regulatory adjustments. Banks across Europe deployed hundreds of billions of state guaranteed loans, provided moratoria, restructured debt, etc... while continuing to apply strict credit worthiness assessments. The NPL wall, expected by some, has not, and most likely will not, materialize.

At the same time, banks have accelerated the changes in their organizations and business models and ensured continuity of service while maintaining their operational resilience. Our teams can be proud of these achievements.

Now we enter in a new phase, where some restructurings will have to be implemented, while a large part of the economy is rebounding strongly, creating other issues such as inflation. Banks have demonstrated that they are best placed to engage with clients, and they are prepared to continue to do so. Whatever their business model, what matters is to ensure that they are not unduly penalized by the regulatory framework, as otherwise this would slow down the recovery. As is now better recognized, the EU economy cannot be competitive without a competitive EU financial sector.

What are the main challenges that the EU banking sector is facing (e.g. digitalisation, climate transition, macro-economic risks, demographic change...) and how are these expected to evolve in the future?

Dealing with multiple challenges is “business as usual” for banks, and most of them are well equipped to deal with them.

In particular, banks have taken major commitments to finance the transition toward a net zero economy, which will require massive work in the next few years, in close cooperation with their clients, which are on the front line to transform their industries to achieve the goals. Banks are best placed to work with clients on their transition and to monitor them. The regulatory and supervisory framework must support and encourage the banks, rather than being excessively prescriptive.

Financing the transition of our clients must be our main focus, on which human and capital resources should be allocated. We are all learning by doing together, at national, European and international levels.

Another issue is the need to improve profitability, which has been hit by low rates, reluctance to cut costs for social reasons, high competition due to overbanking, insufficient consolidation due to the still fragmented European market. Bank profitability is the first line of defense for financial stability. Over the next few years, banks' earnings should not be captured by rising capital requirements, but rather used to finance growth, and the massive IT investments needed to develop the new generation of banking systems: instant payments, digital currencies, ESG reporting, cyber responsiveness, to name a few...

In order to win this battle, competitiveness is key. If European banks have to face competitors which are less affected by

regulatory reforms, or not regulated at all, in the case of techs, they will not be able to generate the earnings needed to ensure their transformation.

After 15 years where the regulatory agenda was focused on banks and markets, it is essential to strengthen the regulatory and supervisory framework for the financial system as a whole, not only to ensure level playing field, but also to make sure that authorities have a holistic monitoring of financial flows, to capture new sources of vulnerabilities.

What are the priority actions required at national and EU levels to relaunch productive investment? How can the investment needs in relation to the green and digital transition be financed in the current macro-economic environment?

The implementation of Next Generation EU needs to be accelerated. In this very accommodative monetary policy, financing the investment needs is not an issue of liquidity, which is cheap and abundant, but of risk, which needs to be properly capitalized and remunerated.

As the EC says, net additional investments needed represents 650bn€ per year. As banks finance 80% of the EU economy, this would require an amount of prudential capital which is beyond EU banks' capacity to grow their capital base. Therefore, capital markets will have to play a bigger role, given banks will be unable to absorb this financing. At the same time, banks are better placed, notably in less liquid segments such as SMEs, to analyze the risks of their clients, based on their local expertise. The only way to get the best of both worlds is securitization: encourage banks to continue to finance their clients, while allowing them to transfer some risks to the market to reduce their capital charge. To unlock the EU securitization markets, solutions are well known, written in all recent reports. Let's move, now.

Does the monetary and regulatory banking framework allow the banking sector to actively contribute to the post Covid recovery in the EU? What additional measures or changes may be needed to support this role?

First, the banking sector should be prepared for a scenario of progressive normalization of monetary policy, and the US and UK have already engaged in this path. This will reduce the overall liquidity available and make it more expensive.

Second, the EU regulatory framework will continue to tighten. On the micro-prudential side banks will have to absorb higher RWA under CRR3, higher leverage requirements, as early as 2022, and binding MREL requirements. And on the macro-prudential side, contra-cyclical buffers are already on the rise, as well as various other more targeted measures, notably on the real estate market.

These two trends only reinforce the urgent need to make progress on the Capital Market Union, so that the tightening effect of monetary and regulatory policies does not slow down the rebound of the EU economy, and the financing of the Green and Digital transition.

GLOBAL COMPETITIVENESS OF THE EU BANKING SECTOR



PABLO HERNÁNDEZ DE COS

Chair - Basel Committee on Banking Supervision (BCBS)
& Governor - Banco de España

The strategic priorities of the Basel Committee

This year will mark the 15th anniversary of the Great Financial Crisis (GFC). Much has happened since then. The Basel III reforms have fundamentally bolstered the global regulatory framework. Banks are now better capitalised and have stronger funding profiles than in 2007. Advances in technology and the growth in non-bank financial intermediation (NBFIs) are reshaping the financial system. Covid-19 has accelerated the urgency of addressing medium-term structural trends.

Against that backdrop, what lies ahead for the Basel Committee in 2022 and the medium term? Four broad themes underline our strategic priorities.

First, the Committee will continue its work related to Covid-19, with a view to ensuring that banks remain resilient and contribute to a sustainable recovery. The past few months have reminded us that the transition from pandemic to endemic is likely to be a bumpy one. The outlook continues to be marred by uncertainty and divergences across regions.

While the global banking system has largely weathered the pandemic to date, it is crucial that banks and supervisors remain vigilant to risks and vulnerabilities as Covid-19 continues to unfold. This includes managing risks related to frothy asset valuations and the trajectory of interest rates, and ensuring that banks remain operationally resilient. The unwinding of public support measures – which were critical in shielding banks from losses thus far – will also test banks' resilience.

The Committee is evaluating whether the Basel III reforms implemented thus far have functioned as intended during the pandemic. Our preliminary assessment indicates that the banking system would have faced greater stress during this period had these reforms not been adopted and in the absence of public support measures. We have also identified some areas in the Basel Framework – including the usability of capital and liquidity buffers, the impact of the leverage ratio on financial market intermediation and potential procyclical dynamics in the risk-weighted framework – that we will continue to evaluate.

Second, the Committee will proactively assess emerging risks and structural trends affecting the global banking system. This includes the ongoing digitalisation of finance, which is reshaping the range of financial services on offer, the distribution channels of these services and the suppliers behind them. We are conducting a set of deep-dive thematic analyses to gauge

the impact of these drivers on banks and will consider whether any additional supervisory or policy measures are needed at the global level.

A related area of focus for the Committee relates to cryptoassets. The potential for this market to scale up rapidly and the wide range of potential exposures to banks merit close attention. The Committee is cooperating closely with other global bodies to assess the cross-border financial stability risks from cryptoassets and identify any gaps in the global regulatory framework. One such area relates to the prudential treatment of banks' exposures to cryptoassets, which we plan to finalise in 2022.

Another area of focus is climate-related financial risks. The Committee is pursuing a holistic approach to help banks and supervisors adequately measure and mitigate such risks. In 2022, we plan to finalise global principles for the effective management and supervision of such risks. We will also liaise with the International Sustainability Standards Board and other global forums to ensure that banks' Pillar 3 disclosures adequately reflect their climate risk profile. And we are assessing whether there are any potential gaps in the Basel regulatory framework for mitigating such risks.

Third, the Committee will pursue a range of initiatives aimed at strengthening supervisory coordination and practices. This includes ongoing work aimed at safeguarding banks' operational resilience, including with regards to the use of third- and fourth-party service providers and cyber attacks. The Committee is also carefully assessing the supervisory implications of the digitalisation of finance, including with regards to the role of artificial intelligence and big data.

The growth in NBFIs raises important supervisory questions for the Committee, given the interconnectedness between banks and non-banks. Events over the past few years, including the March 2020 market turmoil and individual episodes of NBFIs distress, have highlighted how these channels of interconnections can pose risks to banks. The Committee will continue to work closely with other global forums to ensure that banks and supervisors adequately manage these channels of risks.

Fourth, the Committee will continue to promote the full, timely and consistent implementation of all aspects of the Basel III framework including the outstanding standards due in January 2023. Doing so will help lock in the benefits of these standards to ensure that banks can withstand future crises.



ELIZABETH MCCAUL

Member of the Supervisory Board -
European Central Bank (ECB)

Strengthening the resilience of the European banking sector

The good news is the euro area banking system has proven resilient in the COVID-19 pandemic: banks remain generally well capitalised, hold ample liquidity and are performing their key role as sustainable lenders. While reassuring for now, this may not be good enough for the future. European banks have been struggling with low profitability for a decade. Low interest rates and excessive risk-taking as investors push for more yield, may make financial markets vulnerable to abrupt asset price corrections and disorderly deleveraging. Achieving higher profitability is important for strengthening resilience, as is transformation towards more sustainable business models, sufficient investment in digitisation and consolidation to remain competitive. All of this in an environment that is fraught with uncertainty and risk, providing significant challenges requiring action from both bankers and policymakers alike.

For a start, the full impact of the pandemic on balance sheets is not yet known. Nor is the impact of supply chain bottlenecks on growth. Underperforming loan classifications are higher than before the pandemic and loans benefiting from COVID-19 support measures appear to have a slightly higher risk profile. Bankers must ensure solid credit risk management is in place to avoid a new surge in non-performing loans and losses.

Bankers need to adapt their strategies to two major structural shifts: first, digital transformation is an opportunity or even a must for banks to reduce costs, gain efficiencies and identify new sources of revenue. Areas that have historically been the domain of the banking sector are seeing new entrants, reinforcing the need to adjust strategically. Exposure to IT and cyber risk both within and outside the supervised banking sector will increase as this profound shift takes place. Policymakers should ensure a level playing field on risk management between banks and bigtech. The Digital Operational Resilience Act and the Regulation on Markets in Crypto-assets are therefore welcomed. The second structural shift is the green transition. The climate crisis is exposing banks to physical and transition risks, and they will need to strengthen and reassess their strategies and risk management frameworks accordingly to safely finance the greening of the European economy.

For European policymakers, the positive role played by the regulatory reforms since the global financial crisis to reinforce our banking system, and the coordinated supervisory response in the Single Supervisory Mechanism to the COVID-19 crisis should be forceful reminders of the importance of completing the reforms agenda. The implementation of the final Basel III standards effectively addresses important issues concerning the reliability and consistency of capital requirements, especially when risk-weighted assets are calculated by the banks themselves via their internal models. The reform

package proposed by the European Commission goes beyond the Basel III standards and introduces other desirable changes, such as environmental, social and governance risks and the individual and collective fit and proper criteria and harmonised early approval mechanisms.

Achieving a truly integrated European banking market would put banks in a much better position to reap benefits of scale and scope and to finance the green and digital transitions of the European economy. It would enable a greater degree of private risk-sharing, so that shocks hitting a region of the banking union would be more easily absorbed, without the need to consider public support measures. Differences in local rules and practices for crisis management prevent progress towards cross-border banking, so a revamp of the EU's crisis management rules is welcome.

Challenges and risks abound, there are paths for bankers and policymakers to manage safely ahead.

Meanwhile, bankers can choose existing options such as expanding across borders through branches and the direct cross-border provision of services. Increasing digitalisation makes it easier for banks to offer services competitively across borders, while the framework for single supervision should allow a smoother transition to a branch-based structure for all entities willing to take that route – a solution that has already been adopted by many non-EU banks that have relocated to the euro area after Brexit.

Challenges and risks abound, but there are clear paths for bankers and policymakers to manage safely on the road ahead.



FRÉDÉRIC OUDÉA

Chief Executive Officer
Société Générale

Solving the banking sector competitiveness equation

When comparing the present situation to the pre-GFC years, Europe's competitiveness problem becomes blatant. The market capitalization of the main European banks has not only decreased by a third, but a single American bank is now worth as much as the top 10 EU banks combined. Recently, the same bank announced annual net results significantly superior to the aggregated 9-months net results of the main French banks and a ROE more than twice higher.

There are many factors underlying this competitive underperformance.

First, the pace of recovery: massive public-sector intervention both in 2008 and 2020 boosted the US economy. The US economy outperformed the EU after the GFC, and US GDP surpassed its pre-Covid level as early as Q3 2021, while most EU countries are expected to catch up during 2022. Driven by stronger growth, US stocks have outperformed EU markets: the S&P and Nasdaq have soared 35% and 50% in the last two years, while the DAX and CAC have both gained around 20%. The GDP gap is expected to widen, although the US faces rising inflation and the risk of a fiscal cliff, and the situation may yet have unknown ramifications. EU banks continue to face a challenging monetary environment, with low or even negative interest rates.

Second, more structurally, the EU banking sector remains fragmented, depriving the industry of economies of scale.

The greater depth of US capital markets also contributes to increased investment bank activity. Thanks to active securitization, which in the case of mortgages relies on vehicles guaranteed by two Federal agencies, US banks can reduce their balance sheets and have greater capital efficiency. By contrast, integration in EU capital markets is only at an early stage and the euro area still lacks a common risk-free asset. The euro needs to play a more prominent role internationally: in a heavily dollarized world, EU banks will always face additional costs compared to US banks. During episodes of financial stress, EU banks faced higher dollar funding costs than their US peers.

This profitability gap is a threat to the future, as it means that US banks are better positioned to invest in particular, but not exclusively, in large-scale digitalization. This situation of a fragmented bank system with low profitability and underdeveloped capital markets comes at a critical time when we require risk-taking capital and strong finance to ensure that the green and digital transitions can deliver jobs and sustainable growth.

The industry landscape is also being reshaped with increasing competition from neo-banks, crypto asset players and new

payment institutions. Central bank digital currencies are likely to emerge and drive profound change, and the place of traditional banks in this ecosystem is yet to be defined.

On a positive note, Europe has taken a lead on green finance and can rely on strongly capitalized banks. It is on these sound foundations that the EU should now develop the capacity to create its own banking champions. In response to the domination of US card-payment giants, EU banks are working to develop a home-grown alternative in the European Payment Initiative.

The EU should ensure that its regulation contributes to the competitiveness of its financial players, and to the deepening of EU banks' ability to support its economy, both through their lending and markets activities.

The EU should enable European banking champions to emerge.

The first step is to finalize the implementation of Basel reforms in a way which is sensitive to EU specificities and does not constrain EU banks from fully playing their role in financing economic development. This means also addressing the disproportionate costs supported by large banks in prudential and resolution rules. In the longer term, more structural reforms will be needed to reduce the fragmentation in the EU. This means adopting a different mindset vis a vis the consolidation of banks (and solving the home/host debate) as well as the development of securitization.

In any case, it is essential that policies should never be envisaged in isolation, and that their impact on the attractiveness of EU markets and on the competitiveness of EU players should be a primary criterion in their assessment.

If Europe can successfully address these challenges, I have no doubt that the competitiveness gap can progressively be closed instead of further widening.



DOMINIQUE LABOUREIX

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

A competitive EU banking sector is key for European financial sovereignty

Following the Great Financial Crisis (GFC), despite a significant increase of EU banks' resilience, the profitability of a large number of them has lagged behind their international peers, in particular US banks. Over 2014-2020, US banks were able to maintain a higher ROE than their European peers (US 8,5% vs EU 5%); moreover, EU banks price-to-book ratios have, on aggregate, not yet recovered their pre-GFC level – contrary to US banks as early as 2013.

A well-known cause of this gap in competitiveness is due to the higher fragmentation of the EU banking sector, with no sign of this trend being reversed, as M&A activity in the EU banking sector remains limited compared with the US. This low level of concentration is a source of significant inefficiencies and vulnerabilities, because of lower economies of scale than in a number of non EU jurisdictions and a lower cross-country risk sharing. This in turn is fed by the perception of an insufficient risk sharing at Union level, as in case of difficulties, safety nets remain largely national. Fragmentation also leads to “overbanking”, which in the end affects the profitability of the banks in the system – as showed by the higher cost to income ratio, notably linked to the relatively high number of branches within the EU.

A newer source of concern affecting EU bank profitability is the overtaking of EU banks by their US counterparts in their own market as the largest US banks have accounted for more than half of total investment banking revenues in the EMEA region since 2016.

This latest development sharply raises the stakes for further financial integration in the EU, as not only is EU banks' profitability at stake, but also EU sovereignty. Indeed, the increasing market share of non EU investment banks could expose the EU economy to a risk of investment outflows in times of stress. As such the coming years will be crucial to address any systemic risks stemming from excessive reliance on non-EU entities.

The recent CRD6 legislative proposal to harmonise the rules pertaining to the establishment of third country branches and the provision of banking services by third country firms thus goes in the right direction. However, these measures should be calibrated to maintain the liquidity of global markets, particularly with respect to interbank lending, as well as to preserve EU market attractiveness. Autonomy does not mean autarky and we must keep in mind the EU commitment to healthy economic multilateralism.

Securing robust sources of funding at the EU level will also require regaining momentum to overcome banking fragmentation by moving toward the completion of the Banking Union. This would indeed boost the emergence of

consolidated pan-European banking groups that would be able to more efficiently allocate savings surplus to investment needs across the EU.

The EU has achieved significant progress on the second pillar of the Banking Union with the introduction of the backstop. The Single Resolution Fund is now well capitalised, but issues remain on the liquidity of banks in resolution and on the harmonisation of bankruptcy laws. As regard the third pillar, let us be clear: the European Deposit Insurance Scheme (EDIS) needs a major overhaul. Alternative avenues should be explored such as the creation of a liquidity support system between national Deposit Guarantee Schemes combined with a renewed approach, in which foreign subsidiaries would be affiliated to the home DGS.

Digitalisation and the Banking Union are essential to increase profitability and market integration.

The priority for banks to bridge their profitability gap is however to rise to the new challenges facing them: digitalization, climate risk, cyber security. All of them need considerable investments, either to avoid potential losses, or to generate future profits. In a world which changes very quickly, they need to follow the path of digitalisation to keep up with their rising Fintech and Bigtech competitors and to properly address consumers' expectations. While the principle of “same activity, same rule” must consistently apply to prevent less regulated actors from draining profitable businesses, we should pay attention that regulation does not hamper innovation that drives long-term growth prospects. For banks, that means they need to be ahead of the curve.



CHRISTIAN EDELMANN

Managing Partner Europe

Oliver Wyman (UK)

How European banks can close the gap

Europe's banks have had a tough ride over the past decade. Their market value is still down by more than two-thirds from the peak before the global financial crisis.

European banks are falling behind on both sides of the ledger. Not only has revenue growth been weak — cost structures also remain a major burden. U.S. banks boasted a cost/income ratio roughly 15 percentage points better than their European counterparts in 2021, according to Oliver Wyman research. About 80% of that gap was attributable to support function costs: U.S. banks are getting more out of their technology than European banks.

Only one-fifth of the gap was due to higher front-office payout ratios last year. But if revenue and cost trends persist, European banks soon will struggle to keep up with Americans on comp as well.

Granted, some of the malaise is due to negative interest rates, which have taken a major toll on European banks.

Regulation and its implementation, or the lack thereof at the European layer, is another important factor. Both the Banking Union and the Capital Markets Union are key ingredients for creating a simpler and ultimately more level playing field across Europe, which also would help foster well-needed consolidation. European banks also have a point when they argue there is no truly holistic view on regulation across the Basel regulatory framework and the full prudential regulatory agenda. This includes all supervisory tools such as the Supervisory Review and Evaluation Process (SREP) and its drivers, as well as the Asset Quality Review and stress testing. Better understanding of how these regulations and tools systematically impact the business model of typical European bank is critical.

But what if that day of “regulatory panacea” never comes? In this moment of political populism, growing nationalism, and fiery polarization, it has been difficult for European leaders to make progress on regulatory initiatives. For example, the CMU was absent in the President of the European Commission's state of the union address, which sets out her top priorities.

If banks want to get out of their malaise, they will likely have to do it for themselves, and swiftly. It requires nothing less than radical transformation.

Most banking CEOs will argue they have been in constant transformation over the last decade. But they have reacted far too slowly and too gradually. They have tried to preserve what made them successful historically, and then tried to layer on new capabilities largely on legacy infrastructure that in most cases dates to the 1970s and '80s.

Banks haven't leveraged the value of the data they have. And most important, they haven't sufficiently appreciated how the process of value creation has shifted. Historically, banks created value by managing pools of risks —and they extracted so much money out of it that they even offered ancillary services such as custody or payments for free or at cost. They didn't realize the value opportunity that specialist providers have tapped into over the last decade.

Banks need to organize business units around data and customer lines — but so far, none has truly done this. The quickest successes would come from simple improvements such as using data to help customers make better spending decisions. In an extreme scenario, one could imagine a ring-fenced setup in which managing the balance sheet stays in a regulated entity while customer-focused platforms that serve all manner of customer needs sit outside it. It might sound farfetched, but radical thinking is required.

If banks want to close the gap in the near term, they will likely have to do it for themselves.

An example of such a customer-focused platform could be related to climate transition. Indeed, this is one area in which the European political and regulatory environment can become an advantage. Europe is further along the political, societal and regulatory journey than the United States. Banks have a chance to finance and advise corporates along this journey and, on the flip side, distribute such assets to institutional investors who are urgently looking to beef up their climate-friendly investment track records.

These aren't quick fixes; they require major transformations that demand leadership courage and investment budgets. Most firms don't have those budgets and may have to think about selling assets to finance this critical transition, painful though that may be. But they need to be bold. Incrementalism will not do the job.



STANISLAS ROGER

Vorstand, Member of the Executive Board,
Chief Executive Officer - SMBC Bank EU;
Executive Officer and Deputy Head, EMEA Division - SMBC

How international banks can help promote EU competitiveness

The EU has long been attractive to banks which are headquartered outside of the EU. Having been able to carry on business in the EU over many decades, many international banks such as SMBC now view themselves not just as “international” banks but as fundamentally European.

As EU policymakers look ahead to shaping the future of the EU financial markets they will of course consider a wide range of questions, including – “which activities should be encouraged?”, “how much activity?”, and “should all institutions have the same level of access?”. When thinking about these questions it is worth to re-cap some of the policy approaches that will best ensure that international banks are able to offer the greatest benefits to the vibrancy and competitiveness of the EU financial markets.

International banks are best placed to offer benefits to the EU where markets are “open”

EU financial markets should continue their long history of being seen to be “open”, which has encouraged a wide diversity of market participants to do business in the EU. Markets which are easy to access are of course more likely to lead to international banks offering a greater range of banking products and services. The benefits are not just to international banks but are reciprocal; customers across the EU are able to access a huge range of services and products which are offered by international banks. Prices are also better where competition is strong.

The EU has long provided an environment in which this has been possible. International banks – including those coming from the other side of the world, such as Japan – have welcomed the flexibility and openness of the EU financial markets which has allowed huge amounts of international capital to be leveraged for the benefit of EU customers.

Markets may be considered to be less open where they are more difficult to access, whether by requiring a physical presence in a particular member state to conduct business, or by requiring licences to conduct business which go beyond the current framework that international banks have long adapted to.

It is important to take the “global view”

The EU has been successful in communicating and sharing ideas with policymakers in other jurisdictions since the financial crisis on a number of global issues. As policy issues are increasingly required to be seen through a “global” lens – whether because of their global impacts, such as environmental issues, or their importance to global banks, such as capital – the EU should continue to take a global view.

International banks are subject to rules and regulations across all of the major jurisdictions. Complexity in the regulatory framework is an important barrier to EU competitiveness, and is reduced where international banks are able to understand and implement rules where it is clear that common objectives are being looked at in concert.

Including banks in the conversations

Banks are willing partners in the policy debate. In recent years banks operating in the EU have enhanced their resource to be able to effectively participate in industry conversations about the direction of EU policy. These people come from a range of private and public backgrounds which combine to provide an additional layer of expertise that policymakers can leverage to produce policy which works. Moreover, banks have an inherent interest in working together with policymakers to share experiences and influence change. The situation is no less the case for international banks operating in the EU. International banks see themselves as “partners” in the European project and accordingly wish to see a stable, competitive, and efficient EU in which they can do business.

Many international banks see themselves as fundamentally “European” with benefits for EU customers.

The important policy questions of which activities should be encouraged, how much, and who should be able to access the EU markets are always important to consider; not forgetting meanwhile the importance of international banks to the competitiveness and vibrancy of the EU financial markets.



BEATRIZ MARTIN JIMENEZ

UK Chief Executive and
Group Treasurer - UBS

EU capital markets need a strong connection to the global financial system

The European Commission recently proposed legislative measures aimed at stepping up efforts to build the Capital Markets Union. These include changes to the MiFID framework to improve the flow of information to investors and reforms to the regulation of long-term investment funds, aimed at making them more attractive to asset managers and investors.

These are steps in the right direction. Harmonising rules and market practices for financial products and improving transparency of investment opportunities can help to unlock capital so that it flows across national borders. In this way, the right regulation can help to integrate markets and improve competitiveness, improving the supply of, and demand for, investment products.

At the same time, creating deeper capital markets requires scale efficiencies. This is particularly important in the post-financial crisis era where firms are, rightly, required to hold higher levels of capital and liquidity to ensure their resilience.

Yet this significant increase in regulation has been accompanied by significant fragmentation risks that have been exacerbated by geopolitical factors. The industry is, for example, already facing increased costs from emerging regulatory divergence as the EU and the UK begin to review what have until now been shared rules such as MiFID. While some divergence may be inevitable, we will all share the benefits of more integrated and deeper capital markets if we seek to minimise the increased costs that accompany financial fragmentation.

In addition to concerns over divergence, Brexit has also led to increased focus on the concentration of EU financial services in London, which arose over time in large part due to the EU single market. Yet history tells us that while the single market was indeed a key driver in London's growth, another critical factor was the opening up of the UK financial sector to more competition, particularly to international players, through the 'Big Bang' reforms of the mid-1980s.

In the same way, global firms such as UBS can play a vital role in connecting the EU to the global financial system, helping to channel funding into EU capital markets and deliver cross-border banking and investment services to support our EU clients.

Yet the proposed EU banking package would restrict non-EU firms' cross-border access to EU clients and markets. This could lead to a number of downsides. EU-based firms, corporates, governmental entities and individuals could find they have reduced access to global products. EU-based corporates could find it more difficult to raise finance

or manage risk in some non-EU markets, or to make or receive cross-border payments, potentially putting them at a competitive disadvantage and creating barriers to international trade. EU banks and investment firms could find it more complex to manage their liquidity and funding, as accessing counterparties or financial market infrastructure outside the EU could become more challenging.

Restricting cross-border market access in this way would also represent a major change from the status quo whereby a significant number of EU member states offer a range of cross-border licences and exemptions. Usually these come with conditions, including that the relevant national authority considers the regulation of the non-EU firm's home jurisdiction as equivalent. In some cases, the national regulator will also have agreed on audit procedures to ensure compliance with relevant rules.

Global firms such as UBS can play a vital role in connecting the EU to the global financial system.

It is of course fully understandable that the EU wants to mitigate any risks to financial stability that may arise from cross-border financial activity. But there doesn't need to be a trade-off between growing the EU's capital markets and ensuring its financial stability. The EU, like other major jurisdictions, introduced post-crisis measures to mitigate the risks to stability of cross-border derivatives business, for example, through rules mandating clearing, margining and reporting requirements. And while there may be prudential risks from cross-border activity, these primarily relate to the home jurisdiction where the non-EU firm is based.

Any residual risks can and should be addressed through robust regulatory and supervisory cooperation.

EUROFI MEMBERS



IMPLEMENTING BASEL III IN THE EU



GINTARĖ SKAISTĖ

Minister of Finance of
the Republic of Lithuania

Basel III reform should not raise financial stability risks for host states

In face of the ongoing pandemic shock, the European banking sector demonstrated resilience and contributed positively to economic recovery. This showcases that steps taken to reform the banking system after the global financial crisis were indeed timely and effective. Nevertheless, more needs to be done to enhance resilience of the European banking sector to future shocks, and the Basel III package plays a key role in this regard.

By introducing additional capital requirements for internationally active banks, the Basel III package rightly moves in the direction of making the European and international banking system more bulletproof. The COVID-19 crisis is a good example of “black swan” events which cannot be predicted, but cause vast negative effects. In this vein, it is always better to be safe than sorry.

Given this, I welcome the ambitious package to implement the global agreement EU level proposed by the European Commission. Here I would like to stress that while adjusting the package to European specificities – such as those related to the mortgage market – is necessary, we should limit the scope of deviations and make sure that we do not alter the key pillars of the Basel III package. We need to remain committed to the agreement reached at the global level and strive for timely implementation at the EU level.

While Lithuania is overall supportive of the Basel III package, some elements tend to raise concerns. In this regard, the key outstanding issue is the level of application of the so-called output floor. The proposed way of applying it at the level of the banking group is understandable from the perspective of aiming to limit the increase in capital requirements and thus reduce the impact on the banking sector. Nevertheless, it creates risks in terms of financial stability, particularly in the host countries such as Lithuania.

Deviations from the Basel III reform in the EU should be limited.

I firmly believe that while striving for a more stable EU banking system, we should not unintentionally create new pockets of risks. The redistribution mechanism put forward by the Commission would allow distributing any additional capital resulting from the application of output floors between subsidiaries. However, it does not seem to sufficiently address all the concerns. In particular, the proposed solution would not sufficiently mitigate risks at the individual level of the financial institution, and could cause insufficient capital requirements with regard to underlying risks of exposures of individual entities.

This may result in negative financial stability outcomes in case of shocks. Until we have robust and credible safeguards, any changes to application of capital requirements should be treated with caution.

Furthermore, deviating from the principle of applying capital requirements

at all levels of the banking group tends to move in the direction of altering the current fragile balance between home and host countries. It may also create an unwanted precedent and aggravate progress in the broader strategic debate on completing the Banking Union, where the issue of cross-border integration is among the most sensitive ones. Taking this context into account, the Commission and Member States should continue constructive discussions to find an acceptable way forward in applying the output floor. At the same time, we should refocus our ambition and push for completing the Banking Union, while introducing the missing third pillar – European deposit insurance scheme (EDIS).

The Basel III reform is a significant step towards creating stable, resilient and reliable banking system at the EU and international level. We should remain ambitious and implement the package in a timely manner, with as little deviations as possible and taking account of potential financial stability implications in individual countries.



EVA WIMMER

Director General - Federal
Ministry of Finance, Germany

Implementing Basel III: strengthening the financing of the real economy

Implementing the final Basel III package will be the important last step of the post-crisis reform agenda. Following the global financial crisis, we agreed that taxpayers should never again have to bear the costs of bank failures. Thanks to the Basel III reforms, the banking system entered the Covid-19 pandemic much better prepared, with significantly higher capital and liquidity buffers. The final Basel III rules will help to further increase the resilience of banks and to further strengthen financial stability.

In October 2021, the European Commission presented its implementation proposal with amendments to the Capital Requirements Regulation and Capital Requirements Directive. The European Union is therefore one of the first major jurisdictions with a concrete legislative proposal to implement the final set of Basel III rules. Other jurisdictions have yet to publish their plans for implementation.

In Europe, we can build on extensive supervisory measures to improve internal models, including the ECB's targeted review of internal models and the EBA's internal repair

programme. These supervisory efforts have already significantly reduced any undue variability in risk-weighted assets and boosted the reliability and comparability of banks' internal models – fully in line with the central goal of the final Basel III package.

The implementation proposal by the European Commission strikes a careful balance and is a good starting point for the upcoming negotiations. The European Commission proposes to faithfully implement the final Basel rules to strengthen the resilience of banks. We remain committed to this approach, which implements all elements of the Basel package while preventing any double-counting of risks and any undue and automatic increase in Pillar 2 requirements. Global financial standards will only work properly if they are implemented faithfully. At the same time, we have to take into account the structural features of the European economy.

**We should further
strengthen the principle
of proportionality in EU
banking regulation.**

Firstly, we must prevent any negative impact on the financing of the real economy. In this regard, we very much welcome the Commission's proposal for longer transitional periods with more adequate risk weights for unrated corporates. Compared to other jurisdictions, rating coverage for corporates is much lower in the European Union. This holds true even for larger industrial corporations in Europe, which are often not publicly listed and contribute to substantial economic growth and employment across the continent. Hence, in the long-term, we need further measures to improve the availability of external ratings. In the short-term, we must ensure that European corporates have continued and unhampered access to bank lending, as the financing of the real economy is of the utmost importance.

Secondly, we should further strengthen proportionality. The new definition of small and non-complex institutions was a key stepping stone in the last banking package. We should build on this definition to further reduce administrative requirements without relaxing prudential standards. For instance, we should reduce disclosure and remuneration requirements for variable compensation. For unlisted small and non-complex institutions,

these requirements are only an administrative burden without any meaningful positive impact.

Our real economy depends on a wide variety of bank business models. This diversity is a strength, as we have seen in the Covid-19 pandemic. Beyond Basel, the Capital Requirements Directive should leave member states sufficient room for manoeuvre to deal with this diversity. For instance, the fit and proper framework should respect existing rules, including on corporate law and the rights of co-determination and employee participation. Moreover, supervisory powers on mergers and acquisitions as well as material transfers of assets or liabilities should be more proportionate by exempting smaller institutions and internal transactions compared to the initial Commission proposal.

Proportionality is also key regarding the timeline for implementation. The new package will entail some major changes to the standardized approaches. In the European Union, we have chosen to implement these rules for all banks, large and small. As for the last banking package, banks, in particular smaller ones, will need sufficient time to prepare for the implementation in 2025. We should thus aim to finalize this package quickly and are looking forward to continuing the constructive dialogue between all member states in the Council and progress under the French presidency.



ALBAN AUCOIN

Head of Public Affairs -
Crédit Agricole S.A.

A faithful implementation of Basel III can meet European specificities

The 2017 Basel Committee's package must be faithfully transposed, in a way that is appropriate to the European context, and in view of unifying the EU banking market.

One of the three overarching principles set out on the first page of the 2017 package is that it should not significantly increase capital requirements. To be faithful means, first, to respect this objective, which is not limited in time. The implementation of the agreement must therefore observe this objective without a deadline.

A key difficulty in implementing the Basel Committee's guidelines is that the European context is very different from that of other jurisdictions. Transposing, means putting something in another context. It is therefore important to apply the Basel guidelines faithfully to the European context.

First, the European financial markets are small and fragmented compared to those of their peers, and will remain so for a very long time. This forces banks to carry the bulk of the risks of the external financing of the European economy, which inflates their balance

sheets. Therefore, any prudential constraint on the banks' balance sheet is also a constraint on the financing of the economy. Similarly, due to the weakness of the financial market, few European companies are rated, and this is a lasting situation. Hence, if this difference is not taken into account, and this as long as ratings remain scarce in Europe, then the finalization of Basel III will permanently penalize the financing of the European economy.

Second, the housing market and its lending practices are very specific in the EU. Thanks to a double recourse in Europe, both on the debtor and on the real estate, risks can be significantly reduced. If this difference is not taken into account in a structural way and for as long as it lasts, then the impact of the regulation will be very unequal across jurisdictions, because very different risks will be weighted identically.

The convergence of prudential banking standards contributes to the development of a global banking market. American banks, that now dominate the corporate and investment banking market in Europe, are taking full advantage of this. By contrast, Europeans have been fragmenting their domestic banking markets through internal prudential requirements, which have prevented a concrete banking union. It is therefore important that a faithful implementation of the Basel package also concerns the application of its rules at the consolidated level in Europe, starting with the application of the output floor at the consolidated level only.

It is important to take into account the reality of risks and the specificities of each economy.

Another important dimension of transposition is the level playing field. It is important to ensure that the application of new rules does not distort competition between jurisdictions and within the European jurisdiction. Thus, the provisions relating to market operations must be transposed with equal effect and at the same time in the different jurisdictions. Similarly, capital requirements on strategic holdings must be equally applicable to all strategic holdings, regardless of their nature, and regardless of the institution that holds them, whether it is in standard approach or internal model.

Finally, the finalization of Basel III will not improve the comparability of banks' solvency ratios.

Indeed, the finalization of Basel III is very much a return to Basel I and to a standardised approach, whether with the use of the standardised method or with the application of an output floor to an internal model. However, internal modeling was introduced by supervisors in the late 1990s, after standardised approaches were found to be insufficient because they masked differences in risks. After 15 years of implementation in Europe, after validation and periodic controls by supervisors, after a repair exercise by the EBA, after positive reports from the EBA on the stability of models and after an in-depth review of the internal models by the SSM (TRIM), one can affirm that they represent today the most reliable measure of risks in Europe.

For example, the application of the output floor to the residential real estate sector would double the corresponding risk weighted assets of the French banks. Hence, with the black box of the standardized approach obscuring the precise measurement of real risks, these banks would have the same solvency ratios as higher-risk banks. In another example, the risk density in the US banks' balance sheet is higher than in the balance sheet of European peers, thanks to Fanny Mae and securitization of low-return risks. However, after applying the output floor, this difference disappears. The solvency ratios may be identical but may conceal very different realities. Therefore, the current cap on the output floor must be changed to bring it in line with the permanent mandate of non-significant increase in capital requirements.

That is why it is important to take into account the reality of risks and the specificities of each economy.



HENNING DANKENBRING

Head of ECB Office -
KPMG International

The EU Banking Package should allow banks to meet financing needs

After being deferred by one year, in October 2021 the European Commission published its proposal for the final implementation of Basel III in Europe, the Banking Package 2021. The proposal seeks to support financial stability and facilitate the financing of the economy in the aftermath of the COVID-19 pandemic together with the transition to climate neutrality.

As expected, and in line with the Basel documents, the new regulation narrows the scope of the use of internal models to calculate regulatory capital requirements. Management and business decisions will rely more on metrics defined by regulators rather than bank internal analyses and bank specific key risk indicators. The proposal includes the output floor which typically is a key driver of risk-weighted asset (RWA) increase for large universal banks making significant use of internal models. At the same time, the EU Banking Package allows for long transitional periods of different kinds. For example, the output floor will be phased in from 2025 until 2030. Unrated corporates with a probability of default below 0.5% will receive a lower risk weight in the standardized approach at least until 2032. A transitional

pattern has also been included for real estate mortgages. However, investors and stakeholders are likely to ask for fully loaded capital figures early on. Thus, in KPMG's view, it matters whether banks can apply reduced risk weights transitionally or permanently, irrespective of EU discretion to extend transitional rules.

Europe still faces some country specificities related to historical lending practices. For example, in France and Germany many corporate banking clients are not rated. In the Netherlands, residential mortgages are a key banking product. In France, real estate loans typically involve a financial guarantee. Therefore, the new legislation affects different countries and banks in different ways. As a result, we believe that banks with significant portfolios of unrated corporates and real estate mortgages could eventually be more severely affected than mentioned by the EU Committee assessing an average increase of 6.4% to 8.4% in minimum capital requirements. In any event, many banks will have to review their portfolios' risk return profiles and adjust prices of banking products. Certain exposures may be transferred to other market players outside the banking sector. This could change the weight of bank financial intermediation in some economies.

The proposal seeks not only to support financial stability but also to facilitate the financing of the economy.

The EU Commission published the Banking Package at a time of accelerated progression. Economies are recovering from the COVID-19 pandemic and are witnessing longer term implications. Greening the economy is high on governments' agendas and prudential aspects of this are included in the Banking Package. Digitalization also requires significant investment by different economic agents. Considering these developments and increased financing needs, in our view the transitional arrangements for corporates and real estate mortgages should be made permanent. This could enable banks to appropriately meet corporate and household financing needs and at the same time sufficiently strengthen banks' resilience.

On a more general note, input floors for internal model variables together

with the output floor established in the new rules and the limited risk sensitivity of the standardized approach have a tendency to affect exposures with lower risk profiles more than the same exposures with higher risk profiles. This movement towards standardization will influence the way banks define their risk appetite. It could create a trend of increasing exposure to corporates within a given risk weight bucket, moving away from financing lower risk corporates.

KPMG firms welcome the inclusion of ESG factors in the regulatory framework. This represents an important step at the disclosure level and sends a clear signal about the direction of travel for Europe in the coming years.

In general, we welcome the approach taken by the EU Commission compared to the standards published by the Basel Committee. In our view, certain transitional arrangements should be made permanent. Banks will continue to discuss impact assessments and implications to business models together with their internal ratings-based (IRB) repair programme, supervisory findings' remediation workstreams for internal models, and regulatory capital requirements such as counter-cyclical buffers or systemic risk buffers. Business and capital planning will continue to be demanding exercises for the years to come.



HIROTAKA HIDESHIMA

Counsellor on Global Strategy to President and the Board of Directors - The Norinchukin Bank

Bank performance and Basel III implementation – A view from the far east

Banking sector performance during the pandemic: under-emphasised?

There is probably consensus that the banking system worldwide has been a source of strength during the COVID-19 pandemic. Cynics may say it was mainly the fiscal and monetary support provided by the public sector that did the job. While probably true, a careful analysis should also show that the support provided by the banking sector was meaningful.

Another piece of the well heard narrative is that the post-crisis regulatory reforms delivered that strength. Then the usual explanation goes on describing the capitalisation and liquidity levels of banks. While these are important facts, there seems to be under-emphasis on the roles that the banks played. The post-crisis regulatory reforms increased the levels of the minimum and introduced buffers. But it is not clear if the increase in what is known as the “headroom”,

i.e. the amount of capital or liquidity above the minimum and the buffers, results from those reforms, or if it was the determination by banks to stay well above the minimum and buffers. The increase in the minimum is important in itself, especially for ensuring there is enough room for maneuver when a ratio is falling to a level that requires public sector intervention. However, no major bank faced such situation during the pandemic. In such a circumstance, the ability of the banks to keep on lending to the real economy depends more on the size of the headroom than on the size of the minimum. It seems that it was the banking sectors’ efforts to create a sizable headroom that has contributed to the sector’s ability to keep servicing the economy in the face of a major shock, equally to, if not more than, the post-crisis regulatory reforms.

There is also the debate on whether or not the buffers are “usable”. There may be a range of views, but from a practical viewpoint, it seems safe to say that most, if not all, banks are treating the minimum plus the buffers as the new minimum. Buffers are not usable from the perspective of banks. If regulators want them to be usable, the design of the buffers needs to be changed.

**Value of “headroom”,
buffer non-usability, and
enhancement to BCBS
rule-making process
are discussed.**

Basel III Implementation

The Financial Services Agency of Japan (the JFSA) published for consultation the draft rules to incorporate the final portions of Basel III on 28 September 2021. The European Commission published its draft rules on 27 October.

Different regions face different specificities and there is a need to take those specificities into account. In addition, a democratic procedure to ensure the legitimacy of the rule-making process is indispensable beyond any doubt. Different jurisdictions have different rule-making processes in place, and they should all be respected.

At the same time, as an institution operating in Europe, the UK, the US and Singapore, with headquarters in Tokyo, we highly appreciate globally harmonised standards. In addition, like-minded jurisdictions, such as Europe and Japan among some others,

should lead the world by showing the value of multilaterally agreed standards. If at all possible, providing excuses to some actors for not sticking to internationally agreed frameworks should be avoided.

It seems the market is treating European banks as somewhat weaker than their US counterparts with the same capital ratios. Japanese banks faced similar situations in the past. Even if unreasonable, following the demands of the market and international organisations may be the quickest way to overcome such situation. From this perspective, the final pieces of the Basel III package, including the limits to some inputs and the floors, should improve global comparability.

There is the need to strike the right balance between taking regional specificities into account and maintaining globally harmonised standards. There may be no easy answer, but debates taking place at platforms such as Eurofi should contribute to reaching a better balance.

More practically, the following ideas may provide some improvements: As for this round, BCBS members should go back to the Committee once their domestic rules become clear, and report on any major deviations from the December 2017 document. Then, the BCBS should discuss any necessary actions. As for the future process, the way in which international standards are developed and implemented across the BCBS member jurisdictions may need to be improved. One idea might be to reconsider the sequencing of international public consultation and national rule-making processes, and to carry out consultation in the following order: 1) BCBS public consultation, 2) public consultation at each jurisdiction, 3) finalisation at international level, and, 4) finalisation of rules and regulations at the domestic level (currently, these are conducted in the order of 1, 3, 2, and 4).

NEXT EUROFI EVENT

THE EUROFI FINANCIAL FORUM 2022



PRAGUE - CZECH REPUBLIC
7, 8 & 9 SEPTEMBER 2022

RINGFENCING PRACTICES IN THE BANKING UNION



HARALD WAIGLEIN

Director General for Economic Policy, Financial Markets and Customs Duties Directorate - Federal Ministry of Finance, Austria & Member of the Board of Directors - European Stability Mechanism

Can we overcome ring-fencing?

When you consider ways to improve the efficiency of the European banking sector, the need to address ring fencing is very often on the top of the agenda – and there is a reason for it. No matter whether you look at the micro-level where banks are requested to ring fence certain categories of assets or at the macro-level, where the protection of national markets or finance stability concerns are the reasons for ring fencing domestic capital or liquidity in banking groups: all these measures lead to costs and lower the profitability of the group and the banking sector.

These costs derive from the fragmentation of the banking system due to barriers in place and lead as a consequence to the sub optimal allocation of capital and liquidity.

So why have several attempts to address these costs failed so far? The reason is straight forward, but the same does not hold for any solutions, since it will be difficult to align the interest of the different stakeholders involved. Although all of them have to face certain costs associated with ring fencing, the costs are not equally distributed and of different nature. Considering a cross-border banking group, the parent entity is usually worse off if it cannot manage its liquidity and capital on a global basis and might be therefore more exposed to idiosyncratic shocks and risks affecting the domestic economy. For the subsidiaries, ring fencing normally leads to higher funding costs either due to a smaller market or to limited market access. But these costs for the individual entity are often considered as negligible in comparison to the potential benefits of ring fencing measures for the overall financial stability of the host country. In the host country these measures are seen as efforts to protect the stability of domestic intermediation by preserving the individual economic substance of the subsidiaries. Therefore, they are considered as safeguards and not as barriers for cross border-integration.

Ring fencing is a result of a lack of trust, improvements will hardly be achievable in the short run.

Costs in the sense of reduced efficiency might be predominately in the focus during good weather times. However, the potential benefits of ring fencing might become more obvious if we consider the “walkaway risk”, which is highly unlikely for a going-concern group but cannot be entirely ruled out in a crisis. So the stakes are considered high especially in resolution. Despite a complex resolution framework with well-prepared resolution plans and adequate funding for a group, the scars of the past still remain visible and guide today’s political stance. Ideas are put forward to raise the credibility of group support by contracts, but they do not seem to be sufficiently reassuring for the host countries, and trust cannot be prescribed by laws or contracts. As long as national banks are seen as national

champions and the focus remains on domestic consequences of any action or non-action, there will always remain the risk that in a severe crisis, decisions by supervisory or resolution authorities will deviate from agreed mechanism and frameworks. They might even put up with legal proceedings to shield the national market and protect the national interest at the time of the crisis. Furthermore from the parent perspective the more comprehensive the safeguards are, the more expensive will be the support measures and thereby reduce potential efficiency gains from enhanced integration. So the incentives to enhance the credibility of support mechanism might be limited for the parent company, adding up to a deadlock.

Ring-fencing measures (or safeguards depending on your perspective) can be of permanent nature and remain to a certain extent predictable, since at least some of them are publicly disclosed and the prudential regulations provide a legal basis for them. But ring fencing can also be of a temporary nature in the form of ad hoc-decisions by supervisors in response to problems that have emerged. This type of ring-fencing was often observed during the finance crisis. Decisions of this kind tend to catch the other stakeholders on the wrong foot, leading to unplanned distribution of costs and raising mistrust.

The lack of trust combined with diverging interest is the reason why it is difficult to enhance cross border integration. It will remain a challenge to overcome the implicit trade-off between efficiency and credibility of internal support mechanism. Awareness and internalisation of external effects, care-taking of second round effects and enhanced solidarity are areas for improving credibility and trust. It will take a lot of time to make decisive progress here - and it can be unravelled easily in a short time.



FERNANDO VICARIO

Chief Executive Officer
Bank of America Europe

Opportunities to accelerate European banking consolidation now

The near completion of the EU Banking Union, by strengthening institutional co-operation among EU Member States and national authorities, has a key role to play in enhancing financial integration and the achievement of a single jurisdiction status.

The EU banking reforms behind the creation of the Banking Union have been revolutionary rather than purely evolutionary. A lot has been achieved in such short time frame since 2008 such as a convergent set of regulations, supervisory practices, common risk management frameworks and the creation of the different pillars behind the Banking Union. However, also naturally, some of the fears prohibiting further integration are hiding behind ring-fencing and limits to the circulation of funds and capital across borders.

As noted by the EBA in a staff paper series in February 2020, on “Potential Regulatory Obstacles to Cross-Border Mergers and Acquisitions in the EU Banking Sector”, the level of cross border M&A activity in the EU banking sector has remained far below its pre-crisis level, despite the regulatory

reforms implemented after the financial crisis.

Despite progress being made in the convergence of supervisory practices across the EU, the current regulatory framework still largely relies on a territorial approach such as the uneven application of cross-border waivers for capital and minimum requirements for own funds and eligible liabilities (MREL), a multiplicity of macro-prudential tools and the existence of options and national discretions within the Single Rulebook. This favours pre-positioning resources with the subsidiaries and inefficient intra-group financial support arrangements. This causes market fragmentation and can challenge the comparability of institutions across countries and reduce the incentive to conduct cross-border consolidation.

One of the key challenges facing transnational banking groups operating across the EU is the different interpretation and applicability of key laws, rules and regulations (LRR) dependent on the EU jurisdiction in which the bank is based in. Where possible, transnational banks are seeking to apply a common framework/processes around compliance with applicable LRR within its EU Operations, however, this can be challenging due to level of “gold-plating” being applied to EU LRRs by local jurisdictional legislative, regulatory or supervisory bodies.

An integrated financial market will rely on trust between national supervisors and EU authorities

A number of supervisory approaches are not yet fully consistent, as evidenced by the imposition of intragroup dividend restrictions during the Covid-19 pandemic in particular with respect to the link between prudential requirements and restrictions on distributions. There is also a lack of a transparent approach when setting Pillar 2 requirements. The absence of common and fully transparent EU practices for the prudential assessment of M&A transactions, including the determination of capital requirements, further adds to the complexity, in spite of the initiatives taken by the ECB.

The level of systemic buffers (O-SII, SRB) varying across the EU creates an uneven playing field dependent on

where the entity is based. In addition, there is a lack of transparency as to how an O-SII score equates to the level of O-SII buffer being applied, with firms having a higher O-SII buffer also having a higher MREL requirement.

Inconsistent interpretation/application of EBA Outsourcing guidelines across the EU means that providers and receivers of services work to different regulatory standards.

Finally, different national AML standards and inconsistent customer identification requirements across EU jurisdictions, as well as multiple EU/jurisdictional sanction lists, are often required to be met, dependent on the applicable jurisdiction of the banking entity/client or the payment. This leads to different policies, processes and standards being managed by the same teams and salespeople. The prospect of a more harmonized European AML Rulebook will be welcome in order to reduce some of these complexities over time.

Appropriate consideration should be given to the reform of these various barriers to further facilitate the formation of transnational banking groups. A review of the current EU legislative framework and a greater use of regulations across the European Union would be an important step. In the long term, forming an integrated financial market will rely on a high level of trust between different national supervisors and EU-wide authorities. A common EU Deposit Guarantee Scheme would be crucial to support that.



GEDIMINAS ŠIMKUS

Governor - Bank of Lithuania

Completing the Banking Union is a necessary step towards ending ring-fencing

The benefits of cross-border banking are indisputable – it allows for economies of scale and geographic diversification, reduces bank exposure to negative shocks through better risk sharing, and enables a more efficient allocation of resources. So-called ring-fencing practices, such as application of capital and liquidity requirements on banks limiting activities to national boundaries, hinder the deepening of the single banking market. Typically, ring-fencing evolved as a result of countries' concerns about financial stability. The resulting fragmentation comes at a cost for both the efficiency of the financial system and the banks themselves.

While the issue of ring-fencing should be resolved, developing pan-European banks should not come at the expense of host jurisdictions. Only completing and expanding the Banking Union, and complementing it with a deep and well-integrated Capital Markets Union, would sufficiently reduce the risks that can presently be addressed only by domestic ring-fencing.

First, the European Deposit Insurance Scheme (EDIS) – the third pillar of the

Banking Union – should be established and become fully operational. For host countries, a fully-fledged EDIS is crucial. A hybrid model, where EDIS only comes in once national depositor protection tools are depleted, is not an adequate compromise. As banks become larger, we need correspondingly stronger safeguards. Assume that a consolidated transnational bank (for which the prudential requirements are applied on a group level only) fails and the host country has to compensate the depositors of its domestic subsidiary. Local taxpayers' exposure to the risk of losses can be substantially reduced only with a fully-fledged EDIS in place.

Furthermore, a fully-fledged EDIS is necessary to remove present risks of transforming subsidiaries into branches. Home countries as well as hosts face downside financial stability risks, because the home country might be unable to cover depositor claims of the large banks in other Member States. Such risks are even more pronounced when a large entity makes its headquarters in a small home jurisdiction. As occurred in one case in the EU, if a bank's asset portfolio becomes three times larger than the GDP of the home nation, the stakes on EDIS rise.

Efforts should be taken to complete and expand the Banking Union beyond the euro area.

Second, further efforts should be taken to expand the Banking Union beyond the euro area. This is important for countries where a substantial share of the banking sector is foreign-owned, primarily by non-euro area entities. For example, the parent companies of many of the largest banks in the Baltic States are not supervised by the Single Supervisory Mechanism (SSM).

A Banking Union which spans beyond the euro area would solve this issue. We should therefore look for ways to encourage the non-euro area countries to joining the Banking Union through the 'close cooperation' regime by emphasizing the benefits of the SSM supervisory expertise, information-sharing, and efficiencies arising when the home and the host jurisdictions make collective decisions.

Finally, it must be noted that while the completion of the Banking Union with a fully-fledged EDIS and establishing

a pan-European Banking Union are both key in curtailing ring-fencing practices, these alone are not enough. For a truly integrated European banking market, we also need a deep and well-functioning Capital Markets Union. Research shows that while risk is efficiently shared in a banking union when economies are hit with demand shocks, a capital markets union is necessary to help absorb supply-side shocks. Without security market integration complementing banking activities, as well as a higher level of harmonization of national insolvency and taxation regimes among the European Union member states, cross-border banking will remain hindered.

Removing the non-prudential barriers to cross-border banking will take time and determination. Member States need to agree on how to collect taxes on cross-border investments and establish unified definitions of the underlying tax base for banks. Furthermore, insolvency law should be harmonized to make outcomes of insolvency procedures more predictable. For this reason, we have to take a long-term view and aim to reform these specific topics which create obstacles to pan-European activities.

An incomplete Banking Union is the main reason behind the low levels of cross-border consolidation in the European banking sector. Thus, a complete and expanded Banking Union, complemented by a well-functioning Capital Markets Union, should allow us to suspend ring-fencing practices and unlock the full potential of Europe-wide banking.



ELIZABETH MCCAUL

Member of the Supervisory
Board - European Central
Bank (ECB)

Enhancing banking consolidation without major legislative change in Europe

Ring-fencing is an important explanation behind the scarcity of cross-border bank mergers in the euro area. Over the last two decades, an average of thirty to forty bank mergers occurred each year, including a small number of cross-border ones. The costs of ring-fencing practices are difficult to quantify, but we know they can be substantial. For an individual banking group, ring-fencing reduces the economies of scale and impedes the efficient allocation of capital and liquidity that can be realised in cross-border mergers and acquisitions (M&A).

At a sector level, cross-border M&A activity can address overbanking and inefficiencies in the euro area banking sector, improving profitability and strengthening resilience. While consolidation must be a market-driven process and it is not for the ECB to promote specific types of consolidation, sector consolidation delivering efficiencies means that European banks will be in a stronger position to finance important green

and digital transformations towards sustainable business models.

Capital and liquidity ring-fencing of subsidiaries occur primarily in host countries, which fear that their deposit insurance schemes and/or taxpayers will be at risk, if in times of crises the support of the foreign parent company stays away. Ring-fencing could be avoided by further steps in establishing the banking union, especially a European Deposit Insurance Scheme, and by creating possibilities for intragroup cross-border capital waivers. More integration can also be achieved within the existing EU framework with smaller legislative changes.

**More integration will
increase the efficiency
of banking groups
and the competitiveness
of Europe.**

A first route is through establishing a more solid basis for competent authorities to grant waivers for liquidity requirements of subsidiaries with a stronger mechanism to enforce intragroup liquidity support facilities linked to the group recovery plan. Banks generally perceive that market entry is easier through the acquisition of a local entity especially for retail operations. Yet subsidiary-based group structures can face impediments when it comes to the central management of capital and liquidity. A legislative change could facilitate integration by empowering supervisors to enforce intragroup liquidity support included in the group's recovery plan at an early stage in the event of a crisis. This would allow for more efficient liquidity management at the group level, however the extent of the possible use of such waivers is limited owing to national limits on large intragroup exposures in certain jurisdictions. Internal calculations show that the combination of liquidity requirements for individual subsidiaries and national rules on large exposures means that around €250 billion worth of liquidity is currently prevented from moving freely in the banking union. Even if full waivers were granted, €140 billion would still not be freely transferable because of national large exposures rules that would continue to apply.

A second route for cross-border banking is via corporate reorganisations from subsidiaries to branches. We have seen a number of examples of banks

in various Member States transformed into cross-border branches of a bank incorporated in a single Member State, including some of the Brexit banks. Significant benefits emerged in some of these cases, in particular through the elimination of intragroup capital requirements, efficient allocation of capital and liquidity, simplified legal and corporate governance structures, annual accounts savings and centralised risk and control functions. But branchification also comes with sizeable upfront costs, for example for IT integration, as well contributions to deposit guarantee schemes especially for banks with a large deposit base. The latter could be addressed with a second legislative change, and here I am referring to Article 14(3) of the Deposit Guarantee Schemes Directive, which only allows contributions made in the preceding 12 months to be transferred to a new deposit guarantee scheme (DGS).

All contributions made before that period are lost 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. The ECB is in favour of a legislative change proposed by the European Banking Authority (EBA) in 2019, where the EBA will specify the methodology for calculating the contributions to be transferred, without the current limitations. This could lead to a more balanced approach concerning the allocation of resources between the DGS of origin and the receiving DGS.

Adoption of the full banking union is the goal, but smaller legislative changes can support cross-border reorganisation, increase efficiency of euro area cross-border banking groups and contribute to the international competitiveness of the European economy as a whole.



PETER PALUS

Member of the EFC/EWG,
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Overcoming fragmentation in the Banking Union

There is no doubt that the internal market offers great potential for EU banks. It is also evident that this potential has so far been largely unused, even though the opportunities for ring-fencing at the national level have been gradually restricted. Contrary to expectations, the EU dimension of the banking sector is not increasing and in some regions we are even witnessing the opposite trend. From the policy-makers' perspective, this begs the question: Will changing the prudential regulation solve this problem?

First and foremost, it is important to understand what role the banking sector plays in individual Member States from a broader economic perspective. A shared characteristic for most of the so-called host states is a persistently high dependence on bank financing, as alternative forms of financing have not yet been adequately developed there and the market is highly concentrated. Naturally, from the perspective of these Member States, it is crucial to maintain the financial stability of the sector and ensure fair burden sharing in cases when the bank fails. A legitimate requirement for cross-border integration is therefore not only the creation of European

Deposit Insurance Scheme, including loss coverage within a common EU safety net, strengthening of crisis management and bank insolvency procedure, but also genuine Europeanisation of banks operating in the internal market together with parallel development and deepening of the Capital Markets Union.

Importantly, this cannot be achieved by cosmetic changes, but by fundamental steps like breaking of the bank-sovereign doom loop and harmonisation of insolvency law across the EU. The final piece of the puzzle in this regard is the creation an automatic macro-stabilisation mechanism without stigma effects, which would safeguard the financing in all Member States – this, however, deserves a separate focus.

Diversification of bond holdings in bank balance sheets is needed to address excessive interconnectedness between sovereigns and national banking sector. It is not just a prerequisite for mutualisation of the EU banking sector and creation of fully-fledged EDIS, but also for cross-border integration. It would significantly contribute to Europeanisation of banks and removal of the so-called home bias. The risk of contagion from real economy of one Member State to another through financial sector, as well as other possible cliff effects would be minimised.

Europeanisation of the EU banking groups as a precondition for cross-border integration.

Deepening of the CMU would at the same time increase cross-border financing of banks, reduce market concentration as well as dependence on bank financing. Harmonisation of the insolvency law in the EU would be a real game changer in this regard.

Although ring-fencing is undoubtedly an obstacle for cross-border integration, it is certainly not the main driver of problems of EU banks linked to their competitiveness, valuation, or their current underperformance at the international level. The cause can rather be found in banks' business model, conservative balance structure and NPL management. When it comes to cross-border business of EU banks, removal of national prudential measures would undoubtedly lead to capital savings or loosening of banks' capital, which could have a stimulating

effect, particularly when it comes to a more flexible allocation of capital across groups. At the same time, the persistent fragmentation of non-prudential rules, for example in the area of customer protection, deserves attention, as it would significantly boost cross-border business of EU banks.

All in all, if our goal is to overcome the current fragmentation and deepen cross-border integration, bold steps are needed. Seeing the Banking Union as a single jurisdiction will undoubtedly need to be accompanied by changes in governance arrangements, in order to ensure trust among Member States in such system.

Focusing on low-hanging fruit and shortcuts in form of group support, contractual or statutory, may seem tempting, but it will certainly not bring us the desired results.



KARL-PETER SCHACKMANN- FALLIS

Executive Member
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There is no need for EDIS in order to address the home- host dilemma

The Banking Union was set up with the core objectives to ensure financial stability, to prevent bank bail-outs by taxpayers and to establish common principles for adequate banking supervision. While Banking Union has been successful in promoting a more resilient banking sector, European banks are still not making full use of the internal market. Cross-border merger activities within the Banking Union remain at a low level, not the least due to significant roadblocks to an integrated management of bank capital and liquidity.

As a remedy, some voices call for banking supervision law to apply exclusively at group level and not at the level of individual institutions in order to mitigate regulatory restrictions. Many of those are related to ring-fencing by competent authorities in smaller Member States which are often hosting foreign subsidiaries of groups domiciled outside the supervisors' remit. Such measures aim at avoiding

regulatory arbitrage and ensuring a bank's soundness at the subsidiary level so that national safety mechanisms are not put at risk.

To address this home-host dilemma, there are several different alternatives. An obvious solution would be to organise cross-border banking business in Europe by implementing branches and not subsidiaries, the so-called "branchification" concept. A bank with branches abroad continues to be treated as a single entity and remains under the responsibility of the home-country supervision. This lifts the obligation to fulfil capital and liquidity requirements in the various Member States individually. Some of the most important non-European banks have set up European corporations for exactly this purpose, making use of the internal market through their branches.

However, even in case of group structures with subsidiaries instead of branches, there are feasible solutions to address the concerns of host Member States. First, it has to be noted that Banking Union has already brought considerable improvements when compared to the times of the Global Financial Crisis. The cross-border supervision by the Single Supervisory Mechanism now prevents crisis-induced liquidity and capital movements more effectively. In the case of a banking crisis, the Single Resolution Board will resolve and restructure cross border banking groups including subsidiaries.

Further concentration is not the silver bullet for a better functioning banking industry in the EU.

However, while targeted changes to the EU supervisory law are necessary to address host Member States' concerns and to allow at the same time for the free allocation of capital, liquidity and MREL, a fully-fledged European Deposit Insurance Scheme (EDIS) is not. The risks linked to the question of deposit insurance could be addressed much easier by making the deposit guarantee scheme in the home country responsible for the deposit protection function of the entire group. Doing so, the erroneous assumption that a functioning home-host regime only works in the frame of an EDIS could be separated from the discussion about a European insurance framework. A

separate consideration of the issues will foreseeably lead to more timely results, as EDIS is necessarily linked to the various aspects of risk reduction, including the regulatory treatment of sovereign exposures. Similarly, national deposit insurance schemes would not be an obstacle to cross-border consolidation if European legislators would provide for a less restrictive transfer of contributions in case of a merger.

Furthermore, it can be questioned whether measuring the proper functioning of the Banking Union should focus primarily on the existence of so-called "European champions" in the banking sector. This is not the silver bullet to create a better functioning banking industry for Europe, its customers and the real economy. From a financial stability perspective, an increase in concentration is prone to create "too big to fail" scenarios. To name just some of the risks attached: uniformity is increasing the likelihood that banks are hit by a crisis in the same way. Banks can be encouraged to excessive risk-taking due to implicit government guarantees.

Complex group structures can be used to facilitate tax arbitrage and the undue use of other tax advantages. From a consumer perspective, there might also be a negative impact. As soon as regionally operating banks are affected by cross-border mergers, there is a widening operative and functional gap in the banking business. As a result, financing conditions for SMEs will likely deteriorate as they benefit from a regional focus and decentralised responsibility.

A major challenge in the Banking Union is to achieve the goals of an unrestricted single market and simultaneously allow for competitive national subsystems. Steps towards further integration should always be balanced with the entirety of the EU's diversified banking sector in mind.



GILLES BRIATTA

Group General Secretary -
Société Générale

Concrete steps towards progress in the Banking Union

The Banking Union has achieved indisputable progress since its inception. The EU has notably a strong Pan-European bank supervisor, and a single resolution authority and fund. These initiatives have clearly enabled EU banks to operate better and stronger in the COVID-19 crisis compared to 2008 crisis.

However, since the creation of the SSM and the mutualization of resources for resolution from the SRM, only minor improvements have been made. In practice, the Banking Union remains largely unfinished, which lends truth to those that claim that the present situation is in some way a regression compared to the previous situation. Quoting Jacques Delarosière in a recent piece *“subsidiaries of major banks are governed by national rules, known as “host country” rules. This prevents large banking groups from benefiting from the effects of scale that, paradoxically, they had a decade ago. We have therefore taken a step backwards. There was a common banking area, but there was no talk of it; today, there is talk of a Banking Union, but it does not exist.”* The paradox of the Banking Union is that it did not enable cross-border banking groups to emerge.

Pan-European banking groups face cross-border restrictions on capital and

liquidity, limiting their efficiency and agility, at a cost to the financing of the economy. This ring-fencing, motivated by the protection of domestic interests, could perversely make Pan-European groups less agile in a crisis.

The Banking Union has also come at a cost, which is unevenly spread in the EU. Today, French banks contribute 33% of the cost of the Single Resolution Fund (SRF) while they only represent 21% of deposits and 30% of assets of the euro area. And the total cost of the SRF has now significantly exceeded initial projections.

Progress has now come to a standstill, and the complexity of the issue is such that there are few actionable options. We welcome the SSM's call to make greater use of the freedom of establishment by setting-up branches rather than subsidiaries, but it is more complex to meet than it seems. The use of branching is already widespread in the wholesale market (and this explains in part why many incoming banks post-Brexit are organized this way). However, there are many practical obstacles: notably for retail and SME banking (where national specificities remain important), for the management of certain risks (AML-TF, operational and IT) and for resolution issues (as “host states” may not agree with mutualization in a context of cross border insolvency / resolution).

**With progress at
a standstill, every
small step forward
is important.**

The other solution proposed by the SSM, a system of intragroup guarantees between the parent company and its subsidiaries, is also presently not actionable. The current legislative framework grants waivers only at a domestic level and requires demanding conditions which so far have not enabled us to benefit from this clause.

In this context, further advances such as cross border mutualization of deposit insurance seem difficult to achieve, and although Europe suffers from overcapacity in banking, it is likely that consolidation will continue primarily along national lines or around specialized financial services. Société Générale fully takes part in this movement by delivering its Vision 2025 plan, which will lead to the merging of the French retail activities of Société

Générale and Crédit du Nord. It is also worth noting that Société Générale has launched an ambitious project of cross border merger concerning a fast-growing category of financial services by entering into an exclusive negotiation for the acquisition of Leaseplan by ALD.

To go further in the creation of a functioning Banking Union, concrete progress is necessary.

First, we need to correct the uneven distribution of costs of the SRF within the EU. The present system is strongly viewed as unjust and unsustainable by some of the biggest banks in the EU, and the matter has been sent to EU Courts. This is not a sound basis for ensuring minimal support from the industry in favor of the development of a real Banking Union.

In addition, we need clarification on the liquidity provision mechanism in resolution. Ring-fencing practices could reduce the efficiency of the framework, if, for example, they prevent the transfer of collateral from subsidiaries to the resolution entity. Banks could also be associated to the governance of this framework to ensure that such a fund meets its objectives (for example, via a stakeholders' group of the SRB).

In parallel, the EU should progress on the CMU, which will help overcome the current deadlock on the Banking Union. With stronger Pan-European financing provided by capital markets, hence more risk sharing outside of the banks' balance sheets -as it is the case in the US, ring-fencing measures on banking will become less crucial for host authorities. Progress on the CMU will therefore not only help to finance the funding gap for the EU recovery and its transitions, but also relax national ring-fencing measures as a bonus.

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EU BANK CRISIS MANAGEMENT FRAMEWORK



EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board - European Central Bank (ECB)

Priorities for improving the EU crisis management framework

Both the industry and the public sector agree that there is a need to improve the crisis management framework in its different dimensions: supervision, resolution and insolvency. The persistence of divergent views about the way forward for the banking union has so far prevented breakthroughs in this area. The banking package currently under discussion by the co-legislators already includes a most welcome proposal that would allow the supervisor to withdraw the banking license where a bank has been declared failing or likely to fail but does not pass the public interest test for resolution, ensuring that such banks exit the market. We at the ECB strongly support this proposal, but it alone will not be sufficient to ensure that such badly needed market exits

will be orderly, without economic disruptions or indirect forms of bailout by public authorities. Therefore, the ECB remains convinced that additional changes to this framework are needed to enhance the consistency of treatment, in particular of small- to medium-sized banks, and thus to make the EU banking sector more competitive and resilient. Currently, when they do not pass the public interest test applied by the relevant resolution authority, these banks are treated exclusively under national law, and we have seen how different the outcomes can be.

Concrete steps to enhance this framework should prioritise ensuring EU-wide convergence. This would guarantee that, regardless of the differences in national insolvency regimes, the most efficient resolution and wind-down tools are available in all countries – including administrative powers to transfer the assets and liabilities of a failed bank, and the use of a bridge bank to avoid asset liquidation at fire-sale prices. This will help to limit the cost of a bank exit and, as such, is in the interest of all stakeholders: public authorities, the industry and the creditors of the failed bank. But, of course, the use of these resolution and liquidation tools also requires funding. To this end, we need greater European harmonisation of the rules on participation in this funding, including also the rules on burden sharing to absorb potential residual losses.

Now is the time to take very concrete steps to increase the resilience of the European crisis management framework.

Within resolution, the first key issue is exploring the scope for a more consistent and wider application of the public interest test by resolution authorities, which is the necessary precondition for accessing the tools and funding provided by the current framework. For orderly wind-down outside of resolution, the problem is more acute, given in particular the present differences in the role and tasks of the national deposit guarantee

schemes (DGS). Clearly, a broader use of DGS resources in liquidation and resolution would facilitate the application of transfer tools. To achieve this, the ability of the deposit guarantee schemes to support “alternative” measures to depositor payout should be extended and harmonised. This in turn requires further harmonisation of the least-cost test that is the necessary precondition for DGS interventions. Harmonising the ranking of depositors may facilitate these kinds of intervention and deserves some further reflection.

Furthermore, within the banking union, we find it necessary that this ability to fund alternative measures should benefit from support from the whole of the banking union. This should be the case as soon as possible, within a first transitional re-insurance European deposit insurance scheme mechanism already, as a firm step towards completing the banking union, and not only at the end of the process. In our view, this requires centralised management and steering by a European authority – the Single Resolution Board being the most obvious candidate – to ensure the necessary convergence and a level playing field for mobilising this form of European support from the beginning.

Advances in harmonisation should be thus accompanied by concrete progress towards completing the banking union and the capital markets union. Even if a decisive political breakthrough on the banking union is not reached in the months ahead, it would nonetheless be crucial to undertake further reforms on the crisis management front and push for greater European harmonisation.

We need to send a strong signal mobilising the entire Single Market to finance the recovery as well as the green and digital transformation of the European economy. We should not miss this opportunity to reinforce European financial leverage to secure the best possible path out of the crisis.



ELKE KÖNIG

Chair - Single Resolution Board (SRB)

Deposit Guarantee Schemes: remove super priority, harmonise the least cost test

The adoption of the Deposit Guarantee Scheme Directive in 2014 was an essential landmark in the setup of the Single Rulebook for the EU banking sector. While it helps to foster financial stability and reduce the risk of bank runs across the Union, it is time to update it as part of the Crisis Management Deposit Insurance review (CMDI).

With a view to protecting depositors and financial stability, Deposit Guarantee Schemes (DGS) have several functions. Their main role is to pay out depositors of failed institutions. As this is not always the most suitable solution, the regulator provides for alternative uses of DGS funds to better protect depositors and financial stability, while lowering the overall costs for the system. This option has not been transposed by all Member States, creating an uneven playing field.

The SRMR allows the Board to use the DGS funds in resolution, under certain conditions. Yet, the required least cost test (LCT), combined with the DGS' super priority in the creditor hierarchy, significantly limits the use in resolution. Together with the access conditions to the Single Resolution

Fund (SRF), this implies a hurdle to accessing external funds in resolution, hence potentially undermining the credibility and predictability of the resolution framework.

The SRB supports removing the DGS' super priority and adopting a general depositor preference with a fully harmonised LCT; including, but also limited to relevant quantifiable costs. This can facilitate using DGS funds in resolution, as suggested by the European Banking Authority in the European Commission's call for advice on funding in resolution and insolvency. Such a general depositor preference can ease access to funds in resolution through transfer strategies for small and medium-sized banks that would meet the public interest assessment for resolution. Here, we might also consider using DGS funds to bridge the gap until use of the SRF is possible (after bail in reaches 8% total liabilities and own funds (TLOF) for capital support).

In the interest of transparency and consistency in the Banking Union, we should harmonise DGS uses.

As to preventive measures, DGS funds can be mobilised where the costs of these measures do not exceed the costs of fulfilling the DGS statutory or contractual mandate. The DGSD does not give detailed guidance on the approach to this least cost test, therefore different interpretations (including statutory or contractual mandates) give some margins of manoeuvre to the DGS. In the interest of transparency and consistency in the Banking Union, we should harmonise DGS uses.

The rules around use of DGS funds in resolution are more stringent than those outside resolution. No creditor worse off (NCWO) safeguards in the BRRD have to be respected, so that DGS funds have sound protection from losses when resolution authorities use such funds. If there is a breach of the NCWO safeguard, the resolution fund will refund the DGS funds. Such provisions do not exist for the use of preventive or alternative measures; the DGS would have to replenish its funds by raising contributions ex-post from the banks. While we support maintaining the options provided in

the DSGD, we expect further work at a European level to ensure there are aligned incentives and outcomes when selecting different options.

In the CMDI review, the Commission is considering enhancing alignment of the different options and tools available; we hope that ideas in this article around DGS super priority and LCT will help in these considerations. While work on this is an important step forward, we should not lose sight of the steady state. The European Deposit Insurance Scheme (EDIS) would replace the existing national DGS. Private risk sharing reduces financial fragmentation and helps to overcome the sovereign-bank doom-loop. In combination with the SRF, EDIS can significantly increase the firepower and agility to deal with ailing banks in a consistent manner under the second pillar of the Banking Union. As the ECB Financial Stability Review November report recalls, a number of vulnerabilities in the financial sector have intensified. Let us work together to make sure we are equipped with the best possible toolkit when these vulnerabilities materialise.

We should not stop halfway with a partial EDIS. We need to get the ball rolling in the political discussions to upgrade our crisis management framework. We now have a momentum to relaunch the discussions on completing the Banking Union and reaching an agreement on the work plan before the summer. Liquidation of banks, just like resolution, could take place at a European level. We should work towards a European FDIC model with one fund to cover depositors and/ or facilitate – under strict conditions – resolution.



HELMUT ETTL

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The role of institutional protection schemes in resolving small and medium banks

In international debates on how to guarantee an effective and orderly market exit for small and medium sized banks in case of a “failing or likely to fail” (FOLF) it is widely acknowledged that the existing crisis management framework is not yet fit for purpose. What is still lacking, though, is a solution addressing the “elephant in the room”, namely the external funding of wind down and exit-procedures for such banks.

In case of a FOLF of small and medium sized banks, it has to be acknowledged that there is a relevant and substantial risk that these banks may face a shortfall of internal loss absorbing capacity to fund a resolution procedure according to the BRRD. This is a persistent and structural issue rooted in the size and the business model of these banks. To mitigate this risk, possibilities for providing external funding sources will need to be evaluated.

In a previous article in this Magazine, I have highlighted a possible way forward by introducing an administrative liquidation regime including a stand-

ardized additional loss absorbance buffer. Let me try to develop a different way forward this time.

As a starting point, a crystal clear hierarchy of loss absorption has to be a necessary precondition. Shareholders shall bear losses first, holders of other regulatory capital instruments shall follow. Only after the write down of all capital instruments, a discussion may start if and to what extent further external funding could be provided.

Second, it should be common understanding that no additional new funding source are required for small and medium sized banks. The existing sources are sufficient and available. In this context, current discussions are circling mainly around the two main financial funds: contributions from the DGS and the SRF and various combinations of these two elements.

Let me here take a broader approach and consider another existing source of financial means, which was not so much in the spotlight of discussions so far: the IPS. IPS are part of the crisis management framework, have an ex ante fund available and – most importantly - have proven already all over Europe that they are efficient and loss absorbing. The main goal of an IPS is of course to prevent an FOLF of a member institution in the first place. It is thus rather an instrument of the recovery toolbox than of the resolution framework. IPS have nevertheless also supported in one way or the other market exits of member institutions in the past (e.g. by supporting a merger of the failing institution or even a solvent wind down).

The solution is just around the corner: using IPS schemes to bridge the funding gap in resolution.

I would hence suggest an evaluation if and to what extent IPS schemes could provide added value in a resolution framework for small and medium sized banks. More precisely, one should investigate, if and to what extent the role and the function of an IPS could be enlarged in order to (financially) support a liquidation or resolution of an IPS-member-institution in case of a FOLF. In return for this enlarged function of an IPS, the loss absorbing capacity of the IPS (ex-ante funds and ex-post contributions of the members)

could justify a corresponding reduction of MREL-requirements for member institutions. Implementing such an approach for IPS-members would constitute an efficient alternative to the creation of an additional regime for failing small and medium sized banks. The (lowered) MREL requirement for banks included in an IPS would additionally honour their respective business models, which often hamper the issuance of sufficient MREL.

By extending its role, the IPS - as an established model of cooperative and savings banks - might also become more attractive for standalone banks. These banks would have a choice to make to either stay on a standalone basis and – consequently – be fully compliant with BRRD-requirements (including a fully fledged MREL-requirement) or to join an IPS and benefit from a reduced MREL requirement. In addition, bank forming an IPS could seek other economies of scale and synergies regarding resolvability requirements (e.g. common development of playbooks, MIS for data in resolution etc.).

From a supervisor's perspective, incentives for standalone banks to establish an IPS would yield additional advantages regarding going concern and banking supervision, since an IPS-structure entails a consolidated risk monitoring, an early warning system and an IPS-recovery plan. Besides that, banks willing to join an IPS will most likely be subject to a thorough risk assessment by the IPS, which will introduce an additional layer of scrutiny. These factors combined with the mutualized financial means available to avoid FOLF and to support struggling members, would substantially lower the probability of a FOLF of IPS-members compared to standalone banks.

Summing up, by incentivising IPS-structures for resolution purposes of small and mid-sized banks we would make use of successful existing structures and in addition create added value in going concern and banking supervision.



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The way forward on the EU crisis management and deposit insurance framework

The goal of the crisis management and deposit insurance framework is to safeguard financial stability, by managing the failure of all banks - irrespective of their size and business model - while protecting depositors and taxpayers. We have learned a lot over the past years during the rollout of this framework. In particular, concerns have been raised about how the framework manages the failure of small and medium-sized banks without undermining the level playing field and ensuring that failing banks exit the market.

Improving the framework for small and medium sized banks

Small and medium-sized banks in the European Union are a diverse category and ensuring they can fail without jeopardising our financial system or imposing costs on taxpayers is a priority.

Specific features of the current framework may affect how authorities

handle the failure of small and medium-sized banks, in particular for business models funded primarily by deposits and equity.

Under the current framework, there are uncertainties around the ability of small and medium-sized banks funded primarily by deposits to access resolution funds without bailing in depositors, with a possible risk for financial stability in specific circumstances.

In addition, other private collective sources of funding - such as deposit guarantee schemes - may be out of reach in resolution. As it stands, alternative - and more easily accessible - insolvency solutions have been sought, including with the support of taxpayers' money. This needs to change.

Reviewing our framework will put us in a stronger position to manage bank crises in the EU. It is an opportunity to address the shortcomings of the framework, so that we can handle the failure of not just some banks, but all banks in the EU. We need to ensure that banks' internal loss absorption continues to be the first line of defence. What's more, industry-funded safety nets must be accessible for all banks, if and when they are needed, subject to proportionate access conditions.

Reviewing our framework will put us in a stronger position to manage bank crises in the EU.

Deposit guarantee schemes could act as bridge financing tools, helping to meet access requirements to the resolution fund while sparing depositors from bearing losses. This type of funding can play a more substantial role in resolution, beyond what is possible under the current framework.

To unlock the full potential of the deposit guarantee schemes, and to enhance the level playing field, other changes to the crisis management and deposit insurance framework are required. This includes changes to the least cost test and the hierarchy of deposit guarantee schemes claims in national insolvency rankings. In cases where this source of funding might come up short, a hybrid European deposit insurance scheme mechanism would be key, providing liquidity support and ensuring the robustness of the framework.

Failing banks and market exit

Put simply, banks that cannot be put in resolution need to be able to quickly exit the market. The outcome of a resolution procedure is clear and harmonised at EU level - banks that are in resolution may stay in the market (open bank bail-in strategy) or exit the market immediately or after a certain time (transfer strategy).

However, the situation is different when resolution is not in the public interest and the national insolvency proceedings apply, as they remain heterogeneous across Member States. What's more, it is not always guaranteed under the current rules that a bank put in insolvency will exit the market swiftly. We need to avoid these limbo situations, when a bank is failing and does not qualify for resolution, but the triggers to initiate insolvency under national law are not met.

The second EU Bank Recovery and Resolution Directive addresses this - in the event of failure with no public interest in resolution, a bank must be wound up under national law. However, there is still some uncertainty around which procedure to apply in these cases. Should only normal insolvency proceedings apply? Is any available national procedure acceptable, even if it does not entail the termination of the bank's activities?

One way to tackle this could be clarifying the procedures around market exit, particularly on the exit timeframe, possibly leaving room for the form of exit to be determined at national level. This would further reduce the risk of limbo situations and enhance predictability.

To conclude, the review of the framework offers an opportunity to ensure that we have the tools we need to handle banking crises in an orderly manner, in resolution or in insolvency. Among many other parts of the reform, addressing the case of small and medium sized banks would make our framework more resilient, more predictable, and ultimately improve trust in the way we deal with failing banks to protect the depositors, taxpayers, and the economy in general.



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Strengthening the crisis management framework: a milestone for the Banking Union

Over the last decade, the reforms brought significant changes to the crisis management framework. These changes have contributed to improve the resilience of the European banking system, noticeably thanks to the building up of significant MREL/TLAC buffers by banks. The Single Resolution Fund (SRF), as a sector-wide safety net expected at around EUR 75bn by 2024, has also been an important milestone. Although it has never been used, the SRF has come with a steep price for the sector over the years.

However, the EU crisis management system that has been in place since 2016 has not fully lived up to its initial promise: the framework has contributed to maintain a high level of fragmentation of the banking market, and a single banking jurisdiction also lacks to build a Banking Union. As it has failed to be fully implemented and operational for some small & mid-size banks, the crisis management framework further contributed to the renationalization of banking sectors across the continent (especially thanks to the persistent use of public funds)

while at the same time maintaining excess capacity.

The EU crisis management framework should therefore be strengthened to ensure that public funds are no more used at the expense of healthy competition and the streamlining of the European banking sector. This should be done through a comprehensive solution tackling simultaneously all aspects necessary to further foster the integration of the Banking Union: single jurisdiction, cross-border capital and liquidity waivers. Concerning crisis management, this would typically mean an extension of resolution to a larger group of small & mid-size banks in the Banking Union:

- The way resolution authorities conduct the Public Interest Assessment should better capture the financial stability risks stemming from the failure of small & mid-size banks and the higher likelihood that they cannot be simply liquidated without recourse to external funds in a crisis.
- Such enlargement is paramount to minimize competition distortions in the Single Market. Directly competing against big banks, many small & mid-size banks are not subject today to the constraints of the resolution framework in going-concern (especially fully-fledged MREL requirements and other resolution planning works to ensure alignment with the SRB's Expectations for Banks). However they would benefit from external resources in gone-concern (or be rescued even though they are not viable) WITHOUT any strings attached.

The crisis management framework further contributed to the renationalization of banking sectors.

Any access to external resources must remain conditional on a compliance with a stringent burden-sharing requirement. The current rule applicable to access the SRF must remain intact and extended to other possible sources of external funds while ensuring a more balanced allocation of SRF contributions across the banking sector:

- A stringent burden-sharing requirement would ensure that shareholders and creditors of failing banks absorb

their fair share of losses and thus minimize the burden on sound banks.

- To comply with such burden-sharing requirement, small and mid-sized banks should build up a MREL buffer that would enable shareholders and creditors to take a hit before resorting to external resources. As the Chair of the SRB recently said, "the market is wide open". If some of them cannot somehow do this, there are other solutions, like a longer transitional period or creating an escrow account that could be tapped in resolution. Otherwise, it would mean that these institutions are not viable and should either restructure themselves or exit the market.
- Burden sharing should also be made consistent between resolution and liquidation under a national insolvency proceeding, i.e. the 8% TLOF rule should be incorporated into the state-aid rules for liquidation aid. Doing so would decrease the need for external resources to facilitate the liquidation of a bank that has a negative Public Interest Assessment while eliminating the risk of regulatory arbitrage by national resolution authorities or the SRB.

Finally, many stakeholders tout the establishment of a European Deposit Insurance Scheme (so-called "EDIS") as a key element to strengthen the crisis management framework. Instead, without any simultaneous tangible progress on other aspects of the Banking Union such as the single jurisdiction, such mechanism would actually pose an important risk. Indeed, it could generate additional contributions from banks, lead to a hidden cross-border subsidy between healthy and weak banks, without removing the barriers on the market preventing the emergence of a real Banking Union.

We need a holistic European solution. The problem cannot be solved by preserving a set of national banking markets with their own restructuring mechanisms.



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The EU crisis management framework for small and medium sized banks

The EU has a robust crisis management framework in place, underpinned by the BRRD. This addresses the “too big to fail” problem for systemically important banks, protecting taxpayers in the euro area. However, the resolution of small and medium sized banks, which represent the vast majority of total banks in the region, is managed by national authorities, giving rise to several issues.

Firstly, there are level playing field considerations due to the degree of heterogeneity across national approaches to resolution in EU countries. In order to further strengthen the EU crisis management framework, I believe that policymakers should look for ways in which national insolvency procedures can be harmonised for banks that are not considered to be systemically important.

The potential for home-host frictions can also have an adverse impact on cross-border resolution. This is particularly true for SPE resolution strategies for cross-border banks which require home and host resolution authorities to rely on each other. Co-ordi-

nation and clear communication channels between resolution authorities are essential for building trust. This is particularly evident for small and medium sized banks in the EU that are subsidiaries of other banks. Regarding such banks, Barclays Europe Board member Tom Huertas wrote in a 2014 research paper^[1] that, “the SPE approach is viable, if and only if, (i) the home country resolution authority is authorised, able and willing to assume command of what amounts to a global resolution syndicate, and (ii) the host countries are willing to accept such leadership by the home country resolution authority.”

The MREL regime is another area that requires careful consideration by the resolution authorities with respect to small and medium sized institutions. There is a public interest in promoting the financial resilience of these banks but there is also a risk that the imposition of too high MREL requirements could have a negative impact on the real economy. Furthermore, the fact that the MREL calibration for small and medium banks is typically decided by national resolution authorities, and thereby subject to different approaches to bail-in, can give rise to further level playing field issues.

Resolution safeguards must be tailored to address the challenges faced by smaller banks.

As the cost of MREL is likely much higher for small and medium sized banks relative to larger institutions, due to the more constrained market for MREL issued by these banks, potentially lower credit ratings and the requirement to issue smaller size (sub-benchmark) transactions, this group will be more heavily penalised by the cost of meeting an MREL requirement. This could result in them having to constrain their balance sheet to minimise MREL costs, or pass on higher costs to the consumer, making them less competitive. Longer transition periods for these banks would help. Small banks that are growing should also be given sufficient transition time should they become subject to an MREL requirement.

In addition, small and medium sized institutions are often disproportionately reliant on retail deposits in their funding mix. Although this type of funding has proven to be very stable in practice, it is uncertain how depositors would

react in a resolution scenario. The limited available empirical evidence seems to suggest that Deposit Guarantee Schemes, put into place to avoid such scenarios, could be effective in resolution. In the event of substantial and sudden deposit outflows, finding access to alternative sources of debt, such as from shareholders, will determine whether small and medium sized banks can return as going concerns.

Although the implementation of a EDIS would be the obvious way to achieve this, it is met with a degree of resistance by some member states, in particular from those who already have strong national insurance schemes in place. One could argue that a European Digital Currency, if implemented properly, would sidestep the challenge of finding political consensus and a lengthy ratification process into national law. Depositors would hold funds up to a politically acceptable limit in a separate account, which would be fully backed by the ECB. Savers would pay into it and withdraw from it, subject to the cap, whereas excess balances and funds used for transactional purposes would remain in “traditional” savings and current accounts and be subject to national deposit insurance schemes. The latter would also address any Orwellian concerns around the ECB acting in a “Big Brother” fashion.

Ultimately, whatever improvements are agreed, retaining the central principle that resolution safeguards must be appropriately tailored to address the specific challenges faced by small and medium-sized banks is essential. By tackling the national divergence in approaches to this important issue the overall safety and stability of the financial ecosystem across the bloc would be enhanced.

[1] “A resolvable bank”, Thomas F. Huertas, LSE Financial Markets Group Special Paper Series, 2014



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Areas for improvement in the EU crisis management framework

The European institutions have done much work over recent years to develop a credible Banking Union through a single banking regulation, supervision and resolution framework. Regarding crisis management, we should emphasize the progress made by banking institutions in enhancing resolvability, improving their recovery and resolution planning and raising loss absorbing debt (MREL).

Despite these achievements, the Banking Union is far from complete, as shown by the diversity of solutions to the (thankfully) few resolution cases in recent years. Further action is required in the crisis management and deposit insurance frameworks, in three main fields: first, the creation of a European Deposit Insurance Scheme (EDIS), the missing element of the Banking Union architecture; second, a liquidity in resolution tool, an essential element in any resolution regime that the Eurozone lacks; and third, a single

insolvency regime for banks, including a harmonized creditor hierarchy.

Completing the crisis management framework with a fully-fledged EDIS is crucial not only for depositors protection but also for safeguarding the single market and the economic and monetary union. The credibility of any Deposit Guarantee Scheme (DGS) relies on the implicit support by the sovereign. Insofar as deposit insurance is kept in national hands we cannot ensure that one euro is worth the same in any country of the Eurozone and we would be exposed to the risks of fragmentation as well as sovereign and banking risks doom loop. There is a blatant inconsistency in having a European banking regulation, supervision and resolution but maintaining deposit insurance in national hands. The progress made in mutualization of risks with the Next Generation EU funds shows the way to address this inconsistency when there is political will and ambition, although the transition period to a fully fledged EDIS could be relatively long, and hybrid solutions can be considered in the interim period.

Completing the crisis management framework with a fully-fledged EDIS is crucial.

The lack of a funding in resolution mechanism is also a major flaw in the Banking Union. The ESM backstop is a key element in the framework, but it is not enough to deal with a systemic liquidity crisis. The Eurozone is the only major economy lacking a lender of last resort (LOLR), a function carried out by the central bank in most jurisdictions. The reluctance of the ECB to commit to a predetermined course of action in an emergency liquidity situation is understandable, but the authorities need to acknowledge that private insurance mechanisms cannot be a substitute for a proper LOLR.

The remaining differences in the creditor hierarchy across EU countries implies that similar creditors could be treated differently during the resolution or liquidation of an entity, creating a potential problem of level playing field in the Capital Markets Union. A further harmonisation is needed on the triggers to begin an insolvency procedure and the ranking of creditors in insolvency. Parallel to this debate, the future review of the crisis management framework could help to address some

of the shortcomings identified in the current system. Of particular relevance is the treatment of mid-sized banks that fail the Public Interest Assessment (PIA) test and thus remain subject to national insolvency frameworks. For them it is important to apply solutions that guarantee the level playing field, treating similar banks in equal terms regardless of location. The absence of a harmonized insolvency framework also hampers the predictability of the system.

The present resolution framework is far too complex, in particular as regards MREL definition and calculation. A simplification would be welcome, especially considering its important implications for banks' market funding. Banks should be able to convey to the markets relatively simple and stable resolvability strategies.

A series of proposals have been made recently on streamlining the resolution of medium-sized banks (facilitating the sale of business as a resolution tool) and a more flexible and prompt use of the DGS. These proposals are a valuable contribution towards a more pragmatic resolution framework, but it is important in any case to preserve the key role of the bail-in paradigm as a central element of the EU resolution framework.

The COVID-19 crisis has clearly shown the benefits of having pan-European structures to regulate and oversee banking activity, and has made more evident the need to complete the crisis management framework and the Banking Union as soon as practicable. Now it is time that policy makers and legislators complete this work.



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Why regulation is not an end in itself

No exclusion of retail investors of the bail-in tool

Should retail depositors be excluded by the application of the bail-in tool? The answer seems to be clear: of course not. Nonetheless this question is regularly discussed with regard to the revision of the crisis management framework. An exclusion of retail investors by resolution authorities, who were informed according to MIFID-requirements in detail about the risks of the bail-in able instruments, does not fulfil the original objective of BRRD of a high rate of loss absorbency.

Small and non-complex institutions should be out of scope

Europe has to maintain a diversity of different banking models and banking sizes. In 2014 after intensive negotiations, the legislative bodies came to the political decisions to establish a regulatory framework for systemic relevant institutions (BRRD and SRMR) and a regulatory framework for non-systemic institutions (DGSD). One of the main reason for this divergent approach was that the a failing systemic relevant bank could bring the common currency in serious

troubles while the insolvency of a smaller bank is not of relevance for the Monetary Union.

With this background in mind it sounds strange if someone would argue to include small and non-complex institutions in the scope of BRRD. All of them have balance sheets lower than EUR 5 bn and most of them are operating on a national regional level only. A failing of these banks of these institutions would definitely not be of public interest for the Eurozone. In line with the recent adopted exemptions in BRRD II small and non-complex institutions should be out of scope of the MREL requirements due to their size and irrelevance for the common currency.

To include other institutions than small and non-complex institutions in the scope of the BRRD according to the current legal framework the resolution authorities have a broad range of instruments. The requirements of the “public interest assessment” are broadly defined and it does not seem to be smart to limit the definition of these requirements for the application of BRRD. Some authorities have not applied the resolution framework in the past although the current legislative framework would have allowed an application. The resolution authorities should rather change their restrictive application approach in certain cases instead of demanding changes in the general resolution framework.

We have to work out the pressing points but should not turn the whole system upside down.

Maintain highest ranking for covered deposits

The current legal framework provides that deposit guarantee schemes subrogating to the rights and obligations of covered depositors in insolvency have the highest ranking. This highest ranking of covered deposits is the guarantee for a working system as it safeguards the claims of the DGS which has to ensure that payouts to depositors are successfully executed. If the DGS would not be primarily reimbursed by the backflow of the insolvency assets the ambition for DGS for a smooth operation of payouts could be lower than currently. Furthermore the consequence would

be an unjustified severe disadvantage for DGS and the member-banks financing the DGS in relation to other creditors as they would have to finance the payouts but would lose the highest ranking. This approach does not seem to be very balanced.

Preventative Measures for IPS only

Preventive measures of DGS are inherent to banking sectors which are organized in an institutional protection scheme (IPS). An IPS is a contractual liability arrangement that ensures the liquidity and solvency of its member banks to foster their financial stability. These IPS have implemented early intervention and risk assessing systems to avoid bank failures at an early stage. It is obvious that IPS which are recognized as DGS are the typical case of application of preventative measures in the current legal framework as other DGS do not have by far the same instruments. The early intervention and risk assessing systems of IPS have successfully avoided bank failures in the past and should therefore enable IPS as recognized DGS to apply preventative measures in the sense of DGS-Directive.

Restricted use of DGS in bank resolution

Europa should avoid fundamental structural changes like the establishment of EDIS, higher contributions of the national DGS to the resolution funds or a shift of competences from the national to the European level. Such far reaching changes would rather have a negative impact on the confidence of citizens and market participants in the functioning of the systems. The arguments raised for a higher contribution of DGS funds in bank resolutions are still not convincing. While a resolution is only applicable to systemic relevant institutions these instruments cannot be one by one applied to smaller institutions. Therefore the different purposes and instruments of the resolution framework and DGSD should not be mixed up and the use of DGS fund in resolution should be restricted to a maximum of half of the target level of the DGS fund.

BANK MODEL DIVERSITY IN THE BANKING UNION CONTEXT



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The structural lack of profitability is an important concern

In Europe, a variety of bank business models has always co-existed.

At a micro level, there is no evidence that a given business model or category of banks is structurally more stable or profitable than another. There is therefore no immediate reason for EU co-legislators, nor regulators and supervisors, to prescribe a specific preferred business model; they have always tried instead to preserve this diversity by aiming at neutrality in regulation and supervisory practices.

Of course, this diversity sometimes corresponds to national specificities. Although this can be a factor of further resilience at EU level, it can also lead to unwarranted fragmentation in terms of regulatory standards – through specific arrangements and carve outs

– and supervisory practices, that can result in an uneven playing field and be detrimental to the contestability of markets and the ability for investors to approach the European banking sector as a uniform class.

But ultimately, on an economic point of view, what matters is that the most efficient business models are free to prevail as a result of market forces. The question then comes whether this is true in Europe.

One could argue that the subdued profitability of European banks relative to peers, and the institutional shortcomings of the current incomplete Banking Union suggest that today's equilibrium in banking models in Europe is neither optimal nor sustainable.

The fact that the robustness of European banks was confirmed by the Covid crisis is a testimony of what a functioning Banking Union can deliver in terms of resilience and stability, but it should not be a source of complacency.

Indeed, supported by pragmatic regulatory and supervisory measures, and expansive fiscal and monetary policy, banks were able to keep levels of liquidity and capital far above their minimal requirements; their credit supply was resilient and in fact supportive of the real economy, regardless of their business model and region of operation.

But as the European economy normalises, once concerns about asset quality have completely receded, the structural lack of profitability will most certainly remain as the most important source of concern.

On an aggregated basis, financial indicators are alarming: the Return on Equity of American banks is twice as high as Eurozone banks and their Return on Assets is 4 times larger. This situation is not homogenous throughout Europe but it is an issue for all. In practice, it results in a lower capacity to attract outside capital or accumulate reserves, to meet the gigantic funding needs of the digital and green transitions, to invest in the digitization of the sector at the same pace as competitors and to rebuild capital buffers after a shock. As a result, European banks have been losing market shares both at home and abroad, eroding our common financial autonomy and exposing us to outside economic shocks and sanctions.

The causes of this profitability divide are multidimensional.

Over the last years, it may have been aggravated by the conjuncture, the lasting effects of the sovereign crisis and lower potential growth with flatter interest rates curves weighing on net interest margin (the NIM of US banks is 50% higher than Eurozone banks). The fact that investment banking is dominated by US banks also contributes, with much stronger fees and other revenues.

But there are other, more structural, factors caused by the institutional setup of the incomplete Banking Union.

On the one hand, the crisis management regime still allows for many national discretions which in practice mean too much non-competitive banks remaining too long on the market at the expense of others. Overcapacity sustained by regular bailouts is not only prejudicial to the credibility of the European banking sector but it weighs on its profitability, stifles innovation and consolidation.

On the other hand, the persistence of ringfencing practices locking up excess capital and liquidity in subsidiaries puts another drag on the performance of the crossborder banking groups, and does not help reversing the downward trend for such activities in Europe that began after the GFC, at a time when banking becomes more and more a winner-takes-all business.

How can European banks be as cost efficient and capital efficient as US peers if they cannot reach economies of scale on a continental level to deploy banking services that demand more and more investments in fixed-cost IT, nor access to deep and efficient markets to attract investors, sell products and actively manage their balance sheet at competitive conditions?

So if we should certainly keep on having no preconceived view at the most desirable business model for banks in Europe, and make sure regulation remains neutral in this respect, we should take the subdued profitability problem seriously and use the agenda for completing the Banking Union to make sure that market forces can unleash potential for all models and help the best ones prevail.



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EU banking regulation: efficiency matters more than business model

The European Union is characterised by a multifaceted banking sector. This owes both to the history of its Member States, and to an EU regulation which is neutral vis-à-vis banks' business models.

The very notion of "business model" is a long-debated issue with different possible angles to tackle it. Looking at it from the point of view of business mix, two thirds of the ca 3360 banks or banking groups in the EU (as of 2018) are co-operative banks, which represent 17 % of total assets of the banking sector.^[1] Another 6 % are local universal banks with 25% of the total banking assets. Cross-border universal banks represent 2% of the number of banks and 37% of total banking assets. Other business models, such as savings banks or mortgage banks come in smaller numbers, both in terms of entities and of total assets.

Against that background, no particular business model seems to prevail. As shown in the latest EBA Risk

Assessment of the European Banking System^[2], between December 2014 and June 2021, the average RoE for cross-border universal banks was 6.4% versus 5.3% for local universal banks. On the other hand, during the first phase of the pandemic, local universal banks tended to experience a lower decline in profitability. Higher revenues and lower impairment costs for geographically more diverse banks may be the main drivers of these RoE differences. Interestingly, performance can also vary significantly within the same business model.

Cross-border banks show higher net interest income as they operate in regions outside the EU where interest rates are usually higher. Their capacity to generate fee and trading income is also greater since some of these institutions are large investment banks or count on important investment bank divisions. Yet cross-border universal banks also show higher operating expenses. Operating in jurisdictions with different regulatory requirements or where there is a need to maintain a certain branch network seems to limit economies of scale. The lower geographical diversification of local universal banks might have also exposed them more to the macroeconomic underperformance of the EU compared to other economies between 2014 and 2021 and, hence, to higher impairment costs.

The EBA recognises that there is no one-size-fits-all approach to assessing banks' business models.

A variety of situations is also observed for European banks' funding. According to the EBA's report on Liquidity Measures, some business models whose funding originates predominantly from wholesale markets tend to show higher net liquidity outflows and to fulfil their Liquidity Coverage Ratio (LCR) targets by holding higher amounts of liquid assets, but all European banks display LCRs well above 100%, whatever their business model.^[3]

Having a wide range of business models can be a strength for the financial sector and the funding of the economy. This is for instance the case if this results in more tailored financing made available to borrowers. It can also help reduce contagion channels, and as a result systemic risk.^[4] On the other hand, a variety of business

models may also mean that banks are not fully reaping all possible economies of scope and scale, which may result in a less resilient financial sector overall. And this may also create challenges for supervisors to ensure that risks are being consistently and proportionately assessed and managed.

The EBA recognises that there is no one-size-fits-all approach to assessing banks' business models. This is reflected in its guidelines on the Supervisory Review and Evaluation Process (SREP) and in its regular monitoring of banks business models and on how future regulation may affect these. The current updating of the EBA's SREP guidelines will further enrich the procedures and methodologies supervisors can use in this regard. Having an adequate governance and risk management is critical to ensure the viability and sustainability of any business model. Proportionality in regulation and supervision is also of the essence as it is very clear that certain banking activities should be under closer scrutiny than others.

Whatever their current business mix, banks need to pay a specific attention to two important dimensions. The first one is related to the rapid digitalisation of the financial sector which can represent either an opportunity or a threat for banks depending on how they tackle it. The other one is sustainable finance which will increasingly drive business decisions and will diversely affect banks' current business models. Developments on these two fronts will become clearer as the disclosure and reporting -especially on ESG- becomes more established within the industry. The EBA will keep monitoring these developments while maintaining its stance that regulation should be business model neutral.

[1] *Data (2018) for the EBA Cost of Compliance project. The data was not published.*

[2] *EBA Risk Assessment of the European Banking System*

[3] *Report on Liquidity Measures under Article 509(1) of the CRR*

[4] <https://www.suerf.org/policynotes/3991/business-models-in-prudential-policies>



EDOUARD FERNANDEZ-BOLLO

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

Addressing the structural challenges of European banking business models

An essential priority of European banking supervision is to encourage all European banks to actively address the challenges they face in order to ensure the safe and sound development of their business models. Here, as in all aspects of supervision, the Single Supervisory Mechanism has a risk-based approach which takes into account the diversity of these models in a neutral way - a diversity which, in itself, is welcomed for banks to meet their clients' different needs - and aims to enhance the resilience of the system overall.

Profitability - understood in very broad terms as a bank's ability to generate each year revenues that exceed its costs - fosters the safety and soundness of a financial institution, as it acts as a buffer against losses should unforeseen risks materialise. It allows banks to build up capital organically; moreover, banks with sound profitability should be able to raise capital, in whichever form, more easily. Of course, the

impact which profitability might have on the soundness of an institution will depend on how it is achieved. High profitability can be a symptom of excessive risk-taking: financial risks (credit risk or market risk) and other types of risk such as those linked to suspicious activity, for example, money laundering, tax fraud, unethical selling practices or market malpractices like benchmark rate-rigging (EURIBOR). An important criterion is therefore whether or not the profits are sustainable and can be maintained over the cycle in a sufficiently secure way.

Viewed from this prudential perspective, 2022 will be a crucial year for the way ahead to the post-pandemic new normal. Indeed, 2021 saw a recovery in profitability across business models, with the average exceeding pre-pandemic levels: after booking large precautionary impairments in 2020 on their loan portfolios, banks' provisions diminished, and fees, commission and trading revenues increased. However, net interest income has lagged this positive development. It continued to be under pressure as margins declined further in 2020 and only partially recovered in 2021. This does not necessarily imply that banks with lending-focused business models are at a disadvantage, but merely that their income structure has been subject to more adjustment.

All business models in Europe face the same economic challenges, which requires ambitious strategies adapted to their specificities.

It should be underlined that the impact of the pandemic on profitability and business models has affected listed and cooperative institutions in similar ways: booking of provisions and impairments in 2020 and a return to lower provision flows in 2021. Moreover, the increase in fees was relatively broad-based across different business models, as various fee types increased. Asset management fees displayed the strongest growth, on the back of strong asset valuations, but transaction and account fees also increased, allowing lending-focused business models to raise their fee income. Of course, the sector in which banks are lending or risk-taking has an impact on their provisioning needs, but sound risk management helps banks to contain impairments better, whatever their legal form.

And similar challenges remain for both listed and cooperative institutions as we have yet to see not only how the path to a sustainable recovery affects the profile of impairments and of interest income and costs, but also whether the banks' strategies allow them to further improve their structural profitability, which continues to lag behind their international peers.

To tackle this issue, all banks should have an ambitious strategy to adapt proactively to the post-pandemic economic environment and opportunities. The ECB has long encouraged banks to make use of the opportunities given by the Single Market, but I would stress that digitalisation strategies will also be key, again across all the business models, as the pandemic has clearly increased consumer acceptance of digital offers. This will allow banks to accelerate their digitalisation initiatives, leading to a decrease in costs in the medium term, but also, and perhaps even more importantly, supporting the development of the level and nature of services called for by the transformation of the economy and, in particular, their targeted client base.

The appropriate strategy and the corresponding levels of profitability can therefore vary according to the different nature of the clients and products in question. What is essential is that the bank's risk profile remains well managed: from a prudential perspective, riskier assets and less stable funding structures demand higher profits to compensate for the higher risk, but this requires reinforced risk management. While it is for the institution to define its risk appetite to match its particular business model, the robustness and adequacy of a bank's risk management governance and capabilities is an overarching principle that European banking supervision applies to all.



GIUSEPPE SIANI

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Final call for banks' new business models

European banks have struggled with profitability issues since the outburst of the great financial crisis. These weaknesses have been driven by the interaction of both cyclical factors, such as financial crises, the need to deal with legacy assets and the low interest rate environment, and structural features of European banks. In particular, profitability of traditional business models, especially those focused on retail clients, has suffered the increasing competitive pressure from non-banks characterised by innovative business models and technological changes, which decreased the value of large branch networks. Consequently, the ability to raise capital on the market at reasonable prices has been hampered. Looking ahead, the impact of climate related aspects will further contribute to affect banking sector traditional sources of profitability by reshaping the global economy.

As a consequence, banks have accelerated their digitalisation processes and started to consider effects of the climate changes in their strategies and policies in order to successfully face many of these structural changes; the need to take action on these two aspects is at the top of the European regulatory and supervisory agenda.

In particular, both EU regulation and supervision, while neutral on individual business strategies, need to drive the change towards new approaches, aiming at reducing the existence of non-viable or unsustainable business models in the long term, as well as of organisation models that do not prove consistent with the relevant group-wide strategy.

Digital transformation is probably the most urgent matter to deal with: digital channels are nothing new in the financial environment given that they have helped to adjust to customers' needs. However, increased competitive pressure from the non-financial sector and Covid-19 pandemic further accelerated this process of transformation, thus creating both new opportunities and new risks.

The European regulation fostered this evolution, by adopting the digital finance strategy (including DORA and MiCA regulations), in order to support the digital transformation of finance while regulating the relevant risks. On the supervisory side, SSM has already taken the necessary action and will continue to assess banks' digital transformation strategies to ensure the adequacy of business models and relevant strategies in the long-run.

Digitalisation and climate changes are at the top of the European regulatory and supervisory agenda.

Moreover, the increased speed of innovation and the relevant higher interconnectedness among intermediaries and sectors have contributed to widen the traditional definition of IT and operational risk, thus making the industry and supervisors consider the cyber risk as one of the top priorities worth pursuing through specific governance and risk management safeguards.

The Bank of Italy has contributed to the SSM projects significantly and expanded them further by setting up one regulatory sandbox; in particular, it is a controlled environment where supervised entities and Fintech operators are able to test innovative products in banking and financial sectors, while guaranteeing adequate levels of consumer protection and competition, and safeguarding financial stability. Other Bank of Italy initiatives, such as the launch of Fintech

channel and Milano Hub, will help support the ongoing debate in this field.

Climate risk clearly represents the second crucial driver reshaping banks' business models for the foreseeable future. Indeed, the transition to a low-carbon economy will be very defiant for some counterparties, not to mention the current high credit exposures located in areas that are highly exposed to physical hazards. The banking system is best suited to contribute to the desired change supported by Governments all over the world. Most European banks have also started to integrate climate risk into their risk management frameworks, but progress is still too slow.

From the regulatory point of view, it is fundamental to further work on a common taxonomy, thus giving clear and consistent guidance to the market, and on which information must be disclosed. In addition, the recent proposal made by European Commission of implementation of Basel 3 package helps foster the implementation of such long-term goal by explicitly considering the ESG risks within the prudential regulation. From the supervisory point of view, SSM has fostered banks' efforts to make progress in measuring and managing climate risk: for example, it developed its supervisory expectations in 2020 to assess banks' preparedness and will run a stress test exercise focused on climate risks later this year.

Prudential regulation and supervision are at the forefront in digital transformation and sustainability aspects. The banks must play their role reaping the benefits from this big change in business models, while ensuring proper governance of the relevant risks.



PER CALLESEN

Governor - Danmarks
Nationalbank

How banks are bouncing back business

The outbreak of the Covid-19 pandemic has caused significant economic disruption, but EU banks have so far not been substantially affected. Profitability in the EU banking sector has stabilized at levels above those seen in the period leading up to the outbreak of the Covid-19 pandemic. This has been supported by low impairments, as government support has held up businesses in lockdown. Together with higher capital ratios and declining NPL ratios these help make EU banks safer and more resilient against adverse economic conditions.

For the purpose of maintaining bank profitability, as the first line of defense against losses, the banking sector needs to dynamically adjust its activities to changing business environments. In this regard, one of the major topics is the structural decline in interest rates.

In the euro area lending rates have to a greater extent than deposit rates fallen in step with lower policy rates and as a result the average interest rate margins for households and the corporate sector have decreased. Banks' lending rates depend on several factors including the loan composition, as loans with a riskier profile typically pay higher interest. Competition can also play a role. Although interest rate margins are squeezed, net interest income still

accounts for more than 50 per cent of EU banks' net operating income (NOI). Even so, net fee and commission income is making up an increasing share of NOI. As always, banks with a broad-based business model are seeking new ways of generating income to cover lower earnings from other parts of their business, e.g. by adjusting fees. This is a natural part of doing bank business on market terms. Furthermore, timely care towards cost management and focus on new digital ways of delivering customer service can prove important going forward.

The key policy rate in Denmark first became negative in July 2012 but it was not until the beginning of 2015 that banks started to charge negative rates on deposits from corporates. Initially, this was for large corporates and institutional investors, but increasingly for corporates more generally. The share of Danish corporate deposits subjected to negative interest rate now amounts to roughly 90 per cent. Deposits from corporates have so far not dropped, although initial research indicates that they hire and invest more and cut back borrowing when facing negative deposit rates.

The banking sector needs to dynamically adjust its activities to changing business environments.

At the end of 2019, the first bank in Denmark started charging negative rates on very large deposits from private customers and soon thereafter many banks followed suit. Deposits below a certain threshold are typically exempted from negative rates, but this threshold has gradually been reduced. Though somewhat controversial one should not be surprised that corporate deposits and large deposits from private customers – the safest among financial products – bear an interest rate similar to comparable financial products. However, banks are best advised to exempt deposits from negative rates below a reasonable threshold so as to not disturb the use of deposit accounts to make day-to-day digital payments. Since the end of 2021, around 40 per cent of deposits from private customers in Denmark have been subjected to negative rates, yet deposits remain high. Deeper impact analysis awaits upcoming microdata. Aggregate data suggest some portfolio shifts to investment funds, but not large changes in behavior.

Another step to enhance profitability of the EU banking sector has been to harvest synergies through consolidations. From 2008 to 2020 the total number of credit institutions in the European banking sector fell by roughly one-third.

Developments in the regulatory landscape as well as efforts towards preventing economic crime may have increased the benefits of bank consolidation in Europe. Going forward, EU initiatives related to the capital market union will help foster more diverse financing sources and possibly lead to less demand for bank credit.

Some banks' business models may not prove to be viable. A key lesson from the financial crisis was that neither liquidation nor government funds are good ways to manage failing credit institutions. Fortunately, we now have the system and institutions to manage non-viable banks. With BRRD great progress has been made to ensure that well-ordered resolution can be applied without using costly government funds. However, the application of BRRD by authorities might be put to a test in some cases.

It is important that both authorities and credit institutions continue to prepare for a crisis situation and improve the possibilities of rapid, flexible and controlled crisis management.



JACQUES BEYSSADE

Secretary General -
Groupe BPCE

Profitability of banks and diversity of business models

The European banking industry still needs to scotch a number of ideas that generate confusion and concerns on (i) the alleged low profitability of some of its fellow-members and (ii) the one-size-fits-all approach which currently does not sufficiently take into account the broad range of business models.

Added-value of the cooperative and mutual business model

As widely documented and analysed, both academically and empirically, different banking business models increase the resilience of the financial system.

Notably, long-term banks have less pressure to ensure high quarterly or yearly returns on equity and are therefore less inclined to take risks, thereby ensuring overall resilience to shocks and continuous financing to the economy.

More specifically, as a cooperative, our pay-out ratios are lower (our distribution rules are strictly limited by regulations) and the price appreciation of our shares is not applicable (our cooperative shares are not tradable). As a result, we can take a longer-term view on profitability and business orientation.

It allows our regional networks to underpin local prosperity beyond large cities. We make finance work for all, including and especially SMEs, in accordance with the European priority of an “Economy that works for all”. From a banking perspective, this means that all clients –and not only the most profitable ones– deserve adequate services. Public missions such as financial inclusion and education are also very important for us. They are part of our DNA.

Facing regulatory headwinds

However, we are facing regulatory headwinds. Our concern is that our particular model is not sufficiently understood nor taken into account in EU policy-making and supervision. Repeatedly, we deliver the message to decision-makers that a “stakeholder value” approach has merits and that an approach exclusively based on “shareholder value” is just inappropriate when shares are not tradable.

This has important consequences as shown in two recent examples:

On Supervision: the SSM intends to benchmark all banks on several aspects, notably profitability (in comparison with global listed institutions). The ECB horizontal Directorates therefore tend to create a one-size-fits-all approach which mixes up models and undermines diversity. This is a question of method: these benchmarks become more and more important for supervision and should be defined in cooperation with industry and full transparency.

Profitability analysis should not be the sole compass for the supervisors.

On Resolution: a key piece of the BRRD2 legislation imposes MREL and TLAC on the top of our capital ratios. The European proposal did not initially consider the specificities of cooperative banks where shares have a fixed value and reserves cannot be distributed

In both cases, the key issue is alike: how to avoid an inappropriate standardisation of the various business models?

Let's compare what is comparable

The sustainability of banking business models should be assessed through different criteria :

- their capacity of generating endogenously capital in « business as usual »,
- their coping with the growth of RWAs,
- their capacity to recapitalize in smooth conditions when facing crisis.

Profitability analysis should not be the sole compass for the supervisors

When comparing profitability ratios, the right indicator should be the assessment of the bank's residual income after distribution of the current pay-out to equity holders (which is a significant burden on CET1 generation).

Furthermore, it is not fair to penalize highly capitalized banks which put a much lower part of their balance sheet at risk and therefore display a lower profitability which is somehow artificial. This implies to look at the capital required as a fair and equal denominator among banks, and to remember that risk and rewards are to be balanced.

Last but not least, the capacity of the bank to recapitalize in times of crisis is a third criteria that should be taken into consideration. Cooperative banks present strong assets in such a situation: (i) a stronger attractiveness among investors because their shares are not sensitive to stock market fluctuations (ii) the statutory setting up of their (high) level of reserves that cannot be distributed to their members (contrary to commercial banks), which ensures a stability of value during crises and (iii) the non-dilutive nature of their capital in case of capital increase.

A strong European banking sector is crucial for Europe. It ensures its sovereignty and the freedom to decide its future, be it green transition or digital transformation. One of the key strengths of EU Banking Union is the diversity of its banking sector, notably because the various business models increase its financing potential and its overall resilience.

As far as cooperative banks are concerned, maximizing long term profitability is a journey where territorial and social proximity combined with long-term clients' relationships pave the way for a stronger and more balanced economy for all.



KARL-PETER SCHACKMANN- FALLIS

Executive Member
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Embracing the benefits of the EU's diversified banking sector

The EU banking industry is home to a wide array of banking models. These reflect Europe's diversity as they are catering to the different types and needs of its economies. The robust and proper functioning of the Banking Union during a systemic crisis also hinges on the diversity of its banks as they cushion shocks. With different business models, sizes, and ownership structures we see less of the herd behaviour typically associated with concentration of risks. As a result, there is a better chance for parts of the financial system to compensate for the failure of heavily affected banks, for example by being able to continue offering the services needed by customers and by providing liquidity and credit. The importance of a holistic view on the EU's banking sector is warranted, be it when trying to assess its performance or when drafting future-proof regulation.

It is crucially important to note that profitability does not necessarily mean the same for a regionally operating

small, non-complex institution as it does for a listed, globally active bank. Simply benchmarking profit overlooks that different business models and differently structured balance sheets result in their own profit cycles. Investment banking allows for very high gains, but they are very volatile. Retail banking lacks those peaks, and generates more stable cash flows. In order to assess an institution's profitability adequately, different time horizons have to be factored in, too. They are also related to the fact that many banks have no shareholders allowing them to shift from a short-term perspective of investors' interests, to one of long-term sustainable growth. Another important difference appears when institutions follow a public mandate. The German Savings Banks for example provide their services everywhere in the country, be it rural areas or urban centres – not only where it is promising the most profit.

It is necessary to have players in the industry taking higher risks or being capable of executing complex finance transactions. However, locally or regionally rooted smaller institutions are better equipped to cover the needs of the local economies.

One-size-fits-all solutions are no fit for the EU's diversified banking sector.

It cannot be questioned that sufficient profitability is core to all banks, we must however be careful not to become too obsessed with it. Especially in a world that is looking for sustainability in all aspects of life, the views on profitability as the one and only measure to determine successful banking becomes more and more obsolete.

The coronavirus-related disruptions have left and continue to leave their mark in the balance sheets of many European institutions. Sharply decreasing operating results and a rise in risk provisioning inevitably lead to considerable pressure on annual net earnings in 2020, although it seems as if the worst could be avoided. While return on equity is gaining ground, surpassing pre-crisis levels, overall subdued profitability is due not only to the macro-economic development. Other factors include the long-term negative interest rate environment, the enduring payment obligations entailed by the European bank levy or burdensome regulatory requirements.

As for the latter, decision-makers need to have the entirety of the EU banking sector in mind in order to shape an adequate policy framework. Notably with the transposition of the finalisation of Basel III, improvements are possible. The Banking Package 2021 of the European Commission fails to account for smaller non-complex institutions that exclusively use the standardised approach for credit risk. They will face increasing administrative burdens and higher complexity while their risk weights increase at the same time. As it stands, this will be effective as of 2025. Simultaneously, banks using internal models will be granted ample transition periods – some as far as 2032. This is far from the level playing field that the Basel III finalisation aimed to establish. On top, rising fixed costs and complexity affect smaller banks disproportionately. The principle of proportionality was already given an important role in the 2019 banking package, but co-legislators now have to ensure that the EU does not fall behind these first achievements. Another example are changes proposed to the governance framework.

Requiring an ex-ante suitability assessment of members of the management body means to completely disregard a considerable share of the EU's banking sector that will not be able to comply, due to practical reasons as well as public or private legal obligations.

In the light of the important role of the diversified banking sector for recovery and growth, but also during any type of crisis, the EU will need to find a proper regulatory environment. It has to aim at striking the right balance for all whilst providing the right incentives, enabling innovation, and allowing for a well-functioning financial services sector.



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SOLVENCY II REVIEW



PETRA HIELKEMA

Chairperson - European
Insurance and Occupational
Pensions Authority (EIOPA)

Reviewing Solvency II: keeping the regime fit for purpose

The Solvency II Directive came into effect in Europe on 1 January 2016 and was a true milestone, resulting in real progress in terms of risk management and the harmonisation of prudential standards in the European Economic Area. The insurance industry now uses a risk based approach to assess and mitigate risks. It also has better aligned capital to the risks it runs. Insurers have significantly strengthened their governance models and their risk management capacity. Solvency II is definitely an effective framework.

When the Solvency II Directive was introduced, revisions had already been planned to update the method of calculating capital requirements under the standard approach in 2018 and to assess the application of the long-term guarantees measures and measures on equity risks in 2020. At the request

of the European Commission, the scope of EIOPA's Opinion on the 2020 review of Solvency II is wider than that provided by the Directive.

EIOPA's Opinion on the Solvency II review aims in particular at keeping the regime fit for purpose by introducing a balanced update of the regulatory framework and reflecting better the economic situation, while completing the regulatory toolbox.

From a prudential perspective EIOPA is of the view that overall the Solvency II framework has been working well and no fundamental changes are needed, but a number of amendments are required to ensure that the regulatory framework continues to be a well-functioning risk based regime. This is the reason why EIOPA has advised in 2020 an evolution to this prudential framework. More specifically on the aspects of the review of Solvency II that relate to quantitative requirements, EIOPA's Opinion proposes amendments on the long-term guarantee measures and measures on equity risk, technical provisions, Solvency Capital Requirement standard formula and Minimum Capital Requirement. The following does not intend to cover all quantitative aspects.

Solvency II is definitely an effective framework.

From the perspective of the economic situation, there are areas of concern, which the review should address. Subdued economic growth has led to extensive monetary easing, which was further intensified by the Covid-19 pandemic. Also, in the last two years, the euro swap curve moved to negative territory.

EIOPA's advice is that it is essential to recognise this economic picture in Solvency II. In its 2018 review of the Solvency Capital Requirement, EIOPA has proposed changes to the treatment of the interest rate risks to avoid that the capital held against it is underestimated. EIOPA considers that changes are necessary and suggests to reflect the low and negative rates recently experienced. In addition, EIOPA recommends changes to the

interest rate curves used by insurers to value liabilities, especially in respect of the extrapolation. The changes to the extrapolation method increase market consistency and recognizes the changes that happened in the market since the current framework was developed in 2014.

Having said that, EIOPA also recognizes that, due to their long term liabilities, insurers are particularly well suited to long term investments. EIOPA's advice is that there can be a more favourable, prudent, treatment of insurers with long term liabilities. This is reflected in the EIOPA's suggestions of refinements to the volatility adjustment.

More favourable but prudent treatment is also recommended for the long-term equity investment, held against long term illiquid liabilities. EIOPA proposes to revise the eligibility criteria, to make them more prudentially sound, practicable and recognizing the long term character.

With respect to the risk margin, EIOPA proposes to introduce adjustments to account for the time dependency of risks. The effect of such change is a progressive reduction of the risk margin, which increases with the duration of the liabilities. Moreover, the volatility of the risk margin will be reduced through this change especially for long term liabilities.

The proposals of the European Commission published in October 2021 largely share EIOPA's approach and follow the objectives set in EIOPA's Opinion on the 2020 review of Solvency II.

Nevertheless, some important aspects have been modified and result in a reduction of the level of prudence with regard to policyholders. Prudence is an important element of Solvency II to avoid harmful situation for policyholders. EIOPA's advice recommended a more favourable but prudent treatment of illiquid liabilities as well as a balanced update overall. In EIOPA's view the removal of illiquidity considerations for the purpose of volatility adjustment calculations on the one hand and relaxations regarding the calibration on the risk margin and interest risk capital charge on the other, pose potential risks.



MARKUS FERBER

MEP, Committee on
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European Parliament

Use insurance reform to trigger investments

The European framework for insurance regulation, Solvency II, has by and large worked very well. In fact, many consider Solvency II to be gold standard of insurance regulation. Any reform should therefore be an evolution rather than a revolution and should only look at those areas that actually need improvement.

One issue that certainly deserves some attention is the fact that Solvency II is calibrated very conservatively. In general, one wants insurance companies to be run conservatively, with a keen eye for appropriate risk management and in the best interest of policyholders. However, there can be too much of a good thing. After all, people buy insurance products not only to hedge risks, but also to invest for the future. Such prudent long-term investment has become even more important as public pension systems have come under strain over the past decades thus making private retirement planning increasingly important. People buying insurance investment products for the long term need to be able to earn a decent return though. For insurance companies to offer such a decent return, they need

to be able to take calculated risks, such as investments in equities, which tend to outperform bonds over longer time horizons.

In an ultra-low-yield environment, solely investing in 30-year government bonds to match liabilities will simply not cut it anymore. Insurance regulation needs to acknowledge this new reality and allow for certain flexibility.

There is an even bigger role for insurance companies to play though: as a European Union we have set some very ambitious policy goals, for example in the area of digitalisation and moving towards a less carbon-intensive economic model. Achieving those policy objectives will require substantial investments that are measured in the hundred of billions. If we look at how stretched public budgets are following the Covid-19 crisis, it has to be abundantly clear that we will not be able to finance the digital transformation and the “Green Deal” with public funds alone. If we want to achieve our ambitious climate goals, private investment will be key.

The European Union has already recognised this by pushing for an ambitious sustainable finance agenda. Insurance companies could be exemplary long-term investors as they direct vast funds, have a long-term time horizon and predictable cash-flow needs. Hence, they are in a perfect position to invest in the long-term infrastructure projects that are needed in the context of the Green Deal. While this sounds good in theory, we also need to make sure that the prudential framework for insurers allows for such investments.

Insurance companies could be exemplary long- term investors.

Doing that will have a much bigger environmental impact than tweaking prudential rules to favour supposedly green investments. We should be very clear: insurance and reinsurance companies have very strong economic incentives to get their risk models precisely right and to assess long-term risks associated with climate change as accurately as possible. Therefore, there is little reason to believe that insurance and reinsurance companies are systematically mispricing climate risks. Accordingly, there is also little reason to introduce prudential measures to incentivise or disincentivise certain

investments. Doing so would only decrease the overall risk sensitivity of the insurance regulation framework while at the same time misdirecting financial flows into supposedly green assets thus creating financial stability risks. To put it quite clearly: prudential regulation, for banks, insurance companies or other investment firms should not be misused to conduct environmental policies.

Lastly, the Solvency II review should also focus on another aspect that holds insurance companies back: unnecessary red tape and regulatory burdens, in particular for smaller companies. In the banking world, we have succeeded in introducing a more proportionate regime for smaller and less risky entities. While we cannot transpose those provisions one to one to the insurance world, the approach chosen in banking regulation can certainly serve as inspiration. A risk-sensitive prudential framework, that we strive for in insurance regulation, certainly requires that we avoid one-size-fits-all regulations and go for a risk-based regulatory approach instead.

If done right, the review of Solvency II can be a chance to recalibrate the European Union’s insurance regulation framework to make insurance companies fit for the challenges of the future, allows them to invest in long-term and equity investments and enables clients to earn a reasonable long-term return.



FRANK GRUND

Chief Executive Director
Insurance and Pension Funds
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Solvency II: Continuously improving an efficient risk-based framework

The last couple of years have confirmed that the risk- and principles based framework of Solvency II is able to provide the correct answers in an environment that gets more and more complex, both with respect to insurance products as well as the investment universe. The close interaction of qualitative and quantitative requirements under Solvency II allows for the necessary overarching consideration of insurance risks.

Quantitative solvency figures are typically more volatile than under Solvency I, in particular so for long-term insurance contract which are typical in the German life insurance market. Volatility though is not per se negative, as it may be economically justified and ensures risk sensitivity. If actual volatility is however accentuated by a framework such as Solvency II, this can be problematic. To ensure that life insurers are still able to offer long-term guarantee products to customers, the Long-Term Guarantee Measures

were introduced into the system. These have proven to function well in the last couple of years, the volatility adjustment for example has proven to effectively mitigate spread-volatility during the first half of 2020 when the market spreads increased drastically as result of the COVID 19 pandemic. This helped to avoid pro-cyclical investment behavior these days.

The COVID 19 pandemic, which can be considered as the first real stress test of the framework, has shown that the risk-based Solvency II framework overall works well. In particular, increased risks and temporary losses observed especially at the beginning of the pandemic were well reflected in the solvency position of insurance undertakings. It could moreover be observed, that German insurers invested mainly anti-cyclically (e.g. they have bought additional BBB rated bonds which suffered higher market losses) while the majority of other market players has invested pro-cyclically. This has had a positive impact on financial stability.

As already outlined, the Solvency II framework allows to provide an overarching view on the soundness of EU undertakings, this is the basis for our supervisory considerations. During the investigations on the Solvency II review, EIOPA – as does BaFin - has stressed that the overall level of capital required under Solvency II – the level of prudence – is adequate. Changes to the framework proposed therefore intended to keep the balance and leave the level of capital unchanged. Continuous improvements to the quantitative requirements need to be risk- adequate though to ensure the framework staying fit for purpose.

**Continuous
improvements to
the quantitative
requirements need to be
risk- adequate.**

During the last couple of years obvious flaws were identified – which does not come unexpected for a system newly introduced, e.g. negative interest rates are currently not sufficiently reflected in the framework. A huge challenge for the future framework is its potential to reflect sustainability and climate change related risks. Risk-sensitivity also needs to be ensured in this respect, introducing flat ‘green’ and ‘brown’ adjustment factors is not

the appropriate way to ascertain a risk-sensitive prudential framework

Now with first years of experience it was further possible to add more proportionality, e.g. simplifications concerning the capital requirement calculation in respect of immaterial risks. Since the start of Solvency II, being aware of the complexity of the framework and thus resulting efforts for undertakings, BaFin has paid particular attention to a proportionate implementation of the framework, e.g. with respect to exceptions from reporting or Pillar II requirements.

EIOPA also has a strong focus on proportionality. In 2020, the Advisory Committee on Proportionality (ACP) that supports EIOPA on proportionality issues was implemented. The insurance and occupational pensions stakeholders have observer status in the ACP and may submit proposals regarding the prioritization of topics from the EIOPA Work Program and the contents of the advice provided.

Based on the EIOPA Opinion, the draft proposal for the Solvency II Review introduces the category „low risk profile undertakings“ (LRPU), setting out criteria for determining LRPU status and establishing explicitly how LRPU may implement certain Pillar II requirements. Only in exceptional cases may the supervisory authority keep an undertaking meeting all LRPU criteria from using certain of these LRPU specific minimum solutions. LRPU will also be exempted from the newly proposed assessment of climate change risk scenarios in the Own Risk and Solvency Assessment (ORSA).

In addition, BaFin appreciates that EIOPA intends to make the reporting requirements more proportionate for all undertakings by proposing template-specific thresholds for all non-core quantitative reporting templates.



JEAN-LAURENT GRANIER

President and Chief Executive Officer - Generali France

Solvency 2 : for a prudential framework aligned with a sustainable growth model

2022 will be a critical year for the European insurance industry. Many challenges will be on the agenda, one of which is the planned revision of the European prudential framework, Solvency II, with the effective start of the political negotiations. The fact that this revision occurs in an exceptional context of two years of pandemic crisis and now lasting pandemic situation strengthens the importance of this moment.

As Generali Group, we believe that the Solvency II framework has made a positive contribution to aligning capital with the risks incurred by the industry, strengthening governance models and risk management processes. The framework is now well established, has contributed to the stability of the insurance industry and has proven over the years that it is generally well functioning; this is why I believe that the fundamental pillars of the existing framework should be maintained.

However, a few steps should be taken to improve its efficiency and reduce volatility but, and most importantly, with-

out further increasing the overall capital burden for the European industry.

The Solvency II framework has major socio-economic impacts both through the product offering to an ageing population and its stabilizing role of long-term investors. Therefore, the debate on the review should not be a pure technical exercise but should also be guided by a broader perspective. Indeed, insurers can greatly contribute to the key European projects such as the Capital Markets Union, the Green Deal and the sustainable agenda. Thus, the review of the prudential framework should help to support these initiatives without weakening the industry by adding excessive and unnecessary constraints.

There is a significant risk of contradiction between two realities: one on hand, the insurance industry is submitted to a regulatory framework (with capital requirements and undeniable phenomena of market volatility) and, on the other hand, is righteously asked to be supportive of the growth of the economy through investments in equities and infrastructure, in particular in the current context of recovery.

A well-calibrated revision should allow insurers' participation in the CMU and the Twin Transitions.

That is why the review should ensure that undue volatility is better mitigated to facilitate long term investments and that appropriate capital requirements are set to allow insurers' investments, both in standard and alternative asset classes such as sustainability and SMEs projects.

In particular, the strong fluctuations of the solvency ratios in the early stage of the recent Covid-19 crisis proved the inadequate functioning of the adjustment mechanism for volatility which should be made more effective in order to remove unintended artificial volatility in own funds, to avoid pro-cyclical investment behaviour and to limit forced sales of assets.

I also call upon policymakers to further investigate two categories of investments which are very satisfactory in a long-term-sustainable perspective; Sustainable Infrastructures and Green Bonds.

Currently the Solvency II framework recognises a set of qualifying criteria

for infrastructure assets which allow using, in some specific cases, a more favourable capital charge. However, these criteria are restrictive and difficult to apply. Therefore, a more in-depth investigation of these criteria, in order to render them more accessible, including to entities using internal models, and more appealing to investors would attract more capital in these asset classes. This would help to mobilize investments across the EU in areas such as Sustainable Infrastructure which is one of the EU objectives.

The Solvency II review may also be a good opportunity to develop a specific treatment for Green Bond asset class, considering its different nature and risks compared to other types of bonds. Currently, Green Bonds are traded at a tighter yield compared to traditional bonds. To avoid undue penalization in the investment-decision process and to encourage more investments in Green Bonds, it would be relevant to develop a more appropriate risk-weight for this type of investment. Practically speaking, Generali Group has proposed to introduce to the framework a new category of long-term investments in Green Bonds, subject to lower, long-term stresses to the market value of bonds due to an increase in credit spreads, at specified conditions; compliance with the European taxonomy currently being defined on the EU Green Bond Standard, well identified investments and holding period, and capacity to avoid forced sales of each investment in green bonds for at least 10 years.

Generali Group is convinced that this initiative could be a significant contribution of the Solvency II framework towards sustainable growth.



RENAUD GUIDÉE

Chief Risk Officer - AXA Group
& Chair - Net Zero Insurance
Alliance (NZIA)

Solvency II review: targeted improvements to a balanced framework

The Solvency II (SII) directive has firmly established the European Union (EU) as having the most advanced and sophisticated regulatory framework for the insurance industry, leading other jurisdictions to draw inspiration from it and try to emulate it. The design of the current regime is the culmination of years of political negotiations, resulting in a balanced framework that provides for the highest standards of prudence to protect policyholders.

From that starting point, we believe the revision to the SII directive should pursue two objectives. First, leveraging the takeaways of the actual implementation, to derive targeted improvements where these are needed (for instance by further tackling the embedded residual volatility), and taking stock of the observed rate environment (while attention should be paid as well to the rate outlook, to avoid being one cycle late). Secondly, it provides a unique opportunity to put the European insurance industry in a position to contribute fully, with unlocked capabilities, to the EU's strategic ambitions, especially the

Green agenda, the CMU and the EU recovery plan. Removing unwarranted complexity and arbitrary layers of prudence can help to sustain the highest standard of policyholders' protection, including by fostering an optimal capital allocation.

We see the European Commission's proposal on the valuation of insurance liabilities as pivotal if we are to meet both these goals. The proposal regarding the risk-free rate curve on the one hand and the risk margin on the other hand have their merits. Even though some proposed parameters (e.g., the alpha parameter on extrapolation) look overly conservative and should be modified to better reflect the economic reality, the former does incorporate the rate environment observed over the past few years, while the latter reduces a cause for excessive volatility in SII balance sheets.

However, our main concern lies with certain proposed amendments to the volatility adjuster (VA), to which we believe more consideration should be given so as to avoid too many changes that only result in complexity while actually reducing the VA's effectiveness.

**Unique opportunity for
the European insurance
industry to contribute
to the EU's strategic
ambitions.**

At AXA, we have always seen the VA as the right generic tool to address undue volatility in SII balance sheets and since 2016, this countercyclical measure has undoubtedly met its purpose. The fact that the VA is the same for all insurers is a key strength and ensures it does not become overly complex to calculate and supervise. Therefore, while we consider it can be further improved, we should rule out any change that would end up feeding procyclicality or adding complexity. In that sense we think that while the EC's proposal is going into the right direction, two elements are of concern:

- First, we consider the existing risk correction to be calibrated conservatively enough to reflect the impact of defaults and downgrades, and no evidence has been brought forward to prove otherwise. The proposed methodology would impair insurers' ability to reflect significant spread widening in valuing their long-term liabilities.

- Second, further consideration should be given to the proposed enhanced prudency principle for the Dynamic VA. In our opinion, that approach negates the conservativeness of investment policies and implicitly incentivizes undertakings with the safest asset mix to take more risks. This is the result of an unbalanced measure which significantly overshoots the issue that it aims to address, and which is at odds with the one-year 99.5th value-at-risk (VaR).

Separately, a major competitiveness issue could arise with the proposal on restricting dividends for undertakings not breaching their SCR. That measure (art. 144c) would undermine the integrity of SII and conflicts with the duties of the Board of Directors. Such measure will be seen by investors as questioning the robustness of SII, hence increase the cost of capital for providing protection to policyholders. It also does not ensure a consistent approach across the sector as insurers may still face divergent supervisory practices and actions. It would create a third level of capital requirements, in addition to MCR and SCR, which would unduly complexify the framework.

Putting the SII framework and its review in the global context, it will be important to preserve both the high standard SII has set and the competitiveness of EU insurers. The recent change in direction of the International Capital Standards (ICS) discussions has the potential to severely undermine both. Indeed, an ICS is meaningful only if it leads to a level playing field, based on the same fundamental principles that underpin SII: a market-consistent valuation and a capital requirement calibrated to a one-year 99.5th VaR, based on either a standard formula or an internal model. An ICS that would shift from that ambition of universality to a mere equivalence regime would undercut the high standards set by SII and undermine the competitiveness of the EU insurance industry.

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THE EU AND GLOBAL SUSTAINABILITY AGENDA FOR FINANCE

ISSUES AT STAKE

The EU Commission is unfolding a “Strategy for financing the transition to a sustainable economy”. This strategy aims to increase the level of ambition of the EU in terms of share of private capital flows redirected to green investments, be they related to accelerating the transition toward a carbon neutral and less natural-resource intensive economy or to further preserving biodiversity. The objective is also more generally to embed a culture of sustainable governance in the private sector.

Yet this Renewed Strategy comes in the context of the adoption of a first Taxonomy Delegated Act on climate change adaptation and mitigation, and a Corporate Sustainability Reporting Directive (CSRD), which both raise significant implementation challenges, notably data challenges. In addition, the EU must help to overcome the fragmentation of sustainability reporting at the global level, which is one of the main sources of «green confusion» for investors and citizens.

The banking and insurance sectors - and their supervisors – moreover face a number of issues regarding sustainability, given the magnitude of anticipated changes. Banks and insurance undertakings must indeed define - and inform on - how ESG considerations are going to be embedded not only in their risk management arrangements, but also in their governance, business model, product and services definition and strategy.

A definition of EU and ideally global detailed transition pathways is also considered as essential to optimise the contribution of the financial sector and alleviate part of its transition risk.

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Q&A

BERNIE MENSAH

President of International – Bank of America

Capital as the catalyst to a sustainable global economy

What are the main actions Bank of America has taken at the global and EU levels to support the green transition that align to goals of the Paris Climate Accord and accelerate the transition to a sustainable economy? How do those strategies support your net zero strategy for your own operations and helping your clients reach their sustainability goals?

As a leader in sustainable finance globally, our focus is to ensure we are a leading advocate for positive environmental and societal change – and we do that through how we utilize our balance sheet, people and relationships.

A key role we play is matching capital with opportunity to help facilitate the transition to a sustainable, global economy. Bank of America has been deploying capital to support low-carbon solutions on behalf of clients since 2007. To date we've directed more than \$200 billion to these efforts and last year set a \$1.5 trillion sustainable finance goal to reach by 2030 to help advance the United Nations Sustainable Development Goals (SDGs), \$1 trillion of which is dedicated to environmental transition. This goal applies to every aspect of lending, investing, capital raising, and vendor management, and supports clients across sectors.

Our commitment is also core to how we manage our own operations. We were the first U.S. bank to announce a Scope 1 & 2 greenhouse gas emissions reduction goal for our own operations 16-years-ago, and in 2019 achieved carbon neutrality, a year ahead of schedule. We are now working toward a pledge to achieve net-zero greenhouse gas emissions before 2050 in financing activities, operations and supply chain. We are committed to begin to disclose financed emissions no later than 2023.

We partner with a number of organizations aligned with our focus on helping to transform how sectors measure, report

and maintain data in this area. We helped launch the Net-Zero Banking Alliance, part of the Glasgow Financial Alliance for Net Zero, which is working to drive consistency in how banks and the financial sector as a whole approach net zero. As a global member of PCAF (Rocky Mountain Institute Center for Climate Aligned Finance and Partnership for Carbon Accounting Financials) and in collaboration with other financial institutions, Bank of America helped create the Global GHG Accounting and Reporting Standard for the Financial Industry, providing a consistent methodology to assess and disclose emissions associated with financing activities.

At Bank of America, we embrace our dual responsibility to drive both profits and purpose, which we deliver on by using our financing as a catalyst to unlock and help mobilize greater capital flows toward advancing a sustainable economy.

There have been issues raised with ESG reporting standards, the inconsistencies at the global level as well as how to solve for these issues. What is Bank of America doing to address this?

A standardised framework would enable industries and sectors who invest significant resources into their reporting, to compare the same information like-for-like and learn from best practices. It will also enable banks to be the conduit to more efficient capital markets, rather than solely being the provider of capital itself.

Our objective is to have a single global reporting standard for non-financial ESG metrics, including climate related metrics. It is encouraging to see this happening through the work our CEO Brian Moynihan is undertaking through his role as head of World Economic Forum's International Business Council. Working with business leaders across the globe and the accounting firms Deloitte, EY, KPMG and

PwC, the WEF IBC developed a set of Stakeholder Capitalism Metrics (SCM) aligned to the SDGs. These metrics create a consistent way of measuring companies' long-term value, across industries which in turn, helps direct investment toward high performers and align capital to progress on the SDGs. To date, 150 global corporations have agreed to implement reporting on the SCMs. Bank of America is one of those companies, and we published select SCMs in our 2020 Annual Report for the first time. We also support the work of the IFRS Foundation and newly established International Sustainability Standards Board (ISSB), and other work to converge standards.

At Bank of America, we view reporting frameworks as an opportunity to identify ways to improve how we support our employees, serve our clients, perform for our investors, and give back to our communities. We have been publishing climate data for nearly 20 years and continue to expand our disclosure. In addition to publicly disclosed information in our Annual Report/Form 10-K, Environmental and Social Risk Policy (ESRP) Framework, Human Capital Management Report, reporting through the GRI and CDP, in 2020 we issued our first Task Force on Climate-related Disclosures (TCFD) report and Sustainability Accounting Standards Board (SASB) report.

Our activities are guided by our most senior leaders, including through our Global ESG Committee and Sustainable Markets Committee, chaired by Vice Chairman Paul Donofrio. Recognizing EMEA's leadership role in responding to ESG issues and bringing green finance into the mainstream, in 2020 we launched an EMEA ESG Strategic Council, which I am pleased to Chair. The Council is comprised of a broad cross-section of regional and global leaders overseeing and coordinating our ESG activities in the region, across business lines, risk, regulatory deliverables and our own portfolio of initiatives to deploy capital and contribute to our stated sustainability goals.

We work diligently to be transparent and share the progress we're making. We also recognize that this is a long-term journey where all of us have a lot to learn.

What would be realistic ambitions for the financial sector regarding emerging ESG challenges (biodiversity, circular economy, social, ...)?

There is a significant gap between the capital that must be applied to global challenges like climate change, and the amount being deployed today. The financial sector has a key role to mobilize players across the entire financial system to increase the flow of capital.

One example is His Royal Highness The Prince of Wales' Sustainable Markets Initiative (SMI), of which our CEO is Co-Chair, which is working to establish mandates to drive market development in areas like sustainable aviation fuel, where innovation and new technology is needed to help scale a new market.

For companies and governments around the world to reach net-zero, new technologies to reduce carbon across the supply and value chain will be essential. Financing new technology and innovation is a core component of our sustainable finance strategy. We are engaging with our client base – including energy, power and other high-emitting sectors – to provide expertise, innovative solutions and unlock capital and to help them accelerate the environmental transition. We've

also joined a number of coalitions focused on mobilizing capital to support new technology and innovation, including Breakthrough Energy Catalyst, the First Movers' Coalition, and Clean Skies for Tomorrow coalition, both created by the WEF.

How are banks managing sustainability risks? What are the lessons to be drawn from the recent EU stress-tests? What is the contribution of the bank regulatory framework to addressing sustainability risk? Are banks' levels of regulatory capital sufficient? What is being done to address the concerning points (e.g., physical risk underestimation, difficulties to approach the very long term, inconsistencies in portfolio orientation, ...) highlighted on this occasion?

As a financial institution, it is critical we manage and mitigate risk related to climate change. This includes physical risks, transition risks—and opportunities—that will impact communities, the markets, consumer preferences, and regulations. The management requires coordinated governance, a strong risk culture, and well-developed processes to identify, measure, monitor and control risks.

Managing climate-related risks is woven into risk discussions with our Board of Directors, Management team and lines-of-business. We have also established a Global Climate Risk Executive and Climate Risk team within our Global Risk organization, responsible for establishing a rigorous risk management program that identifies, quantifies, monitors and manages climate risk with a feedback loop to the businesses to improve practices. Our approach to climate risk is outlined in our ESRP Framework and TCFD Report.

As climate risk is a new risk type to the banking industry, our Climate Risk team partners closely with all lines-of-business to build education and awareness. We need everyone to have a broad understanding of what climate risk means for the bank as a whole, as well as a deeper understanding of how it impacts their business line or control function. To this end, we have rolled out multiple learning resources online and organized training and awareness sessions across our three lines of defense.

Through our risk identification process, climate and other risks are identified, prioritized and evaluated to determine estimated severity and likelihood of occurrence. We are focused on building our risk management and measurement capabilities to most effectively assess risks for potential impacts and incorporated into the design of macroeconomic scenarios to generate loss forecasts and assess how climate-related impacts could affect us and our clients. To achieve this we are developing new climate risk data sets and models.

In order to effectively manage and mitigate climate risk, banks need to treat climate risk as core to their business model, helping clients meet their own net-zero commitments and driving a just transition to a low-carbon future.



Q&A

XAVIER MUSCA

Deputy Chief Executive Officer
Crédit Agricole S.A.

Working every day in the interest of our customers and society

What are the main actions that Credit Agricole has launched to support the green transition following the COP-21 Paris Treaty? What are the main challenges faced by banks in this regard?

As a major player in the economy, Credit Agricole has adopted a Group climate strategy to increase our financings and investments for the climate and low carbon transition and make green finance a key source of growth and innovation. That strategy was strengthened in December 2021 with the publication of ten new commitments by 2025. Central to these commitments is our objective to contribute to carbon neutrality by 2050 on our scope 1, 2 and 3 emissions. This means we want to substantially increase our financing and investments in the transition together with all our clients, across all our sectors. To give you just a few examples, we already finance one out of three renewable energy projects in France; we aim at doubling the production capacity of renewable energy facilities financed by Credit Agricole Insurance to cover the average energy consumption of four million homes.

Furthermore, we already apply ESG criteria to 100% of actively managed open-ended funds of our asset manager Amundi, and we will invest an additional EUR 20 bn in sustainable funds (so-called “article 9 products”) by 2025. Finally, we also intend to offer all our retail clients a platform to diagnose the energy profile of their accommodation and provide advice and concrete solutions to improve their energy performance.

Dialogue with our clients will be central to achieving these objectives. One of the tools we have developed in that respect is a “climate transition score”, which can provide a dynamic view of a company’s performance to date towards climate transition, its decarbonation speed, and its level of commitment. We are going to publicly share the macro-structure and modus operandi of that scoring tool so that it is available to other financial players in open source and can help a wider range of economic players.

Equally important is our capacity to act in a decentralised way, through our regional banks network. Solutions to address climate change will be developed by local companies, which themselves create a positive dynamic in the regional ecosystem. Our cooperative model, with its participatory governance, and our financial strength, allow us to roll out our climate transition strategy and work with local agents to the benefit of a sustainable regional development for all.

Naturally, we have been facing multiple challenges, chief amongst them being data quality and availability. Just as any other financial institutions, Credit Agricole depends on data from its clients and despite the improvements brought by the Non-Financial Reporting Directive (NFRD), the quality and the accessibility of our corporate clients’ non-financial data have been lagging behind. We therefore hope that the Corporate Sustainability Reporting Directive (CSRD) will address crucial data issues.

What are the issues raised by the current inconsistency of Environmental, Social and Governance (ESG) reporting standards at the global level?

ESG reporting standards can be a very efficient way of supporting our economies’ transition. The inconsistency of current ESG standards at global level leads to distortions of information, lack of comparability, greenwashing, less efficient asset allocation and, ultimately, lower ESG transition. It also entails a level playing field issue as multinational companies may face different and potentially divergent ESG reporting obligations in multiple jurisdictions. As far as EU companies are concerned, data needs have been increasing substantially to meet new requirements, including data from third-country investees. We therefore welcome that the European Financial Reporting Advisory Group (EFRAG) seeks to coordinate, in a “co-constructive” approach with the

newly founded International Sustainability Standard Board (ISSB) and we call for EFRAG to be properly involved in the process of developing the future International Sustainability Standards (ISS).

Transparency alone is, however, unlikely to turn the market around with the necessary speed. Pro-active government action with clear sectoral transition paths is needed to reach net zero by 2050. We welcome the European Green Deal and Next Generation EU initiatives to fund the green transition. These investments are meant to be followed by even vaster amounts from the private sector as the ESG transition is also an important business opportunity. We are ready to finance it but we need to see many more public and private investment projects and a better recognition of transition in the future extended EU taxonomy.

What would be a realistic ambition for the financial sector regarding emerging ESG challenges (biodiversity, circular economy, social, etc.)?

It is very clear that environmental transition and social development go hand in hand. The former cannot succeed without acceptance from the latter. As a mutual bank, our usefulness to society has always been paramount and working for a just transition has been a natural development. Concretely, we recently made several commitments to strengthen social cohesion and inclusion, such as providing financing to the weakest local economies to support local employment, socio-economic integration and access to health care.

We also invest in the circular economy. Our leasing subsidiary, Credit Agricole Leasing and factoring, recently acquired Olinn, a company specialized in reconditioning and recycling of desktops, laptops, network and other equipment.

How are banks managing sustainability risks? What are the lessons that can be drawn from the recent EU stress-tests in this regard?

Credit Agricole, thanks to its cooperative roots and its mutual business model based on usefulness, as well as its commitments in favour of the territories and social inclusion, has always been committed to sustainability: mutual aid, responsibility, equity, solidarity, long-term horizon, and governance based on proximity.

Moreover, Crédit Agricole has integrated ESG risks consideration into its business strategies and processes and its internal governance systems. Supervisors encourage also banks to progress in the risk assessment and management, through stress tests for example. The one that is currently performed by ECB will measure banks' vulnerabilities, especially through credit and market risks, such risks being assessed through the existing risk factors.

It raises again the question of methods and data, the qualitative approach for both clients and transaction being already in place. Credit Agricole also took part in a climate pilot exercise of the French supervisor (ACPR): climate-related risks' impacts remained contained and manageable for the Group and climate levers were identified in addition to management decisions to mitigate the cost of these climate risks.

The ECB has published a guide describing thirteen expectations about climate-related and environmental risk management. Credit Agricole appears to be one of the main advanced bank under the SSM perimeter, with a detailed action plan to carry out the improvement of its risk framework (The state of climate and environmental risk management in the banking sector, ECB report, November 2021).

How are banks managing sustainability risks and what is the contribution of the bank regulatory framework to addressing these risks?

The current EU bank regulatory framework is adequate as it focuses on the "transparency" of financial players' exposures to sustainability risks. Credit Agricole has a permanent dialogue with its supervisors, just as we keep a permanent dialogue with our clients, because we have common goals concerning sustainability, in the interest of the whole society. Nevertheless, one should avoid bureaucracy and excessively burdensome procedures.

As stated by the ECB, while ESG risks drive credit, market or operational risks, they are not a new risk category and their assessment must be risk-based. Of course, a new approach to assessing and managing ESG risks is necessary as historical data, one-year horizons and back-testing requirements are not helpful here. Banks have therefore been developing their own methodologies under the guidance of the ECB. As far as we are concerned, as a cooperative bank, we have a culture of long-term vision and a limited appetite for risk which explain why our exposure to climate risks is limited.

To address data and modelling issues, we follow a step-by-step approach including different tools such as assessment of weaknesses against transition and physical risks with detailed cartographies; medium to long-term projections through dynamic stress tests; building of robust data during loan origination process, external audited data collection; and counterparty analyses of ESG sensitivities.

6 YEARS AFTER THE PARIS TREATY: THE ROLE OF FINANCE



ALEXANDRA JOUR-SCHROEDER

Deputy Director General, DG for Financial Stability,
Financial Services and Capital Markets Union - European Commission

Making banking and insurance fit for the EU's climate targets

The European Union is firmly committed to the goals of the Paris Agreement (COP 21 Paris Treaty). The European Green Deal lays out an ambitious project to make the EU climate neutral by 2050, supporting green jobs, green growth and green investment.

The transition to a sustainable economy will require massive investments, both by the private and the public sector. And an important part of the funds needed to finance this transition will need to come from the financial sector.

Bank loans in the EU account for the highest share of external finance of EU companies in all different sectors, be they large companies, or SMEs. To provide adequate funding to finance the transition while at the same time ensuring that both banks and the system as a whole stay resilient, banks will need to identify, measure and manage sustainability risks in an appropriate way. This will require, inter alia, that they fully and timely integrate those risks in their day-to-day risk management.

In the area of bank regulation, the EU has been prompt to act in this regard. In 2019, it introduced disclosure requirements in relation to ESG risks and mandated the European Banking Authority (EBA) to make recommendations on possible changes to the capital requirements.

The banking package adopted by the Commission last October took a further step in implementing the EU Sustainable Finance Strategy by introducing specific requirements and incentives for banks to implement a systematic and consistent management of ESG risks, and it gives the necessary tools for supervisors to enforce these requirements.

This includes regular climate stress testing by both supervisors and banks. The package also explicitly requires supervisors to assess ESG risks that the banks they supervise are exposed to. Through this process, supervisors will need to evaluate whether banks manage those risk in an appropriate manner, and to impose additional supervisory measures on individual banks if that is not the case.

In the transition to a green economy, the insurance sector will also play an important role. Like the banking sector, insurers are an important source of funding for private investments. The sector as a whole holds more than € 10 trillion in assets.

As for the banking sector, the prudential rules need to make sure that the insurance sector takes into account sustainability factors in their risk management.

With this objective in mind, the Commission amended the technical rules for insurers. Sustainability risks will have to be taken into account in risk management as well as in the investment and underwriting process. The new rules will apply as of August this year.

In addition, the Commission made a proposal for amending the Solvency II Directive.

Under the proposal, insurers would be required to conduct long-term climate scenario analysis in addition to the current risk management rules.

The European Green Deal also called for an assessment of the suitability of the existing capital requirements for green assets. While it is still too early for conclusions, EIOPA should continue work on sustainable and harmful investments. We need to ensure both strict management of ESG risks and no undue barriers to green investments.

Beyond their role as investors, insurers also provide coverage against the risks that a temperature increase by 1.5 degrees will cause. The latter is also reflected in the taxonomy, where insurance can qualify as an activity that enables climate change adaptation.

Climate change makes it even more important that the insurance sector continues to provide risk coverage. However, increasing insurance claims will also lead to an increase in risk-based insurance premiums. Finding approaches to facilitate the supply of affordable insurance solutions is a very complex matter. Nevertheless, we want to kick off discussions with a broad range of stakeholders within a series of "Climate Resilience Dialogues" to produce EU-level recommendations.

All these measures taken on the regulatory side will ensure that the banking and insurance sector remain robust to support the transition and the EU in meeting its commitment to the Paris Agreement.



NIKHIL RATHI

Chief Executive -
Financial Conduct Authority (FCA)

ESG – Everyone says they’re Great...

When I think about the fast-evolving world of Environmental, Social and Governance (“ESG”) finance, the quote “if you’re not confused, you’re not paying attention” springs to mind. It seems the more we learn about ESG in finance, the more challenges we find. The term ESG originated over 15 years ago when a UN-sponsored study described the benefits of integrating financially material ESG considerations into investment decision making. Today, however, ESG is about more than just risk management. It now encompasses a broad spectrum of objectives and strategies that variously consider, promote or pursue ESG characteristics, themes or outcomes.

As the field expands, even identifying a clear objective is no easy feat. The terms “ESG”, “sustainable”, “responsible” and “impact” are used interchangeably and often loosely. Indeed, the confusion around terminology spreads to the variety of strategies directed towards achieving these goals; ranging from “negative screening” to “community investing”, and everything in between. And even where a clear objective has been communicated, it is not always obvious that it is being met. Indeed, in a 2020 study by Barclay’s, analysts combed through two decades of funds data to conclude that the holdings and exposures of ESG funds were often not so different from those of conventional funds.

To make matters worse, investment firms often don’t have access to the tools they need to deliver their strategies. There is a lack of reliable and high-quality ESG-related information from the real economy – let alone consensus on how to demonstrate performance, and especially “real-world” impact. In the absence of clear reporting standards, we see companies cherry-picking from voluntary frameworks. And there is often a disconnect between their ESG disclosures and their financial statements.

As a result, investors have become increasingly reliant on ESG data and rating providers. But how are these providers filling data gaps? And how should an investor interpret an ESG rating that aims to combine indicators of performance on wide-ranging factors such as diversity and inclusion, carbon emissions, biodiversity, data protection and board governance? One recent study calculated an average overall correlation of just 0.54 across the six rating providers in their sample. So, how can we cut through this confusion – and its potential to mislead consumers? I would argue that the answer lies in foundation, regulation and innovation.

Foundation

As a first step, public and private sector actors need together to build institutional foundations and a trusted ecosystem to support and deliver the ambition of ESG. This includes internationally consistent standards, a common language, high quality information and agreed protocols for market-functioning. I am pleased to say that we are starting to move in this direction. In corporate reporting, for example, the IFRS Foundation announced the International Sustainability Standards Board (ISSB) at COP26 in Glasgow. I am proud that the

FCA has been closely involved in this work. The ISSB will set a global baseline for reporting standards for sustainability; one that can be adopted around the world and supplemented, as appropriate, with jurisdiction-specific requirements. This ground-breaking initiative will deliver a step change in the quality and reliability of the information flow from corporates to the financial sector – supporting firms’ decisions; and better equipping finance to be a force for good.

Regulation

Building on these foundations, regulation and public policy can then set guard-rails for the market, enabling firms to innovate and evolve their ESG products and services within a trusted framework. As an example, last year, we wrote to fund managers setting out our expectations for the design, delivery and disclosure of ESG investment funds. Seeing the potential harm from misleading and exaggerated claims by ESG-labelled funds, we saw a need to act to protect consumers and preserve the integrity of the market. We took a principles-based approach initially. To codify too much too soon can be counter-productive in a fast-growing and dynamic market where capabilities are still building, and data, systems and processes are still evolving. But we do need to go further. We recently gathered stakeholder feedback on initial ideas for a framework for sustainable investment labels and consumer-facing ESG disclosures for fund products. We plan to consult on formal proposals by mid-year. As we develop new rules in this area, we will be looking closely at coherence with international requirements and the work of other jurisdictions.

Innovation

Only with the right foundations and guard-rails in place, can financial institutions deliver products and services that will reliably meet consumers’ needs. The demand is clearly there: investors – institutional and retail – are increasingly pursuing ESG outcomes. And continued innovation in ESG investing is essential if the financial sector is to deliver on net zero commitments, and if finance is to play its part in supporting a more sustainable long-term future. Both industry and regulators have a role to play in innovation. Close collaboration is vital and the FCA has been running international TechSprints, FinTech Challenges and a Digital Sandbox programme to crowd-source creative ideas that will help to drive change and overcome industry-wide challenges.

At COP26, I launched the FCA’s new ESG strategy, in which we have committed to working with fellow regulators and the Government to deliver these foundations and regulations. Our work will support the fair and effective integration of ESG into financial market decision-making, and the trusted delivery of ESG-labelled securities, products and services. And we will embed ESG across the breadth of the FCA’s functions. We are looking forward to continuing to work with international and domestic partners as we all navigate what today may be a confusing world, but one that help to deliver positive change tomorrow.



DR. SABINE MAUDERER

Member of the Executive Board -
Deutsche Bundesbank

Financial sector: financing Europe's transition

The Paris Agreement on climate change has paved the way for ambitious action to cut carbon emissions. Now it is crucial to make further progress. The European Union has pledged to reduce its emissions by at least 55% by 2030 and achieve climate neutrality by 2050.

Transitioning the economy is a long-term project that will require considerable investment, including in climate-neutral innovations. Additional investment of up to €350 billion per year over this decade will be needed to meet the EU's 2030 climate targets. Other environmental goals call for further additional €150 billion per year.^[1] Public funds will not be enough. We also need to mobilise private capital, which is where capital markets, banks, investment funds and insurance companies come into play.

The insurance sector is one key player in financing the transition. First, as long-term institutional investors they can green their portfolios, thus steering flows towards green investments. Second, insurers protect companies' and households' assets as risk carriers and risk managers. Insurers can help their clients adapt to climate change by incentivising better risk prevention measures.^[2] One way to do this could be through impact underwriting, for example with climate risk-based pricing and adapted contractual terms that contribute to climate adaptation and mitigation. This way, insurers could be drivers of Europe's transition.

Europe's financial system is still largely based around its banks. Loans will fund a significant portion of climate-related investment. Banks will need to be sufficiently resilient to absorb the climate risks that will materialise over the next years. Adequate risk management is essential, but progress still needs to be made on improving climate risk management practices. Supervisors will further assess banks' climate risk management in upcoming stress tests and supervisory discussions.

At the same time, however, traditional bank-based credit financing will not be enough to spur innovation. There are regulatory limits to banks' risk appetite, and rightly so. To scale innovations up to market maturity, more capital market financing is key. The success of these innovations will decide about Europe's future. Asian and US markets are well prepared and are enabling growth of promising enterprises and technologies.

Capital markets are also adjusting to the Paris Agreement. Bond markets in particular have seen the emergence of new instruments based around efforts by private and public issuers to improve their carbon footprint. As a result, ESG issuance skyrocketed last year, reflecting mounting investor demand and changing preferences. Moreover, the European

Commission plans to issue up to €250 billions of green bonds by 2026 as part of the NextGeneration EU recovery fund. This will further expand sustainable markets.

While these welcome trends look set to continue in the coming years, it is important to address the issue of greenwashing and improve market transparency. This is where aligned global reporting standards and verification processes will be crucial.

Capital markets play a vital role in financing Europe's transition towards carbon neutrality.

In sum, capital markets will and must play a vital role in financing Europe's transition towards carbon neutrality. This highlights the urgent need to further develop sizeable, mature and integrated green EU capital markets. It calls for decisive action to boost capital markets beyond the sustainable finance segment, notably by making progress on the EU capital markets union (CMU). All climate-related plans must go hand in hand with a strengthening of the underlying capital market structures and standards to reduce the risks of national fragmentation. Moreover, the CMU specifically aims at giving innovative enterprises better access to funding. Their projects face high uncertainty and need risk capital, particularly from investors who are willing to finance promising enterprises with a long-term perspective and upside potential. National and European initiatives like the German Future Fund (Zukunftsfonds) and the EU platforms for venture capital promise to nurture the European start-up ecosystem.

It is time to make Europe fit for a sustainable future. We need all hands-on deck.

[1] European Commission, "Strategy for Financing the Transition to a Sustainable Economy" COM/2021/390 final, July 2021.

[2] EIOPA, "Report on non-life underwriting and pricing in light of climate change", July 2021.



EMILIE MAZZACURATI

Global Head of Climate Solutions -
Moody's ESG Solutions

Can net zero finance lift all climate finance boats?

The Paris Agreement was hailed as a landmark in global climate negotiations, but the implementation over the past six years has not delivered in line with expectations.

While emissions dropped in 2020 due to the Covid-19 pandemic, they rebounded in 2021, and according to the Intergovernmental Panel on Climate Change they would need to be almost halved by 2030 to meet the 1.5°C goal. Financing for climate is also far from the Paris goals, with the Climate Policy Initiative estimating flows in 2019/2020 at over €550B globally, well short of the €2-5 trillion needed annually to maintain a 1.5°C pathway.

While Glasgow crystallized a lot of momentum around net zero commitments from the financial sector and the real economy, Moody's ESG Solutions analysis shows that out of the largest 4,400 non-financial companies globally, over 2000 companies (42%) have set emissions targets, but only 3% of the 4,400 have targets that are aligned with achieving 1.5°C by 2050. The average implied temperature rise among assessed companies is 2.9°C. Sector results vary widely, but every individual sector covered has an implied increase of above 2°C and fail to rise to the ambitions of the Paris Agreement.

For financial institutions, capital committed to net zero through the Glasgow Financial Alliance for Net Zero (GFANZ) reached over €110 trillion of private capital committed from over 450 firms, which could theoretically deliver at the scale needed to alter the course of history on climate change.

The key question is now whether financial institutions will be able to deliver on these goals, and whether they have the tools to track and monitor progress in their portfolios. Moody's ESG Solutions' work assessing companies' performance against their net zero targets and the quality of their proposed implementation strategy is geared to provide the required transparency and accountability.

Financial institutions will need to fundamentally transform their business models and decision-making processes to systematically incorporate climate and carbon as a material concern in lending and investment decisions. They will also need to innovate and proactively drive different outcomes by pricing exposure to carbon and offering meaningful incentives to drive decisions in the real economy.

The EU has been a leader in establishing a comprehensive policy framework to help drive the transition towards a net zero economy, but globally more progress is needed in terms of reducing the financing of fossil fuels. The International Energy Agency estimated global fossil fuel subsidies at €310bn in 2020, a sharp drop from the €490 bn p.a. in 2017-2019 due to the pandemic and low oil prices. In contrast, the IMF

recently calculated the true costs of fossil fuels subsidies was over €5 trillion, or almost 7% of global GDP, by counting the failure to accurately price externalities as a de facto subsidy for fossil fuels. This discrepancy between stated goals and the current energy policies in certain jurisdictions can be a critical impediment to meeting global targets, and financial markets may be hard-pressed to provide a counterweight to achieve energy transition.

The area in greatest need of attention is adaptation finance. The Climate Policy Initiative reports almost €1 bn in adaptation finance so far, while the UN estimates the needs at €120 to €260bn annually by 2030, rising to €240-440bn by mid-century. Adaptation finance is hard to track due to the lack of clear definition of what investments qualify as adaptation or resilience, and also because corporations investing in making their operations climate-proof may not report this spend as adaptation.

**Financial institutions will need
to fundamentally transform
their business models.**

There are, however, some relatively simple solutions that would help leverage the momentum for net zero and create broader resilience in the economy. Financing for climate mitigation projects and temperature-aligned finance could systematically include a requirement to incorporate resilience to physical climate risk in the projects. Helping raise awareness of the breadth of the exposure to chronic and physical climate change and mainstreaming the efforts to future-proof new investments to unavoidable impacts of climate change would be transformational and help open flows for adaptation and resilience finance across our economies.



JEAN-PAUL SERVAIS

President - Financial Services and Markets Authority,
Belgium (FSMA)

Has SFDR solved the problem of greenwashing regarding sustainable funds?

Despite the entry into force of the European Regulation on sustainability-related disclosures in the financial services sector (“SFDR”) on 10 March 2021, sustainability still presents multiple challenges for investors, asset managers and regulators.

One such challenge is that sustainability issues are complex. Asset managers have to explain, in easily understandable language, their approach to considering ESG issues in the fund objectives. In addition, the terminology used when dealing with the ESG aspects of investment objectives is far from standardized and covers a multitude of approaches.

Furthermore, even if the aim of the SFDR is to provide more transparency on sustainability, greenwashing remains an issue. Generally, funds have adapted their documents and have further specified their investment policy by describing their sustainable methodology and the criteria used to pick assets and build their portfolio. Nevertheless, the description of the investment policy may be (too) vague, clear binding selection criteria may be missing and, for some, the classification of funds as “Article 8 or 9 SFDR funds” might seem like a marketing concept that covers a large range of funds, rather than an ESG categorization.

Moreover, the SFDR Regulation has not yet been fully implemented. The RTS have yet to be published and will apply only from next year. Given the wide range of products falling under articles 8 and 9 of the SFDR and the difficulty for investors to differentiate between products based on their sustainability, these RTS will increase transparency. They will not only introduce indicators to assess the ESG performance of funds but also provide templates for the ESG aspects, to allow for comparison of the levels of sustainability requirements of the funds.

Another challenge, especially for asset managers, is the lack of data. The entry into force on 1 January 2022 of the European Taxonomy Regulation should further improve the transparency of funds in terms of sustainability. Obviously, it is difficult to calculate portfolio alignment with the taxonomy as the data on the ESG aspects are not yet widely available on the market and some additional legislative pieces of the “Taxonomy puzzle” are still missing. In fact, at present not all Taxonomy delegated acts have been adopted or are in force; 4 of the 6 environmental objectives need further technical screening criteria, while discussions on the inclusion of gas, nuclear energy and agriculture are still ongoing. Until all the pieces of the Taxonomy and of the Corporate Sustainability Reporting Directive are in place, there will be a kind of transition period. Indeed, it will take a few years for these new standards to be fully deployed and for companies to implement them.

Another challenge, especially for regulators, is the extent of their power. Regulators ensure that fund documents are easily understandable and transparent with regard to sustainability. When verifying the implementation of the SFDR, regulators generally pay attention to transparency by ensuring that the classification of funds in the different categories of the SFDR is realistic and consistent with their investment policy. In that context, it seems a good practice to have an independent third party provide assurance for one or more of the managers’ ESG disclosure statements. The EU Ecolabel might also be a partial answer to the assurance issue and to the multiplicity of labels, which all have a different reference system and thus make the sustainable fund offer difficult to understand for investors.

Sustainability still presents multiple challenges for investors, asset managers and regulators.

Finally, advertising is a concern when speaking of greenwashing. Here again, the marketing documents may be vague on their binding criteria and objectives in terms of sustainability. The verification of marketing documents is therefore important because it is usually through advertising that investors become aware of such products. The SFDR provides a response to this issue by requiring that the advertising is consistent with the investment policy of these funds, including with regard to sustainability.



LAURENT ZYLBERBERG

Director of Public, International and European Affairs -
Caisse des Dépôts (CDC)

Achieving the COP21 Treaty targets: where does the solution lie?

Complying with the 2015 Paris Agreements is a matter of shifting our growth paradigm towards a greener economy. Focusing on targets, even if they are ambitious, is somehow an open window to greenwashing. This means more funds directed towards low-carbon investments and a drastic reduction in supporting a carbon-based economic model. It is a matter of long-term investment!

Europe needs long-term investment to meet the challenges ahead and public actors play a central role in long-term investment at local, national and European levels. They can either channel funds toward long-term investments, or make such investment possible, or even finance the investments directly.

In a context of limited public resources, it is necessary for public expenditure to leverage private investment. It can be done in two ways.

First, through financial instruments, an illustration, at European level, can be given with the Juncker plan implemented in 2015 and its successor, InvestEU for 2021-2027. These EU guarantee programmes encourage risk-taking. Blending is another example by combining traditional grants with other financing instruments (loans, debt, guarantees, or other) obtained from a National Promotional Banks and Institutions (NPBIs), EIB or any “implementing partner”.

Secondly, through incentives aimed at directing private financing: regulatory standards, soft law, taxation can be part of this incentivization. The EU taxonomy is a major illustration of this approach. By defining what is “green”, the European Commission provides a common language that enables to classify future investments.

There was a time when the Government was regarded as “The” problem, this is not true anymore, it is now part of the solution. For this, economy should rely on a strong and long-term minded public financial sector. The recent report “Investing for the long-term, a short-term emergency”, by B. Attali, released in January 2022, underlines specifically the importance of the financial sector in this transition towards a greener economy and suggests different types of measures aimed to reinforce the ability to finance this transition, by transforming savings into long-term investments.

First of all, within the prudential framework, some measures could be taken to better direct savings towards long-term investments while, at the same time, maintaining a secure framework. Climate risk is beginning to be included in the assessment of risks, but the protection offered by a diversified, long-term portfolio should also be incorporated into the prudential frameworks.

Among the tools that could be deployed, securitisation is worth to mention. By buying loans recorded on banks’ balance sheets and thus reducing those banks’ default risk, securitisation enables banks to free up part of their balance sheet and thus accelerate the rotation of their equity. Provided these mechanisms are accompanied by conditions and controls enabling the public bodies to verify that the financing margins generated by these transactions are used for long-term investments. The report refers specifically to “green securitisation” that could be put in place to provide loans for the ecological and energy transitions.

There was a time when the Government was regarded as “The” problem, this is not true anymore, it is now part of the solution. For this, economy should rely on a strong and long-term minded public financial sector.

As household savings in Europe have reached a high level, it is also important to design attractive products that can finance long-term investment, while offering sufficient protection. In addition to differentiated risk/return characteristics, the products offered must also offer savers “meaningfulness”. From this point of view, it is appropriate to consider a range of products that are clearly differentiated depending on the level of risk households can accept and bear.

As there is neither Planet B nor Finance B, public and private actors should more than ever work together.



CHRISTIAN DEEGLISE

Group Head of Sustainable Infrastructure
and Innovation - HSBC

Mobilising private investment for sustainable infrastructure

In the six years since the Paris Agreement, rapid progress has been made to mobilise private investment. Creating the policy environment is key. Europe has gone further and fastest: home to the most ESG-focused investors, the most progressive banks, and policymakers determined to set a framework for sustainable finance to flow. In climate risk management, disclosure and creating new products and services, Europe is leading the way to a more sustainable financial system. But challenges remain to create the asset classes needed to achieve the steep decline in emissions to net zero by 2050. Nowhere is this more evident than in infrastructure investment and in creating the financial structures for catalysing private funds at scale and at speed.

FAST-Infra is our latest initiative to accelerate investment in sustainable infrastructure and I believe it provides the best chance for success. Born out of President Macron's One Planet Lab, with founding partners including the Climate Policy Initiative, HSBC, IFC, OECD and the Global Infrastructure Facility, FAST-Infra has made rapid progress, including at COP26 in Glasgow, where we were delighted to showcase FAST-Infra and to launch the FAST-Infra label. This new label, developed following a public consultation, is built on 14 criteria and four core objectives:

- **Environmental:** the project should make a positive impact, such as increasing alignment with low-carbon pathways, more efficient use of materials, and enhancing biodiversity and the natural environment.
- **Adaptation & Resilience:** boosting resilience to climate, environmental, human-made, and disaster risks and in response to actual or expected changes in climate conditions.
- **Social:** improving healthcare, safety, and security of local communities and project parties, strengthening human and labour rights, creating jobs, gender equality, and access to education.
- **Governance:** meeting requirements for policies, processes, and procedures, including around compliance, anti-bribery and corruption, fiscal transparency, and transparent procurement.

We hope that FAST-Infra will help governments incorporate ESG criteria at design and pre-construction phases – since qualifying for the label should attract larger financing volumes – increase the supply of sustainable projects and reducing their financing costs. We believe it is important to avoid fragmentation wherever possible, so we have designed FAST-Infra to be compatible with the EU's Taxonomy Regulation and drawn on best practice from other frameworks such as the ADB ASEAN Catalytic Green Finance Facility Investment Principles; ICMA (Green Bond Principles, Social Bond Principles, Sustainability Bond Principles); and IFC Performance Standards.

We have achieved a great deal, but a huge challenge remains. To meet the UN Sustainable Development Goals and deliver Paris, the OECD estimates that \$6.9tn of sustainable infrastructure investment is needed each year, much of it in developing economies. Current levels of investment are insufficient due to a lack of bankable projects and not enough private capital to finance them. Since we launched FAST-Infra, well over 100 organisations have pledged support, from banks and asset managers to governments and NGOs. Our common aim is clear: to transform sustainable infrastructure into a mainstream, liquid asset class. Building on our success in launching the label, the next phase for FAST-Infra is to create an end-to-end technology platform for infrastructure.

Through artificial intelligence and natural language processing tools, the platform will streamline each phase of the infrastructure financing lifecycle, collecting standardised project data, and facilitating harmonisation and comparability of contractual terms.

**FAST-Infra provides an answer
to one of the key challenges
in delivering the Paris Agreement.**

To bridge the infrastructure gap, everyone will need to play their part, including policymakers who must complete the task of creating the framework for sustainable finance and investment. As project sponsors, governments should plan projects that meet the criteria for the FAST-Infra label. Development institutions have a vital role to mitigate risks and to mobilise as much investment as possible by 'crowding in' the private sector. FAST-Infra provides an answer to one of the key challenges in delivering the Paris Agreement and I urge you all to support it.



LINE ASKER

Senior Sustainability Advisor -
DNB Bank ASA

Policy initiatives to drive the sustainable transition

The financial sector can be a driving force for a sustainable transition. At DNB we use our position and expertise to actively help our customers move in a more sustainable direction, through advisory services, financing, and clear requirements.

However, the financial sector cannot ensure a sustainable economy on its own. There is also a need for policy initiatives and frameworks to transition the economy, in addition to the EU sustainable finance regulations. We thus welcome the initiatives in the EU Green Deal.

These EU initiatives already include many important measures that are necessary to drive the sustainable transition. But continued progress within certain areas may catalyze the transition in business and the financial sector. Notably, correct pricing of environmental externalities, transparency and data availability, incentives, competence building, risk sharing and collaboration. A short reasoning related to each of these aspects follows below.

Correct pricing of environmental externalities: Climate change, biodiversity loss and ecosystem degradation pose serious risks to business and the financial sector. Public policies that put a financial value on environmental impacts can help companies and the financial sector internalize these costs and make better informed decisions about how they manage their environmental risk.

These policies include putting a correct price on environmental externalities beyond GHG emissions, such as the use of raw materials that pose a risk to biodiversity, water use, and other actions that lead to environmental degradation. This process is complex and not straight forward. The EU should thus promote competence building in this area and facilitate discussions on how to include the value of natural capital and the price of environmental degradation in business and financial decisions.

Transparency and data availability: Transparency and ESG data availability is key to enable consumers, business, and the financial sector make informed decision when it comes to sustainability. The CSRD and the European Single Access Point are important initiatives in this area. The EU should continue to develop comprehensive ESG reporting requirements, as well as providing relevant tools.

Incentives: Right incentives are important to ensure that short-term decisions and actions are in line with the long-term sustainability goals, both in the private and public sector. This can include further developing the EU's Green Public Procurement (GPP) initiative and investigating how sustainability incentives can be integrated in business, in the financial sector and at the consumer level.

Competence building: Increased competence and awareness on sustainability issues can enable business, the financial sector, and consumers to make better and more sustainable decisions. Climate change, environmental issues and sustainability are new subjects to many actors. They also find it difficult to navigate the sustainability landscape and prioritize different actions.

The EU could take on a larger role in ensuring competence building at all levels. This can include requirements to include sustainability in education, providing competence building programs for businesses and the financial sector, and more general competence building in the society.

Continued progress within certain policy areas may catalyze the sustainability transition.

Risk sharing: Investments in innovative and sustainable technologies pose may pose considerable financial risk for first-mover companies and financial institutions involved. The consequence is that projects that are necessary to drive the sustainable transition often are deemed to high risk and not prioritized. This is even more prominent when making green investments in high-risk countries. The EU should thus continue to investigate new and innovative financing and risk-sharing measures.

Collaboration: Unnecessary to say, collaboration on all levels is key to reaching sustainability goals. This includes collaboration both within and between business, the financial and the public sector, and, most importantly, across borders. We thus welcome the increased focus on global collaboration in the renewed EU sustainable finance strategy. Climate change and environmental degradation are global problems, and international collaboration and standardisation of measures are essential to solving these issues.

TRANSITION SCENARIO IMPACTS AND PRIORITIES



SARAH BREEDON

Executive Director, UK Deposit Takers Supervision -
Bank of England

Navigating through uncertainty – climate scenario analysis in the financial sector

What happens when you have a destination but are not sure how to get there? You probably open an app on your phone and let it work out the fastest route. But then you remember you will need to stop to refuel. And to take a break. And so your route needs to adjust accordingly.

With climate change we have our destination – net-zero greenhouse gas emissions by 2050 and temperatures below 1.5°C – but we do not know the exact route yet. We do though know that whatever route – or transition path – we end up facing, the financial sector will have to deal with the consequences and play its part in smoothing the adjustment for the economy.

To do that, firms need to understand how different climate outcomes and different transition pathways will impact their business. That will enable them to identify both risks and opportunities. Scenario analysis is the key tool for making these assessments, helping navigate through uncertainty by considering a range of possible outcomes.

Climate scenario analysis is a core component of the Prudential Regulation Authority's (PRA) supervisory expectations for how banks and insurers should manage the financial risks from climate change. We expect firms to use scenario analysis to inform both strategic planning and risk management. And recognising this is still a relatively new field where some firms may not know where to begin, the Climate Financial Risk Forum – an industry group co-chaired by the PRA and Financial Conduct Authority – has produced a series of freely available practical guides and tools.¹

Firms are therefore well supported in undertaking such analyses, increasing with sophistication over time. There is a natural temptation to become bogged down in achieving a spurious level of precision over multi-decade horizons. This can be unhelpful and unnecessary for decision-making. Sound qualitative assessments supported by quantitative analysis and reasonable assumptions where there are data gaps can produce insightful results.

Designing the climate scenarios which plot the transmission of the physical and transition risks that arise from climate change into economic and financial risks is fiendishly complicated. The data and methodologies to translate climate outcomes into macroeconomic and financial risks are incomplete and

inadequate. And of course the future path of climate risks themselves is subject to huge uncertainty. Reflecting these challenges, the Macrofinancial workstream of the central banks & supervisors Network for Greening the Financial System (NGFS) has launched a project to co-design climate scenarios with a consortium of world leading climate scientists. The latest iteration of these climate scenarios was published last summer.² We have learned some valuable lessons along the way.

First, we have a clear picture of where greenhouse gas emissions come from across the economy – so we know what the building blocks of the transition are.

Second, we have learned that the cost to the economy in aggregate of getting to net zero need not be substantial. Our latest economic modelling suggests that reaching net zero might have a small or negligible effect on economic aggregates such as GDP, unemployment and inflation if the transition is managed well – so while we know we need to be prepared for a range of outcomes, we also know that that early action brings lower risks.

Third, even in an orderly transition, the impacts from physical risks are expected to be significant – so we must focus on the race to climate resilience as well as the race to net zero.

That calls for action. At the Bank of England, we are pursuing our own scenario work based on those of the NGFS. In June 2021, we launched the Climate Biennial Exploratory Scenario exercise to assess the resiliency of major UK banks, insurers, and the wider financial system to different climate scenarios. Participating firms have made their submissions and we are in the process of reviewing the results prior to publication by May 2022.

The Bank of England will continue to support the development of climate scenarios and their use across the financial sector, to improve risk management, resiliency, and help navigate the risks and opportunities along the route to net-zero. And by embracing scenario analysis, the financial sector will be better equipped to take the actions that are needed today to reduce the risks of tomorrow.

1. *Climate Financial Risk Forum*
2. *NGFS Phase II Scenarios*



LAURENT MIGNON

Chairman of the Management Board
and Chief Executive Officer - Groupe BPCE

Banks ready to seize the opportunity for environmental transition

All economic actors need to transition their carbon-emitting activities, as only “green” or neutral activities will survive. For the real economy, this requests upfront significant investments, beyond any public possible efforts, and a longer-term strategic approach.

Financial players, as reliable and expert partners of Corporates, retail clients and investors, play a key role to advise them and finance their transition, even more effective as their own transition risk is their clients’ transition risks.

Public authorities need to provide with the adequate regulatory framework to speed the transition while ensuring a fair transition. European authorities have issued a series of useful texts: a common definition of what is a sustainable activity (Taxonomy regulation), disclosure frameworks to enhance transparency and prevent green washing (CSRD, SFDR...), ESG financial products frameworks (labels, ESG client preferences...) and more recently measures to change the supply and demand equilibrium in different sectors like car selling restrictions or reforestation. Public acceptance is also a major concern. The Commission’s initiative to launch a social fund is much welcome to ensure a fair transition.

This is only the beginning. All companies including banks, understand the transition to be a forward-looking way to manage risks, to reduce future costs, ideally undertaken in advance of regulatory/political constraints. It is much more a business opportunity than an economic burden.

Banks’ signature of the Net-Zero Banking Alliance bears witness to this commitment.

French banks already entered transition initiatives. For instance, they took commitments to end coal-related and reduce unconventional fossil fuel financings. BPCE is among the first main green bonds global issuers and has been successfully promoting an attractive financing package to ease the energy renovation of condominiums and of households for senior or low-income population.

We need pragmatic tools to go further. We need available and reliable data. Timing differences, lack of consistency between EU regulations, lack of data for non-EU or small activities... are creating a huge issue for companies to fulfill their obligations. They are forced to use proxies and external providers leading to different results.

We also need an instrument to better recognize the transition efforts, as the heterogeneity of the ESG results and practices is undermining the confidence of all stakeholders. Confidence and transparency go hand in hand in this process.

We very much welcome recent developments to better take into account transition (looking at the evolution of the GAR, transitional and enabling activities, green Capex ...) but this remains far too complex to explain and understand for non-specialists. It may create confusion and undermine the retail market’s trust in sustainable regulations.

Moreover, it keeps not sufficiently promoting the transition efforts that companies undertake, particularly needed for harmful activities: a company might need to invest in a 20 years-project to replace one harmful activity by another. If its commitment is very strong, it is key that the regulatory framework recognizes the harmful activity as being in transition and not shaming it, which would undermine its ability to enter a fair transition by increasing its cost of financing. The idea is to allow profitable activities to finance upskilling and needed infrastructures, to decrease their emissions on the harmful side during this interim period.

**Transition cannot wait.
Banks are totally involved in this
challenge alongside with their clients.**

To effectively redirect capital flows towards the transition, we need first a common methodology to assess the transition plans and communication of our portfolio alignment. We also need a simple and comparable ratio measuring the company’s transition plans. This transition ratio would also be reflected in financial products like the green ratio. French banks are looking at using a common methodology, based on international sectorial trajectories to assess the transition of company’s activities. A third party would assess these transition plans and produce this Transition Ratio used in all investments like the green ratio.

Transition cannot wait. Public initiatives will be key to ensure a fair transition. Banks are totally involved in this challenge alongside with their clients to find pragmatic and effective solutions.



SUSAN REVELL

Deputy Chair and General Counsel, EMEA
BNY Mellon

Enabling the transition in an imperfect data environment

When the COP26 conference took place in Glasgow in November 2021, there was a strange feeling of déjà vu. The Paris conference in 2015 had laid the foundation for a global commitment to keep rising temperatures in check but the years since were mostly spent on other priorities. And so, Glasgow was an opportunity to re-affirm commitments, to confirm net zero transition goals (with varying timelines) and spell out the pathways to getting there.

From the perspective of the financial sector, the relevance of sustainability and responsible investments has followed a more stable path. We have seen an increasing investor appetite for green and sustainable investment products. Rather than being driven by altruistic motives, financial performance – and indeed financial outperformance – has been a key reason why investors have become attracted to this space. As an example, BNY Mellon research¹ demonstrates that financial outperformance is 21% more likely in gender-diverse companies, and 33% more likely in ethnically diverse firms.

Since 2019 we have also seen a regulatory focus on risks driven by climate change. And on the legislative side, Europe has led the charge requiring transparency through the implementation of the Sustainable Finance Reporting Directive (SFDR) and the introduction of the EU Green Taxonomy which was rolled out earlier in 2022.

The challenge with these requirements has not been the sectors' willingness to embrace and implement the initiatives but rather an incomplete external data landscape. Reporting on investment products and their sustainability credentials, and crucially their principal adverse impacts on other sustainability indicators, is complex in a world where the underlying securities' detailed corporate information is often lacking. We often hear about the need for consistent and comparable scope 3 emission data – data associated with indirect corporate carbon emissions (e.g., business travel by staff), but recent research has shown that many corporates are even failing at making scope 1 & 2 emission data widely available². In that context, the financial services industry is the tail that tries to wag the dog. Our responsibility to investors and regulators requires more transparency around investments in corporates that are not themselves obliged, or able, to be transparent around their own sustainability indicators. In that context, the decision to set up the International Sustainability Standards Board is very welcome – another reason to cheer the outcome of the Glasgow COP26 summit – but it will take some time yet for consistent standards and sufficiently rich sustainability data to become available.

There is however no excuse for our sector to throw their arms up. As corporations, we should explain our own

commitments and indicators and lead by example in creating credible transition pathways and indicators. More importantly, we can support the real economy by accompanying their transition plans through financing and servicing of investments, supporting green debt issuance, but also through providing data and analytics capabilities. The goal for the financial industry, which includes both public and private sector stakeholders, is to lead the transition by supporting our clients and the global scale innovation needed to deliver the new technologies required to meet the Paris Agreement goals in a diminishing timeframe.

**The focus needs to be
on facilitating and accelerating
the 'transitioning' process.**

In that process, it is important to avoid simply leaving sector and company assets behind, thus creating stranded assets or moving them into the less or even unregulated sector. The focus needs to be on facilitating and accelerating the 'transitioning' process. And in assessing our own portfolios, in risk managing our own assets, we need to be careful not to allow a simple switching out of "brown" assets to "green" assets. In that context, I welcome the Commission's announcement in July 2021 – as part of their renewed sustainable finance strategy – to work on a 'transition taxonomy' that would recognise interim transition efforts by companies. Such an approach should set the standard for other jurisdictions to follow and could prove another key milestone in our joint path to net zero.

[1] <https://futurefirstforum.bnymellon.com/pdf/F3-RecapArticle.PDF>

[2] https://www.tcfhub.org/wp-content/uploads/2021/10/PAT_Measuring_Portfolio_Alignment_Technical_Considerations.pdf



KATSUNORI YOKOMAKU

Deputy Regional Executive for EMEA
MUFG Bank, Ltd.

The responsible road to COP27

The end goal of the transition to a net zero world has been committed to by more than 450 financial institutions during COP26 in Glasgow. The financial world directs USD 130 trillion to net zero by 2050. There is no turning back now. The next significant milestone of progress will be reported by COP27 in November of this year. All financial institutions member of GFANZ, are working to further define their existing ESG ambitions and make them concrete, credible and consistent with industry best practices. The world is watching.

Banks' role facilitating transitional pathways

Banks have and will continue to play a crucial role in financing the economy. They also help providing solutions for social issues and can help build a sustainable society where clients can achieve sustainable growth. For banks operating globally, sustainable strategies will have to reflect the interests of all stakeholders; national policy makers, central banks, the industry, regulators as well as the public. Each economy has their own starting point, their own energy mix and their own unique incentives and ability to transition to a net zero world. Most banks support a wide range of companies and industries, including those in areas which are reliant on oil, gas and even coal for the most basic needs of heat, food and shelter. This will not change overnight. The key for these sectors is to become more energy efficient and banks can encourage these efforts by adjusting their individual ESG policies and procedures. However, they must do so in a responsible manner to ensure the energy transition runs a smooth course without unnecessary disruption to the financial system and the real economy.

Policy and Regulatory framework and the transition

Transition Financing has become the key focus of the private sector, but also policymakers and regulators. The EU taxonomy was an important first attempt to draw a clear line between which economic activity is sustainable and which is not, but it is important that we continue to ensure that the regulatory framework remains open to allowing for transitional activities. Regional sectorial pathways will become a key focus across all jurisdictions and we will have a better picture about how credible these pathways will be due to improved reporting, enhanced risk management and more coherent public policy frameworks. And while climate change is a global phenomenon, the dynamic nature of ESG risk and opportunities - and the dynamic nature of the transition - in local markets will need to be taken into consideration when assessing progress of individual financial institutions.

It cannot be said enough; we need all regions on board and we cannot afford to leave anyone behind. We have seen a strong

commitment from the financial services industry to find a global policy and regulatory framework for a global problem and we need to prevent fragmentation along jurisdictional lines. At the same time, this ambition does not mean we cannot provide flexibility for local market dynamics, which will need to take into consideration technical innovation in energy efficiency, energy consumption patterns and market dynamics in new energy sectors.

A set of principles for Transition Financing will be essential to facilitate pathways to net zero.

Working together to support the transition

Achieving net zero targets, even with the resources, talent and technology available today, is going to be a tremendous challenge. We need to recognize that an orderly transition to a net zero society requires a huge sum of money reoriented to "hard to abate" sectors, the expectation is that private banks provide the funds to reduce GHG emissions of these sectors (e.g. oil & gas). Societies at large need to work together to explore opportunities for new energy solutions and the financial sector remains key to provide financing for the transition. In the context of the Net Zero Banking Alliance, our bank is leading the work to put together transition finance principles which form the global baseline for steering a responsible road to decarbonized banking, allowing for a credible framework on the road to Sharm El Sheih.

GLOBAL ESG REPORTING STANDARDS: CONSISTENCY AND GREENWASHING RISKS



**SYLVIE
GOULARD**

Second Deputy Governor -
Banque de France

The ISSB should provide a comprehensive baseline to ensure a level-playing field

As highlighted by the outcome of the public consultations run by the European Commission and the IFRS Foundation prior to their recent disclosure initiatives, there is a strong demand from investors, public authorities, regulators and civil society for high-quality information from businesses about environment, social and governance (ESG) matters. This information is crucial to assess the extent to which companies are exposed to ESG risks and to hold executives accountable for the ESG impacts of their companies' activities.

Indeed, similarly to financial risks, ESG issues have global implications that require policy coordination at a global level. In this respect, all Member States of the United Nations have pledged their support for the Sustainable Development Goals. However, in order to ensure consistency in policy implementation

worldwide, it is critical that jurisdictions further agree on a common language to describe and measure ESG risks and impacts. We must hence aim at a minimum set of highly comparable international key ESG metrics.

Failure to coordinate a coherent international ESG disclosure framework would result in the multiplication of competing regional initiatives, leading to fragmented disclosure requirements. Comparability across reporting standards is required to avert the risks of greenwashing and confusion for the users of ESG data, including consumers, investors, NGOs and scientists. Fragmentation could also raise level-playing field issues across jurisdictions and increase the red tape for international companies.

Therefore, we support the initiative from the IFRS Foundation to provide a global baseline for high-quality ESG disclosure requirement and strongly encourage the International Sustainability Standard Board (ISSB) to pursue swiftly an ambitious standard-setting agenda covering all ESG dimensions with a building-block approach. One of the main expected challenges to build minimum consistency globally stems from the risk that the ISSB may lag behind the expectations from some jurisdictions that are adopting ambitious action plans in order to promote sustainable growth. The building-block approach will however enable policymakers to add complementary components to the baseline without harming comparability.

**It is critical that
jurisdictions agree on
a common language to
disclose ESG risks
and impacts.**

Meanwhile, we also support the work undertaken by the European Financial Reporting Advisory Group (EFRAG) to devise European Sustainability Reporting Standards consistent with the international baseline set out by the ISSB. These standards will provide the additional disclosures necessary to achieve the specific policy objectives laid down in the European Commission's Sustainable Finance Strategy. Even if

its own strategy is more ambitious, the European Union is committed towards a global disclosure framework and remains the first contributor to the IFRS Foundation's voluntary funding scheme. Another hurdle to overcome is the materiality assessment that companies are required to carry out in order to determine which information is relevant to their stakeholders and, consequently, should be disclosed. While in some jurisdictions (e.g. US), materiality assessment may be anchored in the legal framework and subject to judicial scrutiny, leaving little room for a globally harmonised approach, from our standpoint, it is however critical to stick to a double materiality perspective encompassing the impacts of economic activities on the environment and the people.

There is no miracle recipe to ensure international convergence as the latter rests on extensive engagement to reach a shared and mutual understanding.

The standards issued by the ISSB should become the global common baseline while providing the flexibility to implement complementary disclosure requirements essential to meet local policy needs. The baseline should however be comprehensive enough to ensure a level-playing field globally and circumvent the risks of dumping. Issues such as gender equality, environmental preservation or the rights of ethnic minorities are just as relevant all-over-the-world as they are in Europe. ESG standards are not superfluous as they ensure human dignity and fairness worldwide.

Let us also keep in mind that high quality disclosure standards should go along robust enforcement mechanisms in order to ensure that disclosures are reliable, exhaustive and understandable. In that regard, ESG and financial information should be put on an equal footing. ESG information ought to be audited and the governance bodies and management should be held liable for failure to publish comprehensive and accurate information. In addition, the mandate of securities market, banking and insurance supervisors could be broadened to monitor the consistent implementation of the standards. Finally, a key feature of success will be that the standard-setting bodies including the ISSB and EFRAG establish and maintain the appropriate fora to discuss interpretation issues arising from the implementation of their standards.



CYRIL ROUX

Deputy Chief
Executive Officer -
Groupama

ESG standards are an issue of sovereignty for Europe

To define ESG standards is to define corporate standards of conduct. Different polities will have different expectations for the firms operating in their jurisdictions. Let's take a few examples. Corporate social responsibility, embedded in the S of ESG, encompasses workforce composition. Some aspects of this may be settled, such as gender equality. Other aspects are more fraught however, such as race equality. In the USA, it can be measured and reported, as people are used to declare their race or ethnicity. And race equality in the workforce can be increased numerically through affirmative action. In France by contrast racial statistics are outlawed, and affirmative action goes against constitutional principles. So French firms will be hard pressed to quantify the degree of racial equality in their workforce as measured by American standards. The World Economic Forum suggests measuring diversity or participation of lower represented groups, leaving open the specifics, and shying away from mentioning race or ethnicity explicitly. This may be wise indeed.

Other issues of social responsibility are just as vexed. It's easy in principle

to condemn firms working in countries trampling on human rights or sponsoring terrorism, but it is unlikely that we will agree on the list of those countries. Certainly, the lists drawn in Washington, Brussels, Beijing, Pretoria and Abu Dhabi will very much differ. There is scope to sidestep the widest differences on the blacklisted jurisdictions by concentrating on child and forced labor, and conviction for corruptions, but only to a degree. So, the difficulty in agreeing on corporate responsibility standards in this instance, and quite a few others, is not primarily a measurement problem, nor an issue of data availability, or a question of engineering the right metrics. It is first and foremost an issue of politics and civilization.

My last instance will be the most openly and fiercely debated of the last few months. Energy production and consumption is at the heart of sustainability. Finding common ground on which sources of energy should be used by responsible firms is paramount for the whole ESG project. But in this instance even intra-regional differences are stark. Europe is severely torn between countries which tout nuclear energy as part of the solution to climate change, and those countries that would rather use local coal, or accept dependency on the fossil fuels of foreign regimes for decades to come, than put European people at risk of another Chernobyl or Fukushima.

The European Union must define its own ESG standards.

Most Frenchmen would find no issue with the metrics around carbon or emission of GHG. But as the EU debate on taxonomy makes clear, finding common ground what is and what isn't green energy will be hard enough within Europe. Certainly, a world where French industries would show poor regional or global ESG metrics because of their use of nuclear-based electricity is unlikely to be accepted by French authorities.

In addressing the difference in views on what constitute proper corporate behavior, we may choose the lowest common denominator in order to define global standards. There is very good work done in this spirit by the World Economic Forum. This would not preclude additional, more stringent or more specific rules on a regional basis. Alternatively, we may choose to

recognize as equivalent several regional standards. This would recognize that there are optimal areas for agreement on specific standards, in the same way that there are optimal currency areas, and that the globe is too wide and diverse to be one in itself. What I think the European Union must not do is to abdicate its worldview and adopt purported global standards at odds with it, or worse still, flag its intention to adopt yet unspecified standards. Sovereign countries such as the USA or China will not do so; the European Union must be as resolute in asserting its values, in defining what it expects or require from European companies, and not relinquish its sovereignty on the matter.

The adoption of global standards sight unseen is either naïve or fatalist. It would be the course of action most likely to leave Europe as the sole region not making its own corporate rules. There is more than enough contestation of democratic deficit already in Europe to worsen the situation in this manner.

A last word of caution is needed about the interplay between this debate and international trade. The European Union can no longer expect the ratification by European member states of bilateral trade agreements with countries in which companies behave in a way unsanctioned in the EU. European citizens no longer accept trade agreements opening the single market to foreign firms which contribute to deforestation, release massive amounts of GHG, or follow health and safety standards way below those imposed on European firms. It would be wise for EU representatives to keep this in mind when negotiating the international architecture of ESG standards.



ALEXANDRA JOUR- SCHROEDER

Deputy Director General -
DG for Financial Stability,
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European Commission

Towards interoperability of sustainability reporting frameworks

The Corporate Sustainability Reporting Directive (CSRD) proposal aims to improve sustainability information disclosed by corporates. It takes a comprehensive approach, including a wider coverage of companies than is currently the case, the introduction of an assurance requirement, and the digitalisation of sustainability information. The centrepiece of the proposal, however, is the introduction of mandatory EU sustainability reporting standards.

EU standards must be coherent with the EU's political ambitions and with our existing framework for sustainable finance. From the onset, EU standards will cover all ESG topics, including but not limited to climate, under both materiality perspectives: how sustainability issues create risks and opportunities for the company, and

an objective account of the company's own impacts on people and the environment. To ensure coherence with the EU legal framework the information companies report must be aligned with the information investors need under the EU's Taxonomy Regulation and the Sustainable Finance Disclosure Regulation. From a financial markets perspective, investors increasingly need sustainability information. Ambitious sustainability reporting frameworks will ensure that companies listed in the EU disclose all material information that investors need. We expect similar trends in investor expectations in capital markets across the world. Europe is leading the way on many of these issues – but we know we cannot do it alone, which is why we continue to place a high priority on our cooperation with global partners.

Companies need to be encouraged to switch corporate decision-making to a more long-term and stakeholder oriented, "sustainability mind-set", starting at the strategic level. We need to increase transparency in the market place about the sustainability performance of companies including via additional reporting requirements. Such transparency will allow companies to signal their transition efforts to investors.

**We will build on
what exists seeking
in principle global
alignment while meeting
EU's specific needs.**

The Commission strongly welcomes efforts to create more alignment of ESG reporting standards at global level. The Commission supports the IFRS Foundation's plans to create a global baseline of sustainability reporting standards under the recently established International Sustainability Standard Board (ISSB). The ISSB standards should be a useful foundation on which we can build according to the EU's ambitious political priorities and legal framework.

The Commission is also closely looking at ESG reporting frameworks being developed in other jurisdictions. The US Securities and Exchange Commission (US SEC), for example, is currently working on a proposal on disclosure rules on climate and some other issues.

Cooperation between global and regional standards-setters is key to

assure coherence and interoperability between reporting frameworks. We welcome the fact that the International Financial Reporting Standards Foundation (IFRS Foundation) is considering mechanisms for how the ISSB will interact with standard-setters at jurisdictional level. In charge of developing draft sustainability reporting standards, the European Financial Reporting Advisory Group (EFRAG) has already established close technical cooperation with the IFRS Foundation. Overall, we see global and jurisdictional interaction as a two-way process. EFRAG has put forward the concept of "co-construction" to describe this.

The EFRAG Project Task Force on EU standards has signed Statements of Cooperation with the Global Reporting Initiative, and with Shift, one of the leading authorities on the UN Guiding Principles on Business and Human Rights. EFRAG is also considering the disclosures originally developed by the Sustainability Accounting Standards Board (SASB).

There is already a lot of common ground for global coherence on sustainability reporting. For example, the CSRD proposal incorporates all the key elements of the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations and the work of the ISSB and the US SEC are also likely to refer to the TCFD Framework.

We also consider that an equivalence system may be a useful tool. The CSRD proposal envisages the possibility of granting equivalence to the sustainability reporting rules of other countries. The equivalence system would be developed by the Commission in due time, once the CSRD proposal becomes law, but it is clear that there has to be an appropriate level of convergence of measures and ambitions to deliver an equivalence system.

The European Commission fully supports the goal of greater global alignment of sustainability reporting standards. It will build on them and seek as much global alignment as possible. However, global standards should be a common floor, not a ceiling. They should be flexible enough to accommodate the need for different jurisdictions to go further and faster according to their own priorities.



TRACEY MCDERMOTT

Group Head – Conduct,
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Chartered Bank

Consistent disclosure standards are critical to mobilising ESG finance

The message from 2021 is that we need to take urgent action to prevent further irreversible damage to our environment. The cost of action is outweighed by the cost of inaction, in terms of the impact to our economies, societies and households.

Despite encouraging progress and growing climate ambition laid out at COP26 in Glasgow last November, we need greater sustainable investment to deliver the goals of the Paris Agreement and more broadly the UN's Sustainable Development Goals (SDGs). This is particularly true for emerging markets, which continue to face growing shortfalls in the private capital needed to meet their investment needs.

Disclosures are a critical tool in scaling investment in the fight against climate change and the delivery of sustainable development globally. They allow the pricing of externalities, such as greenhouse gas emissions. They facilitate the

effective allocation of capital and more informed decision-making in terms of strategy and risk management to achieve more sustainable, long-term growth. In this sense, disclosures are not just about transparency, they are transformational.

This potential is recognised in both the public and private sectors.

Our Zeronomics report (<https://www.sc.com/en/insights/zeronomics/>) found that 81% of senior managers from both multinationals and large domestic corporates believe standardised, globally consistent measurement and reporting standards would help accelerate their net zero plans. High-quality, comparable, and reliable data enhances the assessment of sustainability-related risks and opportunities. Furthermore, it provides a common language to measure and report on society's progress towards sustainability.

In the public sector, policymakers globally are active in developing these standards. However, in October 2021 the G20 Sustainable Finance Working Group roadmap stressed the challenge of inconsistent and fragmented sustainability-related disclosures and highlighted the need to improve international coordination.

**Disclosures are not just
about transparency, they
are transformational.**

To achieve this, COP26 saw the official launch of the IFRS Foundation's International Sustainability Standard Board (ISSB). We support its building blocks approach, aimed at providing a global sustainability reporting baseline while providing coordination on additional jurisdictional reporting requirements. This promotes greater comparability and consistency. Some degree of flexibility alongside a global standard is understandable, particularly for social and governance factors of 'ESG' which are context and location specific.

But the global standard needs to form the baseline.

As a bank operating in around 60 markets, we are used to a certain amount of divergence across jurisdictions. Regulatory-driven fragmentation, however, needs to be avoided as it risks hampering the rapid scaling of sustainable investment and

the channelling of capital to where it is needed most. It forms barriers to market entry, confuses those who actually use the data and disclosures, and damages the attractiveness of the market.

The solution is proportionate regulation and better international cooperation. Coordination should focus on the development of common principles that promote interoperable standards, which can be applied across all jurisdictions while providing for the different transition trajectories toward net zero of individual markets. Such an approach would support standardisation by defining key metrics, while its associated variation in threshold levels would help address regional heterogeneity in green qualification and reduce the risk of greenwashing.

We are committed to ensuring sustainable capital reaches the regions where it is needed the most. COP26 showcased the extraordinary support from the private sector, and its importance in creating the enabling policy to reach this goal. I am proud to chair the Net Zero Banking Alliance, which is promoting standardised approaches and shared tools for transition across the banking sector, and Standard Chartered published its own net zero strategy last year [<https://www.sc.com/en/sustainability/net-zero/>].

The unprecedented effort of the financial sector in helping the world transition needs to be supported by enabling policies that facilitate and incentivise cross-border finance, in addition to managing risk and ensuring stakeholder transparency. Let us build together a framework that allows the financial sector to support the transition not only in developed markets, but globally. Otherwise, we will fall a long way short of what is needed.



EMMA CRYSTAL

Chief Sustainability Officer -
Credit Suisse

Consistent ESG disclosure is required to advance the transition agenda

The scale, complexity and urgency required to tackle the climate and nature crises demand unprecedented global action. Addressing these challenges and delivering more generally on the UN Sustainable Development Goals to enable human well-being will involve renewable energy, infrastructure investment, sustainable agriculture, ecosystem restoration, and many other innovative measures. In this context, regulatory fragmentation in sustainable finance policy appears as a key risk and potential impediment to the development of innovative and scalable solutions. Moreover, the lack of consistent, comparable, and quality data on sustainability factors is a major hindrance to advancing the sustainable finance agenda and as a result the transition to Net Zero.

We believe that ESG disclosure requirements are a fundamental enabling and supporting tool in the race to Net Zero. However, for this tool to deliver its full potential, ESG disclosures should be internationally aligned, built on existing standards (e.g., TCFD, GRI, SASB), and applied to financial and non-finan-

cial participants alike, to provide investors and the public with the required transparency to efficiently guide investment decisions towards the transition to a low-carbon economy and prevent greenwashing. Accordingly, we strongly support the International Sustainability Standards Board (ISSB) developing a comprehensive global baseline of sustainability-related disclosure standards and welcome EFRAG's commitment to working with the ISSB to 'co-construct' those standards.

While each country, firm, investor, and individual understandably pursues its own sustainability journey, to have a common language in sustainable finance would be an invaluable help to make the sustainable finance market more transparent and channel capital more efficiently into sustainable investments. Today, the proliferation of ESG reporting frameworks across the globe, though being a clear signal of progress and interest in the field of sustainability, threatens to overwhelm investors and reporters. As a financial institution operating globally, we are facing various mandatory ESG disclosure requirements in different jurisdictions, reflecting local specificities and policy priorities, and necessitating the mobilization of substantial resources to ensure compliance.

Clarity and transparency, both at firm and product-level, are crucial for investors and the public.

The complexity of having to establish tailored ESG reporting systems for each jurisdiction risks being further exacerbated if jurisdictions develop rules with extraterritorial application as is the case with the EU Corporate Sustainability Reporting Directive (CSRD) proposal. We are concerned by the extraterritorial reach of the CSRD, which would require many non-EU financial institutions to comply with the EU sustainability reporting requirements at the level of their group consolidated reporting for their entire portfolio across the group operations, including in third countries.

Beyond the practical and operational challenges of complying with the CSRD and related EU Taxonomy disclosures with respect to activities and exposures outside the EU, this extraterritorial approach would require international firms to produce several consolidated sustainability reports according to different sets of rules; thus, increasing

the complexity of transparency towards end-investors who will have to consider several sustainability reports for the same issuer. We therefore hope to see the rapid development and establishment of the ISSB Sustainability Disclosure Standards, which should allow jurisdictions to defer to other countries' disclosures if they are aligned with those standards.

To navigate the increasingly complex sustainable investment landscape, clarity and transparency, both at firm and product-level, are crucial for investors and the public. With this in view, we believe that sustainable finance rules and regulations should be aligned to the greatest extent possible, including the development of taxonomies for the classification on sustainable economic activities. Moreover, it is important to ensure that ESG ratings providers are subject to appropriate oversight and harmonized requirements to improve the transparency of the methodologies, information and assumptions they use, which are currently lacking consistency and leading to disparate ratings. Wherever possible, we prefer the selection of measurable KPIs as opposed to more subjective expert-based assessments which may vary from one ESG rating provider to the other.

In this respect we welcome the recent IOSCO recommendations for ESG ratings and data products providers as a step in the right direction to improve the quality and transparency of ESG ratings, which are widely used to evaluate the sustainability of assets and to value the products and sectors that orbit the growing ESG investing space.



We thank the **French EU Council Presidency** and **the partner institutions** for their support to the organisation of the Eurofi Paris Seminar



CORPORATE SUSTAINABILITY REPORTING CHALLENGES IN THE EU



SÉBASTIEN RASPILLER

Assistant Secretary,
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ESG Data, a prerequisite for achieving the transition

The European Union has embarked on an ambitious social and environmental agenda for the upcoming decades. On the climate side alone, in order to succeed in containing the temperature rise of the planet below 1.5°C, in accordance with the Paris Agreement, the EU vowed to decreasing its emissions by 55% by 2030 and achieving carbon neutrality by 2050. These public policy objectives require adequate data from the real economy, so as to be able to assess the cost involved, steer the transition and track the progress made. Against this backdrop, the European Commission published on 6 July, 2021 its Strategy for financing the transition to a sustainable economy, which complements and updates the 2018 Action Plan on financing sustainable growth.

As part of this roadmap, the EU has been developing a holistic framework for ESG data, ranging from the establishment of a European green Taxonomy, which provides a clear definition of sustainable economic activities, to introducing some first ESG disclosure requirements for investors and, lately, an overhaul of corporate sustainability reporting, through the ongoing revision of the non-financial reporting directive.

The EU Taxonomy, the metric system for sustainability

In June 2020, the EU adopted the Taxonomy Regulation, an EU-wide classification system for sustainable economic activities. Sustainability is assessed across the economic activities contribution to six environmental objectives, two of them being climate objectives (climate change mitigation, climate change adaptation), while the rest covers water and marine resources, circular economy, pollution and biodiversity. Also, a sustainable economic activity should do no significant harm to any of these objectives - this is the so-called DNSH principle - and meet some minimal social safeguards. Developing such holistic and science-based instrument was made necessary by the complexity and multidimensional nature of environmental challenges.

European sustainability standards will allow to capture the ever-evolving nature of ESG information.

In practical terms, it is a powerful tool to avoid greenwashing: it allows to make sure that resources invested in sustainable financial products truly contribute to financing the transition and, thereby, that promises made to investors are fulfilled. It entails a whole range of disclosure requirements for companies, who will have to report on the alignment of their economic activities on the Taxonomy, as well as for market players, including for the financial products they distribute. From this year 2022, as the Taxonomy enters into application, climate data will start to flow through the investors and corporates ESG disclosures, made mandatory in particular by SFDR and CSRD.

Investors Disclosure, Corporate Sustainability Reporting

In November 2019, the EU adopted the Sustainable Finance Disclosure Regulation, known as “SFDR” or “Disclosure Regulation”. This piece of legislation requires that financial market participants disclose ESG data to investors, both at the entity and financial products levels. The information provided, such as the Principal Adverse Impacts (PAI) for example, will be harmonized through templates proposed by the European Supervisory Agencies and soon to be adopted by the Commission: the so-called Regulatory Technical Standards, which will enter into application on 1 January, 2023. In the meantime, the EU is negotiating the Corporate Sustainability Reporting Directive (CSRD), which aims to provide a clear and renewed framework for sustainability reporting published by corporates. Companies in the scope of the directive, which should be extended from the 2014 framework under NFRD, will publish sustainability information annually, in line with EU sustainability standards, so as to harmonize ESG data and improve their quality.

The reporting will cover the full spectrum of ESG factors and comply with the principle of double materiality, whereby the company must take into consideration not only the financial materiality but also the impact of its activities on the environment and society. The audit of these reporting will be made mandatory, a key step to ensure the reliability of ESG data. Last, alongside the European Single Access Point (ESAP) project, CSRD aims to make ESG data digital, and easily - and freely for the vast bulk - accessible through a common public database.

Next steps and challenges

European sustainability standards will allow to capture the complexity and ever-evolving nature of ESG information, through a dynamic process of standard-setting by the EFRAG, involving wide consultation of stakeholders and taking into consideration the sectoral dimension of companies. Global convergence of standards will be sought through active collaboration between the EFRAG and other initiatives, including the International Sustainability Standards Board (ISSB) recently established by the IFRS Foundation.



ARNE STAAL

Group Head of Benchmarks and Indices - London Stock Exchange Group (LSEG) & Chief Executive Officer - FTSE Russell

Accelerating towards net-zero – supporting the economy in the climate transition

In the coming years, greening our economies is one of the greatest challenges we face. To address it, a substantial amount of capital is required to finance the journey to net zero by 2050, and there remains significant progress to be made. FTSE Russell research shows that only around 7% of the global equity market can be considered green based on its Green Revenues model.

The economy will not change overnight. But we need to fast track the transition if we are to meet the Paris Agreement objectives.

Sustainability-related information on business activities is still in short supply and difficult to compare. No common definitions currently exist for most environmental and social data points, and a lack of common reporting frameworks further complicates analysis of performance in these dimensions. Consequently, methodologies used by banks and investors to allocate capital

in line with sustainability targets often rely on arbitrary methodological choices and assumptions.

Tackling these issues requires swift action. Businesses need to go further and faster in developing and disclosing credible frameworks for managing climate-related risks and opportunities. That is why, in October, LSEG published climate reporting guidance to support our issuers in implementing the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD).

To be of greatest value to investors disclosures should include transition plans. The latest TCFD recommendations offer guidance in this area including FTSE Russell's research on investor-oriented carbon targets. Initiatives such as the TPI Global Climate Transition Centre to be launched this year will provide free and publicly available data on 10,000 companies' transition preparedness – can help investors with their assessments.

We also need to enhance understanding among companies as to how their sustainability practices and performance flow through to investment strategies or indexes. Transparent methodologies and initiatives like Climate Action 100+, which enable engagement between investors and companies, help to inform business leaders on the impact of sustainability performance on their cost of capital, and in turn incentivise alignment with sustainability objectives.

To be of greatest value to investors disclosures should include transition plans.

While the private sector has an important role to play in driving disclosure, governments need to develop sustainable finance policy frameworks at pace. Businesses should be required to make high quality sustainability-related disclosures on a mandatory basis. The EU is leading in this regard with its Corporate Sustainability Reporting Directive (CSRD), which will oblige 50,000 European companies to report on the integration of sustainability into their strategy, business models and governance from 2024.

Financial markets rely on a common language, and international coordina-

tion on sustainability reporting will be crucial. The global baseline reporting standards being developed by the International Sustainability Standards Board (ISSB) will make it much easier for companies to make meaningful disclosures, and for investors to conduct accurate assessments of their sustainability performance.

Beyond establishing relevant indicators, the ISSB should set out a clear definition of materiality to guide issuers in reporting relevant, industry-specific information. While some would suggest only tracking sustainability issues that are financially material to a company, under the notion of “double materiality”, the EU argues we should also consider companies' impacts on society and the environment. These two perspectives are reconcilable as the difference between financial and double materiality is often just about time horizons. What is material for society and the environment ultimately becomes financially material for the company in the long term.

The UK has already announced its intention to incorporate the ISSB standards into its upcoming Sustainability Disclosure Requirements – an approach that should ideally be adopted on a global basis. Divergent disclosure rules would create market fragmentation, impede cross-border capital flows and increase compliance costs for companies operating worldwide. The same logic applies when it comes to green taxonomies and, accordingly, the common-ground taxonomy work of the International Platform of Sustainable Finance is highly important. Although it may be a challenge to obtain perfect alignment between taxonomies, defining global high-level guiding principles drawing on the experience of the EU Taxonomy, and common environmental performance indicators for all taxonomies would be a solid foundation.

2022 is thus a milestone year for improving sustainability reporting. The shaping of reporting standards and the interoperability of taxonomies are crucial to obtain relevant data from businesses and efficiently support the transition to a sustainable global economy.



JULIA HAAKE

Managing Director for
Market Strategy -
MOODY'S ESG Solutions

Challenges around ideal ESG data sets and their importance in assessments

To make informed decisions on Environment, Social and Governance (ESG) related questions, financial market participants require a holistic understanding of corporate non-financial risk management and its real-world impact, including current, backward and forward-looking information and data. While ESG research providers have been producing data and analysis for almost three decades, there is a growing need for increasingly sophisticated and granular data in the responsible investment and sustainable finance community in light of complex and expanding set of topics and angles to cover, in addition to new regulatory demands.

There are several obstacles to overcome and some principles to follow in order to produce high-quality ESG data.

Standardized reporting: The more standardized corporate sustainability reporting is, the easier it is to build coherent and comparable sets of data. Much progress has been made on building a reporting ecosystem that reflects ESG risks and impacts - from the

Global Reporting Initiative, that now underpins European standard setting, to the Sustainability Accounting Standards Board and the International Integrated Reporting Council, now part of the IFRS Foundation's International Sustainability Standards Board. While these efforts are essential in creating a consistent and reliable foundation for ESG disclosure, they are still nascent and will need to grow into more coherent frameworks to facilitate the aggregation of data. It may also take a number of years before this foundational layer of disclosures across all ESG criteria are widely adopted, even as new disclosure standards are already pushing more and more companies to report, most notably in the EU through the Corporate Sustainability Reporting Directive (CSRD), but also increasingly across the world.

Data gaps: In addition to varying from one company to the other and using different calculations, corporate sustainability reporting is not a reality in all companies, especially in emerging economies and within smaller firms. In order to construct coherent ESG datasets, research providers thus face the challenge of how to fill gaps when companies don't disclose. One option is to leave gaps open and to attribute poor scores for non-disclosure. While this is an option for ESG scoring models, it doesn't help when looking to build coherent "raw data" sets. A second option is to use modelled data and advanced analytics, which however only produces reliable results if models use real world data on a given company (geographical location, size of company, etc.) and don't simply apply sector averages.

**There is a growing
need for increasingly
sophisticated and
granular data.**

How to look into the future?

There are two ways to forecast a company's future ESG performance. The first is quantitative: basing analysis on past evolution data, for example, when using climate scenarios. The second is through examining policies (human rights, supply chain risk management, etc), which can help to predict the extent to which a company may reduce its future negative impacts. ESG data also requires context. Narrative reporting analysis has always been a key component of a complete ESG assessment that complements

metrics and targets data. For example, expertise lies not merely in confirming whether a policy is in place, but also whether a policy has been implemented effectively.

Up to date assessment also needs to go further than looking into how a company manages its ESG risks through policies and implementation measures. Comprehensive ESG Assessments should also assess actual behaviours and incorporate controversies risk assessment data as they happen, providing a real-time adjustment to ESG scores.

In addition to analysing the basic sustainability framework and cross-sector ESG topics such as GHG emissions, percentage of women on board, human rights policies, etc., the thorough ESG analysis of a company must take into account sector specificities. E.g. What is the percentage of low-emission vehicles in the overall product portfolio of a car producer? How does an agribusiness / food company manage the use of pesticides? How does a textile & apparel company manage human rights or labour rights aspects in its supply chain?

In sum, while much progress has been made, the ESG data landscape is still evolving. Demands for greater usefulness of ESG data will prompt further scrutiny into disclosed information and encourage more innovation to help answer questions that stakeholders are seeking to answer.



ROMAN SAUER

Group Chief for Accounting and Reporting - Allianz SE & Member of the Board - EFRAG

Do or die: sustainability reporting urgently requires alignment & prioritization

Challenges like climate change, pandemics and cyber risk represent major structural changes for economies and firms alike. They are inherently global in nature and thus require international coordination and global solutions, including associated policy and regulatory architecture. However, policy frameworks were rather developed in parallel in recent years with a significant increase in the scope and volume of regulatory instruments being announced and implemented – especially in the area of sustainable finance.

The financial sector plays a crucial role in facilitating the economic transition towards a low-carbon, sustainable future. Yet, to fulfil this role, the availability, high quality and comparability of sustainability data is essential. Currently, users of sustainability data all over the world are struggling with a plethora of (upcoming) sustainability reporting frameworks and standards that do not enable comparable disclosures.

The standardization that has already taken place in financial reporting offers a blueprint for success. Therefore, the launch of the International Sustainability Standards Board (ISSB) and announced establishment of a “global baseline” for sustainability reporting is a critical milestone in the process to consolidate frameworks while building upon existing and proven standards (e.g. the recommendations of the FSB Task Force on Climate-Related Financial Disclosures (TCFD)). However, the journey towards common climate and broader sustainability disclosures is at an early stage and individual jurisdictional approaches developed in parallel to global standards generate transitional challenges.

In this context, we highly appreciate the EU Corporate Sustainability Reporting Directive (CSRD) to achieve fast progress on reporting while supporting ambitious wider policy priorities of the EU. The Directive will allow to streamline sustainability disclosure legislation at EU level, enable financial market participants to make better and more sustainable investment decisions and address data needs for other reporting requirements (e.g. EU Taxonomy Regulation, Sustainable Finance Disclosure Regulation (SFDR)). It is clear that the EU cannot wait for ultimate global standards considering the urgent need for action and the near-term application of several EU sustainable finance regulations.

It is of utmost importance that the EU engages closely with the ISSB.

However, it is of utmost importance that the EU engages closely with the ISSB to ensure full alignment and interoperability of the EU sustainability reporting framework with the ISSB’s global baseline. In order to facilitate a co-construction process, it is essential to start with a climate-focused, prioritized set of standards while other sustainability topics, including with view to any upcoming ESG challenges, are tackled step-by-step over the next years. Jurisdictional add-ons to meet regional specifics should only be included (as relevant) after final alignment on the global baseline.

However, a prevailing challenge remains that the integration of sustainability into business operations

of financial service providers (including risk management, transition plans, transparency, products) is required much earlier than the expected arrival of relevant corporate sustainability data. In order to bridge the gap, it is necessary to develop uniform approaches for proxying key variables, which are feasible to produce and accepted by supervisors.

The vision of globally aligned frameworks for sustainable finance is based on the common goal to mitigate global sustainability challenges while ensuring market integrity, efficiency and resilience for the benefit of market participants, the environment and ultimately society as a whole. In contrast, a permanent divergence of sustainable finance policy frameworks and reporting requirements creates an unlevel playing field. This would result in challenging implementation, coordination and prioritization issues for financial market participants, the real economy and regulators as well as a heightened risk of greenwashing and confusion for consumers. It could ultimately constrain efforts to scale up capital needed for a successful transition to a net-zero future – a price which the world cannot afford to pay.

We therefore need to ensure integrity in sustainable finance markets from a global perspective – this requires strong foundations, including high-quality, verifiable, and comparable global sustainability data – and the opportunity to act is now.



MARY SCHAPIRO

Vice Chair for Public Policy,
Special Advisor to the Founder
and Chairman - Bloomberg L.P.
& Head of the Task Force on
Climate-related Financial
Disclosures (TCFD) Secretariat

Seizing the net zero opportunity for financial services

It is abundantly clear that climate change is not only a scientific challenge, but also an economic one. Just as scientists have long warned of the catastrophic physical effects of rising global temperatures,¹ economists are sounding the alarm bells.

The risk is existential, but there is also opportunity. Recent analysis has demonstrated that the transition to net zero emissions could drive as much as 25 percent higher cumulative GDP growth over the next two decades alone,² turning this existential risk into an enormous commercial opportunity. The European Central Bank's economy-wide stress test also underlined that firms benefit from adopting green policies earlier rather than later.³

The question is how the financial sector will navigate and enable the transition.

The transition begins with disclosure. Without a view on how companies are managing climate change effects or portfolio net zero alignment, capital markets cannot accurately price the

financial impacts of a warming planet. Investor demand for consistent, comparable, and reliable data is rapidly growing, but there are still challenges to accessing quality data.

The Task Force on Climate-related Financial Disclosures (TCFD) was born as a solution to this problem. Established in 2015 by the G20's Financial Stability Board, the TCFD created recommendations for climate-related financial disclosures to promote more informed investing, lending, and insurance underwriting decisions. In 2017, the Task Force published voluntary disclosure recommendations and guidance focused on four thematic areas: governance, strategy, risk management, and metrics and targets.

Support for the TCFD framework has grown rapidly, reflecting a desire to improve the quality and quantity of reported data in the market. More than 3,000 organizations representing a market capitalization of \$28 trillion now support the TCFD recommendations. The G7 and G20 have endorsed the framework along with more than 110 regulators and government entities. At COP26, the International Financial Reporting Standards Foundation formed the International Sustainability Standards Board which will develop a global sustainability reporting standard based on the TCFD framework.

Climate change represents both risk and reward for the financial sector.

Europe has consistently led progress on improving disclosure: the EU was the first major region to introduce mandatory climate disclosure. Both the European Commission and European Financial Reporting Advisory Group are building upon the TCFD recommendations to create a unified set of mandatory sustainability reporting standards through the new Corporate Sustainability Reporting Directive's framework. These standards will be critical to helping investors assess climate and sustainability risks and opportunities, which in turn will direct capital towards long-term sustainable projects.

If we are to achieve the systemic change required, we also need coordinated action across the global financial system so that every financial decision takes climate into account. Governments and regulators need to work together

to ensure standards are derived from common baseline metrics and inputs from market participants.

The Glasgow Financial Alliance for Net Zero (GFANZ) was launched to coordinate and raise the financial sector's ambition on climate change. The alliance unites all sectors of the private financial system, covering banks, insurers, asset owners, asset managers, and service providers into one coalition. Today, over 450 financial institutions from 45 countries – across Europe, Latin America, and Asia – and representing over \$130tn in assets, are members of GFANZ. GFANZ members must adhere to the UN Race to Zero's criteria for inclusion, which means they have committed to using science-based guidelines to reach net-zero emissions by 2050 and have set 2030 interim targets that represent a fair share of the 50% decarbonization required by the end of the decade. Further, they must publish a net-zero transition strategy and commit to transparent reporting and accounting on progress against those targets.

This global initiative will drive much-needed consistency, science-based rigor, and public accountability in how financial institutions determine, disclose, and achieve progress against net zero targets. Together, GFANZ financial institutions are working with their clients to channel investment to green solutions, reduce emissions, and drive economic growth.

COP26 was a significant turning point as the private sector demonstrated their willingness to play a key role in fighting climate change. High-quality disclosures and credible net zero targets are key mechanisms to mobilizing private sector investment for sustainability. Ahead of COP27, and to meet the pace and urgency of the financial crisis, financial institutions and governments alike must deliver on their commitments. There is a tremendous opportunity to act in a way that benefits both business and our planet, and the financial sector in partnership with government is a catalyst to seizing the net zero opportunity.

1. https://www.ipcc.ch/site/assets/uploads/sites/2/2019/06/SR15_Full_Report_Low_Res.pdf (pg. 10, 12)
2. https://www.moody.com/sites/products/ProductAttachments/Moodys_ReadyOrNot.pdf (pg. 2)
3. <https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr210922~59ade4710b.en.html>



FABRICE DEMARIGNY

Global Head of Financial
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The challenges of reliable and comparable Corporate Sustainability Reporting

According to the proposed Corporate Sustainability Reporting Directive (CSRD) currently under legislative discussion, EU companies with more than 250 employees, listed companies (except listed micro-companies), and companies meeting the CSRD's turnover or balance sheet thresholds will have to integrate sustainability disclosures into the management report. This new corporate reporting dimension will include ESG data into investors' decision-making frameworks and boost the coverage of sustainability indicators across the Union.

A key feature of this new reporting framework is the concept of double materiality that obliges companies to measure both the impact of sustainability topics on the company itself as well as their impact on the environment, society, and the economy. This information will form part of an integrated set of information to provide users of that information with an overall understanding of the performance, the development, and the impact of

the company. In other words, to be meaningful, sustainability and financial information cannot be prepared into two parallel silos. Consistency of financial and sustainability information is a precondition for added value sustainability reporting. Such Integrated Reporting will bring together material information reflecting the commercial, financial, social, and environmental context within which the company operates.

The immediate practical challenge for companies will be to define, collect, process, and ensure the quality of the relevant information. Data availability, quality and comparability will then be essential. The CSRD will translate into EU standards that will help harmonizing transparency around data acquisition, materiality, aggregation, and metric weighting.

Once presented in accordance with the forthcoming sustainability reporting standards, information should be reliable and comparable. For that purpose, the CSRD, introduces the concept of assurance over sustainability reporting. The objective is also to prevent sustainability reporting from green or rainbow-washing suspicion.

**Reliable and comparable
sustainability
information needs
independent and high-
quality assurance.**

While there is a need to start as soon as possible, there is also a need to ensure an efficient and comprehensive sustainability reporting framework. To favor effective compliance with the new requirements, the CSRD proposes a twostep approach. In the initial phase, company's sustainability information will be subjected to 'limited assurance' by which the assurance service provider reduces the risk of material misstatement to an acceptably low level. With such level of assurance, the service provider's primary focus is to understand the process used to compile the reported information (enquiry, observation, and analytical procedures) and reach a negative opinion by which nothing has come to suggest that the information provided is materially misstated. Several years after the entry into force of the CSRD, sustainability information will be subjected to 'reasonable assurance' by which the assurance service provider obtains sufficient appropriate evidence that the

information provided is not materially misstated. The work effort with such level of assurance entails more extensive procedures than in a 'limited assurance' engagement. They include: (i) risk identification and assessment that any matters may not be presented fairly; (ii) testing the operating effectiveness of the company's internal controls; and (ii) substantive procedures. The result is the expression of a conclusion in a positive form.

Such assurance will be carried out by the statutory auditor(s) or audit firm(s) to help ensure the connectivity between the financial and sustainability information. However, the CSRD will also open the possibility for Member States to allow independent assurance service providers to provide a conclusion on sustainability information. To avoid sustainability assurance quality differences, independent assurance services providers will need to be accredited under the same conditions than auditor(s) or audit firm(s).

Time pressure will nevertheless most likely lead companies to request such sustainability assurance from their existing statutory auditor(s) or audit firm(s). The result is that this new integrated reporting market, embracing both financial and sustainability reporting, risks replicating the long-lasting audit market concentration evidenced in the last Audit Market Monitoring Report of the European Commission (COM (2021) 29 - January 28, 2021). This makes all the more relevant the initiative by the Commission to revisit the Audit Directive and Regulation, to create a more vibrant and diverse EU audit and assurance market.

SUSTAINABILITY TRENDS IN ASSET MANAGEMENT



MARTIN MOLONEY

Secretary General -
International Organization
of Securities Commissions
(IOSCO)

The best should not be treated as the enemy of the good.

It was famously observed by Voltaire that the pursuit of perfection can get in the way of doing good. Considering the current juncture in building Sustainable Finance, it is a point worth recalling.

Around the world, embedding sustainability goals into the economic and fiscal policies of Governments and the strategic plans of corporations remains a work in progress.

Financial markets – as they often do – have pushed ahead of the political process. Sustainable finance has become an urgent focus in financial markets. But the data and resourcing requirements are proving challenging, as European firms seeking to comply with the Sustainable Finance Disclosure Regulations have found. The scale of greenwashing is driven by the lack of appropriate data and market structures to meet the demand. The markets are struggling to do the right thing.

IOSCO recognised in 2020 that it needed to step in. Following the vision put forward by IOSCO in June 2021, the IFRS has now put in place the ISSB to lead the development of global standards. The plan is to adopt standards on climate-related disclosure in 2022 and to move on from there with an ambitious future agenda.

But Europe has already gone ahead with its own ambitious programme of regulation on Environmental, Social and Governance-related requirements. Is there a coordination problem?

Some supporters of the EU approach have expressed concern that the global initiative will not adopt the EU ‘double materiality’ approach, but will instead just look at the impact of issues such as carbon emissions on ‘enterprise value’. What about all the ‘non-financial’ impacts of a corporation’s activity which don’t get reflected in its value?

There is also some concern that the global approach doesn’t seem fully committed, in advance, to going beyond climate to all environmental issues or going beyond the environment to the ‘S’ and the ‘G’ of the EU approach.

The ISSB standards will be a foundation on which different sustainable finance approaches may be built in different parts of the world.

Could the global initiative slow Europe down or create barriers between EU capital markets and others? The IOSCO answer is a definite: ‘No!’

Our ambition in IOSCO is to put in place a global baseline that different jurisdictions can build on and vary from, depending on the local perspective. Not only that, but global success for our initiative will actually help achieve many of the goals of the EU agenda.

All stakeholders will find the globally consistent and audited cross-sector metrics the ISSB will recommend particularly useful. With regard to emissions, for example, companies will disclose Scope 3 GHG Emissions, which can span the entire value chain. With

regard to social issues, companies that purport to have responsible or certified production and sourcing programmes will need to make appropriate disclosures on those.

Furthermore, at least with regard to climate, as economic and fiscal policies (and corporate investment programmes) focused on carbon neutral targets do become firmer commitments and get implemented by Governments (and corporations), a ‘scissors effect’ will emerge, increasingly narrowing the gap between non-financial double materiality disclosures and enterprise value disclosures. ‘Transition risk’ and the risk of ‘stranded assets’ will become more substantive and more material to enterprise value.

We see this ‘scissors effect’ already at work: In the quite recent past, carbon emissions were mainly monitored to assess global warming. They have now become increasingly relevant for investors to assess how net zero transitional plans affect the companies’ assets, financial prospects and ultimately, its pricing.

Some argue that convergence in materiality perspectives only applies to a subset of the topics. This is true, at least for now. But the situation will not remain static. The ISSB standards will not seem perfect to the many passionate advocates for ever-broader impact disclosures. But that is no reason to devalue the process.

The ISSB standards will be a foundation on which different sustainable finance approaches may be built in different parts of the world. The EU will be able to proceed with its full ESG agenda while aligning with the ISSB standards. Advocates all over the world for additional disclosures in relation to a broad range of stakeholder impacts and concerns will be able to advocate for their preferred disclosure without anyone being able to tell them that what they want is incompatible with the global standards. At the same time, by conforming to ISSB standards European disclosures will exist within a data architecture that allows for comparison and analysis by investors across the globe. ISSB standards will not constrain, they will enable.

This will be a very substantial achievement and one that pushes the sustainable finance agenda decisively forward.



NATASHA CAZENAVE

Executive Director -
European Securities
and Markets Authority
(ESMA)

Completing regulatory framework for ESG investments will take time

Sustainability embodies one of the most prominent opportunities for the financial industry as sustainability considerations, and, in particular, the fight against climate change, are reshaping investor preferences. ESMA's market monitoring indicators show that only during the second half of 2021, the sustainable bond market grew by 19% and the size of the ESG fund market by 9%. Currently ESG funds represent roughly 19% of the assets under management of EU equity, bond, mixed and money market funds publicly marketed in the EU.

While this dynamic can play a positive role in Europe's green transition, it also raises numerous questions: How can investors who wish to invest in sustainable or ESG products be assured that their money is being directed into projects aligned with their investment objectives? How can product labels and their ESG investment strategies be made clear, comprehensible, and comparable? How can we ensure

meaningful disclosures? How can we tackle the risk of greenwashing, i.e. the risk that investment products present themselves as greener than they really are?

In order to respond to these significant challenges, and in particular to ensure comparability across a growing variety of financial products, the EU has embarked on the development of a transparency framework based on the disclosure of relevant information by financial market participants at the entity and product level, and ESMA has been contributing extensively to this initiative in recent years.

Accordingly, the EU Sustainable Finance Disclosure Regulation (SFDR), and the European Supervisory Authorities' implementation measures are designed to help institutional and individual investors understand, compare, and monitor the sustainability characteristics of investment products.

ESMA continues to be committed to contribute to facilitate the transition to a more sustainable economy, notably by aiming to curb greenwashing and enhancing the reliability of the ESG information that is disclosed to the market.

Importantly, the SFDR will be supplemented by the recently proposed Corporate Sustainability Reporting Directive (CSRD), which will support the publication of relevant disclosures by corporates that is currently lacking. This proposal expands the requirement to publish sustainability information to a larger group of companies and establishes more detailed mandatory disclosure rules on various sustainability topics, including on transition plans. The legislative process appears to be moving swiftly towards achievement of this additional measure which should help mitigate some of the issues around data availability and reliability.

The CSRD will result in the better provision of ESG data by corporates, which will then help regulated entities meet their disclosure obligations for their investment products under the SFDR using that ESG data. Today, reliance on ESG ratings and ESG data

providers remains high and illustrates how important it is not to ignore this sector and the need for harmonised standards and oversight here too. It is essential to match the growth in demand for these products with appropriate regulatory requirements to ensure their quality and reliability. Against that background, ESMA is working with National Competent Authorities to try and reach common interpretations and foster convergence in the supervision of ESG products.

The proposed establishment of a European 'Green bond standard' is also welcome in the context of increasing green bond issuances. Here, the Commission proposal foresees that ESMA would oversee external reviewers of EU green bonds, with a view to strengthen the credibility and reliability of the overall regime.

Looking ahead, I would expect some further pieces moving towards our common objective of facilitating financial flows in sustainable investments and avoiding greenwashing. With the establishment of International Sustainability Standards Board (ISSB), we hope to see progress towards further alignment in relation to disclosures globally. ESMA will stand ready to contribute to this work given its importance and the overall need for international consistency of standards. Also, the IOSCO Sustainable Finance Task Force is expected to carry on follow-up work on regulation of ESG ratings and ESG data providers, after publishing its first report in November last year. In the EU, with the establishment of European Single Access Point (ESAP) in some years, ESMA hopes to further facilitate investors' access to sustainability-related data in an easier and machine-readable way, which would be paramount to helping them make better investment decisions.

Overall, ESMA continues to be committed to contribute to facilitate the transition to a more sustainable economy, notably by aiming to curb greenwashing and enhancing the reliability of the ESG information that is disclosed to the market. However, while the necessary regulatory framework continues to be developed, the desired level of transparency and comparability of financial products will take time to be achieved. We are still at the beginning of a transition phase, and with all parties involved on a fairly steep learning curve, given how big challenges ahead of us are.



PAUL TANG

MEP, Committee on Economic and Monetary Affairs - European Parliament

A booming and targeted European green bond market

The green bond market is booming. Over the past six years, its global market size has grown by 50% each year. And the pace keeps picking up. Sized €230bn in 2020, it's predicted to reach one trillion dollars next year.

With the European Investment Bank, Europe has pioneered the green bond market. And you can see it clearly still. Half of all green bonds are issued in Euros. In the market of sustainable finance, Europe has taken the global lead.

Yet despite this great momentum, our challenges are greater still. The European Commission calculated that Europe needs some €350 billion in additional investment per year to meet its 2030 emissions-reduction target in energy systems alone, alongside the €130 billion needed for other environmental goals.

The green bond market is as of yet too small to sufficiently contribute to our transition. This because many green bonds simply re-finance already existing green assets, not providing 'additionality'. And also because green bonds frequently finance projects

which are either not essential to our transition or simply go against it, i.e. constitute greenwashing.

This 'greenwashing' is a significant problem. Nationale Nederlanden calculated that 15% of the existing green bond market shouldn't carry the label. This might be for social reasons. Think of companies exploiting forced Uyghur labour. Or it may be for climate reasons. Saudi Arabia, for example, issued green debt without weaning itself off fossil fuels. We thus not only need a bigger green bond market, but also a green bond market that better targets truly sustainable projects.

Fortunately growth is still possible. Green Bonds represent just 3% of bond issuances. A main tool to stimulate targeted growth is the European Green Bond Standard (EuGBS). This standard can address information asymmetries in the green bond market, where investors are willing to accept lower returns on green bonds, but cannot sufficiently – or cost-efficiently – ensure investments are spent correctly.

Being tied to the EU's Taxonomy, the EuGBS has a detailed prescription where proceeds should go, and by obliging the use of well-supervised external reviewers, the trustworthiness of issuers can be guaranteed. In these ways the EuGBS is stricter than existing standards such as the market-leading ICMA standard.

The EuGBS should be the undisputed market standard, both usable and free from fears of greenwashing.

And this strictness is necessary. Green bonds can best stimulate new investments, and thus generate additionality, if the issuer has a clear expectation of the financing discount he gets, i.e. the greenium, on green bonds. For a greenium to be established, a liquid and harmonized green bond market is key. For investors are only willing to apply a discount regardless of the issuer if they trust the standard is well-applied,

The Commission proposal is a great starting point, yet should be strengthened in a few important ways. Firstly, investors may fear reputational risks from exposure to companies who, although spending bond proceeds on green projects, continue polluting

activities. The EuGBS is a great tool for all companies, green or brown, to transition. However, they should be serious about doing so. By obliging issuers to adopt a transition plan with regular steps to reach net-0 by 2050, the benefits of the EuGBS reach the right place. This avoids the need for additional requirements by sustainably-minded investors.

Secondly, the current debate about the inclusion of fossil gas and nuclear may fatally undermine the EuGBS. Current issuers – from Energy de France to the Polish government – explicitly exclude fossil gas and nuclear energy from their green bonds. By including them, the EuGBS would fail to be the 'gold standard' the market so urgently needs. It would also fragment the market into four segments, with different pricing depending on whether the issuer allocates the proceeds to gas and/or nuclear.

Third, sustainability is a broad concept and relates both to environmental and social concerns. That is why the Disclosure Regulation obliges financial market participants to look at possible negative effects of their sustainable investments. Falling outside the scope of that Regulation, however, the Commission doesn't require this of issuers of EuGBs. Integrating the approach of the Disclosure Regulation allows for social effects to be closely monitored and protects investors against greenwashing.

Lastly, differences between EuGBs and other sustainable bonds should be easily monitored so they can be priced in. That is why it would be sensible to extend the reporting requirements of the EuGBS to other sustainable bonds. Allowing for example, the percentage of taxonomy-compliance to be compared.

Green bonds are a powerful tool to stimulate green investments. However, for this potential to be achieved, an EuGBS needs to be developed that can truly become the undisputed market standard, being both usable and free from fears of greenwashing. Developing this standard can cement European leadership in the market, and pave the way to a more sustainable future.



ROBERT OPHÈLE

Chair - Autorité des Marchés
Financiers (AMF)

Climate change and the financial sector: accountability for promises

On the bumpy road to net zero, we are at a tricky juncture when commitment has been made but the ways and means are not yet fully clarified. The 26th Conference of Parties (COP) has demonstrated yet again that the private sector, and, in particular, the financial sector, has a key role to play to keep the 1.5-degree objective alive. In his closing statement for the COP26, António Guterres, UN Secretary General, called for the development of “clear standards to measure and analyse net zero commitments from non-state actors”. As recently reviewed by the AMF’s Climate and sustainable finance experts committee, several broadly convergent frameworks are already available for non-financial companies.

These frameworks are useful to clarify the underlying concepts of net zero and define targets. However, these frameworks offer little or no help on verification and monitoring.

Methodological challenges are even more daunting for financial institutions. The credibility of the Glasgow Financial Alliance for Net Zero (GFANZ) will thus very much depend on this alliance’s ability to deliver robust frame-

works, providing transparency and comparability to the market on the decarbonisation and future alignment of individual and consolidated portfolios.

Absolute reduction in greenhouse gas (GHG) emissions should remain the prime and undisputable objective, with progress that is demonstrable over time.

Several related priorities come to mind, based on our work on financial institutions’ climate-related commitments, jointly conducted with the French prudential authority.

Firstly, we need better data on individual and aggregated exposures to fossil fuel sectors. Such information will be requested by SFDR, but this would imply consensus on how to measure such exposures. Other sectoral information will also be necessary, as the focus widens from the most obvious sources of GHG emission reductions to other carbon-intensive sectors.

Secondly, work on transition plans should be a priority (as initiated by the EFRAG Climate Cluster), so that the relevant information is promptly available to investors and other financial institutions. Such transition plans should include measurable intermediate targets, as well as information on financial implications for the companies.

**The market needs a
harmonised framework
rapidly on portfolio
decarbonisation and
alignment.**

Thirdly, investors should be transparent on how they intend to engage with companies, so that claiming to finance transition does not mean status quo, but rather actually financing the structural changes and the investments that are needed, in line with science-based scenarios.

Fourthly, there is a need for more clarity on green financing. Reporting on taxonomy-related KPIs will help, nevertheless the EU taxonomy needs to be completed as soon as possible to cover more activities and other environmental objectives. Then there are other outstanding important questions, such as the treatment of small and medium-sized enterprises, or the articulation of taxonomies at international level, not to mention

the numerous queries from corporates regarding the implementation of the rules, such as eligibility of the entire value chain or specific eligible operational expenditures.

Fifthly, the Corporate Sustainability Reporting Directive (CSRD) has rightly focused attention on the external review of the information published, an issue to be considered broadly, including in relation to transition.

Will this reduce the risk of green washing and remove doubts about the rapidly growing sustainable investment market? One avenue is market discipline in the implementation of product categorisation under SFDR and of the upcoming requirements on sustainability preferences under MiFID 2 and IDD. Key questions stand around the definition of sustainable investments and the consideration of investments’ principal adverse impacts (PAI).

The long overdue adoption of SFDR technical standards and the publication of the first product periodic reports containing sustainability information may well help. However, more realistically, the European Commission should take stock of the first months of implementation of SFDR and act to reduce the current confusion in the market. Minimum standards and a better account of the actual and evolving product offerings in the sustainable investment market will be needed.

Finally, the sharp growth in ESG products have offered ESG rating agencies and data providers a major role to play. It is urgent that the Commission make proposals regarding the regulation and supervision of those entities, addressing matters such as transparency, conflicts of interest, processes and organisation.

Here, standardisation is not the objective, since market participants value diversity in the approaches and methodologies proposed. However, the market will eventually need robust data and more convergent assessments of a company’s decarbonisation trajectory.



NATALIE WESTERBARKEY

Director & Head of EU Public Policy - Fidelity International

Point de bascule : y sommes-nous déjà arrivés?

It is uncertain, from a scientific point of view, whether we have already crossed a tipping point with regards to climate change. The definition of a tipping point differs depending on whether it relates to climate science, sociology or physics. But one aspect in common, regardless of sector, is that once a tipping point is reached, there is an irreversible point of no return after which accelerated change takes place.

As long as the climate tipping point is uncertain, we must keep trying everything within our power to change human behaviour and prevent the worst outcomes.

Public policy aims to achieve this by directing human and corporate behaviour. It uses carrot-and-stick tools to steer consumers, corporates, non-governmental and state actors and channel our collective actions.

Substantial progress in public policy and the asset management industry has been made since the signing of the Paris Agreement in 2016 which addresses climate change mitigation, adaptation, and finance.

Asset managers are now integrating ESG factors in an almost mainstream

way into their investment and distribution process and engage actively with investee companies to accelerate their transition based on their disclosure. Policy initiatives such as the EU taxonomy have helped define and pave the way for a common global understanding of E, S and G factors. Additional important taxonomies are in progress for social factors and the other four environmental goals, comprised of marine protection, transition to a circular economy, pollution prevention and restoration of biodiversity and ecosystems.

A policy tipping point to accelerate our path towards a better, sustainable economy has been reached and hopefully launched an irreversible societal journey towards a more responsible way of living.

The question is which policies increase the impact on the sustainability transition of the economy and what in particular is the role of asset managers in incentivizing a household transition. Asset managers play a key role here by highlighting the correlation between individual health, financial wellbeing, and the need to invest in line with sustainable and ethical goals. As such, industry players raise awareness that households can align their savings with ESG investment objectives and therefore make a significant difference in the transition towards a greener and more responsible global economy.

**Point de bascule :
consumer choice is the
true tipping point.**

Investor education and financial literacy are fundamental building blocks to achieve this. Asset managers undertake extensive efforts in the area of investor education at both corporate and industry level. The European asset management association EFAMA will publish its second report on Investor Education in Q1 2022. It includes case studies of asset managers such as Fidelity, where we provide insights on promoting financial holistic wellness among EU and global citizens.

Local asset management associations also play a vital role. For example, the French AFG highlighted the importance of reconciling *“economic performance with social and environmental impact by funding companies and public institutions that contribute to sustainable development regardless of their business sector,”* in its recent publication *“12 Principles for Savings & Investing”*.

The asset management sector works closely with key public sector actors, such as IOSCO, the ESAs, the European Commission and local regulators on the topic of investor education to incentivise household savings to a more sustainable economy.

EFAMA for example participated at the recent ESA consumer conference in financial services. It highlighted that also advisors will play a key role in educating consumers on sustainable finance at the point of sale. MiFID II and IDD will require advisors to identify consumers' sustainability preferences. Eco-labels are also important to guide consumers.

Asset managers furthermore hosted an EFAMA financial literacy session during IOSCO's World Investor Week launching a recent publication on *“Investing in a better future : 5 tips”*. It was translated into 20 languages and incentivises individuals to assess - as a starting point - if an investment matches ones financial and sustainable/ethical investment goals.

A key policy in this context is the CMU Action Plan #7, which provides the European Commission with a mandate to conduct a feasibility assessment for the development of a European financial competence framework. The coordination role at EU level is aimed to support progress at member state level. According to the CMU Action Plan, the framework will assess the possible introduction of promoting local learning measures with a focus on responsible and long-term investing.

It has never been more important for households to plan their personal finances, given the current environment of low interest rates, and inflation, ie rising costs of living. Point de bascule: consumer choice is the true tipping point to reach a sustainable economy and enable a better future for all.



STÉPHANE LAPIQUONNE

Managing Director
BlackRock

Managing the transition towards net zero

The net zero transition is more than abstract ideas or scientific targets. It is a transformation of the entire economy at a deliberate pace. European Governments are leading the way in setting out how this transition to a net zero world will take shape; showing ambition in presenting concrete goals and putting transformative proposals on the table like the European Green Deal and the Fit for 55 Package. The world needs all governments to provide clear pathways and consistent sustainability policy, regulation, and disclosure across markets. Governments and companies must ensure that people continue to have access to reliable and affordable energy sources. This is the only way we will create a green economy that is fair and just and avoid societal discord. Government must also support communities affected by the transition, help catalyze capital for the emerging markets, and invest in the innovation and technology that will be essential to decarbonizing the global economy.

To successfully achieve the goals set by governments, every company and every sector will need to evolve, though some industries will have an easier time than others. It is up to all companies to set a course to adapt their businesses in line with concrete goals and with that turn

to financial markets for funding. The financial sector has a tremendous role to play in supporting these companies that plan and act on achieving net zero goals. This includes both companies that provide exposure to the new technologies and business models of a net zero world and carbon-intensive companies that are transforming their businesses.

To provide investments, we need to understand how those companies are adjusting their businesses for the massive changes the economy is undergoing. As part of that focus, we are asking companies to set short-, medium-, and long-term targets for greenhouse gas reductions and asking companies to demonstrate that their plans are resilient under likely decarbonisation pathways and the global aspiration to limit global warming to 1.5°C. We are also asking them to issue reports consistent with Task Force on Climate-Related Financial Disclosures (TCFD) in anticipation of EU and Global sustainability reporting standards.

For investors to navigate the net zero transition, they need to be able to measure and forecast it.

For investors to navigate the net zero transition, they need to be able to measure and forecast it. They need data, models, analytics and tools that provide them with the ability to understand physical risk, transition risk and temperature alignment at the security, issuer and portfolio levels. Standardised sustainability reporting will help investors and other stakeholders better understand the implications of the transition to a net zero world and reduce reporting burden on companies.

We are very supportive of the initiative of the IFRS Foundation and the International Sustainability Standards Board to develop a new global set of baseline sustainability reporting standards, on which different jurisdictions could build to meet their regulatory requirements and public policy objectives. And to enable a market-wide understanding of sustainability risks and opportunities, we believe that large private companies should also provide sustainability reporting similar to public companies. There is no doubt that the quality and availability of data has significantly increased in the last decade, but

global convergence is needed to further improve the quality of information available to investors and other stakeholders.

Asset managers have a responsibility to help end investors better understand the investment opportunities and risks linked to the transition. The vast majority of European clients are on this journey of making sustainability their standard. Asset managers are working closely with clients to achieve this goal.

Asset managers are enhancing tools, analytics and portfolio advice to help their clients invest amidst high uncertainty about the pace of change in policy and the real economy. Asset managers are expanding our set of investment vehicles to help clients invest in the transition, working across both public and private markets. This ranges from strategies that help clients tilt their broad market exposures to be more climate-aware and to strategies that help them capture investments opportunities in net-zero technologies and business models.

Only if governments set clear pathways, companies take leadership in transforming their businesses and the financial sector together with the public sector provide the capital needed, we will achieve a net zero for all.



ELIZABETH GILLAM

Head of European Government Relations and Public Policy - Invesco

Making ESG as simple as 1, 2, 3

Two of the EU's top priorities are its Sustainable Finance Strategy and the Capital Markets Union. A key vector linking the two is how to encourage retail investors to engage in capital markets and finance sustainable investments.

We know that retail investors are increasingly interested in using their money for good. For example, consumer research undertaken by Invesco last year showed that sustainability and sustainable investing is increasingly important to retail investors: 79% of respondents considered sustainability to be important regarding how their money is invested and 85% were interested in sustainable investing, with 45% already invested in sustainable investments or in discussions with their financial advisers about making such investments.

Of those already investing sustainably, 46% plan to increase their allocation to sustainable investments over the coming 12 months.

However, while there is a strong desire by retail investors to invest sustainably, our research also showed that this appetite is being held back by a number of key barriers that are all too common

when trying to engage retail investors in sustainable investments:

1. A lack of knowledge and confusion about the language used to describe sustainable investing
2. Uncertainty as to the impact of sustainable investing on financial performance and risk
3. A lack of transparency and trust that sustainable investment products will deliver as promised
4. A lack of support from financial advisers in helping them navigate the sustainable investing universe

The EU's actions to date have gone some way to address some of these barriers. The introduction of the Sustainable Finance Disclosures Regulation and EU Taxonomy will ensure that investors have access to more information about the products on offer and the introduction of the new rules on sustainability preferences will encourage advisors to engage clients on a discussion on these topics. However, the regulatory regime that has been put in place today still has some way to go in order to address the needs of retail investors. We need joined up thinking between the Sustainable Finance Strategy and Retail Investment Strategy to ensure that the two can become mutually reinforcing: many of the challenges set out above, regarding complexity of language, lack of trust, need for better advice and guidance, are not unique to sustainable investing but hinder retail investors participation in capital markets more generally while interest in sustainable investing can provide a new avenue to get retail investors interested in investing.

We need joined up thinking between the Sustainable Finance Strategy and Retail Investment Strategy.

Firstly, we need to ensure that the information we provide to investors is understandable and accessible. When we consider that only 14% of those we surveyed understood the term "ESG", it is clear that referring to products as "Article 8" or "Article 9", let alone terms like "Taxonomy-aligned" or "sustainable investments", is unlikely to resonate with retail investors. As we look to deliver better and more accessible information to investors, we should seek to ensure that sustainability is included and subject to extensive consumer testing to ensure that the

information provided is concise, simple and jargon-free and lays out clearly the different options and choices available to retail investors.

But we know that disclosures can only get us so far. Retail investors therefore need help to engage in sustainable finance, both through embedding sustainability in financial literacy initiatives but also through their discussions with their advisers. Our research underscored the critical role that financial advisers could play in helping retail investors understand the different options available to them.

The implementation of the new sustainability preferences regime, therefore, represents a huge opportunity to facilitate these client conversations and we must avoid the regime becoming another "tick-box" exercise. Joining the dots between disclosures and sustainability preferences, it is clear that a legalistic approach to implementing the new sustainability preferences is likely to disengage investors or lead to misleading results. Therefore, we need to ensure that advisors can engage in a meaningful conversation with their clients about what is important to them and how their preferences can be reflected in the products in which they invest.

To conclude, the EU has a huge opportunity to deliver for people and planet by putting retail investors at the heart of its policy agenda. But to rise to this opportunity, we need to get out of our regulatory ivory tower and put ourselves in a retail investor's shoes.



ELODIE LAUGEL

Chief Responsible
Investment Officer - Amundi

Race to Net Zero: reflections on the Glasgow Financial Alliance for net zero

Walking a thin line between long-term collective ambition and pragmatic individual first steps

The current emission reduction targets taken by countries under the framework of the Paris Agreement still fall short of the 1.5°C target. Even though the commitments taken and the pledges made at COP26 will significantly reduce greenhouse gas emissions, they are still not sufficient to meet the 1.5°C target and associated global neutrality by 2050. Few private companies and organization have embraced 1.5°C compatible decarbonisation targets and the policies issued by the public sector do not yet manage to set the scene for such scenario either. Moreover, the Climate Policy Initiative estimates additional \$1.6 to \$3.8 trillion per annum are needed to finance the energy transition. Public capital has a significant role to play, but it will not be sufficient on its own: the challenge lies in the gap between the financing needs on the one hand, and the financing available on the other.

There are, therefore, at least three gaps in the road to net zero: a climate ambition gap, a climate policy gap,

and a climate-financing gap. My conviction is that even though the financial sector cannot be a substitute for policy makers, we are in a unique position to have a significant impact in helping to close ambition and financing gaps of the energy transition. COP 26 was the first COP at which financial institutions have taken official collective engagement.

The Glasgow Financial Alliance for Net Zero (GFANZ), which represents 130 trillion of dollars in capital across 450 financial institutions, announced that it committed to transforming the economy and achieving net zero by 2050. Within the GFANZ, investors are in a unique position to play a key role in the energy transition, as they can finance energy transition projects, helping to close the climate financing gap, and engage with the companies they invest in, influencing them towards the energy transition, closing the ambition gap.

By nature a net zero objective is ultimately a long term collective and global target.

For these reasons, in July, Amundi joined the Net Zero Asset Managers Initiative, committing to reach carbon neutrality by 2050 or sooner. To support the goal of global carbon neutrality by 2050, we are currently working on expanding our climate-related policy, supporting net-zero aligned investment across sectors and regions, and ensuring that investors are equipped with efficient and ambitious climate investment strategies. In December, we launched our 2025 ESG Ambitions plan, setting ten concrete objectives to accelerate Amundi's ESG transformation and pave the way towards carbon neutrality in 2050. For example, we will engage with 1000 additional companies to define credible strategies for reducing their GHG emissions, to vote at their AGM and for management remuneration packages to be linked to these strategies. Moreover, we aim at increasing our allocation towards impact funds, reaching €20 billion to invest in companies that seek positive environmental and social performance.

We will also introduce a new energy transition rating that assesses companies' efforts in decarbonizing their operations and developing sustainable activities, covering €400 billion of actively managed funds.

Even though I believe the 2025 ESG Ambitions plan launched by Amundi is an ambitious one standing out within the asset management industry, other financial actors are also taking similar commitments to transform their companies and get closer to the ultimate net zero target in 2050. Together with the announcements made by the GFANZ in the wake of COP26, ESG ambitions from the financial industry should be praised, engaged with, and supported in view of the road to net zero. While it is critical to recognize that by nature a net zero objective is ultimately a long term collective and global target, it is equally important to set clear and tangible contribution targets at individual level in the short and medium term as transition to low carbon economy is path dependent.

At Amundi we recognize that we have been on a remarkable sustainability journey, but we also acknowledge we still have a long way to go in the race to net zero, and that calls for both humility in leadership and pragmatism. I believe that to align with the Paris Agreement, which to a large extent a long term forward looking process ("global neutrality in 2050"), urgent action from the financial industry is required so that the significant changes we need materialize on time. The coming ten years are key if we want to avoid huge financial and social costs related to climate change. We have to address numerous challenges that the green transition is bringing: acceleration of technological innovation, adjustments of human skills and engagement.

To address this collective challenge, actors that used to work in silos will need to collaborate, with clients, between peers, with regulators and with civil society as a whole. No actor will be able to do this running solo.

EMERGING ESG CHALLENGES



SYLVIE GOULARD

Second Deputy Governor -
Banque de France

When realism means grasping more: acting only on climate change is no option

In 2015, the United Nations defined sustainable development goals (SDGs) to be reached by 2030. One among 17 SDGs, climate action has led to considerable effort from finance, although making financial flows consistent with climate objectives as per the Paris Agreement requires further effort. Yet, the financial sector has started paying greater attention to other environmental, social and governance-related (ESG) topics. To quote but a few examples, the issuance of social bonds surged to protect health in the pandemic, while consideration for the environment beyond climate increased, as countries are heading to Kunming to adopt the Post-2020 Biodiversity Framework. However, the last SDGs Report (2020) warns that even before the pandemic, we were not in track to reach the SDGs by 2030, which would “demand nothing short of a

transformation of the financial, economic and political systems that govern our societies today.”

While there can be a fear of biting off more than what finance can chew, treating climate in isolation is illusory. Encompassing interrelated sustainability issues may indeed help mobilise finance and people for climate change mitigation while enhancing the resilience of nature and societies, which is key to adaptation and to conducting the necessary transformation. On the one hand, climate action is crucial to meet other SDGs. As the Intergovernmental Panel on Climate Change (IPCC) highlights, climate change puts food and water security at risk, affects human health and increases inequalities, even more so for groups that are marginalised, e.g. on the basis of gender. On the other hand, securing access to food, water or health care is key to the resilience of societies in the context of climate change, and inequalities fuel climate change, with richest countries and individuals responsible for most emissions.

Finance and companies have to consider emerging sustainability issues despite challenges.

Relations between climate and biodiversity, which go in both directions, have attracted particular attention, see e.g. the workshop report co-sponsored by the IPCC and IPBES (2021), its equivalent for biodiversity and ecosystem services. Connections between human, animal, plant and planet health (One Health) also came to the fore with the pandemic.

Certainly, trade-offs between the various dimensions of sustainable development can appear. Examples include increased land artificialisation and mining to develop renewable energy production, or reduced purchasing power and employment due to higher carbon prices and tighter environmental regulations without compensation. The current context also shows that efforts are not always rewarded: in the case of dairy farming, larger supply of organic milk

is available after years of adaptation, but in a context of increased inflation, many consumers cannot afford to buy organic. Public policies have a role to play in a fair transition, as the EU Just Transition Mechanism and Social Climate Fund illustrate.

For its part, the financial sector should look for synergies, wherever possible. In fact, transformation opens up new investment opportunities, for nature-based solutions as well as new technologies. While this is not always profitable at first, much can be done with the support of public and development finance: e.g. the Agence Française de Développement is committed to dedicate 30% of its climate financing to investments with co-benefits for biodiversity by 2025. Besides, progress can be made on certain fronts, such as on gender and diversity more broadly (e.g. men have held 93% of ECB governing council positions), without any trade-off with other ESG dimensions, and maybe even leading to greater consideration for emerging challenges.

Albeit each issue has specificities, there seems to be enough similarities for finance to leverage the work made on climate change and the related risks. The EU disclosure framework that covers both climate and other sustainability issues is key for more transparency on sustainability-related risks and opportunities. Globally, the International Sustainability Standards Board is also meant to develop baseline disclosure standards beyond climate. It is complemented by issue-specific initiatives, such as the Taskforce on Nature-related Financial Disclosures. As to risk assessment, the Dasgupta Review (2021) and researchers within central banks, starting with De Nederlandsche Bank (2020) and Banque de France (2021), have begun warning about biodiversity-related financial risks that may – like climate-related risks – be classified between transition and physical risks, including litigation risks.

Hence, finance and companies have to consider emerging sustainability issues despite challenges, for their staff, for their clients, because they are part of society and not only because of regulators’ pressure. As for climate, the sooner the transformation starts, and the more orderly it is conducted, the better.



THIERRY MARTEL

Chief Executive Officer -
Groupama

Setting realistic ESG ambitions for the financial sector

It behooves Eurofi to ask the question of realism when defining contributions of the financial sector to the United Nations' sustainable goals. Blue sky thinking is fine, but there is a difference between ambition and overreach; one cannot run a firm to the ground for the sake of misplaced militantism. Indeed, the right approach for setting ESG ambitions starts with the G: a financial firm, properly governed, will define at Board and ExCom levels its ambition as regards corporate responsibility, which covers both the S of social goals and the E of environment. A mature conversation includes the competitive environment, employment policy, use of energy and other material resources to determine the size, location, composition and pay structure of our workforce, and our product offering. This conversation covers also how much the way we do business contributes to maintaining the social fabric and how much it enables innovation to address the challenge of climate change. This is true for firms of all kinds, whether they are financial, industrial, or otherwise.

I am convinced that European financial firms are among the most advanced in running these conversations at governing level and in making the hard choices they imply – because indeed

these are business decisions calling for tradeoffs and progressivity like any other. The title of our round table refers to emerging ESG issues such as biodiversity or other unspecified topics – I would put to others the proposition that being realistic also means to focus first on the main topics: how much our employment policy strengthens or weakens labor participation and equality, and whether our offers contribute or not to the efficient use of finite resources. For insurers, repairing rather than replacing, using videoconferencing rather than physical travel, substituting electronic mail for millions of paper contracts and invoices are also ways to limit our carbon footprint.

Financial firms have an extra role to play on ESG issues: not only do we determine our own ambitions, but we are in a position to weigh on the ESG course of our clients and on the ESG policies of the companies we invest in. Let's start with our clients. For insurers, this is in part old wine in new bottles – helping our clients prevent claims, making it worth their while to invest in the safety of their homes, of their buildings and factories, is a mainstay of the insurer's business. Insurance pricing embeds a risk assessment which translates into fewer accidents, or into claims of lesser severity, and thus helps avoid or reduce destruction of human and physical capital. Likewise, proper credit writing by banks avoids the extension of capital to ventures unlikely to succeed and thus the consumption of physical resources for little or no use.

Deadlines for disclosure coming before data can be gathered will not lead to useful outcomes.

Avoiding pointless infrastructure projects, bridges to nowhere and the construction of untraveled roads is a worthwhile contribution of private financial firms. Financial firms help their clients steer their own capital and resources in a productive, energy-saving way. This is a longstanding contribution of finance to society, to keep in mind when assessing finance contribution to the United Nations' sustainable goals. Measuring and reporting this contribution is difficult, and will not happen overnight; indeed, if we have some progress in environmental taxonomy, we can't say the same for social taxonomy. A realistic timetable is needed here as well – rushing obligations and defining

unattainable deadlines for disclosure before a taxonomy is defined and the data is gathered will not lead to useful outcomes.

Let's turn to our role as institutional investors. The blunter instrument is exclusion. Investors will turn away more and more from companies whose policies are beyond the pale: companies which use forced labor, which sanction corrupting kickbacks, or which contribute to the dirtiest energy extraction. Emerging ESG topics such as biodiversity can be addressed by this route of exclusion, for instance divesting from companies which are at the center of deforestation.

The better instruments at the disposal of institutional investors for weighing on ESG policies of traded companies are shareholder participation and voting policies. We weigh on firms to adopt a multi year strategy to address inequality in their workforce or pay policy, or to reduce their carbon footprint. Here also, the instrument of shareholder participation is equally well-suited to address central ESG challenges and emerging ones such as preventing further loss of biodiversity. There are existing metrics for this activity as investors, well suited for ESG issues as a whole.

To conclude, progress on taxonomy, on data and disclosure will continue apace; financial firms are fully invested in ESG policies; and regulation should set an ambitious but realistic timetable to help us all attain the United Nations' sustainable goals.



OLAF SLEIJPEN

Member of the Board, Executive Director of Monetary Affairs - De Nederlandsche Bank (DNB)

Like climate-related risks, ESG risks deserve our full attention

Like many other central banks and supervisors, we are deepening our understanding of how other environmental and social challenges besides climate change could translate into financial risks. Biodiversity loss is often considered one of the greatest risks to society and the economy. This is why we have analysed the extent to which financial institutions in the Netherlands are exposed to risks related to biodiversity. As in the case of climate-related risks, we have identified physical and transition risks. Firstly, biodiversity loss gives rise to physical risks as Dutch financial institutions have considerable exposure to firms that are highly dependent on ecosystem services.

Secondly, government actions aimed at reducing biodiversity loss lead to transition risks facing financial institutions that have high exposure to firms contributing to biodiversity loss. In earlier studies we found that Dutch financial institutions are also exposed to financial risks stemming from other sustainability-related challenges, such as water stress, raw material scarcity and human rights controversies.

As a prudential supervisor we expect financial institutions to adequately manage sustainability risks. Pursuant to European law and international standards, financial institutions are required to have sound risk management practices in place, enabling them to understand and manage all material risks, which include sustainability risks. Managing sustainability risks starts with embedding them into the governance, strategy and risk management cycle.

First and foremost, it is important that financial institutions assess the extent to which sustainability risks are a material source of financial risk for their portfolios.

Second, as in the case of climate-related risks, when identifying and assessing sustainability risks, they must formulate concrete metrics and limits and use forward-looking methods such as scenario analyses, stress tests and alignment methods to mitigate identified risks. Lastly, it is important that financial institutions report meaningful information and indicators on material sustainability risks.

Managing ESG risks starts with embedding them into governance, strategy and risk management.

Although financial institutions are making good progress in their awareness of sustainability risks, embedding these risks into core processes could be further improved. A survey we conducted among Dutch pension funds, insurers and banks showed that they are making headway in embedding sustainability risks into their core processes. However, this is typically limited to climate-related risks.

Furthermore, many financial institutions have not adequately embedded sustainability risks into their risk management cycle or they find it difficult to measure sustainability risks. Also, reporting on sustainability risks could be further improved.

These results are in line with the ECB's supervisory review on climate-related and environmental risks, which shows that few European banks have integrated climate-related and environmental risks into their core processes. This is especially true of 'non-climate-related' environmental risk drivers, such as biodiversity loss and pollution.

It is encouraging to see that integration of ESG risks in the international prudential framework is making good progress. In 2020, the ECB published its guide on climate-related and environmental risks. Recently, the European Commission has put forward proposals to further integrate ESG risks into the CRD and Solvency II directives. For pension funds, ESG risks have been embedded in the IORP II directive since 2019. In developmental terms, climate-related and environmental risk management requirements have reached the highest maturity. It makes sense to prioritise these, as not everything can be done at the same time. We believe, however, that social and governance risks must also be tackled as a matter of some urgency, as studies indicate they could be important too.

Next to the microprudential impact of environmental risks, insight into the systemic impact of environmental challenges must be improved. The Dasgupta Review has shown how nature and biodiversity are inextricably linked with our economies. These linkages warrant further analysis, both nationally and internationally. A recent NGFS study explains how the risks of biodiversity loss and a disorderly transition are of systemic importance. As a next step, together with the PBL Netherlands Environmental Assessment Agency, we are currently exploring whether we can assess the risks that biodiversity loss poses to financial stability in the Netherlands.

Summing up, like climate-related risks, ESG risks deserve our full attention. In the years ahead we must strive for a deepened and integral understanding of them, and we must do so by means of close international cooperation.



DAVID CRAIG

Co-Chair & Founder -
Taskforce on Nature-related
Financial Disclosures (TNFD)

Nature: solving a risk blindspot

The erosion of nature poses a growing financial risk to corporates and financial institutions. Biodiversity loss ranks in the top three of the most severe risks to the world in the next decade, behind failure to solve the climate crisis and extreme weather, reports the World Economic Forum (WEF).

The commercial imperative of managing nature-related risks is now evident for many. Increasingly, market players are also connecting their nature and climate agendas. Because while biodiversity, extreme weather and climate change are separated out in WEF's new global risk ranking, the risks are in reality inextricably interlinked. Halting climate change requires protecting and restoring nature. Nature-based solutions could contribute over one-third of the cost-effective cuts in greenhouse gas emissions. Similarly, unabated climate change escalates biodiversity loss. To take one example, the increased frequency and intensity of forest fires that comes with a hotter world leads to loss of forests and their biodiversity.

Climate- and nature-related risks must be managed in tandem. But robust risk management requires that organisations first understand their

current risk exposure - and at the moment, organisations do not have the information they need to assess how their immediate or long-term financial performance relies on nature.

Market-led response

The market has responded to their nature blindspot by putting their collective weight behind the Taskforce on Nature-related Financial Disclosures (TNFD), which is developing a global risk management and disclosure framework. The initiative builds on the work done in the climate space by the Task Force on Climate-related Disclosures (TCFD). Once released, the TNFD framework will guide organisations through how to assess, manage and report on nature-related risks. A core group of 34 leading corporates, financial institutions and service providers with more than US\$18trn of assets under management are currently working on a first iteration of the framework, which will be released to the market in Q1 this year. More than 250 organisations - including market players as well as scientific experts, governments, regulators, central banks and NGOs - have signed up as supporters. Many of them will be piloting the beta version of the framework this year, before a final version launches in 2023.

Managing nature-related risks requires progress on data and capacity building.

This iterative market-led approach, where market players take a leading role in designing the framework while being supported by scientific experts, means the resulting framework will be both scientifically rigorous and readily implementable for businesses and financial institutions.

Input and output data

Managing nature-related risks requires improving different forms of data.

Input data is used by businesses to diagnose, understand, measure and manage their own risk. Critically, input data must be location specific, as the risks associated with nature impacts vary significantly depending on where they occur. A biodiverse section of rainforest is not interchangeable with a piece of grassland (or even another rainforest). Nature-related data offerings specifically targeted at

financial institutions and corporates are emerging. Many center around satellite data and other geo-specific data.

In turn, output data takes the form of disclosures and reporting so investors can understand the risks, and subsequently measure and compare across organisations when making investment decisions - and then report on their own nature-related risks. Regulators will also rely on output data from organisations to make informed decisions for the economic and financial system as a whole.

Closing data gaps only first step

Solving the data challenge around nature is the first step towards robust risk management. Alongside, corporates and financial institutions must also dedicate resources to capacity building on nature across their leadership teams and wider staff, in the same way they have needed to build in-house expertise on climate and other sustainability topics. The challenge is that nature is even more complex. In addition to the need for location-specific data, nature lacks a single metric and global target. Mapping and managing nature risk throughout whole supply chains will require significant efforts.

Ultimately, nature-related risk management requires a shift in capital flows from nature-negative outcomes towards nature-positive outcomes, so that the nature base that the global economy and financial system relies on can be restored. This shift to nature-positive, alongside the shift to net zero, can't be achieved if organisations consider nature-related risk management solely a data challenge or tick-box exercise. But nature-positive is within reach if organisations apply the full extent of their resources and talent - this is the challenge ahead.



STEFANIE OTT

Head Group Qualitative Risk Management - Swiss Re Management Ltd

Biodiversity, Ecosystem Services and ESG – it’s all connected

What do pandemics, wildfires, severe floods and droughts have in common? Firstly, they have all been major loss events for the insurance industry and, secondly, they all have a strong relation to habitat destruction. All this can be measured against a decline in biodiversity.

The fact that they caused major losses underlines the fact that Biodiversity and Ecosystem Services (BES) plays a major role in the global economy in a manner that can be likened to that of water retention, flood protection and pollution.

A simple example: no business can function without clean water anywhere in the world. Yet, in many parts of the world, we are already water stressed – meaning we consume more water than nature can supply. If supplies dry up, power production stops, crops can no longer grow and hospitals can no longer function.

What this means in economic terms was analysed by the Dutch Central Bank, the DNB. The DNB estimates that a staggering EUR 510 billion, or 36% of all investments from Dutch

financial institutions, would be lost if the ecosystem services underpinning the Dutch economy were no longer available.^[1] What is true for the Netherlands is true globally. Swiss Re research has shown that 55% of global GDP is currently moderately or highly dependent on BES.^[2]

And the impacts are becoming more apparent. The recent floods in Germany were partly driven by not having enough natural retention and room for flooding rivers. The result of this habitat destruction was that the rivers flooded settlements instead. Pandemics, on the other hand, are triggered by humans coming into contact with pathogens in the wild.^[3] While that contact rarely made it to larger settlements in older days, in today’s world with rapidly increasing deforestation and habitat destruction, these contacts happen more often. With the world being more interconnected than ever before, coupled with the present day’s ease of transportation, a contact can quickly move across the globe and trigger an epidemic or a pandemic.

Pandemics and severe flooding are partly driven by Biodiversity & Ecosystem Services decline.

So, if the degradation of the environment worsens while, at the same time, insured asset values increase, it is to be expected that we will see more frequent and larger loss events in future, ranging from pandemics, lost harvests to even more severe cat losses. Given the scale of the impact, the time to act is now!

For insurers and financial market participants this is a massive challenge and many of the tools we need in the field of climate change, for example, have not yet been developed. But they are being worked on.

The financial sector started the Task Force on Nature related Financial Disclosures (TNFD)^[4]. The TNFD aims to establish and promote the adoption of an integrated risk management and disclosure framework that aggregates the best tools and materials thereby promoting worldwide consistency for nature-related reporting.

Companies have also taken up the challenge. Swiss Re developed a Biodiversity and Ecosystem Services

Index^[5] specifically tailored and fed by data relevant to the insurance industry. This index contains links to the UN Sustainability Goals (SDGs), which in turn relate to the Environmental, Social and Governance factors widely used in the financial services sector and beyond.

These are activities that need to be enhanced and coordinated over time. While, at the start, identifying the right data sets and bringing them together in a smart way will be the key focus of the work in the insurance industry, we must over time also apply the insights to the decisions we make in our underwriting and asset management activities. This will mean taking the ESG externalities into account when insuring as well as when investing.

In conclusion, ESG, SDG and BES are all connected. Addressing them jointly, will not only help manage risks better going forward but will also create an environment in which we can work to develop new nature-based solutions with the goal of restoring our environment to a healthy level.

[1] *Indebted to nature. Exploring biodiversity risks for the Dutch financial sector* | PBL Netherlands Environmental Assessment Agency
 [2] *A fifth of countries worldwide at risk from ecosystem collapse as biodiversity declines, reveals pioneering Swiss Re index* | Swiss Re <https://www.swissre.com/media/news-releases/nr-20200923-biodiversity-and-ecosystems-services.html>
 [3] *Why deforestation and extinctions make pandemics more likely* (nature.com)
 [4] *About – TNFD* <https://tnfd.global/about/>
 [5] *Biodiversity and Ecosystems Services Index: measuring the value of nature* | Swiss Re



SNORRE STORSET

Head of Asset & Wealth
Management - Nordea Bank

Strong momentum on sustainable finance in Europe but still lot of work ahead

Nordea has been committed to sustainable finance for long. This commitment rests on the realisation that an economic system, which does not properly price negative externalities, will at some point breach the limits of what the earth's ecosystems can support. The climate crisis, being the direct result of unpriced human emissions of CO₂ in the last 300 years - is the most obvious example of that. The same period that has brought unprecedented increases in the quality of life for a large part of humanity, has also brought us to a point where we are nearing the scientifically defined planetary boundaries. And there are other dimensions, in which companies must learn to limit their negative externalities, while further increasing their important positive contribution to society at large.

As a leading Nordic universal bank, Nordea plays a vital role in encouraging and inspiring the transition to a climate neutral economy in the Nordic countries, with a major impact from its lending and investments activities. Nordea's ambition is to become a bank

with net zero emissions by 2050 at the latest. To reach this goal, Nordea has set a mid-term objective to reduce carbon emissions from its lending and investment portfolios by 40-50% by 2030.

Nordea fully supports the Commission's Action Plan for Financing Sustainable Growth. ESG and sustainability-themed investment products have seen record inflows over the last years even as the Taxonomy and Sustainable Finance Disclosure Regulations are still being put into practice and further work is going on regarding the criteria on biodiversity, circular economy etc.

The importance of introducing circularity and of preserving biodiversity gets more and more investor focus. Recently announced regulation to require certification of the deforestation-free status of soft commodities imported into the EU, has made the issue financially material all along the value chain, from exporters through to retailers - and this will help get investors' attention. There is also lot of interest from investors to invest in a socially responsible manner and to contribute to the social development goals. Specifically, the ongoing pandemic demonstrates very clearly that investments in projects catering for social needs need also a renewed approach.

To achieve a workable taxonomy, related data challenges need to be solved.

The above mentioned areas currently lack universally recognised concepts or comparable parameters that would allow investors to support these goals in a fully coherent way. Expanding the taxonomy into these areas would add balance to the focus of the EU sustainable finance strategy. A social taxonomy should provide for a valid benchmark by defining social sustainability objectives and essential characteristics of investments that would qualify as socially sustainable. This would provide an important guidance for both institutional and retail investors and make it easier to take informed investment decisions. The taxonomy should be based as far as possible upon international treaties and conventions to evolve as a global standard for social investing. The ultimate goal should be to develop a social taxonomy that is recognised as benchmark for socially sustainable investments at the international level.

To achieve a workable social taxonomy, related data challenges need to be solved. Issuers need to provide the necessary data before banks and asset managers are able to make the right judgments and report on taxonomy alignment. This data challenge has already become apparent with the difficulties in demonstrating minimum safeguards alignment in the environmental taxonomy, and any proposal for a social taxonomy should be considered against the availability of such social disclosures.

Nordea strongly supports the Capital Markets Union initiative about a European Single Access Point with the ESG data being key priority to be included. All financial firms need sustainability data on non-financial companies and having a central European access point would be very helpful. Realistically, such an access point would not displace private providers of ESG data for investment purposes. But, properly structured and with priority given to easily accessible and interpretable data, it would go a long way towards creating a uniform basis for evaluating the sustainability characteristics of investee companies. On this basis both innovators (the so-called Green RegTechs) and the by now established incumbents in the ESG data space will be able to add value.

There is a strong momentum in Europe towards sustainable finance with rapidly increasing customer demand, growing industry supply and strong public interest, supported by regulation. An open dialogue between policymakers, the industry and the users of financial services can ensure that this transition does not lose momentum and that it can fully support sustainable recovery of the EU economy.



GEMMA CORRIGAN

Head of Policy and Advocacy -
Federated Hermes (UK) LLP

ESG Outlook 2022: from commitment to action

Looking at the year ahead, ESG themes will continue to gain prominence for the financial sector. Yet, after a year of pledges, 2022 must be a year of action.

In particular, there are growing expectations of financial institutions to assess and improve their impact on systemic issues such as climate change, biodiversity and social justice, with regulators watching closely to ensure they are walking the talk. The sector is expected to evaluate how its capital allocation impacts the transition, whether providing funding to new climate solutions or withdrawing capital from harmful activities.

Furthermore, pressure is mounting on investors to responsibly steward the assets they invest in. This means not just factoring environmental, social and governance issues into investment decisions, but engaging with investees to support and drive them towards a more sustainable footing. Advocacy with policymakers is also key in shaping a system that operates more effectively in the interests of end-investors, society, and the environment.

We can expect the focus on climate to continue with more detailed transition plans and interim targets being

expected from financial institutions, companies and governments. For asset managers, this means understanding their current climate-related risks and impacts, and identifying how to mitigate the negative impacts and seize opportunities to mobilize capital in support of the transition. It is crucial that targets and implementation strategies incentivise real world emissions reductions, and encourage an engagement-first approach, with divestment as a last resort. There will also be greater focus on how to better support emerging and developing countries to reach net zero and deliver a 'just transition' for all.

Other environmental issues – in particular biodiversity and nature – are rising rapidly up the agenda. During COP26, we saw a greater focus on biodiversity, particularly the issue of deforestation, in recognition of the interlinked nature of these two environmental crises. Healthy ecosystem services and nature based solutions are an important part of climate change mitigation, for example through carbon sequestration.

The financial sector will now be focused on how to deliver on pledges in the lead up to COP27.

Several financial institutions – including the international business of Federated Hermes – responded to the UN High Level Champions' Call to Action by committing to strengthen their efforts to tackle deforestation in their portfolios. We also joined the Natural Capital Investment Alliance which aims to accelerate the development of natural capital as a mainstream investment theme. All members have plans to launch, or have launched, investment products aligned to Natural Capital themes that target mobilising more than USD 10 billion in aggregate by the end of 2022.

Social issues have also been rising on the agenda to include an assessment of the social implications of corporate climate strategies. However, fewer than half of the companies that are committed to respecting human rights demonstrate it through tangible actions like human rights due diligence. And at a time when the focus on inequality is increasing, businesses have an opportunity to change the way their business models operate to benefit wider society.

The financial sector will now be focusing in earnest on how to deliver on

these pledges. This means collaborating both within and beyond the industry to develop methodologies to better measure companies' exposure to deforestation and biodiversity impacts (positive and negative) and pushing for increased data availability through company disclosure and improved reporting frameworks through the work of the TNFD, Nature Action 100, Human Rights 100 and others.

As the financial sector becomes even more vocal on environmental and social issues and client demand rises, we can expect regulators to increase their scrutiny in terms of the authenticity of financial products claiming to be sustainable. The UK and the EU have both set out clear sustainable finance strategies with increased transparency as a key aim. The EU Taxonomy and Sustainable Finance Disclosures Regulation are already driving increased corporate and financial disclosure. Other jurisdictions are also ramping up disclosure expectations, the ISSB and the potential for a 'common ground taxonomy' could offer a much needed baseline level of global comparability. This would support financial institutions' disclosures, which are underpinned by data from the companies they invest in, lend to and underwrite.

This year, all eyes will be on financial institutions and how transparent they are about their current position on these systemic issues. They will be urged to collaborate with others within and outside of the industry to move forward on a positive trajectory. Those firms who can demonstrate authenticity in driving a more sustainable financial system, actively supporting the transition to a net zero and nature positive economy, are set to benefit.

NEXT EUROFI EVENTS

THE EUROFI FINANCIAL FORUM 2022
7, 8, 9 SEPTEMBER 2022
PRAGUE – CZECH REPUBLIC

THE EUROFI HIGH LEVEL SEMINAR 2023
APRIL 2023
SWEDEN

5

CMU IMPLEMENTATION

ISSUES AT STAKE

Implementing CMU remains a key objective in the post-Covid context to support the economic recovery and the green and digital transition objectives of the EU. A new CMU action plan published in September 2020 completes the previous ones with additional actions for making capital market financing more accessible to EU companies, in particular SMEs, and a stronger focus than previous plans on increasing retail participation.

Four legislative proposals were published by the European Commission in November 2021 to implement this action plan: setting up of a European Single Access Point for corporate information and proposing enhancements of three key existing legislations ELTIF, AIFMD and MiFIR to better support CMU objectives, in addition to changes to insurance and banking prudential requirements regarding long term investments. Further proposals are planned for 2022 concerning listing rules, open finance and corporate insolvency rules.

These actions are meant to be game-changers for the CMU project, which faces several challenges. Firstly, implementation challenges, due to the breadth of the project and the urgency of its implementation, which is not easily compatible with the protracted European legislative process. Secondly, challenges related to the post-Covid macro-economic and monetary context that tends to favour debt financing and liquidity hoarding over long-term investment. Thirdly the limited financial literacy and risk averseness of many EU citizens.

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Q&A

DR. THEODOR WEIMER

Chief Executive Officer - Deutsche Börse Group

A strategic view on EU capital markets

How are EU capital markets evolving 6 years after the launch of the CMU and one year after Brexit? Has progress been made in terms of integration and competitiveness?

We urgently need a sustainable, efficient, and globally competitive European capital market. The Covid-19 pandemic along with weak economic growth, high inflation, unprecedented levels of debt, and an increasingly constrained banking system have put us in a very challenging situation.

The Brexit and the enormous financing challenges raised by the transformation towards a sustainable and digital economy reinforce this reality. High time to understand the critical role of capital markets as a largely untapped growth engine for the EU and key pillar of strategic autonomy.

While I welcome the significant efforts undertaken by politicians and regulators over the past years, EU capital markets unfortunately continue to underperform across key proxies. Despite the record number of more than 1,800 IPOs globally last year, only about 10% took place in the EU. On top of that, the unlevel playing field created by MiFID II/MiFIR has resulted in a strong fragmentation with more than 650 trading and execution venues across all asset classes.

It creates significant drawbacks for liquidity, transparency, and broader market quality. The underperformance is further underlined by market capitalisation realities, where EU-listed companies come in at around 52% GDP while the comparative US figure is about 150% of GDP.

This means: We have a lot of homework to do and must double up on our efforts in this critical time! Which is why I welcome the clear emphasis by Commissioner Mairead McGuinness on the need for “strong EU financial market infrastructures”.

Can a significant impact be expected from the CMU package of measures proposed in November 2021 in terms of further development and integration of EU capital markets?

Capital markets do not only unlock potential for growth, innovation, and jobs. First and foremost, they provide the unique opportunity for future generations to directly participate in Europe's economic success. Let me elaborate on three dimensions in this context: First, with regard to the financing of companies and notably SMEs, which requires particular attention for a swift Covid-19 recovery. I welcome the initiative around the European Single Access Point which strives to improve visibility and data availability. Not overburdening issuers will be the key recipe to success; but there are additional key elements that need to be tackled swiftly, such as the work on securitisation, where other markets are miles ahead.

Second, it is absolutely critical that we put our citizens at the heart of our markets. With pension systems across the EU being increasingly under pressure, it will be very important to open this segment to equities in a different way, ensuring participation and creating significant welfare effects. We need to advance financial education and improve transparency!

Third, MiFID II/MiFIR has failed to establish a market structure and market data quality that is in-sync with this broader political vision. It needs to be reformed.

Going forward, we need to ensure a holistic policy approach that differentiates between primary and secondary markets. We should not forget that exchanges play a very particular role in society through their positive contributions to transparency and price formation, but also by being an essential part of the IPO ecosystem. The ESMA market structure report has underlined this very clearly: While EU exchanges get disadvantaged, non-EU alternative execution venues emerge as the champions!

Will the new CMU action plan support adequately the EU post-Covid recovery? Are further measures needed in the capital market area to support the financial autonomy objectives of the EU following Brexit?

Any action plan must ensure that it creates an efficient symbiosis of regulators and the markets to strengthen strategic autonomy and to build a strong and globally competitive ecosystem, especially in light of Brexit.

The EU's Covid-19 response marks a historic turning point – as the EU itself is now turning to global capital markets. This shows both the importance but also the responsibility that capital markets carry for the future of our society. Regulation needs to complement and foster this responsibility. At Deutsche Börse Group, we stand ready with our vast products and services portfolio to play our part – be it with regards to the issuance process with our Clearstream operations or also the structural development of derivatives markets with Eurex. This stems not only from our history as technological innovator, having been the pioneer in introducing electronic trading in the 1990s and now harnessing the opportunities brought about by DLT. It's also rooted in our self-understanding as European corporate citizen aiming to build sustainable markets for generations to come.

Our Eurex Clearing Partnership Programme and the Euroclearing offer is a particular case in point here. Having been built to support our customers in times of significant regulatory uncertainties while simultaneously catering for the legitimate public interest of the EU, we are proud to have achieved a market share of about 20%. The next phase will require further incentivisation measures to help the market transition into a healthier environment, finding a new equilibrium with more competition and significantly reduced risk concentration.

Do the MiFID II/MiFIR review proposals tackle the main transparency and level playing field issues in the EU securities markets? Could more be done to increase the competitiveness of EU capital markets?

We have a high-quality and crisis-proof regulatory framework in Europe today. Nevertheless, in particular MiFID II/MiFIR still show great potential for further – mindful –

improvements. All while I caution not to undermine its effectiveness by overengineering its purpose.

This is why I strongly welcome the proposal to delete the open access provisions for ETDs – rules that no other jurisdiction ever had or tested. This will reduce financial stability risks and guarantee the global competitiveness of EU infrastructures. I am also in favor of the proposed ban on payment for order flow. We cannot afford to tolerate conflicts of interests and have to ensure an equitable market structure.

However, it is exactly on this latter dimension where the review proposals fall short. This holds especially true for the SI regime, which was introduced for large institutional orders – and should be used only and exclusively for those. About 250 SIs have been created in the internal market since 2018. This regime needs a radical reform to effectively ensure market transparency.

Speaking of transparency, let me add a few words on the consolidated tape proposal. A consolidated tape could have a positive impact for the EU's investment climate. Yet, with a complete lack of data quality in the non-exchange segments, no consolidated tape has emerged yet despite already being included in MiFID II/MiFIR.

While exchanges are already making their high-quality market data freely available on a non-discriminatory basis after 15 minutes, alternative execution venues deliver neither high quality nor free data. This needs to be addressed urgently, as it prevents private sector offers from emerging. I believe the EU should work on establishing a CT that is fast to implement, does not come with significant costs for market operators or participants, and creates equitable value for all investors, not only professional ones.

Only if we understand that exchanges form the central heart-piece of our capital markets, we will be able to create deep, liquid and globally competitive capital markets that meet the expectations of EU citizens.



Q&A

PATRICK THOMSON

Chief Executive Officer for EMEA -
J.P. Morgan Asset Management

The role of the asset management industry in a sustainable, open and competitive Europe

What is the role that asset managers are playing in the green transition? What is the extent of the impact of asset management activities on the green transition? Are further regulatory measures needed to support this role and do certain obstacles need to be addressed?

The success of the green transition will be predicated on the efforts of both policymakers and market participants. As to the latter, asset managers have a significant role to play and indeed, have been at the forefront of industry efforts. We have seen both individual commitments and industry-wide collaboration, with Climate Action 100+ and the Net Zero Asset Managers Initiative being powerful examples of asset managers working together to meaningfully drive forward the green transition.

While the role of the asset management sector is multi-faceted, there are three particular elements worth highlighting. First, asset managers can help educate and empower investors to take advantage of investment opportunities created by the green transition. Investors are increasingly vocal on the importance of ESG considerations in their investment objectives; it is now often a critical part of the discussion between asset managers and clients. The industry has responded in kind, helping clients to further understand the importance of the transition, as well as offering a variety of products and strategies across the spectrum of client ESG preferences.

Second, in seeking investment opportunities in line with investors' ESG objectives and, in doing so, factoring in the relevant risks during the investment process, asset managers can contribute to the appropriate pricing of climate-related risk by financial markets. Third, the stewardship activities asset managers undertake with portfolio companies helps to promote long-term shareholder value. Amongst other things, this dialogue may encourage investee companies to have robust transition plans and enables constructive engagement where progress is not fast enough.

On the role of policymakers and ESG regulation, we believe their primary objectives should be to set the appropriate standards for financial markets to facilitate the green transition and ensure investors have the necessary information to make informed decisions. The EU has been at the vanguard of global regulatory efforts and should be commended for bringing international attention to climate risk, as well as highlighting the importance of public-private sector collaboration. While Europe has enjoyed first-mover advantage, with certain elements of its framework becoming the industry standard, several challenges remain including, sequencing, insufficient clarity and lack of consistency with existing legislation. It is crucial these issues are addressed, in order to fully establish a well-functioning regulatory regime that delivers on the needs of all stakeholders.

Looking ahead, we note two additional considerations. First, we believe the focus of regulation to date has emphasised the channelling of capital to already green activities. However, the green transition will likely necessitate greater focus on the larger part of the economy that is not yet green but has the potential to be so in the future. Furthermore, to the extent possible, we continue to recommend international alignment of standards. The challenges presented by climate risk are global and will require a globally-coordinated response.

Is there a significant risk of greenwashing, what are the underlying issues in the asset management area and how to address them?

As investors' ESG considerations and the facilitation of the green transition more prominently influences the direction of capital, we acknowledge there is a material risk of 'greenwashing'. Greenwashing, as described by ESMA, are instances where the sustainability profile of a company, a financial instrument or a financial product that is disclosed does not accurately reflect the underlying sustainability risks and impacts. We believe that well-calibrated, unambiguous

disclosures, which enable investors to assess and identify the most relevant financial products in line with their objectives, are critical to address concerns in relation to greenwashing. The EU has again been an early mover in this regard, through its SFDR framework. In addition, investor education will have a crucial role to play.

It is important to also recognise that discussions on greenwashing can be highly subjective. Given the diversity of views on what constitutes 'green' – for example, the classification of nuclear power – and there yet to emerge a consensus view, concerns around greenwashing are often scenarios where a product or strategy does not align with an individual party's definition of green. Similarly, all stakeholders are operating in a rapidly-evolving and dynamic environment. It is important that, in seeking to minimise the risk of greenwashing, policymakers do not proscribe new sustainable strategies and inadvertently stifle market innovation.

Do the proposed AIFMD amendments tackle the main areas where a further efficiency and integration of the AIF market is needed? Are the reviewed provisions of the AIFMD concerning delegation rules and liquidity management tools in particular likely to have a positive impact in terms of investor protection and financial stability?

The AIFMD review, which proposes changes to rules for both AIFs and UCITS, has come at an opportune moment. The investment funds industry, like broader financial markets, experienced a live stress test during the pandemic-related market volatility in March 2020. While we believe the funds industry broadly performed in line with expectations, it is prudent to assess whether there are elements of the framework that can be improved. We believe this has been recognised by the European Commission and we commend them for their targeted and balanced legislative proposal.

Regarding liquidity risk management, we strongly support harmonising the availability of liquidity management tools (LMT) across the EU, which we believe will directly contribute to improving financial stability. Nevertheless, we would urge caution in two areas. First, while we understand the desire for regulators to want to prescribe granular requirements, this should not come at the expense of the flexibility asset managers and fund boards have in selecting the most relevant tools for their circumstances and in the interests of investors. In addition, we continue to believe asset managers and the board are best placed to make the decision to activate LMT. As observed during March 2020, not all fund types faced the same set of challenges. Therefore, a decision by regulators to activate tools across a group of funds may introduce a contagion effect and procyclicality, thereby undermining market resilience.

On delegation, we welcome the acknowledgement from the European Commission of the contribution the current model has made to the global success of the UCITS framework and also, increasingly, for AIFs. The delegation model has been a critical feature in enabling the UCITS brand to permeate and appeal to investors on an international scale that is without comparison, and it is widely recognised as a best-in-class product. We appreciate the rationale and motivation behind some of the proposed changes, which we believe are driven primarily from a supervisory convergence perspective, rather than to address any material shortcoming in investor protection. In principle, we fully support efforts to ensure the consistent application of

EU rules across Member States, although, in practice, we have seen few – if any – instances where this is not currently the case, in the context of delegation.

As such, we would urge caution when considering potential changes to the current delegation framework, which should be approached principally from the perspective of what is best for investors. We further encourage policymakers to avoid compromising the practical benefits in order to address theoretical concerns.

Are the measures proposed in the ELTIF review likely to position ELTIFs as a significant source of long-term finance for the EU economy and a key enabler of the CMU? Can revised ELTIFs become a significant investment vehicle for retail investors, and will they be easier to operate for AIF managers?

A core tenet of the updated CMU project, particularly in light of the effects of the COVID pandemic, is to encourage and facilitate a more sustainable and resilient economic recovery. We believe ELTIFs will have an important role to play in delivering this.

We welcome the ambitious approach taken by the European Commission in the ELTIF Review. ELTIFs have seen little uptake to date, largely as a result of the restrictive nature of certain provisions in the original framework. The new proposal seeks to amend some of these without compromising investor protection. In particular, we would highlight the revisions to the eligible assets requirements and, notably, the provisions relating to investments in other collective investment undertakings. We agree with the European Commission that these specific changes may facilitate fund-of-fund strategies, which we believe will help the scale up of ELTIFs and enable more diversified portfolio construction.

Regarding retail investor participation in ELTIFs, we believe the legislative proposal represents a step in the right direction. The most prominent example of this is the removal of the €10,000 'entry ticket' but we also believe the provisions that seek to align the ELTIFs regime with other EU legislation, notably the cross-border distribution of funds and MiFID suitability requirements, will be helpful. In addition, the provisions that seek to increase the liquidity profile of an ELTIF could also enhance retail investor participation.

CMU WAY FORWARD



UGO BASSI

Director, Financial Markets, DG for Financial Stability, Financial Services and Capital Markets Union - European Commission

What will the CMU package of 25 November deliver?

The CMU initiative was launched in 2015 and the Commission took several sets of measures since. They all aimed at addressing specific issues on capital markets - be it limited access to financing or hurdles for retail investment. The CMU indicators dashboard published last June demonstrates that the impact finally starts showing in data - as there was an inevitable lag between the moment the Commission adopted a proposal and the moment the impact of enacted legislation started to be felt on the ground. EU capital markets are now better positioned to boost economic growth and facilitate the sustainable and digital transition of our economy.

The package of four legislative proposals adopted last November will further contribute to the three CMU objectives:

- 1) help smaller companies get off the ground and expand, and larger companies to thrive;
- 2) make it easy for people to invest safely in their future; and;
- 3) integrate national capital markets into a genuine single market.

Firstly, we will create a European Single Access Point (ESAP). ESAP will provide free, seamless and integrated access to financial, sustainability and other non-financial information published by companies and other entities. Because this information is now scattered across various websites and national registers, ESAP will make it easier and cheaper for both EU and international investors to find the information they need, thus facilitating cross border investment. And because ESAP will put European companies on investors' radar screens, it will increase their funding opportunities. This is especially important for smaller companies and for companies located in smaller capital markets.

We also want European long-term investment funds (ELTIFs) to play a bigger role in supporting our economy post-recovery and facilitating retail and institutional investment in long term assets such as infrastructure, social and sustainable projects, including housing and clean energy. In particular, ELTIF is a very suitable vehicle for financing SMEs as well as new technology projects. Currently, ELTIFs are not yet being used to their full potential. The revised framework will make the rules more flexible and clarify the distribution rules. This will make it easier to market ELTIFs across the EU and thus support a single market for capital.

We have also looked at the alternative investment funds' (AIFs) market. Overall, the European rules regulating AIFs' managers are working well, so there was no need for an overhaul. Still we want to further facilitate access to finance by EU companies by harmonising rules for funds that issue loans to companies, as a viable alternative to bank lending, and enable funds to originate loans across borders more easily, while safeguarding investors' interests. Therefore, the Commission wants to make sure that managers of loan-originating funds follow robust internal processes and procedures when issuing loans, avoid damaging conflicts of interest and keep investors informed about the performance of the credit portfolios.

Lastly, we want all investors to have easier access to trading data in capital markets, in instruments such as shares, bonds and derivatives by bundling information from the more than 400 EU execution venues in a consolidated tape. This electronic system will collect and combine close-to-real-time trading data for use by investors and intermediaries. Stock exchanges, particularly smaller ones, will receive a fair participation in the revenue generated by the data they provide for the equity consolidated tape. And we are also changing the rules to make trading more transparent.

**Given today's challenges,
we have no choice but to make
swift progress on CMU.**

Negotiations with the co-legislators on these proposals have now started. Delivery will require everyone's goodwill and political determination. We now need Member States and Members of the European Parliament to match the Commission's ambition. So far, co-legislators expressed strong support, which shows the consensus that the benefits of the CMU are not limited to financial ends, but that they are closely linked to essential objectives such as combatting climate change, supporting sustainable post-COVID growth and the EU's role on the global stage.

And indeed, given today's challenges, we have no choice but to make swift progress on CMU.



ALEŠ KRÁLÍK

Head of Capital Markets Department -
Ministry of Finance, Czech Republic

Capital Markets Union vs national strategy for the development of capital market

European Commission published Green Paper “Building a Capital Markets Union” in February 2015, followed by Action Plan in September 2015 and mid-term review in June 2017 and new Action Plan in September 2020. Already in February 2015 we realised in the Czech Republic that the possibilities of European Union to develop capital markets in EU are limited. Much more is needed to do on national level, therefore we started working on our own National Strategy for the Development of Capital Market in the Czech Republic. We cooperated closely with Structural Reform Support Service of the European Commission, which helped us to realise several projects. Firstly the World Bank analysed the capital market and business angels in the Czech Republic with some recommendations for further development. Secondly EY prepared a report “Capital Markets Literacy in the Czech Republic” and a website “Capital Guide” in order to educate SMEs about the possibilities of financing through capital market.

The National Strategy is mainly based on the idea of stability and predictability of regulatory environment. The idea behind it is that you cannot develop capital market through regulation (it is a market, so it should be market-driven). This is similar to the bottom-up approach of the original Capital Markets Union. Constant changes of regulation are burdensome and discourage market participants, especially the small ones for which the compliance with ever-changing regulation is devastating (complex rules favour bigger players). Several market players in the Czech Republic for example ceased their activity because of huge fines under Market Abuse Regulation. And if small players leave the capital market, there is no one left to serve SMEs from the real economy (as bigger players prefer bigger clients). In this regard - the less changes of regulation, the better.

Unfortunately European Union always includes review clauses in its law, so every piece of legislation is subject almost to mandatory changes after 5 years. For example in relation to AIFMD, most market participants were satisfied with its functioning and did not consider any change necessary, but still AIFMD review was introduced in November 2021 (though the changes are supposed to be targeted).

More regulation can lead to paradox results, which can be demonstrated especially in relation to investor protection. More and more rules on investor protection lead to retail investors being overloaded by many documents which they are not able to read or analyse. If the investor receives a 2 pages document, it is very probable he will read it. However if he receives 20 or more pages, it is very probable he will not read it. Also for example PRIIPS which should have increase investor protection in fact lead to less consumer choice as many product manufacturers decided not to target retail

investors any more. I also know cases of investment firms (or banks) who do not offer investment services to retail clients and by this they avoid compliance with many rules that would be otherwise obligatory. Therefore it is always welcomed when the European Commission comes with a regulation that is voluntary, for example UCITS, EuVECA, EuSEF, ELTIF, PEPP or Green Bond Standard. These voluntary regimes mean no obligatory compliance costs and as such are mostly harmless (in the worst case scenario nobody will comply with them).

**More and more rules on investor
protection lead to retail investors
being overloaded.**

The reason why European Union can do little to develop capital markets is because of the main drivers for development, which are pension funds, taxation and financial literacy. European Union has very limited powers in these areas. What the European Union can do is build an infrastructure, like for example ESAP or CTP in MiFIR. Although infrastructure is important for capital markets (and I consider all professional market participants to be the infrastructure), the basic actors remain to be households (and their savings) and companies (real economy). We need to attract more household savings to the capital market (which will help their resilience and will enable them to beat the inflation). At the same time we need to attract more companies to the capital market, taking into account that bank loans and grants remain to be the main source of financing entrepreneurs.

In my opinion most work needs to be done on national level and the best EU can do is DNSH - do no significant harm.



HARALD WAIGLEIN

Director General for Economic Policy, Financial Markets and Customs Duties Directorate - Federal Ministry of Finance, Austria & Member of the Board of Directors - European Stability Mechanism (ESM)

Substantial changes need a combination of measures

By the end of the last year the negotiations have started on the first deliverables of the Capital Market Union-package, the European Single Access Point (ESAP) which aims at more funding and creating better business opportunities for companies, the review of the European Long Term Investment Fund Regulation (ELTIF) aiming at the promotion of long-term investments by way of a fund, the review of the Alternative Investment Fund Manager Directive (AIFMD) intending to facilitate access to funding for companies and a review of the Markets in Financial Instruments Regulation (MIFIR) aiming to enhance market transparency by means of the build-up of a consolidated view of the market. Less noticed, additional CMU-measures in the form of incentives for direct investments in companies by banks or insurance companies were published as part of the Basel III.5-proposal and the Solva II-review. Other legislative action is expected for 2022 and 2023 thus complementing the CMU-working program of the current legislative period.

I wonder if the rising attractiveness of currently less liquid but labelled product like the ELTIF will have recognizable impact on customer engagement in the capital markets. Enough alternative products are already offered by market participants thus representing attractive investment opportunities for customers while ensuring satisfactory investor protection and conduct of business rules on a high level. However, the lowering of undue administrative burden, easier access to funding opportunities and the broader dissemination of financial literacy will have an impact on the liquidity of capital markets at least in a medium-term perspective.

The publication of the Commission and the OECD-INFE-joint framework for adults was a good start into this year with regard to financial literacy as this framework is aimed at improving financial skills with a view to enable more adults to making thoughtful decisions regarding their personal finances and investments. To ensure the effectiveness of this framework, measures on an international, EU- and national level will complement each other. Such an approach makes sense and should also be used elsewhere.

Easy access to funding opportunities is the vision behind several measures aiming at improving the transparency of capital markets and the visibility of companies seeking for funding and liquidity which cannot be fulfilled by products offered by traditional banks or investment firms. The impacts of the pandemic will raise the demand for such products as soon as public subsidies will be reduced. In this respect, the proposed amendments of the OGAW- and UCITS-Directive, in CRR and Solva II can supplement traditional banking activities and the crowdfunding framework set up by the previous CMU-package. ESAP can improve the visibility of companies and the comparability of investment opportunities.

Forthcoming CMU-measures will allow additional progress. Hopefully, these measures will ease administrative burden and complexity, accomplish their respective aims and enable progress also in legislative environment (e.g. insolvency law) where still hesitant developments are made from a capital market perspective.

Informed legislative action on EU-level can set important incentives.

Let us be clear on one thing: Legislative action on EU-level can set important incentives but a political will to set actions and a deeper understanding of the investment activity on EU and national level is needed to ensure significant progress in order to build up efficient capital markets. Of course, a decision to complement a contribution-based pension system with partial capital market based financing, as recently made by a big Member State, decisions to professionally invest, manage and administer EU-Funds and public incentives which effectively contribute to the portfolio diversification of customers with products of the capital market do make a difference also in a short- and medium term perspective due to direct and relevant effects for capital markets.

Let me conclude with a more general observation: substantial changes require a combination of measures.



ROBERT OPHÈLE

Chair - Autorité des Marchés Financiers (AMF)

What the Capital Markets Union most needs is strong political support

More than a year after the European Commission announced its new action plan to strengthen the Capital Markets Union, we are at a stage where effective delivery becomes absolutely critical for the credibility of the whole process. It is an essential milestone to create a deep and efficient Single Market in financial services, strongly needed as the EU faces significant challenges. The recovery from the economic crisis caused by the pandemic has made it key to improve access to market financing, to support the EU economy in the long run and to improve its resilience against future crisis. And even more after Brexit, the Union needs to develop autonomous and competitive financial markets.

In this context, the legislative package recently published by the Commission rightly puts a central focus on some key elements that, if rapidly endorsed and implemented, would embody real progress; delivering consolidated tapes for equity, bonds, ETFs and derivatives, settling an ambitious EU regime for sustainability disclosure by corporates accessible through a single access point as well as financial statements, improving the regulatory framework of the fund industry especially when investing in non-liquid assets, devising an EU regime for digital assets and digital asset service providers would be quantum leaps in the bumpy road towards a fully-fledged CMU. They would demonstrate that the EU can compete and lead in international capital markets.

The Commission's initiatives to improve transparency on company data and trading data on financial markets will ease access to EU capital markets. The project to establish by 2024 a single access point (ESAP) bringing together, for the public and for investors, the regulated information of businesses and market participants, covering both financial data and data related to sustainability, will bring a significant added value to transparency. Likewise, the proposed revision of MiFIR to enable investors to access post-trade information on equities, bonds and derivatives practically in real time, via a consolidated tape, is a concrete positive step forward. Moreover, the proposals to strengthen the pre-trade transparency obligations applicable to systematic internalisers and to better calibrate the deferred publication provisions for bond trading data address long-term concerns that MIFID II has not fully responded to.

The CMU must also support the key role of asset management in financing the economy, while ensuring investor protection. In this field, the proposed revision of the AIFM directive should improve circulation of information and coordination between EU supervisors, as well as clarify the rules applicable to delegation. This will contribute to improved investor protection. Retail investors' access to long-term investments in good conditions is also an essential requirement to ensure the EU's economic development; in this perspective,

the revision of the framework for European Long-Term Investment Funds (ELTIF) is a unique opportunity to develop a high-quality European vehicle on this collective investment management segment.

One could obviously regret that some, maybe more fundamental issues, such as the harmonisation of fiscal rules and insolvency laws or the development of a single supervisory framework are not in the EU agenda. But they will come in due course if the current steps are successful since they will appear as necessary in order to avoid forum shopping.

**Without some rapid delivery,
the credibility of the whole process
would be at stake.**

Efficient European supervision is actually a cornerstone of the CMU, together with the establishment of an effective single rulebook. Previous legislative attempts towards more integrated supervision have not received enough political backing, despite a broad consensus on the need for a consistent implementation of rules across the EU. As efforts are made to promote supervisory convergence with existing tools, there will be rapidly clear evidence that convergence exercises are reaching their limits, in particular as they largely depend on national authorities' resources. The EU capital market needs a harmonised and unified supervision that ensures a level playing field for all market players and eliminates arbitrage opportunities.



LIEVE MOSTREY

Chief Executive Officer -
Euroclear S.A.

The finishing line for EU post-trading? Or, new inefficiencies at the horizon?

The Capital Markets Union (CMU) action plan has proven to be a marathon, with some pieces of the action plan going as far back as 20 years. Yet, I believe we should recognise the progress made to overcome barriers and harmonise practices in the post-trade area. CSDs have come a long way and today represent, robust and highly supervised institutions that are the spine of to Europe's financial stability.

I firmly believe that we should remove the word “barriers” - that we have been using for so many years - from our CSD vocabulary. We have seen some considerable successes within our ecosystem. The implementation of Target2Securities (T2S), the CSD Regulation, the ongoing harmonisation efforts within the frame of the Eurosystem Collateral Management System (ECMS) and the planned connections of Euroclear Finland, Euroclear Bank and Euroclear Sweden to T2S are all significant steps that bring CSDs and their environment to a new level of efficiency and stability. The inefficiencies that remain are national differences in securities law, withholding tax procedures and supervisory approaches. When these challenges are tackled, we will be closer to the finishing line of the marathon.

The CMU package proposed by the EC in November 2021 is less relevant to the industry where Euroclear operates. We do welcome all the efforts geared towards further market standardisation and cross-border integration. Those initiatives will add significant muscle to the EC's plans to realise the CMU.

The expected CMU initiatives for 2022 that concern post-trading, the revision of CSDR and planned work on the withholding tax procedures, will be crucial steps which should allow us to clearly see the end of the post-trade harmonisation agenda.

For the CSDR review, we support the direction of travel indicated by the EC for the upcoming CSDR REFIT which will largely focus on improving CSDR elements that are unhelpful for the cross-border activity of CSDs or their international competitiveness. This should also support the EU open strategic autonomy. As CSDR is still a relatively new regulation, a fundamental review at this stage would be superfluous. Even so, there are pivotal elements that did not work well and need to be addressed:

- The passporting process was counterproductive and made cross-border service provision more difficult rather than easier
- The mandatory buy-in regime - following its helpful postponement - should be changed to a more market-friendly arrangement
- The provisions on third country CSDs should ensure a level playing field between third country and EU CSDs

We fully support the EC's intention to tackle one of the last challenges identified by the Giovannini Group almost two decades ago - the EU withholding tax procedures which differ substantially between Member States. New technologies and a drive towards more digitalisation could greatly improve the current manual and labour intensive processes.

Digital innovation will be key to the success of CMU. We are excited to see the benefits of new technologies such as DLT and smart contracts which can be utilised in our area of activity and the broader CMU agenda. The EU should reflect on and implement a sound European regulatory approach which reflects the inclusion of these technology solutions to allow its capital markets to reap those efficiency advantages. If not, there is a risk that renewed fragmentation, non-harmonised practices and regulatory arbitrage would re-introduce inefficiencies and risks that took 20 years to remove. For example, we today already see different approaches within EU-27 to national digital asset legislation, adding to the complexity of having 27 different securities laws. This approach could result in additional fragmentation and contribute to increased risk.

**We should remove the word “barriers”
from our CSD vocabulary.**

Looking beyond the current CMU action plan, we believe renewed holistic market attention will be required on how the trading, clearing and settlement layers operate cross-border, post implementation and revision of major regulations such as MiFIR/D, EMIR, CSDR, taking into account different dynamics of cash instruments (equities, debt). The Commission could also seek evidence on the effectiveness of the open access and interoperability requirements included in MiFID, EMIR and CSDR and the reasons for a potential lack thereof, and how such requirements would apply in a digital environment.



CHRISTIAN STAUB

Managing Director Europe -
Fidelity International

Catch 2022: EU citizens' inflationary options

Paradox

2021 brought the recovery many had hoped for. Businesses reopened, commuters returned to their desks, and the bravest of us even went on holiday. And yet the macro environment for capital markets in 2022 - rising prices, high debt levels and past-the-peak growth - increase the risk of a policy mistake in the next 12 months as central banks and governments try to navigate various 'Catch-22' (or Catch-2022) paradoxes reminiscent of Joseph Heller's 1961 novel.

One such paradox is how central banks might tighten monetary policy and rein in inflation without killing off the recovery. Another is how to cope with higher energy prices while continuing to drive world transitions to a low-carbon economy.

But the current inflationary environment has injected paradox into the retail markets too. While keeping cash on deposit might seem like the prudent thing to do as consumers grapple with unknown cost-of-living raises and the prospect of further pandemic disruption, savers actually need a counter-intuitive mix of cash and investment to both provide short-term cushioning and protect their purchasing power against inflation at the same time.

Thankfully, there are a number of levers available to policymakers as they seek to stimulate the right mix of cash saving and capital market investment.

Pensions

EIOPA's work on pensions dashboards and tracking services will help Member States identify emerging gaps in their pensions systems and EU citizens to navigate the same. Compulsion could be key and it will be interesting to understand the current mix of DB and DC retirement provision across Pillars 1 and 2. Likewise, whether Member States are considering auto-enrolment into DC IORPs.

Within the workplace, so-called 'side car' saving-schemes that allow salary sacrifice to build up a cash reserve alongside IORP investments themselves could help combine inflation-linked cash cushions with inflation-proof long-term 'retirement resilience' on one single Workplace platform. IORP consolidation is another means of driving efficiency, as is extending the scope of IORP provision to smaller firms and even individuals via third-party multi-employer scheme structures such as Master Trust IORPs.

We also hope that pensions tracking services are ultimately constructed along the same API lines as Open Banking under PSD 2 - even if they remain 'read-only' not transactional

tools for citizens for the time being. Being able to see one's cash savings and pensions investments in one place will be a powerful financial educational tool in helping citizens set appropriate short- and long-term targets.

Participation

Policymakers might also consider connecting EU workplace investors more directly to economic growth aspirations. For example, the ELTIF could be targeted specifically at IORPs as a means of giving DC scheme members DB-like investment exposure to less liquid higher return assets. And in all of this, IORPs would benefit from PEPP's focus on web-based and mobile applications to better engage and educate scheme members about their asset mixes and attendant choices.

The current inflationary environment has injected a purchasing power paradox into retail markets.

We also think that advice has a key role to play in helping consumers navigate Catch 2022's world of counter-intuitive inflationary thinking, and would warn MiFID 'inducement' reform against leaving the EU with the same 'advice gap' as exists in the UK. And, as ever, we urge the Commission to accelerate the roll-out of Open Finance technology to empower consumers to know their financial selves better in the first instance. This should include the 'sustainability' of their asset mix and aspirations as well as its 'resilience' to inflation.

Policy

So, short term, 2022 will be a key year for monetary policymakers focused on the big dilemmas of inflation and growth. But longer term, it will mark a crucial 12 months for retail policymakers too, in their management of the financial health of EU citizens. Both now and for future generations to come.



BJØRN SIBBERN

President European Markets -
Nasdaq

Together for inclusive and long-term growth

In this time of response to and recovery from the pandemic, efficient capital markets and financial ecosystems are more important than ever. This is why the European Commission consistently driving the Capital Markets Union project, including with the Listing Act initiative, forward is the right thing to do. The focus needs to be to find the best conditions for smaller market participants – both smaller companies and retail investors – to come together and create sustainable and inclusive growth.

In 2021, Nasdaq, particularly strong in attracting these small- and medium sized enterprises, became the leading European exchange with 219 equity listings, including a record number of 174 initial IPOs, raising a total of EUR 13.4 billion. A testament as good as any to the power of many. In addition, secondary capital raisings reached over EUR 20 billion, illustrating the value of public markets for corporate financing. The numbers confirm the opportunities for inclusive long-term growth and job creation.

I especially welcome the European Commission's attention to retail investors. In this context I want to stress the need for the regulatory framework to deliver a market organization that both protects and engages retail investors.

The price formation process that happens on the multilateral and transparent markets needs to continue to be efficient, robust and reliable. This requires the MiFID/MiFIR rules to ensure that transparent markets represent the collective interests forming the price. Large transactions need a less transparent place, and bilateral systematic internalizers can be one such place, but they need to be allowed to execute only such large transactions. This also means that the overall regulatory framework must not incentivize participants to direct retail flow away from the multilateral and transparent markets. Addressing Payment for Order Flow (PFOF) in the MiFID review is the right thing to do for equity trading in EU. The review of MiFID/MiFIR should aim at simplifying the framework in a way so that it can be practically enforced and deliver on its intentions. Effective supervision and enforcement need to be at the heart of the rule-making process.

With my experience from markets with a high proportion of retail investors, I agree with those that argue that private investors are not a homogenous group. Some have been active a long time and are experienced, while others are newer to capital market investments. A more differentiated categorization of non-professional investors would allow a better calibration of investor protection rules. Simplifying administration – where appropriate – has the potential of unlocking more financing opportunities. This is a concept I support within the Listing Act initiative.

Along the lines of simplification, I also welcome some of the other ideas in the Listing Act initiative. For instance, shortening prospectuses. For issuers listed on Nasdaq's SME Growth Market 'First North', and who fall outside the scope of the Prospectus Regulation, our rules prescribe a 'Company Description' instead. This document may be around 60 pages long and it has worked well in the Nordic SME market for some time now. This shorter document is better tailored at smaller non-professional investors, as it is easier to digest as a basis for investment decisions.

Focus needs to be to find the best conditions for smaller market participants.

Similarly, I see room for simplifications and clarifications of the market abuse framework. This framework is core to the integrity of markets. However, details and uncertainties add a lot of cost for issuers. In addition, divergent interpretations and applications across Europe raise barriers for cross-border investments. Internationally active investors should not be discouraged by uncertainties in diverging implementation and application of EU rules.

Another area with room for harmonization is SPACs. Nasdaq has a SPACs offering in place, including rules and ongoing surveillance. The current situation of different regulatory approaches across EU member states is however not satisfactory. I welcome an initiative aiming at ensuring a harmonized picture and appropriate investor protection.

Nasdaq will always continue its close dialogue with national and international stakeholders in the markets where we operate, contributing to creating the best environment for inclusive and sustainable long-term growth.



THE EUROFI
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RETAIL INVESTMENT STRATEGY



BENOÎT DE JUVIGNY

Secretary General -
Autorité des Marchés
Financiers (AMF)

Make targeted policy adjustments to improve retail access to capital markets

Encouraging the participation of retail investors in EU capital markets is a key priority for the development of the CMU. In this respect, a review of the EU framework to enhance retail investment should aim at developing cross-border investments and providing long-term investment options to European households, while making sure they have access to good quality advice and strong investor protection.

Savings accumulated during the pandemic and the currently low level of returns offered by low-risk investments provide an additional window of opportunity. In France for instance, in the latest 2 years and amid the turmoil of the pandemic, 965,000 new retail clients invested in equities for the very

first time (this development remains to be monitored).

Policy-wise, the Commission has rightly set the long-term needs and interests of investors at the heart of its renewed CMU action plan, in particular with its proposals to enhance transparency and give investors more access to trading and company data (through the consolidated tape and the European single access point respectively) ; and to foster long-term savings and investments (through revisiting the EU framework for existing long-term vehicles ELTIF).

To go forward, the recent consultation for a European retail investment strategy is very welcome. Overall, the existing regulatory framework is solid, coherent and satisfactorily protective, and no deep regulatory overhaul is warranted. Yet, some targeted adjustments could be made in response to recent developments within the financial industry and to spur retail participation in capital markets, particularly in equity markets. Rules could be reviewed notably in the following areas.

On one hand, to further ensure investor protection for safe cross-border investments within a digital market, one should aim at limiting regulatory arbitrage between Member States to avoid differences in investors' rights. In the absence of unified supervision at EU level, improvements should be made to the passporting framework to ensure higher and more harmonised protection. Measures should be taken to strengthen coordination between home and host authorities in situations where firms infringe upon the rules in host jurisdictions while acting under the EU passport. No genuine single market in financial services can be established unless confidence is restored in cross-border investment services for retail clients.

On another front, investors must be empowered with adequate knowledge, information and advice to support their investments.

The objective of improving the offer of, and access to, financial products for retail investors is intrinsically linked to the development of financial literacy. Financial knowledge is indeed essential for EU citizens to get the most out of the investment products and services

available to them. Notwithstanding Member States' competence in the field of education, there is room to develop initiatives to ensure coherence and coordination within the EU, and reach the highest number of potential investors, on matters of common interest (eg. risks and performance of financial products ; time horizons of projects and investments; typical scam techniques – a major issue in many countries).

Moreover, in order for them to be incentivised to invest, individuals should benefit from relevant, fair and proportionate information: in this field, work should be done to adjust the existing disclosure requirements to make them more meaningful and tailored to investors' needs, hence more understandable. The PRIIPS Regulation is an example where amendments are needed to ensure a better information of investors, with a view to enhance their access to financial products. It is important to review the general approach of the PRIIPS Level I Regulation with the objective of making the key information document a useful, understandable and not misleading source of information for investors.

Ultimately, for less sophisticated investors, information will not be sufficient, and high quality financial advice will be needed. This also means that retail investors should have access to unbiased advice. To ensure that investors effectively receive such advice, the comprehensibility of inducement disclosures should be enhanced; ESMA's recent technical advice contained proposals to improve the clarity of inducement disclosures which should be supported. Conversely, introducing a general ban on inducements would have a detrimental effect on retail investors by depriving them of access to proper advice (at least in some countries like France). Such a ban would have the unwelcome effect of boosting the sale of in-house products by banking networks (who could use other remuneration schemes not captured by a ban, eg. for intra-group money flows) to the detriment of open architectures.

In sum, finding the right balance between appropriate advice, adequate information, and a suitable level of protection for safe cross-border investments should be a driver for a future EU retail strategy.



UGO BASSI

Director, Financial Markets,
DG for Financial Stability,
Financial Services and
Capital Markets Union -
European Commission

The EU retail investment strategy

What are we seeking to achieve through a retail investment strategy?

The Commission is seeking to ensure that the legal framework for retail investments empowers consumers, enhances their participation in the capital markets and helps ensure improved market outcomes.

In September 2020, in the New Capital Markets Union Action Plan, we announced our intention to come forward with a strategy for retail investments in Europe that seeks to ensure that retail investors can take full advantage of capital markets and that rules are coherent across legal instruments. Our strategy will set out measures to encourage more participation from retail investors by ensuring that they are adequately protected and enabled to make better use of EU capital markets. This is one of the keys to the success of the Capital Markets Union Action Plan.

Our objectives received strong support from both the Council, which called on the Commission to “initiate, within the mandate of this Commission, the implementation of the other parts of the Action Plan that aim to boost investment

activity, including and in particular by retail investors inside the European Union, while maintaining a high level of consumer and investor protection”^[1], as well as from the European Parliament, which in its resolution on the Capital Markets Union Action Plan, called for a mobilisation of retail demand to be made possible through a change in investment culture, which “[...] will only happen when retail investors become convinced that investment in capital markets is desirable while being subject to risks that are acceptable and clearly defined.”^[2]

Evidence gathering

Over the past year, we have been preparing the ground for the implementation of an ambitious new strategy. That has involved a wide-ranging evidence-gathering exercise including work on an extensive external study, issuing calls for advice to the European Supervisory Authorities, holding discussions with Member States, meetings with a variety of stakeholders, as well as a 3-month public consultation to seek stakeholder views on the broad range of issues around the retail investor journey.

We need in particular to cater for a younger generation of retail investors.

186 stakeholders responded to the public consultation, from various backgrounds – business, private citizens, NGOs, consumer organisations as well as public authorities. That variety was reflected in the different views expressed about the state of the current framework and whether, and if so what, changes might be needed in order to stimulate greater retail participation. In particular, we noted the strongly diverging views on questions around potential conflicts of interest in the sales process and the different perceptions as to how understandable current disclosure documents are. On the other hand, we also noted a degree of convergence regarding the need to adjust the framework especially to accommodate digital challenges. The results have provided the Commission with food for thought about all the major topics and constitute a solid basis upon which to make our policy choices.

Next envisaged steps

Our intention is to come forward with legislative proposals before the end

of 2022. We are currently working to develop these policies and assess different options in the accompanying impact assessment. While not wishing to pre-empt the outcome of that work, it is already clear that we will need to address a number of problems that have been identified through our evidence gathering exercise. These issues cover the length of the retail investor journey, starting with investor education, but moving on to the way products are distributed to investors, the way in which disclosures are made towards investors and the quality of the advice that is dispensed. We will in particular need to modernise the rules to ensure that they are less product and more client focused, while harnessing the potential benefits that digital and sustainable investing offer and ensuring greater consistency across sectoral legislation.

We must ensure that the new rules cater especially for a younger generation of retail investors, with measures that encourage their engagement whilst at the same time ensuring that the investor protection framework is future-proof and provides appropriate safeguards for retail investors in the digital environment.

[1] Council Conclusions on the Commission’s CMU Action Plan, 3 December 2020

[2] European Parliament Resolution of 8 October 2020 on the Further Development of the Capital Markets Union



GABRIEL BERNARDINO

Chair - Portuguese Securities Market Commission (CMVM)

Towards a new paradigm for retail investors information

It's time retail investors take central stage at the European capital markets. Not only should the financial system be at their service, namely by providing solutions that can offer better returns for their savings and are well aligned with investors' preferences and needs. Retail investors also play a vital key role in the economic recovery in Europe and help European markets compete with other economic blocks.

However, for retail investors to trust European capital markets as recipients of their savings, a new paradigm of information disclosure must be considered. Good, sound and easy to understand information is vital to promote confidence and to engage retail investors, old and new, in capital markets, as this will enhance transparency and trust which are major pillars of a well-functioning financial sector.

The principles laid down in the current rules are correct: information to consumers should be easy to read, understandable and comparable. However, the way these principles have been embodied in the European legislation could be improved. Change

is necessary if we wish to be truthful to our own principles and contribute to consumer protection, market development and financial stability.

In this sense, we must start by humbly admitting that there is room for improvement. There are (too) many examples of information complexity that is currently disclosed to investors. This creates unnecessary costs and hinders investors willingness to engage with and trust capital markets.

A new disclosure framework should offer clear, credible and simple information that is perceived as such by investors. This does not mean we need new data. In fact we must avoid past mistakes that - over and over - have resulted in additional data carried to informational documents. So, I think that incrementing or even partial changing the status quo is not the right answer. The capital markets union and in particular its most recent action plan is the 'perfect moment and place' for all of us to improve financial regulation of information disclosure.

First, we need public disclosure requirements that consumers can effectively use. For example, we could begin by agreeing that information available to retail investors should be layered and less complex than the one provided by product providers and distributors. Such a change would also help supervisors.

Information should be simpler and market conduct supervision should be enhanced.

Second, we should use digital tools to disclose and centralize information. That is, informational requirements should be adapted to the digital age. As an example related to the heart of a real capital markets union, we should aim at developing simulators and comparable fees and costs tables for financial products that are distributed across Europe.

It is also fundamental to ensure that simpler and more appealing 'language' is used in the documents. Information can be made radically simpler. Simplicity should be a foundational stone of the new paradigm. Let's consider the following and simple example - and without disregarding that more complete information should be made available for more sophisticated retail investors - the normal retail investor seeks answers to the following

questions: How much will the product cost in terms of fees and charges? On average, how much could I earn or what is the possible return? How much could I lose, particularly in an extreme scenario? And, what are the ESG impacts of my investment decision?

As simple as this may seem, if we add a plain description for the 'common citizen' of what the product is and label it accordingly to its main characteristics, I believe this ultimately will be all the information our fellow citizens will need to invest consciously and in a much simpler way. Labelling of financial products, and not only for ESG purposes, would definitely help. This said, even with simple and comparable information and high levels of financial literacy, investors may fall prey of behavioural biases and limitations. So, when designing informational documents, we must also consider the behavioural dimension in retail investment decisions affected by such documents.

As a corollary, to better support this new information paradigm and to mitigate mis-selling practices we should reinforce market conduct supervision in a coordinated manner. These supervisory actions should include, among others, value-for-money analysis, and result, if appropriate, in the use of the product intervention powers.

In conclusion, I believe that the capital markets union and its latest action plan should seriously consider this new approach and pave the way for a new era for retail investors information disclosure. Such a new approach, one that entails financial instruments that are more transparent and clear, would strengthen investors trust and participation in capital markets. Investors and Europe need this new approach.



STÉPHANIE YON-COURTIN

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

Building a Capital Markets Union for savers and citizens

Building up popular support for the Capital Markets Union project is not an easy task. Still today the financial sector enjoys low levels of trusts from European citizens, and the regulation of financial services has fallen off from newspapers' headlines, fortunately due to lesser perceived risks to financial stability, one decade after the great financial crisis.

Citizens could however unleash their power as savers to unlock new funding for European SMEs and corporates. The forthcoming Retail Investment Strategy should lay the foundations for the CMU action plan to reach every saver, and promote a more responsible capitalism, geared towards the green and the digital transition.

Participation of consumers in finance and investor protection are two sides of the same coin. Consumers' trust that financial intermediaries are acting in their interest have been erode by numerous episodes of local, national and international mis-selling scandals. Rules tailored for each individual consumers will be paramount to restore this trust. These rules should be anchor

in three core principles: transparency, accountability and dialogue.

Without free of charge access to meaningful information on financial products, savers will lose appetite to invest. With or without the help of a financial adviser, each consumer should be able to tailor the information they receive based on their needs and their understanding of financial products.

The forthcoming review of the PRIIPs Regulation should bring about the 2.0 version of the Key Information Document. The KID 2.0 will be fully digital and interactive, giving consumers direct access to all relevant information on risks, costs, performance, sustainability and consumer rights in a user-friendly format.

In creating the KID 2.0, we should remain attentive to avoid the exclusion of consumers with lower digital literacy, and we should maintain the original ambition of covering all financial products and providers.

The first PRIIPs Regulation has led to increased attention from distributors and providers on the value provided to consumers. The second PRIIPs Regulation should aim to boost consumers' own awareness on the power of their savings.

Participation of consumers in finance and investor protection are two sides of the same coin.

The accountability of financial intermediaries and advisors should be reinforced, so that consumers know they are acting in their interest. In addition to clarification on the principle of alignment of interests at level 1, ESMA and EIOPA can play a key role in fostering coordination across national competent authorities, notably with their new explicit competences in relation to mystery shopping.

Ultimately, consumers should not face situations when advisers are able to sell the same products with a different rulebook on product governance. Aligning the MiFID and IDD frameworks will limit discrepancies in regulation and supervision. This will require a difficult but necessary legislative debate on the processes ruling the interaction between consumer, distributor and provider.

We should remain mindful of the specificities of each distribution market, linked to national competences on taxation for example, as imposing one-size-fits-all model onto existing practices will only deter consumers from investing more into the economy. Accountability should however run deeply in the veins of the distribution networks for financial products, and the proposed EU competence framework for financial advisors will be a crucial tool to deliver on this objective.

With increased transparency and reinforced accountability will come better dialogue. Consumers and financial intermediaries should be in constant dialogue on saving need and investment opportunities, in good and bad times.

With a change of culture, consumers will be able to see financial intermediaries as partners in their life choices related to their personal finance. Consumers should be not restricted to limited choices based on a few ready-made packages, but should be accompanied to build personal saving strategies tailored to their needs. They should not be offered only the products their intermediaries manufactured, but should be given access to a wide range of solutions.

Financial awareness is not limited to financial education at schools and universities. It is first and foremost a life-long learning project, to which public institutions, employers and trade unions, and civil society organisations can all contribute for the benefits of consumers.

Fostering dialogue at the level of every consumers, and at the broader societal level, on the benefits of active savings strategies, will be a strong driver for support in the Capital Markets Union project, much needed to finance the EU's strategic autonomy.



JOS HEUVELMAN

Member of the Executive Board - Dutch Authority for the Financial Markets (AFM)

The Retail Investment Strategy: one year after the Gamestop Saga

More than a year has now passed since the so-called 'Gamestop saga', when meme stocks entered the mainstream and retail traders took on professional investors. The lockdown and low interest rate environment accelerated existing digital trends.

As more consumers start to invest, or express the intention to start investing, the need to adequately protect retail investors is more urgent. The European Commission announced in 2021 its Retail Investment Strategy to help, protect and facilitate individuals to participate and benefit from Europe's capital markets to realise their financial goals.

The AFM shares this ambition and believes high levels of investor protection go hand in hand with improved access.

In the Netherlands, approximately 85% of consumers invest in capital markets through mandatory participation in cost-efficient occupational pension schemes. With the shift to defined contribution schemes and an increase

in the number of self-employed, there is additional need to facilitate and protect retail investors. Trust in financial services and capital markets remains crucial. Hence, retail products must be cost effective and greenwashing must be prevented. People need to be able to trust that something good is being done with their money.

Apply insights from behavioural finance and economics

Digitalization has made investing easier and more accessible but also made sales and marketing techniques such as gamification and online targeting possible. This could increase the number of people that are triggered to invest and subsequently treat investing as a game. Yet, gamification also has its benefits, such as explaining complex subjects playfully and accessibly. IOSCO recently published a landmark report on this issue.

We like to believe that consumers act rationally, however research has shown that consumers are prone to behavioural biases. Research from the AFM has shown that one in three retail investors trade suboptimally. Examples include trading too frequently or buying unnecessarily risky products. With the growing popularity of digital investing apps, the choice environment and how it provides access to investment products has become important.

Firms throughout Europe already employ behavioural aspects in apps and other online environments in ways that do not always benefit consumers.

Digitalization made investing more accessible, but it also gave room to methods such as gamification.

Although online nudging –and even gamification– can be used to promote sensible financial decisions, firms can also use them to steer clients toward risky and more expensive products for their own benefit. A future proof retail protection framework addresses how the online choice environment influences consumer behaviour positively.

Simplify consumer disclosures

Consumer behaviour insights can also be used to simplify and improve pre-contractual consumer disclosure

documents. However, relying solely on consumer disclosures about the features, costs and risks involved with financial products does not necessarily lead to better decisions. Although disclosure requirements are a fundamental part of the investor protection framework, using insights from consumer behaviour is crucial to keep a high level of effective protection in the digital age. The design and framing of the information play an important role in consumers' choices. Recently, the AFM published a discussion paper on how firms and policy makers can use behavioural insights to improve and simplify consumer disclosures. Moreover, streamlining the disclosure requirements across financial areas could improve comparability of products and services, while reducing costs for firms and preventing information overload for consumers.

Effective cross-border cooperation

Digitalization contributed to more choices for consumers and an increase in cross-border activities. However, supervisors have less sight on activities in other member states, especially if this takes place in closed channels. Transparency of market practices necessitates better cooperation between national competent authorities (NCAs), it prevents the risk of greenwashing and increases the trust of investors.

AFM believes that cooperation between NCAs is the pillar of success by enhancing the single rulebook and promoting supervisory convergence. The AFM and the French AMF have jointly published a position paper on cross-border retail services advocating for providing host member state NCAs and ESAs with adequate instruments and competences so that they can effectively assume their supervision responsibilities.

Strengthen product governance

AFM encourages to strengthen the application of the Product Oversight and Governance (POG) framework to risky and complex investment products in non-advised services to prevent consumer harm. In the Netherlands, POG rules have been a key element to ensure that retail investors have access to suitable products, to prevent mis-selling, and to ensure that firms have their clients' interests top of mind when developing and distributing financial products.



GUILLAUME PRACHE

Managing Director -
Better Finance

Retail investor Strategy: some inconvenient truths on biased advice

The EU initiatives – the “Capital Markets Union” Action Plan and the EU Strategy for retail investors – both rightly set as a key objective to “ensure bias-free advice”.

What is most at stake here is the conflicts of interests in the distribution of retail investment products, as the dominant distribution model in Europe is commission-based (providers paying sales commissions to retail distributors, often surprisingly labelled as “investment advisors”). EU legal jargon calls those “inducements”, a term most EU savers do not understand. The former chair of EIOPA used to call them “kickbacks”, which is much more plain language for retail investors.

“Inducements” are purely sales commissions, certainly not “advice” ones

Commissions never remunerate advice, but in fact sales: they are solely linked to sales: no one will get commissions by advising a product but not selling it under the commission-based model. Vice versa, advice-less sales get the same commissions as “advised” ones. This is indeed the best and most egregious proof: so-called

“execution only” investments – which by definition include no advice at all – yet pay the same commissions as for “advised” sales.

These commissions are in reality much higher than disclosed as they are charged 12 to 25 times or more for each single investment. For one investment product sale, the sale commission is typically also due every future year for its entire holding period, that is to say 12 years on average e.g. for the most sold retail investment products in France (life insurance), or 20 years or more for personal pension products.

Therefore, average sales commissions in France for unit-linked insurance and for personal pensions are not 0,75%, but about 10 to 15% or more on each investment (including the average entry fee).

The massive negative impact of biased advice on investment performance is being ignored.

The total cost of retail investment products is severely understated

A recent industry-funded report, but also, unfortunately, several regulators’ reports, severely underestimate the annual ongoing cost of retail investment products sold with commissions. The main reason is that they refrain from looking beyond about only 9% of retail financial savings in the EU: mostly the small minority of retail investment funds distributed without any wrapper. These reports ignore the reality of the retail distribution where most sales of investment funds sold to retail investors are done via life insurance and pension products. For example, in France, the average annual cost of equity funds held economically by retail investors is not 1,55% as estimated by the regulator, but 2,88% at least for most of them (i.e. those sold via insurance wrappers).

The massive negative impact of biased advice on investment performance is being ignored

These reports also do not look at all at the impact of the conflicts of interests generated by the commission-based model on the performance of retail investment products, which is extremely harmful to European pension and long-term savers. For example,

recent findings unveil that 62% of the funds sold to French retail investors (i.e. those sold via unit-linked insurance) include almost no “clean share class” ones and almost no low-cost index ones. Those two categories do not pay commissions or much lower than the other funds. Even the very tiny portion of index ETF funds sold is charged more than twice the market average for example in the case of French stock index ETFs (not even adding the cost of the insurance wrapper).

The result of this massive “anti-selection” generated by sales commissions is devastating, knowing – through many independent academic works – that “active” funds are on average under-performing capital markets over the mid- and long term, and that costs and mid-and long-term net performance are reversely correlated:

- Over the last 21 years to 2020, the French UL market delivered a net real performance of -14% when capital markets delivered +77% (source: BETTER FINANCE).
- Over the last 5 years to 2020:
 - the main French stock index returned an average annual: 7,82%,
 - the very few ETF units (priced more than double the market average): 6,06%,
 - the very few “clean share class” units: 5,52%,
 - and the remaining 98% high-commission units: 4,07%.
 (source: GoodValueForMoney).

It is therefore time for at least minimal action against widespread biased “advice” as recommended by the High-Level Forum on the CMU in 2020:

- End the massive regulatory arbitrage by extending the MiFID provisions on conflicts of interests (regarding in particular independent advice and portfolio management) to all other (and much larger) categories of packaged retail investment products (such as life insurance and pension savings), by harmonizing the provisions of IDD, PEPP, IORP, etc.
- End the inducements charged on all the “execution only” transactions. The recent EC’s proposal to ban payments for order flows is hopefully a good sign of walking the talk on ensuring “bias-free advice”.



SIMON JANIN

Head of Group Public Affairs -
Amundi

Qualified financial advice is key to foster retail investment in capital markets

Despite a slight decline in early 2021, the level of household savings remains particularly high compared to the pre-Covid-19 crisis level. The European Central Bank sees euro area household savings rising to extraordinary levels since the beginning of 2020, half of which has been invested in cash and bank deposits^[1]. In France, the savings rate was 36% higher in mid-2021 than at the end of 2019^[2].

Such a level of savings is a real opportunity to finance the recovery of the post-Covid-19 economy by improving access to financing for SMEs through the deepening of European capital markets. A better allocation of households assets would not only help to finance sustainable growth and the European digital transition, but also allow the investors to have access to more diversification and the possibility to achieve higher returns.

In view of this, initiatives to increase the participation of retail investors in financial markets shall only be encouraged. The European Commission's Action Plan on Capital Markets Union (CMU) published in September 2020 is definitely a

step in the right direction. In it, the Commission rightly aims to revise the ELTIFs Regulation, in order to fill a crucial gap in the current European fund regulation landscape, allowing long-term savings to be invested in 'long-term' assets. It is indeed essential to give retail investors the opportunity for greater diversification and the benefit of the returns associated with investment in long-term assets. Proposed amendments to MIFIR are also rather well designed to increase financial markets' transparency, thus to make access to financial products cheaper. However, some market specificities, especially in the area of fixed-income, should be factored in to achieve the right balance between transparency and liquidity.

Also, the Commission's efforts in developing its forthcoming Retail Investment Strategy should be highlighted. Its work on information disclosure is very valuable. Similarly, we praise the Commission for looking closely at ways to improve financial literacy and investor access to financial products through technology and digital means. However, any reform should be properly calibrated in order to really improve the investor experience and not create additional barriers for investors. In this respect, we invite the Commission to carefully consider reviewing the distribution models by banning retrocessions of management fees for distributors. As a KPMG study^[3] points out, such an outright ban of inducements would be detrimental for the own interests of retail investors, as it would lead to restrict access to qualified financial advice without reducing the total cost of ownership.

It is essential to give retail investors the opportunity for greater diversification.

Reduced access to qualified financial advice for retail investors has already been observed in those countries where a ban of inducements has been adopted (UK, NL). On the contrary, under the 'commission-based' model, the mass retail investors are all given access to advice at a reasonable cost and can benefit from added value services.

Replacing the current freedom of choice with a single regulatory model, that does not suit the preferences of retail investors, would be then detrimental to the latter. It would also be counterproductive to the CMU's

objectives of channeling capital flows towards the financing and the speeding up of the economic recovery and the green and digital transition. In addition, a "one size fits all" approach may not be appropriate in this specific case since many differences exist amongst member states in the level of investor education, risk approach, access and use of mobile services, as well as attitude to invest in capital markets. Therefore, the current system, allowing each Member State to adapt its legislation to the specific characteristics of the national retail investment market, should be preserved.

The same conclusion of maintaining the role of the adviser is also reached by a double observation. On the one hand, as the Commission points out, "financial literacy is an essential skill for making good decisions about personal finances, but many people have not yet mastered it"^[4]. On the other hand, financial expectations are increasingly coupled with extra-financial concerns, primarily the ESG dimension, whose complex regulatory contours are still under construction and whose KPIs are not easily understandable autonomously by the non-professionals. In this respect, the role of advisor will also be essential to channel the savings of retail investors towards sustainable investments.

[1] ECB Economic Bulletin (May 2021): https://www.ecb.europa.eu/pub/economic-bulletin/focus/2021/html/ecb.ebbox202105_04~d8787003f8.en.html

[2] Stat Banque de France (November 2021) : <https://www.banque-france.fr/statistiques/epargne-des-menages-2021t2>

[3] KPMG (November 2021) : *Commission-based remuneration vs. Feebased remuneration: is there a better model for retail investors?*

[4] CMU Action Plan Action 7



ROBYN LAIDLAW

Head of Distribution,
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Addressing inherent conflicts of interest is key to an investor-centric CMU

The EU has built strong foundations to facilitate retail investment. It has a world leading investment product – UCITS – as well as a strong policy framework that focuses on investor protection. Yet, levels of retail investor participation in the capital markets remain significantly lower than in the US and the UK. This is particularly problematic in light of the looming pensions' savings gap in Europe and the pressing need for market-based financing of the European green and digital recovery.

To strengthen the culture of investing in the EU and ensure it is truly impactful and positive for citizens' financial wellbeing, an investor-centric reform of current rules is required. We welcome, therefore, the European Commission's stated intention to look at each step of the investor journey and make sure that there is a sufficient level of transparency across the value chain. The publication of a dedicated Retail Investment Strategy later this year is a unique opportunity to promote a holistic approach to making capital markets work for everyday investors in the EU.

Vanguard believes that putting consumer outcomes at the heart of product design and distribution could significantly contribute to the further development of the Capital Markets Union (CMU) and improve long-term financial outcomes for European citizens. To this end, the Retail Investment Strategy should seek to create a framework that helps better engage society in their financial health and resilience and ensure that – when investment is the appropriate choice for citizens – the system delivers valuable outcomes. The CMU will only be a success if retail investor participation in the capital markets increases, and retail investors get a fair deal.

To this end, it is crucial that every part of the investor journey is made easier and more transparent. Further simplification and harmonisation of disclosure and marketing rules (including taking into account recent and future digital developments), enabling greater provision of a sliding scale of advice and guidance options, and removing conflicts of interest in the distribution chain are key steps necessary to ensure retail investors are getting the best possible outcomes.

Facilitating the provision of unbiased advice to meet the differing wants and needs of EU investors.

Their lack of financial literacy is recognized as a barrier to EU citizens achieving long-term financial health. It is therefore essential that we develop the societal infrastructure to encourage people to engage with their overall financial health. Related to this, we need to ensure that those seeking financial advice have access to an open and competitive market that is free of potential conflicts of interest and delivers consumer-centric outcomes. However, the prevalent EU practice of investment product providers making inducement payments to financial advisers threatens this goal and negatively affects the quality and objectivity of advice given to retail investors. We need a system where consumers do not worry about the risk of being exposed to conflicted advice, reduced product choice, and high costs. The Retail Investment Strategy offers a rare opportunity for the EU to catalyse a regime that encourages people to save for their long-term future, reduces barriers to investing, and ensures

people have access to a “fair deal”. We believe a ban on commission-based sales practices is the best way to ensure the provision of unbiased advice to retail investors. Where introduced, a ban on inducements has had a demonstrable beneficial impact on the type of investment advice and products on the market. Such bans have enabled investors to have access to open and competitive advice market that are free of potential conflicts of interest, whilst also maintaining the commercial incentive for advisers to provide their services.

We also believe that consumers' financial health is improved where they have access to a sliding scale of advice and guidance options, ranging from simple financial guidance through technology-enabled advice to traditional face-to-face advice. Technology-enabled advice has been proven to be particularly helpful in ensuring that the younger generation is engaged with their finances and make better investment decisions as a result of more bespoke and streamlined investing journeys, reduced complexity and lower costs. Alongside technology-enabled advice and guidance services, Open Finance has the potential to radically increase the ability of EU citizens to understand their financial affairs and move between different investment service providers. In doing so, Open Finance could be a further catalyst to creating a successful investing culture in the EU and achieving the goals of the CMU.

In closing, we welcome the European Commission's efforts to put in place a CMU framework that empowers citizens to make better retail investment decisions. Facilitating the provision of unbiased advice to meet the differing wants and needs of EU investors gives investors the best chance for investment success.



GERBEN EVERTS

Executive Director -
European Investors'
Association

Allow the next generation to invest in the future they see fit

The world is in a key societal transition. A transition towards digitalization, sustainability, inclusion and equity. The EU Retail Investment Strategy is a unique chance to include the (retail) investor in this transition. This is the momentum, and the EU should lead. A CMU is only a success with retail investors in it. The more investors know how markets work, the more willing investors are to participate, the more eager investors are to assist in the transformation of our society and the more able investors are to sustain their purchasing power despite high inflation and low interest rates. The next generation should be offered every opportunity to invest in the future they see fit.

Although the participation of retail investors is currently low, progress is being made. The strategy is clear: the EU wants a higher level of retail integration and prevent misallocation of capital. Hence, we should manage cultural difference, simplify the volume of information, streamline listing rules, establish a level playing field between different platforms and

create a more optimal and tailored distribution of products.

The EU has enormous savings. Considering the Green Deal's dazzling funding ambition, breaking down the barriers for investors preventing them from cross-border, and, truly pan-EU investing, particularly in companies and initiatives that drive the transition toward a sustainable economy, is a crucial precondition for its success and social backing. Therefore, European Investors-VEB firmly subscribes to the urgency as much as the importance of the strategy. Effectuating the strategy engenders tremendous innovation and growth potential, as much as it supports addressing the imbalance inherent in the preponderant bank financing of the EU economy. We wholeheartedly applaud the EU's increased awareness and recognition of retail investors' importance. The Retail Investment Strategy is a prerequisite to a more sustainable economy paired with the ancillary social reforms.

Ideally, the strategy should cross the finish line as one comprehensive package of objectives and initiatives. We recommend that prior approval be sought from the European Parliament and the Council on the strategy as one package. This approach has proven to be successful with the Financial Services Action Plan. Regrettably, the CMU has been unnecessarily delayed and with counterproductive fragmentation.

**We wholeheartedly
applaud the EU's
increased awareness
and recognition
of retail investors'
importance.**

In view of the coherence between the distinct regulations, directives and recommendations, it is inappropriate to concede on components, to make political trade-offs, or to uphold domestic variances. We strongly call upon the European Commission to secure both the integrity and the progress. Equally, we appeal to the European Parliament and the Council of the European Union to exercise a certain restraint where it concerns adaptations likely leading to fragmentation. Only if the whole package is delivered, more pan-EU allocation of retail money will follow. This requires a combination of trust, opportunities, and retail protection. We must prevent a weakest link.

New entrants to the financial markets are seen to be susceptible to dubious and unregulated investment products. This development should be stemmed. This requires ample dedication to the protection of retail investors, behavioral aspects of investment decisions, and financial literacy. An overly paternalistic approach must be prevented. In principle, retail investors should be offered the same opportunities as large institutions. The more vulnerable amongst them should be offered adequate protection to reestablish the balance between the professional sell-side and retail. EU Supervisors must execute robust enforcement where protection is considered necessary.

Whereas inducements are the single most important barrier to the CMU's success, European Investors-VEB emphatically promote an EU-wide categorical prohibition of inducements, regardless of their form. This includes the current practice of multi-layered fees. As investor education is received from the sell-side, no bias-free advice is currently available. All advisors are in fact sellers and none of them would be incentivized to advise on ETF's for example. This favors expanding the MiFID II prohibition on third-party payments.

Prompt, straightforward, and accessible accommodation of collective redress for harmed investors must be a priority and it ought to be an integral element of the Retail Investment Strategy. It is virtually impossible to obtain legitimate redress in cases of deceit or fraud, particularly in cross-border situations. Investors directly investing in financial markets are excluded from EU collective redress regimes - their not classifying as consumers causes them to be outside the scope of Directive (EU) 2020/1828. This current reality is the most obvious candidate to be the weakest link.

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MIFID II / MIFIR REVIEW PRIORITIES



**ROBERT
OPHÈLE**

Chair - Autorité des Marchés
Financiers (AMF)

MiFIR review: priorities for improving EU markets structure and transparency

In November last year, the European Commission published its much-awaited proposal reviewing the Market in Financial Instrument Regulation (MIFIR). The aim of the review is to enhance transparency and increase competitiveness of European markets; in that perspective, the creation of consolidated tapes on main asset classes would be a key deliverable. The European Securities Markets Authority (ESMA) has provided many advices on possible avenues of reforms in these areas.

We should first recognize that it is indeed very challenging to find the right balance between measures enhancing transparency and those favouring liquidity or between lit and dark trading ; it is rather tricky to adapt the trading rules in order to have the most efficient price formation mechanisms, to rightly implement the

best execution principle, and ultimately to ensure a level playing field between service providers located in thirty different countries and supervised by thirty different national authorities but proposing their services Union-wide.

The discussion on these issues has been going on for a long time and should be regularly re-opened, sometimes triggered by trading innovations. We should remain modest in these matters; there is no ultimate regulatory framework. Obviously, the review of MIFIR will not close all the issues but the European Commission proposal, carefully drafted, goes prudently in the right direction.

Who could pretend that a consolidated tape providing, in a first step, almost real-time post-trade data for shares would be irrelevant when we have currently around one hundred and fifty trading venues in the European Union, where one could trade equities? There is a strong public good factor behind such a project and if, despite the mandatory contribution feature introduced in the European Commission proposal, there is no commercial solution popping up one should think to a public solution and indeed ESMA could be a fall back worth exploring.

**At some point, the
European Union should
move and rapidly deliver
and the time has come.**

How could we support payment for order flow in a single market where best execution remains a rather vague concept enforced by thirty different national competent authorities? Obviously if we had a single supervisor in the European Union or a requirement to provide a very precise, trade-by-trade, proper justification of best execution, a ban of payments for order flows (PFOF) would be much more debatable. In the current circumstances, when we observe a surge of “neo-brokers”, which are very welcome when they attract more retail to financial markets, a ban is the most appropriate approach.

How could we have a Capital Markets Union if we accept that deferrals for post-trade bond transparency

requirements could vary from one member state to another?

One could certainly have been more ambitious in this review, for example limiting Systematic Internalizers perimeter to Large In Scale trades or increasing the transparency of public debt markets; nevertheless, at some point, the European Union should move and rapidly deliver and the time has come.

When devising the most appropriate framework, one should also take into account the competitive angle, specifically at a time when the United Kingdom is also reviewing its wholesale market regulatory framework. The issue is especially sensitive for bonds where we do not have trading obligation and where the market is more global and more wholesale by nature. While reviewing the patchwork of types of possible deferral criteria – such as transaction size, rating (high yield or investment grade) ...- coordination with the United Kingdom’s authorities should therefore be highly encouraged in order to be as aligned as possible.



MARKUS FERBER

MEP, Committee on Economic
and Monetary Affairs -
European Parliament

MiFIR review: focus on transparency and a level playing field

The Covid-19 crisis has put European financial services market structure to a test. Particularly, in the early months of the pandemic in 2020, we have witnessed extraordinary high levels of volatility in nearly all asset classes. Overall, European markets have coped well during this stress test and have shown their resilience. Regulated markets have played a big part in that. We have seen that in times of high uncertainty, more trading volume goes to regulated markets as safe, transparent and robust trading venues where core price formation takes place and where there is ample liquidity. Transparency and liquidity are highly appreciated by all market participants, as it is a crucial precondition for financial stability and efficient markets.

While the European Union's financial markets have passed the Litmus test of the Covid-19 crisis, the EU's market structure is far from perfect. The reforms introduced with the original MiFID II and MiFIR have also had some undesirable side-effects such as the growth in off-exchange trading and the growing number of Systematic Internalisers (SIs) that do not help the price formation process. As a result

- and contrary to the intention of MiFID II - the share of price-forming lit trading activity has decreased to the detriment of issuers and investors alike. The reason for this is arguably that the playing field in between venues is uneven in many areas. The review of MiFIR should attempt to remedy the existing market structure issues, level the playing field and raise overall levels of transparent trading significantly.

The proposal by the European Commission for a revision of MiFIR that was presented as part of the Capital Markets Union package is a good starting point for addressing the issues, but in many instances falls short of what needs to be done. The Commission for example suggests extending the minimum public quoting obligations for Systematic Internalisers to twice the standard market size. While this is a clear improvement over the status quo, there is good reason to go further and increase the thresholds significantly, possibly even up to the large-in-scale waiver threshold. The Commission proposal is simply too timid here.

The review of MiFIR should level the playing field and raise overall levels of transparent trading.

Waivers themselves are also an area that require another critical look. The current regime features several different waiver types as well as the infamous double volume cap. Overall, this results in a regime that is overall very complex, yet offers too many avenues for circumvention that many market participants are skilful to exploit. Simplification of the waiver regime is therefore the order of the day. The European Commission in its MiFIR proposal attempts that, but is not radical enough. While the Commission proposal rightly attempts to get rid of the double volume cap (and replaces it with a single volume cap) and tinkers with the minimum threshold trade size for the reference price waiver, a more comprehensive approach would have been worthwhile. Such a more radical approach would have simplified the entire waiver regime by reducing the waiving possibilities to only the large-in-scale waiver thus increasing overall transparency levels in the market.

Lastly, the Commission proposal also moves into somewhat unexpected

territory by suggesting to ban the controversial practice of payment for order flow that has risen to prominence in early 2021 in the context of the Game Stop trading frenzy. While business models based on payment for order flow certainly raise legitimate questions in relation to conflicts of interests, best execution, cost transparency and compliance with the inducement regime, banning the practice seems to be the nuclear option. After all, we have found ways to deal with such conflicts of interests in less intrusive ways in other pieces of financial services legislation before.

Business models based on payment for order flow that are often utilised by so called neo brokers to offer free or very low-cost trading can be credited with democratising access to financial markets to broader range of retail investors, which very much matches the ambition of the Capital Markets Union. However, we need to make sure that retail investors are adequately protected when accessing financial markets.

Right now, there seems to be a noticeable mismatch between the investor protection provisions applied by neo brokers and those by traditional intermediaries. However, looking into such aspects of the level playing field should be a topic for the upcoming retail investment package and the revision of MiFID rather than the MiFIR review.



MARTINA TAMBUCCI

Head of International
Relations Office -
Commissione Nazionale
per le Società e la Borsa
(CONSOB)

Transparency versus competition

MiFID I made the choice to increase the level of competition among execution venues in the Union as a way to curb the costs of trading. The consequent fragmentation effects were anticipated by accepting transparency as a compensation measure to grant a fair price discovery process (as symbolically expressed by the equation that follows).

Competition is to trading costs reduction as transparency is to fair price discovery

A way to assess the measures under the current review package is to check the terms of such an initial paradigm with a view to verify whether it still holds true. MiFID II already attained to a partial rethinking of the belief that the proliferation of execution venues would have only had positive outcomes, which led to the introduction of the share trading obligation along with the derivatives trading obligation. After some more years passed along, there is even more room for re-consideration of all the terms of the equation.

At the time of MiFID I, the objective was to catch up to the lower costs for

both trading and post-trading in the US internal market. However, the expectation was not much in terms of competitiveness vis-à-vis other outside financial markets but rather to let European investors, in the internal market, to benefit of lower prices and better investment choices, as well as to improve the channelling of financial resources to the real economy. This is still at the heart of the EU vision, as testified by the CMU Action Plan. However, whichever the efforts to create a sound and united capital market of a European dimension, this cannot be dealt with in isolation but rather needs to be put in a wider perspective.

Competition primarily occurs between EU and the rest of the world and not just among execution venues in the EU. The projection of the EU in the international landscape changed significantly as result of two major factors: Brexit and the digital era. Brexit unveiled the actual threat of an important financial market so close to Europe, not only geographically but in the way it is framed and governed. The digital era made clear that “no place that far”.

**Competition occurs
between EU and the rest
of the world and not just
mid execution venues
in the EU.**

Transparency is a much relevant term of the equation above and MiFID II already reached a difficult balance amid several concurring goals. Some shortcomings or inconsistencies in the transparency regime may be fine-tuned in light of the experience of the last four years and the changes in the market structure occurred in the meanwhile as an effect of the MiFID II implementation. However, additional transparency, if not adequately calibrated, particularly for certain asset classes, may lead to higher costs (not just administrative), which may in turn negatively affect the competitiveness of the EU markets.

In other words (see the following equation), to keep costs of transactions low it is important to realise the consolidation of transparency data, awaited since a long time and meant to improve the price-discovery process. At the same time, transparency should be set to stay at a level capable of not hampering competition of the EU as a whole.

CTP is to trading costs reduction as transparency is to competition

All efforts should be put to ensure that a proper consolidated tape could emerge. The EC has been looking into the experience of some other developed financial markets and all involved aspects have been considered, with a view to grant the success of the initiative. Should this not be sufficient, the solution of empowering ESMA to realise such an important function seems the most rational one, also in light of possible synergies with the creation of a European single access point (ESAP), should this be handled also by ESMA. That said, the proposal is not neutral in terms of potential impacts for market data providers and EU operators and therefore the challenge for the EU co-legislators is once again to find the right balance between the feasibility and success of the project and the competitive instances. Attention should also be given on how to implement such projects in technical terms. The precedent of the European Financial Transparency Gateway (EFTG), which essentially makes use of the blockchain technology, is an interesting one. Such a choice could make the realisation time longer but would certainly contribute to an additional aim: that of carrying Europe into the digital era.

Finally, in order to make the most of a fair price discovery process and of competition at the level of execution venues, it is important to avoid any undue influence, such as a compensation towards investment firms for directing the orders received to a particular market maker or exchange. The proposed ban of the so called payment for order flow (PFOF) somehow represents just a clarification aimed at giving legal certainty in a context in which it was dubious - as left to interpretation of existing rules on conflicts of interest, inducements and costs and charges - whether such practice were legitimate or not.



CLAUDIA GONZALEZ CABANILLAS

Executive Director,
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JP Morgan

Keeping EU Capital Markets at the core of the MiFID II Review

This year will be another milestone year for the development of market regulation in the EU. The European Commission recently published its legislative proposal on the MiFID II Review, which aims to empower all investors, in particular smaller and retail investors to access the market, and help increase market liquidity.

It will be important for co-legislators in the European Parliament and Member States to focus on further increasing the attractiveness of the EU capital markets and putting in place a regime that is flexible enough to face any future adverse market conditions. The MiFID II Review can achieve this by continuing to support a wide diversity of trading mechanisms, and recognizing that a 'one-size-fits-all' market structure does not work well for all financial instruments and under all circumstances. Adjustments will need to be considered to increase meaningful transparency in the market, but MiFID II/R transparency requirements should also be well calibrated to achieve the objective of fair and effective markets.

Whilst MiFID II seems to have fallen short of providing the expected transparency to the market, this is mainly due to the lack of accessibility of the data – the fragmentation of data across the different venues and Approved Publication Arrangements (APAs) – as well as its lack of readability, being reported in different formats.

The MiFID II Review should therefore first and foremost focus on the creation of a Consolidated Tape and focus on smaller and retail investors which will help increase their participation in EU markets. A Consolidated Tape has the potential to significantly increase transparency by providing investors with a single, cohesive view of trading across the market. Once we have a Consolidated Tape, we will then be able to better assess the transparency that we currently have in the market and will be better placed to make further and more informed changes to the regime.

The new MiFID II regime will also need to strike a delicate balance between more real-time transparency on the one side, and the liquidity costs of introducing too much transparency too quickly on the other. When looking at these issues it is important to take into consideration each asset class separately as the liquidity profiles and market activity will significantly vary from one to the other.

The CMU should promote policies that maximise the funding of the real economy.

In the bond space, for example, the Commission is proposing to significantly reduce the post-trade deferrals for corporates bonds, to a maximum of end of day for price information and a maximum of two weeks for volume information. Shortening the post-trade deferrals will result in a reduction of capital deployment to facilitate those trades. This will risk worsening market liquidity and prices for European investors, when dealing in illiquid or large in scale transactions. Associated costs will be particularly felt for instruments where risk taking intermediation is a more important part of liquidity provision. Indeed, some of these instruments are by nature less liquid (there are fewer readily available buyers and seller in the market), and therefore liquidity providers play an increased role in liquidity provision in these markets.

The Commission proposal therefore does not provide sufficient flexibility to cater for the wide spectrum of bond instruments in scope of the regime and underestimates the role that risk taking liquidity provision plays in the European markets.

The Capital Markets Union (CMU) should promote policies that allow financial markets to maximise their role in funding the real economy. Behind a strong, more innovative and competitive CMU is market infrastructure, which promotes deep and liquid markets. COVID has reminded us how fragile market liquidity can be and of the importance of having efficient markets and encouraging a diversity of trading mechanisms to be able to better deal with adverse market conditions. Whilst reviewing MiFID II, policymakers should also continue to take into account the different execution venues and the role that they each play in the wider ecosystem.

A diverse market structure and the existence of competitive business models is the backbone of an integrated, resilient, and competitive European market. Rather than focusing on pushing more trading on exchanges, as seems to be the intention of the recent proposals in the equities space, MiFID II should focus on providing end-investors with choices which in turn can optimise their trade execution, fosters competition and drive transaction costs down. It also facilitates market stability by avoiding concentration of trading on just a handful of venues during venues outages.



HEATH TARBERT

Chief Legal Officer -
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Strengthening EU capital markets through transparency

The Dalai Lama once observed that “a lack of transparency results in distrust and a deep sense of insecurity.” What is true generally is certainly true in markets. Transparency is key to building the public trust and confidence that healthy capital markets require.

As the former Chairman of the US CFTC, I saw first-hand how vital transparency is to well-functioning markets, including by shining a light on areas where systemic risk can build. Transparency allows an honest assessment of market structure and risk, making it essential to sound regulation and fostering greater competitiveness, depth and liquidity.

I believe that the proposed enhancements to MiFID II will make EU capital markets more transparent — and thus more competitive and resilient — by establishing real-time post-trade consolidated tapes (“CTs”) across asset classes and streamlining transparency deferrals. These measures are critical to the future growth and competitiveness of EU markets, consistent with the objectives of the Capital Markets Union.

Consolidated Tapes

The proposal contains several features that are critical to its success:

- The CTs will cover post-trade transaction data only, which will make them simpler to implement than pre-trade quote CTs, minimize concerns about latency, and significantly reduce any impact on exchange market data revenues.
- The CTs will be comprehensive, covering both on- and off-venue activity, ensuring a level playing field, including between exchanges and systematic internalisers (“SIs”).
- Mandatory contribution, free of charge, of necessary market data will facilitate the emergence of commercially-viable yet low-cost CT offerings, while revenue sharing for equities market data will recognize the role that primary listing venues and lit secondary markets play in capital raising, price discovery and liquidity formation.
- Appropriately-tailored CTs will be established for a broad range of asset classes, including equities, ETFs, bonds and cleared OTC derivatives. Prospective CT providers are already actively developing offerings and consolidating currently available data in each of these critical segments of EU capital markets.

Real-time post-trade CTs will make EU markets more transparent, competitive and resilient.

- The collection and dissemination of market data as close to real-time will unlock the full benefits of transparency. Real-time data is critical so investors can compare quoted prices to those of recently executed trades – which is central to assessing execution quality with accuracy and demanding accountability from liquidity providers. Real-time data also minimizes information asymmetries, which increases investor confidence across all market conditions, enhances pricing and risk management capabilities, and helps dampen volatility and improve overall market resiliency. Given the volume and frequency of transactions in EU equity markets, even a 15 minute delayed tape would not yield these same benefits.

Deferrals

Streamlining post-trade transparency deferrals in the bond and cleared OTC derivatives markets is essential to leveling the playing field for investors and to creating the conditions necessary for a CT to emerge. Today,

real-time pricing data is not available in these vital markets for the vast majority of transactions, and is instead typically deferred for 4 weeks. Such stale data yields no tangible benefits for investors and, left unaddressed, would leave little meaningful data for a CT to publish. The proposed enhancements will allow vital pricing data to be published in a far more timely manner, while still allowing a deferral for associated volume data.

Academic research has conclusively documented the material benefits associated with increasing transparency in historically opaque markets. The post-trade CTs implemented in the United States for bonds and OTC derivatives both have a maximum price deferral of 15 minutes. During my tenure at the helm of the CFTC, we considered whether to extend the deferral period for large OTC derivative transactions. After conducting economic analysis and receiving extensive public feedback, we concluded that a 15 minute deferral was appropriate, acknowledging that “[t]he vast majority of commenters opposed a 48-hour delay” and “expressed concerns that a 48- hour delay would have a negative impact on transparency, price discovery, and liquidity.”

Conclusion

Healthy capital markets are fair and open. As a former regulator, I applaud the launch of a thoughtful post-trade CT framework for EU capital markets. CTs will strengthen EU capital markets by making them more transparent, and thus more competitive and resilient. I also believe that CTs will raise the visibility of regional venues and promote on-venue trading. The myriad long-term benefits will far outweigh the implementation costs and any short-term concerns by incumbent trading venues, intermediaries or data providers. The best interests of EU financial markets and investors at large should drive the EU to seize this historic opportunity to embrace more transparent capital markets.

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CONSOLIDATED TAPE: PROSPECTS FOR DELIVERY



HANZO VAN BEUSEKOM

Member of the Executive
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Back to the future - From the bond cabinet to the consolidated tape

Few people active in the bond market today are familiar with terms like board boys, bond cabinets and telegraph operators. It is hard to imagine that these were at the heart of the bond trading universe at the New York Stock Exchange in the 1920s. While it may not be what you would expect given the current bond market structure, up until the late 1940s the majority of bond trading took place through a highly transparent open orderbook model. Transaction information was also widely available.

Back then, most bonds were traded through written orders filed in the “bond cabinet”. (Yes, an actual cabinet) Since most bonds were - like today - only traded infrequently, clerks would record bid and ask quotes in the cabinet, as well as the sizes, brokers and dealers. Traders on the floor could

thus easily obtain information on the market for any bond, simply by asking the clerk. This method was effectively a central limit-order book.

Trade information was also distributed broadly. Transactions concluded would be recorded by trade reporters, who would pass on the information to the board boys. The board boys would immediately post the prices on the board and notify the telegraph operator. Shortly afterwards the information appeared on bond tickers throughout the US. Apart from the manual technology, the workings of the bond cabinet and board boys are very similar to electronic order books and the consolidated tape that are now (re)emerging in the EU bond markets.

The open orderbook model disappeared in the 1940s when merchant banks became the dominant force in this market. The majority of trading shifted to over-the-counter relationship-based trading between dealer banks and institutional investors in large sizes; a situation that lasts to this very day. It remains difficult to grasp that bond markets had a higher level of pre- and post-trade transparency long before the invention of the computer.

Bond markets had higher levels of transparency long before the invention of the computer.

100 years later, we seem to be going back to the future. The EU bond markets are rapidly adopting (multilateral) electronic trading protocols, thereby overcoming a range of shortcomings in terms of liquidity, fungibility and transparency of bonds. And as part of the MiFIR Review published in November, the European Commission (EC) is addressing a range of fundamental post-trade transparency issues with the proposal for a post-trade consolidated tape (CT) as its centerpiece.

As a firm believer in the need for fair, open, transparent, and multilateral bond markets, the AFM has frequently underlined the need for a bond CT to fundamentally improve the market structure. Such a CT has a few preconditions. First, a mandate

is needed under the revised MiFIR framework for trading venues and APAs to contribute the required data fields to the CT, as well as tools for managing and supervising the contributions and supporting commercial CT models. Second, there is a need to define common data standards, to set required data fields, and to agree on data access and governance models to ensure the efficient working of the CT. Third, significant regulatory changes are needed to simplify the current fixed income post-trade deferral regime which hampers the availability of sufficient transaction data.

We applaud the EC that several preconditions are being addressed in the MiFIR Review proposal, most notably on the contribution mandate for trading venues and APAs and the deferral regime. At the same time, questions remain around fair revenue redistribution for data contributors to the CT, as well as criteria on the tender and award process for CT providers.

More work is also needed to further define the CT product from a vendor, data contributor and user perspective, as well as clear data standards and improvement of current data quality/availability in order for a CT to be commercially attractive for providers and end-users. It is a joint responsibility with the industry to ensure that CTs emerge across asset classes and contribute to transparent and liquid EU markets working for investors and issuers alike. Now is the time to deliver. So why is the analogy with the 1920s so important? The orderbook-driven market was highly liquid, transparent, and attracted a broad investor base. With a CMU in mind, there may be a lot we can learn from past market structures. Although I doubt the bond cabinet, the telegraph, and the board boys will ever return.



RODRIGO BUENAVENTURA
 Chair - Spanish Securities and Exchange Commission (CNMV)

A forward step to build the CMU: market data consolidation

MiFID II and MiFIR have set out a more transparent trading landscape in the Union since their entry into force in 2018. The application of transparency provisions to bonds and derivatives instruments and in general to OTC trading (including systematic internalisers), has enhanced the information available to investors. It has also increased competition, enabling the emergence of new types of venues (MTFs and OTFs), that have challenged the predominance of the incumbent regulated markets.

However, it seems that these reforms have not fully achieved their objectives of increasing liquidity and reducing costs for investors. According to many, a significant side effect of competition has been the fragmentation of EU markets. While it is expected that more competition should reduce costs for investors, fragmentation on the other hand has increased complexity and therefore costs; in order to identify buying and selling interests, executing firms need to navigate the complexity of execution venues, thereby adding costs to their clients. Worse still, trading at

best possible terms might be missed out in the absence of a comprehensive picture of the available prices.

MiFID II has brought about a rather complex market structure and trade reporting regime. The ecosystem is composed of trading venues, systematic internalisers and investment firms trading purely OTC. It also includes an array of trading models, including new features such as frequent batch auctions (so-called periodics), and an intense usage of transparency waivers and deferrals that make market data difficult to consolidate.

The need for an aggregated view of the market is stronger the more fragmented and complex the trading activity is. OTC trading currently represents a significant market share and an important source of information. Also influenced by the fragmentation of liquidity, there has been an increase in the automation of trading and risk management processes.

CTP is too important to rush it. We should apply a staggered deployment, to make it a success.

The European Commission (EC) aims, as part of the objectives of the capital markets union initiative (CMU), to put in place a consolidated tape as part of the development of the single market. However, the fulfilment of this objective has met so far a number of entrepreneurial difficulties, operational complexities and technological challenges. How the CTP can get the data from the different types of execution venues and the lack of commercial incentives to apply for authorization as a CTP are two of the main obstacles that have been identified. Also, additional work in relation to the data to be reported may be needed.

In the last three years there has been an intense debate between public authorities and market participants to identify the main obstacles to the consolidation of data and the best possible solutions, which finally materialized in the form of the publication of a legislative proposal (2021).

Briefly, the EC's November 2021 proposal includes the set-up of four real-time post-trade information CTPs for shares, ETFs, fixed-income and cleared derivatives. It requires mandatory

contribution from trading venues, APAs and investment firms (including systematic internalisers), defines what is considered core market data and mandates ESMA to prepare technical advice for data issues. Finally, ESMA will play a crucial role in the selection process and, in the event that no CTPs emerges as a result of the process, the EC envisages that ESMA itself may perform the consolidation function.

There are still certain issues that I hope will be addressed during the discussions by co-legislators. In particular, revenue sharing should provide a reasonable and balanced reward for all market data contributors.

The CTP is a tool worth pursuing and it is too important to rush it. Given the complexity of the task and the differences between asset classes and the way they are traded, it seems prudent to have a phase-in or staggered approach for the CTPs' implementation; priority should be assigned to the projects where the need of consolidation is more acute, such as the CTP for bonds (executions only).

Then, with the lessons learnt from that first phase, the equities tape could be addressed. My assessment is that it should also concentrate on post-trade transparency, latency issues being an impediment for a real pre-trade CTP for execution purposes.

There is less demand among market participants for ETFs and derivatives. A derivatives CTP seems to be a distant project, as the issue of identification of these instruments needs to be fixed first.

To sum up, improving liquidity and reducing trading risks are objectives we all share in Europe. Let us hope that a well-designed consolidation, taking into account the different types of markets and the needs of investors will be instrumental in achieving them.



NICHOLAS BEAN

Chief Executive Officer -
Bloomberg Trading Facility BV

The commercial viability of operating a Consolidated Tape remains a concern

The technical challenges of providing a Consolidated Tape (CT) for bond markets has recently enjoyed outsized attention within the EU. However, Approved Publication Arrangements (APAs) which collect, collate and redistribute trade data already conduct a technical activity almost identical to that of a Consolidated Tape Provider (CTP). As such, the greatest challenge of bringing about a bond CTP has always been the matter of commercial viability to attract a potential vendor, and not matters related to technical implementation. This remains the case in light of the latest MiFIR proposal (henceforth 'Proposal').

There is no bond CTP today within the EU largely because 'the devil was in the detail' of the original text. To avoid a repeat of this, the content of the current Proposal should be considered with great care. The good news is that the Proposal removes the obligation of a bond CTP to give its product away for free after 15 minutes, and addresses disparate data structures across data providers – two of the key impediments to commercial viability. Unfortunately,

the Proposal has also introduced new concepts that may impact the commercial viability of a bond CTP. A useful example for demonstration purposes is the concept of Market Data Contributors (MDCs).

MDCs may be a Systematic Internaliser (SI), Investment Firm (IF), APA or Trading Venue (TV). The Proposal would permit them to contribute directly to a bond CTP, which would mean the scope of contributors would be expanded from APA/TVs to also include SI/IFs. The objective of this change is unclear, but it is likely that vendors will see it as challenging with respect to the operation of a bond CTP. Under the current legislation, a bond CTP consumes trade data from APA/TVs. The trades of SI/IFs enter a bond CTP via APAs.

This is advantageous because, i) there are only a limited number of APAs, thus a limited number of operational connections, ii) data is a core business for APAs, so when a CTP engages in operational matters it is doing so as a peer, iii) the key APAs and CTPs are both regulated by ESMA, so there is a common regulator to mediate on matters of implementation (admittedly a recent development).

If SI/IFs submit directly to a bond CTP, it would have i) a far higher number of operational connections, ii) the complexity of connecting to SI/IFs, and not the other way around - per the language of the Proposal, iii) to engage with non-data professionals in operational matters, and iv) to operate in a challenging conflict resolution environment, across ESMA and 27 National Competent Authorities (NCAs).

As always, legislation remains exposed to 'the law of unintended consequences'.

Furthermore, under today's legislation the obligation for the implementation of deferrals rests with the source of the trade data, i.e. the SI/IF. According to the Proposal, a bond CTP would have a new obligation to ensure the correct application of deferrals. This would essentially extend a regulatory obligation from the SI/IF to the CTP. Clearly all of this would create significant commercial disincentive to operate a bond CTP. Yet the consequences of the MDC concept do not stop there.

It is likely that SI/IFs would not only find contributing to a bond CTP operationally attractive (connectivity obligations laying with the CTP) but also financially attractive, since the CTP would need to apply any revenue share uniformly. Essentially, if a bond CTP is rebating the SI/IF directly this would have a negative commercial impact for the APAs, as the value of their trade data would plummet.

However, SI/IFs would still have to use an APA to comply with transparency reporting rules, which notably require that trade data becomes free after 15 minutes (an obligation the CTP would no longer have). Thus, the APA would likely recover lost data revenue via the fees it charges SI/IFs - otherwise it may become commercially unviable.

The bond CTP for its part would thus be getting duplicate data, once from the APA and once from the SI/IF, which it would need to reconcile, adding yet another burden on its commercial viability.

Therefore, when considering the MDC alone (as a single example of challenging concepts within the Proposal) it may lead to a greater operational burden, thus operational cost, for vendors interested in operating a bond CTP, than what is the case under the current legislation (where the MDC concept does not exist).

In conclusion, there is a risk that the disincentives for a vendor to operate a bond CTP under the current legislation may have been replaced with new disincentives within the Proposal. As always, legislation remains exposed to 'the law of unintended consequences'.



QUENTIN VAN LIDTH

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Focusing on the CT key success factors and managing liquidity

BNP Paribas supports the ambition to build a Capital Market Union (CMU), improve MiFID II / MiFIR, develop fair, efficient and resilient markets and, to this end, build a Consolidated Tape (CT).

A phased approach for the scope of asset classes: first a CT for equity and bonds

We believe there are clear use cases for a CT for equity shares and for bonds, in terms of price formation, risk management and best execution. We see fewer use cases for OTC derivatives and ETFs.

One of the key aspects when assessing the use case of a CT is (i) whether the instruments are fungible versus bilateral/bespoke agreements, (ii) the nature of the instrument and its liquidity, whether based on the instrument itself or on its underlying, and (iii) the natural investor base. On this basis, we believe the prioritisation of a CT for equity shares and bonds is the most

appropriate. Concentrating efforts and resources in these asset classes will give the best chance of success.

Focus on market data IP rights

One of the main reasons a CT has not yet materialised is the lack of access to data on reasonable commercial terms. This is due to intellectual property (IP) rights being asserted by Trading Venues (TV), and Approved Publishing Arrangements (APA).

Deferrals are enabling liquidity, rather than impeding the CT

Well-calibrated deferrals for prices and volumes are crucial ingredients of efficient markets, rather than an impediment to the CT. For illiquid instruments and trades of large sizes, deferrals are critical for liquidity providers to hedge their positions. Deferrals must adequately represent the time needed for dealers to recycle positions in order to retain the ability to offer liquidity to clients from their balance sheet, in all market conditions. Ultimately, BNP Paribas supports real-time transparency for liquid instruments and trades of small sizes, for which hedging and risk management are straightforward.

A phased approach for managing the delicate balance between transparency and liquidity

First, build a CT. Then analyse the data and understand the transparency, liquidity and market structure. Only then can deferrals be fine-tuned.

**First, build a CT.
Then analyse the data...
only then can deferrals
be fine-tuned.**

Yes to mandatory contribution

We welcome the mandatory contribution submitted free of charge by TV and APA to the CT provider. Separately, market participants will continue to subscribe to the direct and low-latency data feeds required for trading execution and market-making. Regarding these feeds, we encourage regulatory authorities to continue to monitor contracts and fee models from TV and data vendors.

Public good and run as a utility instead of maximising revenue

Instead of a revenue maximising approach, market data should be

treated as a public good and made available as widely and cheaply as possible. Moreover, in the context of CMU, the CT should not be compromised to secure revenue for exchanges. Healthy, efficient and progressive capital markets need to be based on competitive business models rather than on subsidising existing infrastructure. Given the above, we believe the CT should be run as a utility, i.e. on a cost recovery basis, by providing data for a small fee reflecting the cost of aggregation and distribution. This improved access to data would increase participation and generate more executions for which TV can charge.

Pre-trade transparency for equity from day 1

For equity shares, the identified use cases are based on the availability of pre- and post-trade transparency. For bonds, they are based on the availability of post-trade transparency.

For bonds, the use cases are about getting more price information on liquid instruments and trades of small sizes from post-trade transparency. And investors are willing to pay a small fee for this. For equity shares, the use cases are primarily about making aggregated price information available to a wider investor base than those who can afford it at present.

Data quality needs everyone's involvement, beyond the CT

Data quality depends on instrument reference data, golden sources and standard definitions. These subjects are complex, and more so in bonds than equity given the range of instruments. For example, today, there is no worldwide industry golden source for the outstanding notional amount of all bonds, not even the most liquid sovereign bonds.

Continuous improvement in data quality is a matter that requires the contribution of all stakeholders of the financial markets ecosystem: market participants, operators, data vendors, technology firms and regulatory authorities. This active collaboration is already taking place now beyond the CT and must deepen.



JAMES MCKEONE

Vice President, Head of
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A tape is no silver bullet for EU markets – it could do more harm than good

The EU is once again updating its financial markets regulatory framework, known as MiFID/MiFIR. This is an important endeavor that will have long-term effects on the functionality and competitiveness of European financial markets. One of the triggers for this revision is that despite the clear political will for increased market transparency, since the last reform, EU markets have in fact become darker.

Transparent markets are crucial in bringing end-investors and companies together, and in providing companies with access to capital. They also protect investors. By allowing all investors to trade listed financial instruments and ensuring a quality price formation process, exchanges and other transparent markets ensure a fair and verifiable outcome. This is key to well-functioning capital markets and justifies the need to promote and preserve an adequate price formation process.

The proportion of dark trading in the European market is disputed.

This is primarily due to the lack of undisputable information about transactions that have happened on various venues active throughout the continent. By comparison, details about the price and execution of transactions happening on transparent markets are easily accessible. This is indeed not the case for trades executed by banks in their internal systems and OTC. A consolidated tape aimed at creating an overall picture of trading happening throughout the European continent would be an important step forward and would allow investors small and large to verify execution quality and to consistently identify venues where the best price can be found.

However, this is not what the European Commission is proposing.

In addition to advocating one post-trade consolidated tape per asset class (shares, ETFs, bonds & derivatives) able to give a full coverage of trading (this is good!), the European Commission proposes to establish a real-time post-trade tape of core market data for shares, leaving the door open to a pre-trade consolidated tape in the medium term. This constitutes a significant threat to European transparent markets and the financing of the economy.

A badly calibrated EU tape can seriously hurt transparent markets in favor of dark trading.

What would make more sense is an EU consolidated tape that creates a consolidated view of all transactions that have happened on the various venues and markets across the EU - a post-trade tape. Moreover, this tape should be delayed to allow for a proper sequencing of transaction data. Given the scattered geography of Europe and the multitude of execution mechanisms that will publish transaction data with a different time span, a real time post-trade tape would not show transactions in sequence and the publication of time stamps would not help in this respect, unless the tape is delayed.

What would be equally inappropriate is an EU tape that would want to show quoted prices in the markets i.e., a pre-trade tape. Because these prices would not be accessible to all viewers at the same time, the tape would become misleading. Some market participants will have faster access to prices and in reality, the liquidity shown on the tape will no longer be available – this

is a problem that the U.S. tape is facing and that regulators there are currently looking to address.

A badly calibrated EU tape can seriously hurt transparent markets in favor of dark trading. Contrary to the US model, the revenue model proposed by the Commission is unlikely to adequately remunerate transparent markets for the data that they contribute. The model envisaged requires transparent marketplace operators to provide real-time data for the EU tape, free of charge, while the industry has no obligation to consume the same data. Consequently, it is likely that the revenues of the EU tape would only cover its functioning, leaving transparent markets with revenue losses and investment challenges – and all to support a tape with very little added value to the wider financial eco-system and that does nothing to improve the functioning or transparency of financial markets.

The EU tape needs to strike the right balance between being useful & valuable to market participants, whilst not undermining transparent markets. An End of Day tape, or a 15 minute delayed tape, can achieve such a balance. The voices arguing that anything but a real-time tape would not deliver an improvement to transparent markets need to consider that a real-time tape will never be truly real time. Market players that have the technical capabilities to overcome latency issues will benefit- to the cost of small firms that do not. The use cases that have been highlighted favor a delayed post trade tape if we are to deliver a tape that is truly useful to all market participants.

The consolidated tape is no silver bullet to promoting transparency in EU financial markets. What is needed is an appropriate reform of the EU market structure and we trust the legislative process will refocus the text and create a market structure that allows European capital markets to thrive and support economic growth and job creation.



GERBEN EVERTS
Executive Director -
European Investors' Association

To deliver on best execution, more optimal price discovery is key

The current generation policy makers will have to deliver on important projects. Most urgent is obviously the transition towards a sustainable economy. Risk-bearing capital is required to finance this transition. A Green Deal without the CMU is just an ambition. Delivering on the CMU in full is a prerequisite for turning this ambition into a success.

Europe needs a 'Schengen' for financial markets. More effective allocation of capital is required to enlarge the EU capital markets, to finance the most innovative businesses and to grab its full economic dividend. Institutional investors already deliver on impact and engagement. We want young people and the self-employed to invest in their real future as well, in real assets listed on EU stockmarkets, instead of something crypto and illusionary.

To gain trust and prevent disappointment, we have to adjust current revenue models. As individual companies might have no incentive, policy makers need to step in. In the most ideal CMU reality, (retail) investors no longer have to worry about the pricing of transactions, settlement and clearing offered by a chain of intermediaries. The consolidated tape project will

assist investors in finding the most optimal allocation of their savings more automatically.

In principle, we are in favor of conducting as many transactions as possible on the most suitable, lit and transparent multilateral platforms. As regards the revision of the MiFID II/MiFIR regime, we advocate more targeted and meaningful transparency for investors and other stakeholders. Consideration must be given to the specific characteristics of the various market segments, market participants and the type of instrument.

Although MiFID II has certainly brought improvements, the overall sentiment among investors is that MiFID II has not yet delivered on all of its goals. Electronic trading system grow in market share. However, OTC-Request for Quote- and voice trading systems are a remaining hurdle for new entrants and their price discovery in the bond markets.

Furthermore, while MiFIR can be credited for providing a more solid regulatory framework for pre- and post-trade transparency, European Investors - VEB has genuine concerns regarding the way market participants are increasingly seeking to diverge from transparent central limit order book models through internalization, as well as through alternative types of trading and execution venues. A more level playing field between those alternative liquidity pools and multilateral trading venues is key.

We strongly advocate implementation of a real-time consolidated tape for equity and bonds.

Transparency and comparability are important in ensuring that markets are fair, sound and efficient. European Investors - VEB strongly advocates the implementation of a real-time consolidated tape for equity and bonds. A consolidated tape will result in less fragmented price information, as well as other information, in the European markets.

The goal is to achieve more efficient pricing and capital allocation, early identification of risks to financial stability, and greater market integrity. The quality of public data is currently quite poor. Data quality and transparency on cost of market data need to be

improved, in which supervisory action and convergence are necessary.

The post-trade Consolidated Tape Provider (CTP) is considered a most essential part of the CMU. A CTP has the potential to significantly improve transparency by aggregating information from increasingly fragmented markets across trading venues. The availability of common reference price information is improved. However, the jury is still out on the benefits of pre-trade transparency. This requires significant investments in data collection, distribution and analysis - as order data is extremely volatile and less-trustworthy. Data quality, the amount of data sources, the achievability of real-time, and the time-to-completion are precisely the practical constraints, which should temper expectations.

Hence, some important concerns remain. For equity markets, more transparency is called for. The opt-outs could be simplified and further restricted. For bonds, the current waiver and deferral regime should be simplified, and the liquid instrument scope increased. For derivatives, the scope of the DTO should be adjusted and better aligned to reduce complexity and to increase flexibility.

Delivering the consolidated tape project in the most ambitious, though practical way is key. It will help in creating a real European Capital Markets Union and will improve opportunities for monitoring execution quality (best execution) for market participants and investors. With the infrastructure being more stable, this MiFID promise to investors is now urgently required.

SME EQUITY FINANCING



BENOÎT DE JUVIGNY

Secretary General - Autorité des Marchés Financiers (AMF)

Ever-changing capital markets framework and its impact on SMEs

It is a well-known fact that the European SMEs are more heavily reliant on private debt or equity financing (e.g. loan-based bank financing) than their peers in other major jurisdictions, namely in the US, which are mostly financed through their domestic capital markets.

During the Covid-19 crisis, European governments have put in place an arsenal of public measures that allowed SMEs to confront the sharp fall in demand and business opportunities. These supporting measures were mostly debt-based and included for example schemes involving public guarantees for loans granted to companies. This has generated a substantial increase of the level of debt on SMEs' balance sheets compared to the pre-Covid levels. Additional equity financing, and lower levels of leverage on companies' balance sheets are needed to re-balance the current corporate financial structure, and provide companies more room for manoeuvre for sustained growth.

During that same period, European legislators have enacted in an unprecedentedly swift manner certain legislative measures, in the context of an EU recovery package, in order to facilitate SMEs' access to capital markets. Among those measures, the European legislators created a temporary 'recovery prospectus', a new short-form prospectus, aimed at simplifying the procedure for listed issuers to swiftly seize opportunities to raise equity in the capital markets during the COVID-19 pandemic. At this stage and despite the significant number of capital increases in 2021 on financial markets, this new format has had very limited success.

In order to increase financial research activity on SMEs, the recovery package also removed, for SMEs only, the research fees unbundling obligation that was introduced in MIFID 2, with the goal to give small issuers more visibility for investors. MIFID 2 recovery package is helping SMEs to be better covered by financial analysts as it allows investment firms to recoup the costs of SME research with other income sources.

Targeted adjustments are worthwhile to tackle SMEs' access to capital markets.

As part of its 2022 work programme, the European Commission announced its intention to adopt a legislative proposal in the second half of 2022 to provide for additional regulatory simplifications and ways to reduce costs and red tape for companies, especially SMEs, and to foster their listing. This initiative is high on EU's CMU agenda, considering also that the global competitiveness of the EU is at stake. Indeed, following Brexit, the UK has also introduced significant changes to its Listing Rules, and is considering a fundamental overhaul of its Prospectus Regime with a view to further increase its attractiveness.

Overall, the existing European regulatory framework is sound and robust. Even if they entail costs and administrative burden for issuers, regulations such as Market Abuse or Prospectus are key for market

integrity and investors' confidence. A comprehensive and structural change of those pivotal regulations under the Listing Act review could significantly scare off investors and destabilise the market. At the same time, targeted adjustments are worthwhile to tackle SMEs' access to capital markets. Proposals touching for instance on the prospectus requirements targeting SME growth markets are welcome. An interesting route could be to repeal the obligation to draw a prospectus for public offering in SME Growth Markets, and to transfer to market operators the responsibility to define the content of an information document that would be required by European law.

The ESAP project (European Single Access Point) is currently being designed in the EU so that such regulatory information, including financial and sustainability-related information of European companies, can be accessed in a digital format via a central entry point within the EU. ESAP will provide increased visibility for issuers, in particular smaller ones, increasing their chances of having access to a larger pool of investors. ESAP will facilitate investors' access to capital markets to make sound investment decisions. An important point of attention is that the project should not increase or modify companies' general reporting obligations, and should not generate additional costs for issuers.

Harmonisation in regards to the loan origination framework proposed by the European Commission is welcome as well. This will further encourage the funding to SMEs and provide them with an additional source of funding. This is also the case for the ELTIF proposition, which shall support the long-term growth of SMEs while providing an investment option for retail investors to participate in capital markets.

Retail interest and trading activity in the public markets have indeed significantly increased since the beginning of the Covid-19 crisis. This renewed interest may benefit publicly listed SMEs, which is why it is key to consider proportionate measures that would increase their visibility and facilitate their access to the public markets, without jeopardizing market integrity, key for long-term success.



ALAIN GODARD

Chief Executive Officer -
European Investment Fund (EIF)

Venture Capital in Europe – mind the (scale-up) gap

The EU Industrial policy has entered a new phase. It is a new phase that aligns the EU action to changes in the economic and geopolitical global landscape and which is built around powerful concepts such as Industrial Ecosystems or Economic Strategic Autonomy.

On this basis, the new policy clearly wants to address main topics such as a strong European presence in certain strategic productions, the issue of vulnerability of value chains, the promotion of an effective dual transition. With the clear understanding that a competitive Europe is a stronger Europe: economically, politically, in its capacity to influence other geopolitical blocks.

In light of the above, the EU Industrial policy indicates the importance of startups and of the building of an appropriate context for their development. Startups represent ideas, jobs and growth. Startups are the future. And the Capital Markets Union reinforces this vision. As a matter of fact, one of its strategic objectives is to improve access to Venture Capital (VC) financing.

The EIF has been in the first line on this policy goal. The Fund has contributed to building the VC market

and to its growth. It supported it during challenging times, including during the COVID recession. On that, there are good news coming from latest data. They indicate that the market quickly bounced back from the measurable harm of the first wave of lockdowns and does not show signs of “long COVID”. The European VC market showed a new level of resilience, unseen during previous crises, with VC fund managers optimistic regarding their current state of business and the long-term perspectives of the VC market in Europe.

These are positive news but there is still work ahead. Some of the traditional features of European financial markets persist and there is still a significant and growing activity gap versus other regions of the World, in particular the US. One data is particularly meaningful: in 2020 VC fundraising in the US was 4,5 times the value in Europe.

Among the issues to be tackled is also ensuring the conditions for growth of startups. We still have an underdeveloped IPO market, the overall VC market is still too small, funds generally have limited sizes and there are too few large funds.

**It is time Europe
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This latter aspect is especially worrying. The gap for large fund sizes between US and Europe is still striking. This is a difference with strong repercussions. Larger funds mean possibilities to invest bigger tickets (which are necessary in scale up financing) and also to achieve portfolio diversification. The consequences are known: for large financing rounds in Europe, non-European investors are filling the void. In turn, European entrepreneurs supported by foreign VC investors have a higher chance to experience a foreign exit or be acquired by a non-European buyer.

The stakes are high: risk of foreign relocation of European firms, brain drain, loss of tech leadership and negative sovereignty implications. We

are, in sum, at the core of European Economic Strategic autonomy, at the core of creating a stronger Industrial Europe for future years.

What needs to be done to counteract this situation is also clear. It is, on one side, to continue working and strengthening the Capital Markets Union and, in parallel, to have a clear engagement by large institutional investors and public support for late-stage VC funds.

This is where the EIF is acting – fully aligned with the indication of European Industrial Policy; this is the bulk of the Scale up Initiative.

As a matter of fact Europe needs a Large Fund of Funds specialising in the later stage of equity financing: to help the constitution of European specialised fund in this segment, to bring institutional investors in this area; to create the conditions for NPI focusing in this direction.

It is a great European effort we have to spur. But is clearly in the right direction. Europe is at the forefront of research, our human capital is considered first class in Universities and research centres all over the world, our creatives are shaping tastes and visions in the global markets.

It is time Europe develops a capital market that helps and nurtures these ideas, supporting people from the start or their activities and throughout their entrepreneurial trip. This is one of the priorities of the European Commission and the aim of the Capital Markets Action Plan of 2020 which is speeding up its implementation.

Scale up is fully in that line. It is about ensuring that European ideas have the possibility of becoming big here. It is a technical concept, but with a political ambition clearly stated in the European Industrial Strategy.

The EIF, as the financial institution of the Union specialised in the financing of SME is and will be in the forefront in this challenge.



BEATRIZ ALONSO-MAJAGRANZAS

Head of Exchange - SIX

Exchanges promoting the capability for growing and consolidation of SMEs

It is well known that Small and Medium Enterprises are the backbone in supporting the economic tissue in Europe. In fact, this reality has only been reinforced during this long-lasting pandemic and the measures aimed at supporting SMEs in all financial sectors.

Moreover, SMEs cater for many needs of the financial sector, such as innovation, compliance with ESG and best practices, along with visibility for diversity and sustainability of business models. Nevertheless, SMEs still face multiple challenges, especially related to financing and visibility in the broader financial panorama, that constrain their potential and their capability for growing and establishing themselves as solid market participants.

There is a need for reviewing the regulatory and economic conditions that surround SMEs in order to provide them with additional legal certainty and proper ability to reach consistent sources of funding. Regulation must

not create such a burden that it deters SMEs from entering the next stage of funding at regulated markets. In this sense, it is paramount that policy makers make a conscious assessment that brings balance between the inherent risks of financing of small and medium companies and the potential benefit they can create for the whole ecosystem.

This assessment inevitably goes through the revision of the proportionality of requirements, and the review of MiFID II and the current discussions about its content pose the most favorable moment to do so. Aspects such as the access of retail investors to SME assets, enough coverage of small and medium sized companies, and a consistent and homogenous concept of what is considered an SME are elements that stakeholders consider critical to support SME growth.

The targets included in the CMU Action Plan constitute another relevant contribution: in particular, the support to the access to public markets or to the vehicles for long-term investment. Also, there is the aim of building retail investors' trust in capital markets and enhancing cross-border investment in these kinds of companies.

The review of MiFID II is an opportunity to make our financial system more dynamic and inclusive, taking one decisive step forward in the completion of the CMU. The MiFID II Quick Fix has been a good movement in the right direction.

Exchanges and regulated markets have the expertise and tools to maximize the potential of SMEs.

The fostering of research services for SMEs will contribute to increasing the visibility and accessibility to SMEs to promote their portfolios.

The review of the Prospectus Regulation and Market Abuse Regulation in the framework of the Listing Act is a welcomed initiative too. It is crucial to ease the requirements for SMEs to be listed and to carry on secondary issuances. Harmonizing the criteria that National Competent Authorities apply to register a prospectus for SMEs through a common guideline will also be very helpful. Finally, the adaptation of market abuse rules to the capacities

and structures of SMEs will be also of the utmost importance.

Other developments, even if they are not exclusively under the EC competence, are relevant. Tax incentives are effective, for example, for the involvement of retail investors. A carefully dimensioned tax regime, paired with tax incentives, needs to be implemented throughout the EU to level the playing field for SMEs vis-à-vis the rest of companies. Furthermore, the range of vehicles for investment currently available and well established (such as venture capital or ELTIFs) needs to be further assessed to make the most effective usage.

European companies in general need to pick up momentum in order to increase competitiveness vis-à-vis the rest of the world, and SMEs are no exception; this will also result in the building of a more sustainable EU in the long term and constitutes a step forward towards achieving the Capital Markets Union.

Exchanges and regulated markets play an important role in this environment, as they count on the expertise and the solidity to put tools at the disposal of SMEs to maximize their potential. SME Growth Markets create a relevant space for companies, putting the focus on their local imprint, allowing them to grow in a convenient ecosystem and accompanying them in their evolution. They provide visibility, transparency, and quality in terms of corporate governance under a regulated environment. In an earlier stage, initiatives from growth markets such as consultancy and fundraising prior to listing, legal and compliance guidance, and gap-bridging between companies and potential investors have the capacity to draw companies to the financial market.



RIMANTAS ŠADŽIUS

Member - European Court
of Auditors (ECA)

Equity financing through better integrated capital markets – EU auditors' view

As the Union's independent external auditor, the European Court of Auditors (ECA) not only assesses the implementation of the EU budget, but also the performance of EU institutions and bodies in reaching their objectives. Among others, we evaluate actions of the European Commission, the European Supervisory Authorities, the European Central Bank as banking supervisor and the Single Resolution Board. Recent reports scrutinized the Commission's work on the Capital Markets Union (CMU) project and on the development of a Single Market for investment funds.

Equity is key for businesses as it enables risk taking, innovation and growth. The level of equity financing determines the resilience of businesses during economic downturns and crises and therefore of the economy as a whole. The EU enhanced the stability of bank financing through big steps in building the Banking Union. In contrast, the progress in integrating capital markets has been limited to date and the Commission's measures had little catalytic effect so far. However,

integrated capital markets are crucial in providing more equity financing to EU businesses. Otherwise, in the absence of strong capital markets, extensive public support will be required during rainy days, resulting in excessive deficits.

In our assessment of the first CMU action plan, we observed that capital markets in the EU remain highly heterogeneous. They vary significantly in size, maturity, average financial literacy of SMEs and businesses and even financial products available. This hampers equity financing for SMEs in certain Member States and regions of the EU. Therefore, it is essential to push forward less developed capital markets in parallel to their EU-wide integration into one Single Capital Market. We recommend that the Commission should help Member States to achieve this through its technical assistance programs. This is especially relevant for smaller markets, which alone do not benefit from economies of scale and therefore lack investors' interest.

Investment funds also play an important role in equity financing for businesses, as they offer investors diversified and professionally managed portfolios paired with a higher level of investor protection. In our report, we conclude that while cross-border business was enabled through the passporting regime, the number of true cross-border funds remains limited.

Essential to push forward less developed capital markets in parallel to their EU-wide integration.

While UCITS was a great success in the EU and abroad, it did not yet result in the desired effects, such as real market integration and reduced costs for investors. As a result, smaller Member States with less developed capital markets are disadvantaged. We also conclude that this can change neither within the current framework nor through limited revisions of individual pieces of legislation.

The second CMU action plan foresees a number of helpful legislative and non-legislative measures. However, we found repeatedly that the use of Directives rather than Regulations in the area of financial services is inefficient, as their implementation is usually very slow, results in significant additional administrative burden

on all levels and creates obstacles to supervisory convergence and effective enforcement. For instance, the complete transposition of the AIFMD Regulation in all Member States took eight years.

Non-legislative measures could be very valuable, in particular when they increase transparency of capital markets. One example is the European Single Access Point for information on listed companies, though it is not yet reality. Furthermore, we recommend a tool for the comparison of investment funds, allowing investors to understand key differences.

We also found that the European Securities and Markets Authority (ESMA) does play an important role in the integration of markets through its supervisory convergence work, but still faces significant challenges. The supervision of investment funds remains dominated by national interests and continues to differ within the EU. As a result, enforcement actions are rather rare. Only through introducing a more European perspective in the supervision of capital markets, deeper integration can become a reality. The establishment of EU banking supervision has already proven this.

The participation of retail investors in capital markets could foster equity financing of businesses in the EU, while offering them higher returns for their savings. However, obstacles exist. For example, inducements disadvantage investors significantly, as they create inherent conflicts of interest and high costs. They account for about half of the total costs charged to investment funds holders. Nevertheless, they are still the standard in most Member States. Thus, we recommend that the Commission propose stricter rules on inducements.

The ECA will continue to report on the EU's progress towards an efficient and resilient Single Market for financial services. We have recently started an audit to assess how EU banking supervision deals with the management of non-performing loans.

ELTIF / AIFMD REVIEWS



RODRIGO BUENAVENTURA

Chair - Spanish Securities
and Exchange Commission
(CNMV)

Regulatory push for collective investment: a much needed review

The proposals to modify the AIFMD and the ELTIF Regulation pursue quite different objectives. The first aims at improving the liquidity management and the supervision of AIFs and, more importantly, UCITS. The second incorporates some positive changes to stimulate the way that collective investment can contribute to CMU objectives. These reforms boost collective investment as an effective and safe way to attract more retail investors to capital markets.

Regarding AIFMD and UCITS there are two hugely important modifications. The first is the introduction of liquidity management tools, since they step up the requirements for an adequate and effective liquidity management. We at CNMV welcome this, since we

have long advocated for reinforcing the requirements linked to liquidity management and we have been very active in their supervision, mainly in periods of stress such as those experienced in 2020. This should also soothe some concerns about possible systemic risks: investment funds will be even better regulated and supervised after these reforms become effective.

The second change worth mentioning is the modification of the reporting regime to NCAs, since the previous regime did not include the detail of positions in the portfolio, which reduced its usefulness. Speaking from a jurisdiction (Spain) that requires since 1990 monthly reporting of detailed ISIN-level positions at individual fund level, I can assure that this is an immensely useful tool for supervision with very low ongoing costs for management companies once the systems are built. I hope the granularity and frequency are sufficient to enable proper monitoring and supervision.

**These reforms boost
collective investment
as a way to attract
more retail investors
to markets.**

A third positive element is the planned modifications in the loan funds with the aim of supporting the CMU strategy. However, in this case, I have the feeling that the proposal is too flexible in two main issues. On the one hand, the alternative funds are not prevented from granting individual loans to retail clients - there is just a 20% diversification limit when lending to financial entities or collective investment vehicles -. This, in itself, does not create a significant risk, but I doubt that direct retail loan activity by AIFs is meant to mean any substantial difference in terms of availability of credit. On the other hand, the fund is expected to be closed only when the amount of loans exceeds 60% of the assets managed. This figure may be too high for an adequate and effective management liquidity policy, in order to ensure reimbursements and equal treatment between investors.

The proposal does not include some more technical elements that were

mentioned in the ESMA letter to the European Commission, to clarify the application of the MiFID regulations. In the same level, a clarification of the rules applicable in the case of cross-border structures has been left out, especially on the respective responsibilities of home and host supervisors. This is an element with a high impact in some jurisdictions.

ELTIFs have so far failed to become a meaningful EU label. The amendments to the ELTIF regulation are deep and relevant, in line with the CMU's strategy, for which this vehicle is considered a relevant piece.

Beyond a set of positive technical and operational considerations that should make their operating regime more flexible - such as reduction in coefficients, a greater number of eligible assets and other modifications in the case of a vehicle focused on professional investors -, the Commission's proposal includes two key points, a priori suitable, but not exempt from uncertainties.

Firstly, the idea of a "secondary market" for ELTIF's "shares". This seems a laudable initiative, so that investors have an early way out. But the key will be to ensure that investors are aware that liquidity cannot be ensured, even with that mechanism. The Level 2 measures by ESMA to develop information requirements will be, in this sense, essential.

The second key point refers to the ambitious modification of the requirements for its commercialization, with the aim of spreading the investor base. The Commission approach is bold, with a triple removal: i) the minimum subscription amount (established at €10,000), ii) the limit of 10% of the investor's financial assets and the requirement of advice. The proposal keeps just the suitability test requirement and the (written) warning when the product's 10-year maturity is exceeded. I think that we should remain vigilant and strengthen information to investors to avoid that this important softening of the regime produces excessive concentration and liquidity risks on retail investor's portfolios.



MICHAEL MCGRATH

Assistant Secretary,
Financial Services Division -
Department of Finance,
Ireland

Evolution, not revolution is needed in the review of the AIFMD framework

The European Commission's package of measures to boost Europe's capital markets provides the potential to further develop our capital markets. This should boost the real economy and facilitate post COVID-19 growth. The AIFMD was originally adopted in 2011 in response to a crisis of a different nature, that of the global financial crisis that exposed weaknesses and vulnerabilities in certain fund activities. That led to a framework which ultimately sought to provide high-levels of investor protections while also facilitating EU AIF (Alternative Investment Fund) market integration, in tandem with a coherent supervisory approach to the activities of AIFs – still valid objective today.

The development and implementation of this framework was not without its challenges and therefore it was heartening that the European Commission ultimately concluded that it had largely achieved its original objectives. This conclusion was accompanied with the caveat that the AIFMD could benefit from targeted

improvements and to take account of new developments in the market since 2011. Ireland has developed a vibrant fund and asset management industry over the last number of decades. We have significant policy and supervisory experience and bringing our experience can help this review process. In this regard, there are a number of key areas focusing attention right now.

Liquidity management tools can have a role to play in strengthening the EU framework. At present, the AIFMD does not provide for a minimum harmonised set of LMTs available to AIFMs that would enable fund managers in every Member State to adequately deal with pressures under stressed market conditions or in order to better handle potential cross-border spill-overs of liquidity tensions. A standardised approach across the EU would be sensible and the experiences of some member States in this regard should inform the debate. The ability to delegate functions to third parties allows the AIFM to benefit from cost savings, utilise expertise in specific markets and access global trading capabilities while being subject to strict control, oversight and accountability by those funds' national regulator in compliance with EU rules. This crucial element of the AIFMD framework has facilitated Fund Managers (AIFM) to fulfil their remit to serve investors in the AIFs that they manage and act in their best interests.

**AIFMD brand can't
be overstated, it's an
integral aspect of the
EU's global investment
fund offering.**

The Commission has rightfully acknowledged that the current delegation model as facilitated by AIFMD has worked well and remains one of the key pillars supporting the EU's cross-border investment model. The proposed changes to the delegation rules largely focus on minimum substance requirements and transparency in relation to delegation practices. During the course of negotiations it is crucial to ensure that any changes made, however slight, do not undermine the global funds model or contradict our agreed goal of deepening the EU Capital Markets Union. Provisions in the AIFMD surrounding the harmonisation of depositary liability and functions have been successful in enhancing investor protections. The Commission's pro-

posal to allow for cross-border access to depositary services under strict parameters has the potential to be a pragmatic compromise but we must remain vigilant to the potential creation of additional risks. Loan origination by investment funds play a positive role in a well-diversified financial system, complementing bank based funding and supporting the real economy. In 2014 Ireland became the first EU country to introduce a specific regulatory framework for loan origination by investment funds. Recognising the importance of loan origination by funds the Commission has sought to introduce a degree of harmonisation to the regulation of this activity having regard to the fact that there are a myriad of national loan origination regimes, and none.

As a jurisdiction with a pre-existing domestic regime for loan-origination by AIFs, we are supportive of a harmonised approach which provides common legal framework to mitigate against the potential risks related to this type of activity.

The need for an effective framework, encompassing governance and risk management, is heightened by the potential role which loan-originating funds can play, within appropriately calibrated parameters, in the deepening of our Capital Markets Union. This function would allow these AIFs to play a larger role in supporting job creation, economic growth and contributing to the recovery from the Covid-19 pandemic; ultimately aligned with our shared objectives for the continued development of the Capital Markets Union.

Finally, unlike other vehicles such as the current version of ELTIF, the AIFMD has proven to be a European success story that continues to fulfil the stated objectives of providing robust investor protection and addressing systemic risks.

The importance of the AIFMD brand cannot be overstated and it is an integral aspect of the EU's global investment fund offering.



STÉPHANE JANIN

Head of Global
Regulatory Developments
and Public Affairs -
AXA Investment Managers

AIFMD and ELTIF Reviews: how to boost contribution of asset managers to the EU?

As published in November 2021, the proposal by the European Commission (EC) to amend AIFM and ELTIF legislations has to be welcome.

Regarding AIFMD, and as promised, the EC only spotted a few targeted topics to be reviewed or introduced: Liquidity Management Tools (LMTs), Delegation, Supervisory Reporting, Loan-originating Funds, Depositary, Fee Disclosure. The EC was fully right in trying to avoid a comprehensive review of AIFMD, which would have broken a successful Directive to the detriment of investors and EU-based asset management companies. We think that this proposal is largely well calibrated on delegation and depositary in particular.

However, as usual, the European Parliament (EP) and the Council have a key role to play to improve further the initial draft proposal issued by the EC. For LMTs, setting a list of tools to be made available in all Member States

makes sense, to make sure that fund managers are equally equipped to manage any exceptional situation they might face regarding open-ended funds. But a crucial point to be amended is to be more specific on the scope of “technical details” to be provided at Level 2 by the EC and ESMA: as currently drafted, they would set for instance the conditions for “selection and use of suitable” LMTs by fund managers. In our view, the use of LMTs is by nature related to ad hoc circumstances, and otherwise we might end with ‘strait-jackets’ – e.g. defining market triggers – which would automatically generate Systemic Risks if all fund managers had to use the same LMT at the same moment due to a given market circumstance. Over-harmonization would unwittingly lead to Systemic Risk.

Regarding loan-originating funds, some provisions do not appear as rightly calibrated yet. For example, the 5% retention rule from the Securitization framework has been replicated here, but without any exemption. This is surprising – and potentially harmful – as in major Member States some legislations applicable for many years (e.g. in France since 2016) provide for an exhaustive list of fully justified limited exemptions: in case of liquidation of funds, in case of fund units held by a single investor, in case the purpose of the sale is to avoid a breach of the fund’s investment rules, etc.

Over-harmonization would unwittingly lead to Systemic Risk.

On fund fee and charge disclosure, the provisions proposed by the EC in AIFMD review might create additional confusion, as we already have to comply with UCITS, PRIIPs and MiF in that matter. We would suggest keeping only the references to this three latter series of measures.

Regarding Supervisory Reporting, the proposal by the EC to increase it for UCITS funds at EU level has to be carefully assessed by the EP and Council before giving any narrowed mandate to ESMA on that topic: today, EU asset managers have already to report their fund inventories to the ECB and national central banks, line by line, and should not therefore end with new, additional reportings based on complex and costly calculations that our non-European competitors do not have to carry out and produce today.

The first and key action is to ensure that the ECB and central banks share with ESMA and national securities regulators the data they already receive from us. From an EU competitiveness perspective, new reportings should not be added.

Last, regarding ELTIF review, we strongly support it. As everyone knows, it was not an EU success up to now. The point is not vis-à-vis professional investors: they usually ask for dedicated funds that we can easily build; so this type of investor should not be the priority of the review. The core progress to be made for ELTIF review is vis-à-vis retail investors, to allow them to finance European ‘real economy’ assets, such as infrastructures or SMEs: it would be a critical way for European institutions to make EU citizens feel closer to European enterprises and contributing to job creations and economic growth in the Single Market.

Various cases of successful domestic vehicles exist in Member States, such as the French ‘Relance’ evergreen funds ensuring national infrastructure and SME financing by true mass retail investors - with 80% of individual subscribed investments below 10 000 euros each. But to replicate such domestic successes at EU level, it implies amending further ELTIF rules towards retail investors: lower subscription threshold, more flexibility in investment, distribution rules and tests fully governed by MiFID to ensure a level playing field with other financial instruments.

Why not introducing such amendments, to bring at last EU citizens a concrete tool to become active builders of the Union projects?



FABRICE REMY

Senior Counsel,
Senior Vice President -
Capital Group

Targeted enhancements of the rules that build on the existing successful regime

The AIFMD and the UCITS Directive form the backbone of the regulatory framework for the asset management industry in Europe and have a long and successful track record, repeatedly tested through several stressed-market conditions. The current review is at the centre of the EC's plans for a stronger CMU in the service of the European economy, investors and consumers. To deliver on this goal, it is critical to build upon the successes and make adjustments that can enhance, but not jeopardise, the current high-quality standards and sound mechanisms, as these have allowed investor choice, product innovation and effective investor protection and management of risks.

Overall, the legislative Proposal published last year acknowledges these merits and aims to close certain gaps via specific adjustments. While further consideration may be necessary for some of the suggested actions, the overall principle of not reshaping a regime that is functioning properly constitutes a pragmatic approach and is the right course of action for the co-legislators.

One of the main areas addressed in the Proposal relates to delegation arrangements. As a global leading asset manager of actively-managed equity and fixed income strategies offered to investors around the world, Capital Group has deep experience with delegation, how it ensures high quality results for investors and a truly competitive position for Europe, while remaining fully overseen by the EU supervised entity. Our mission is to give our investors equal access to the best, largest and most diversified team of portfolio experts we can assemble and via proprietary research on assets and industries that are located globally. This allows investors to benefit from a true cross-border ecosystem, while at the same time maximises our ability to engage with portfolio companies locally as the most effective possible steward.

**The principle of not
reshaping a properly
functioning regime is the
right course of action.**

Currently, AIFMD rules ensure outreach to the right expertise, and are balanced with appropriate investor protection, oversight and accountability safeguards. The EC acknowledges this and aims to make limited additions relating mostly to gathering information and strengthening proper supervision on how control and oversight are performed. Although it is our experience that this reporting is largely already taking place among asset managers and supervisors at the national level, we understand that further coordinating the flow of the information among regulators remains important for investor and regulator confidence. At the same time, the approach taken should avoid a counter-effective debate as to how much is or should be delegated. Instead, it should focus on addressing remaining information gaps – without duplicating – and importantly, aim to protect the level and quality of expertise necessary for appropriate management. This is the only approach that can ensure best investor outcomes.

Another key area of the Proposal relates to liquidity risk management. We share regulators' need to understand what went wrong with the market volatility of 2020 and draw the right lessons as to risk prevention in the future. From the perspective of open-ended funds in Europe, one key observation is that amid this "real-life liquidity stress test" only

a limited number of funds suspended redemptions while the vast majority were able to maintain their portfolio structure. Here, the AIFMD framework showed its merits: via requiring liquidity risk management processes based on the portfolio composition and liquidity characteristics. It ensured the sector was equipped with tools properly calibrated to market conditions and liquidity demands and remained resilient to market pressures.

Reinforcement proposals include ensuring the full list of liquidity management tools is at the disposal of asset managers in every jurisdiction. We fully agree, as this will further enable funds' readiness and resilience. In addition, strengthening supervisory convergence on that front can be helpful, keeping in mind that proximity and understanding of local characteristics is crucial, as is the role of national competent authorities.

Where we would draw attention is with the suggestion to allow regulators to step in at the individual fund level and trigger liquidity tools. We firmly believe that risk management requires in-depth understanding of the assets, liquidity profile and strategy employed by each fund and therefore asset managers are best placed to reach such decisions and properly report to their supervisors.

While we understand the need for a level playing field and legal consistency, it is important to also remember the differences between the two frameworks. UCITS is a product regulation focused on specific retail-oriented collective investment vehicles, while AIFMD is a framework for management companies that captures a heterogeneous population of funds targeting, to a large extent, professional investors. As such, different approaches and distinct requirements may apply and be appropriate.

BANK CONTRIBUTION TO THE CMU



DENIS BEAU

First Deputy Governor -
Banque de France

How can banks contribute more to the CMU (and vice versa)?

Everyone agrees with the benefits of the Capital Markets Union at a time where we need a better allocation of the abundant savings in the EU to help finance two decisive transformations, the ecological and the digital one. However, so far, the deliverables have remained too slow and disappointing.

How can we better and quicker move forward? One lever is to go beyond the complementarities between bank and non-bank financing. Such complementarities have already materialized through several dimensions notably since 2007.

Banks and capital markets acting as close substitutes are key enablers of financial stability. Capital market funding has indeed developed in the wake of the GFC to diminish overreliance on bank funding in the EU, which then happened to be procyclical. Conversely, during the covid-19 crisis, the banking sector has countercyclically substituted thinner market funding provided by

MMF market or provided additional liquidity to the corporate and sovereign bonds markets.

Bank and non-bank financing channels also contribute to risk sharing in different ways, contributing to the financial stability of the system as a whole. Our companies, especially the most innovative ones, need to combine all types of funding for their financial soundness, consistently with their stages of development.

But banks are also important players in capital markets. They are investors (investment banking is still banking) but also originators and distributors of financial products through their dense commercial networks. In many financial segments, if not all, they are also the main market makers. Financial conglomerates play a decisive role in this regard.

However, taking advantage of CMU for their own needs, they could contribute more. A first “booster” could be a wider use of safe and transparent securitization, as a way to enhance both the banks balance sheets’ velocity and the depth and breadth of financial assets available for investors. The upcoming review of the 2017 framework will provide an opportunity to make decisive progress in this direction, in particular regarding green securitization.

Going beyond the complementarities between bank and non-bank financing, to move the CMU forward quicker and better.

Another “booster” would consist in a rebalancing of financial activities on the Continent in the wake of the Brexit. Such rebalancing has already taken place in certain financial segments. It has to be confirmed and extended to central clearing activities. The European Commission gave several leads to achieve such a goal, including regulatory incentives, in its November communication. They should be pursued in the coming months.

CMU should conversely help boosting the European scale of individual

banking groups, to optimize allocation of bank loans and markets funding within the European Union. The sound financial situation of the European banking sector in the aftermath of the Covid crisis facilitates such move.

Creating the CMU requires a strong banking sector, meaning banking actors reaching more systematically a European scale, for which Banking Union (BU) is an absolute cornerstone.

In this regard, without denying the political challenges related to the reinforcement or implementation of mutualized deposit guarantee schemes (i.e. the so-called “third pillar”), priority should be given to its reshaping, building both on increased liquidity solidarity between systems and reassignment of foreign subsidiaries to the home deposit guarantee scheme.

Thus, in order to move beyond home/host issues, an effective implementation of cross-border liquidity waivers within the EU could be promoted, combined with a preferential treatment for intragroup exposures in the BU. Last but not least, the forthcoming review of the crisis management framework could be a perfect opportunity to propose the harmonisation of bank bankruptcy regimes across the EU, in particular the depositors/creditors hierarchy.

All these progress, which are at hand, would provide, in conjunction with a stronger CMU, a genuine “Financing Union for Investment and Innovation”, a powerful asset for our ecological and digital transformations.



CARLOS CUERPO CABALLERO

Secretary General of the Treasury and International Financing - Ministry of Economy and Digitalization, Spain

Banks as enablers in the Capital Markets Union

During the last financial crisis banks were severely shaken by ripple effects. The interbank market choked and a credit crunch was set off. European SMEs and households dependency on banks became evident.

This time banks are part of the solution and can provide crucial support to funding as the public stimulus programs are becoming more targeted. Reforms have made the banking system more resilient and ready to face economic turmoil. Moreover, banks can help deepen Capital Markets Union (CMU), acting as issuers, intermediaries of issuance and as investors.

The current context of low interest rates makes bank credit widely available. The most recent Survey on the Access to Finance of Entreprises (SAFE) survey by the European Central Bank reflects that firms across size classes anticipate a return to pre-COVID 19 loan supply levels. Spanish SMEs expect their access to bank loans to improve even further. In a first stage, banks contributed to the Spanish emergency economic

policy response by granting more than €135 billion in public guaranteed loans to meet firms' liquidity needs, serving as a countercyclical element. In a second stage, the sector remains a key tool to ensure that credit correctly flows and that financing conditions remain stable.

Companies also have the opportunity to diversify their financing sources, and banks are well positioned to help them do so channeling unprecedented pandemic savings from retail investors to entities listed on stock markets. Many European banks have been very active in the capital markets in their current quest to diversify their income sources.

2021 has been a record year for IPOs in Europe. To strike a successful IPO highly skilled advice is needed, and Europe will profit from retaining its competitive investment services industry. This is a good example of how banks can act as intermediaries, underwriting and placing financial instruments, but also as direct investors.

Another trend is banks setting up venture capital funds investing in start-ups in Europe. Some of these investments have paid off after the boom in capital markets and the emergence of many new unicorns. The Spanish authorities are aware of the need to further drive this change and have adopted the adequate regulatory framework with two legislative initiatives to promote the constitution and growth of companies and to remove barriers for start-ups.

Banks adaptation to sustainability and digitalization will be key to complete the CMU.

The CMU has embraced two pillars: sustainable finance and digitalization. And in both initiatives, credit institutions are key actors mobilizing the substantial volumes of private and public investments that the twin transitions require. Therefore, advancing sustainable finance within the CMU framework must be a priority. This implies addressing issues identified by investors such as market fragmentation of standards and accountability on the level of greenness or the availability of ESG financial products that match consumers' demands and are aligned to the highest standards. Given their close, trusting relationship with their customers,

banks will have an increasingly important role offering ESG financial products for retail investors. Finally, until recently there were not many reference assets that are needed for pricing other sustainable products. Spain achieved an important milestone in 2021 with the first issuance of a €5 billion sovereign green bond. Demand was 12 times the amount issued, showing the large appetite for these bonds. This instrument was needed to push the green market to new frontiers in Spain and its greenium shows that environmental ambition is not incompatible with the economic rationale of a treasury bond issue.

Digitalization is a transformative force in the banking sector, delivering automatic, customized solutions to customers. This process coupled with the need to rationalize costs has led many banks to reduce their physical presence throughout the territory. Yet, there is the risk of leaving behind their less digitally literate customers, especially in rural areas. Digitalization should not lead to financial exclusion. Even though banks are already engaging in offering mobile branches and improved call centres more efforts are due.

A balanced solution between efficiency gains and social utility is necessary. In this sense, recent Spanish banking associations' commitment to issue a code of conduct to ensure the access of the elderly to financial services is a step in the right direction. Similarly, their engagement in social projects to improve financial literacy is also welcome. Capital markets will profit from this, since banks can allocate their resources more efficiently elsewhere and citizens are more knowledgeable and keener to participate in financial markets.

Banks have an important role in capital markets that goes well beyond traditional banking services. Their ability to adapt to sustainability and digitalization will be of paramount importance to their business, but also to the success of these initiatives in the CMU.



ROLF STRAUCH

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

European financial integration: the role of banks in capital markets

European capital markets are fragmented and small when compared with the US markets. The larger role of capital markets funding is one of the reasons usually mentioned to explain the faster US economic recovery after the global financial crisis of 2008. 2020 and 2021 will surely be remembered as the years of the pandemic. I would wish this and the coming years will also be recalled as a turning point for capital markets in Europe.

The crisis has induced extraordinary policy responses on all fronts. Support measures were successful in preserving financial stability by maintaining credit flows to the real economy. As we are gradually heading out of the pandemic, emergency crisis measures are being phased out and market financing of the recovery and the twin transition to a more digital and sustainable economy will be crucial. Europe should focus on two priorities that, although connected, are different in nature: first, Europe needs larger and deeper domestic capital markets to overturn the endemic capital markets underfunding; second, Europe needs further integration of its capital markets.

Advancing the capital markets union (CMU) initiative is key to succeed on these issues. Banks could promote progress on CMU and also benefit from it. There is consensus on the pivotal role of banks in CMU and in the European economy: banks are direct lenders to a significant proportion of the economy and are intermediaries in capital markets.¹ A single market for capital in Europe is, without a doubt, beneficial for the banking sector.

More integrated capital markets open the possibility for more cross-border activities. Banks' holdings of domestic assets could be better diversified. CMU would also expand banks' investor base for their equity and debt issuances, which are crucial in increasing their resilience. In addition, a harmonised securitisation framework would support banks' efforts to make further progress on risk reduction. Since the risk exposure of banks is an important political consideration for the completion of the banking union, progress on the CMU initiative could support removing some unresolved deadlocks. Several of the recent deliverables of the 2020 CMU Action Plan – such as the proposal to amend the Capital Requirements Regulation (CRR), European Single Access Point (ESAP), and Markets and Financial Instruments Regulation (MiFID) reviews – have a direct or indirect effect for enabling banks' activities in capital markets.

Banks are best placed to turn savers into market investors.

Banks are in the drivers' seat to achieve better capital allocation in CMU

European banks are best placed to turn savers into market investors considering the size of savings sitting in bank deposits and the trusted relationship that clients have with their banks. For that to happen, banks need to provide more and better financial intermediation services including market making, both on a domestic and cross-border basis.

Banks constantly face the choice between intermediating between borrowers and depositors while retaining the credit risk on their balance sheets, or between issuers and investors where the credit risk is passed onto the investor. Unfortunately, there is not enough provision of investment banking services to SMEs,

which complicates capital market access for these companies. Enhancing the capacity of European banks as intermediaries and market makers to support primary and secondary markets is key for financing SMEs during the recovery and the twin transition.

Banks' role in providing financial advice is of fundamental importance. Retail investors would benefit from access to independent advice, breaking possible conflicts of interest across the distribution chain. The low level of financial literacy in Europe is a problem. Financial education is a long-term objective and one cannot expect tangible and swift results in shifting savers into investors without help from banks. Banks can also be useful in providing direct long-term equity financing, which is increasingly relevant as companies' capacity to absorb debt is reaching its peak.

The CMU project can clearly benefit from an enhanced role of banks in the financial services industry and, in turn, integrated capital markets will provide greater space for banks' business. Importantly, financial integration, via CMU and banking union, offers risk-sharing mechanisms that can mitigate the impact of global or country-specific shocks and, therefore, contribute to macroeconomic stability. More private risk-sharing remains crucial within the euro area, where policy's space to address asymmetric shocks is limited. These projects would also facilitate the implementation of the Recovery and Resilience Plans, particularly investments and reforms aiming to promote the green transition.

[1] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Action Plan on Building a Capital Markets Union, European Commission, 2015, p. 21.*



BERNHARD SPALT

Chairman of the Management Board - Erste Group Bank AG

Doing the right thing: developing capital markets to step up on climate

The latest round of legislative proposals concerning the CMU from November 2021 include the creation of a European Single Access Point (ESAP), making European Long-Term Investment Funds (ELTIF) more accessible to retail investors, introducing a consolidated tape and measures to enhance the integration of the Alternative Investment Funds' Market. These priorities illustrate that the focus of policy makers currently is on attracting more retail investors and smaller companies to actively engage with capital markets.

All measures currently foreseen will in the long run support the creation of a true CMU. For us, more capital market in the EU means to increase our economy's resilience by means of a more balanced financing landscape. Ideally we envision an EU where roughly 50 percent of the economy is financed through banks and the other half comes from the market. We believe that this will not only reduce financing risks but also reestablish a growth culture in Europe, especially when we think of equity investments. As examples from around the world show, only this will help to identify and grow

our own Teslas, Alibabas and Apples from our outstanding pool of SMEs within the EU.

From our perspective, there is a lot that retail banks can do to support these ambitions. Fundamentally, banks have access to a large retail client base with substantial holdings of savings. As liquidity in our markets is currently not a matter of concern and will presumably not be in the foreseeable future, customers could put their funds to "better" use, inter alia by investing in the capital market. Banks can and should support this by creating appealing, easy-to-access products. This should be accompanied by measures to increase financial literacy among clients in order to enable them to make informed decisions in regard of their investments.

Our priority: linking capital market development and the fight against climate change.

Since Erste's foundation over 200 years ago as the first Austrian savings bank, we have been following the principle of making financial products and services accessible to everyone in society with the aim to disseminate prosperity. Assuming responsibility for our actions and offering our services to reduce poverty and social exclusion has been our purpose and guiding principle ever since. As one of the largest financial services providers in the Eastern part of the EU, we continue to create added value for people, the environment, the economies and, more generally, for the region and communities in which we operate. In this sense, we very much embrace the idea to increase capital market participation of both our retail and corporate customers.

A key contribution as a bank is to be a conduit between capital markets and sustainable investments.

But we have to take it further: securing the prosperity of future generations also means to reevaluate how we relate to the use of natural resources. At Erste Group, we understand that everything we do has an impact on the environment, which also includes our premises and the mobility of our employees. Most importantly, we believe that the nature of our products and services can make a real difference. Compliance with ESG standards is becoming one

of the single most relevant aspects of investment decisions of retail customers. Hence, attracting people to invest their savings in the capital market will be increasingly subject to sustainability related considerations. At the same time, transforming our economy in a sustainable way is the greatest challenge of our time. Viewed from this angle, our most important contribution to CMU development will be to sustainably link capital market development to the ESG topic. Retail banks should act as conduit between the capital market and investments with the overarching goal to transform our economies in a sustainable way.

What does that mean in practice? A key element to go forward is to create more attractive products like ELTIFs with a dedicated ESG character. We should also think of private equity-based investment funds in the ESG universe with banks as anchor investors. We see the need to campaign for more capital market friendly taxation and regulation, especially when green investments are affected. We should specialize on supporting young, ESG oriented innovative firms to access capital markets. All of this should – again – be accompanied with financial education for both individuals and young corporates.

These efforts will be supported by our digitalization agenda, within which we aim to continuously improve our digital footprint, covering our clients' needs along the entire financial lifecycle. We believe that the future of capital markets very much hinges on our ability to facilitate digital access to products, along with relevant information and an attractive customer experience. In this respect we would appreciate the EU putting more efforts into cross-border aspects of digital product offering, meaning that national regulation will have to become much more streamlined to permit efficient product design and launches.



STEVE GANDY

Managing Director and Head of Private Debt Mobilisation, Notes & Structuring - Santander UK Corporate & Investment Banking

CMU: what can banks and policy makers do? Securitisation example

It is a desirable goal for European banks and policy makers to promote CMU in Europe in order to support the growth of the European economy as (hopefully) it emerges from economic drag of pandemic restrictions by providing businesses and individuals with a greater choice of funding. Both parties have a role to play. Below I offer a short list of considerations for both the banking sector and regulators to help achieve the goals of CMU, using some securitisation examples (which is my specialty) to illustrate my points:

What can the banking sector do?

1. Aim for wide distribution across geographic and investor types

I suggest that banks should make a conscious effort to cultivate new investors outside their home jurisdiction. Wide distribution reduces reliance on a small number of investors, promotes liquid-

ity and gets new investors comfortable with the peculiarities of your home jurisdiction.

2. Strive for documentary and structural consistency across issue types and legal jurisdictions

Even though structures have to be adjusted to fit local rules, banks can harmonise disclosure and structure practices to “build a brand” that investors recognise and can compare. For example, our Santander Consumer unit has subsidiaries and affiliates in 12 European countries which have established regular securitisation programmes that strive to include common structural features and disclosure practices.

3. Commit to the highest level of disclosure transparency

Beyond legal requirements, especially with structured products such as securitisations. Investors value high levels of disclosure, both before and after issuance. This will build the bank’s reputation and attract new investors

I offer a list of considerations for banks and regulators to help achieve the goals of CMU.

Distribute a greater portion of lending assets into capital markets, using various repackaging techniques. An “originate to share” policy will encourage more institutional investor interest in bank assets. We have all heard the statistic that 80% of financial assets in the USA are financed in the capital markets, while only 20% are financed by banks. It is the opposite statistic in Europe. Banking assets can be attractive investments for institutional investors, when packaged correctly, to meet institutional investor requirements and which comply with regulation. Securitisation can convert illiquid assets into tradeable securities which are not linked to the risk of the banks, thereby offering investors a diversified investment opportunity in assets that they would otherwise be unable to originate in jurisdictions where they may have no physical presence.

What should CMU and Banking Union initiatives be focused on?

1. Creating common rules to address varied legal requirements, tax and bankruptcy laws and restrictions within Eurozone countries. For ex-

ample, the STS (simple, transparent and standardised) securitisation legislation was one of the first CMU initiatives that contributed to this process. Much is left to be done, as demonstrated by the many recommendations for improvement put forward by market participants as the European Commission conducts its Article 46 review of the legislation. But as the name suggests, the legislation went a long way to creating common rules for all securitisations across Europe, which in the long run will promote greater participation across Europe by institutional investors. The legislation creates a category of high quality securitisations – the so-called STS securitisations - which must comply with a series of required structural and disclosure criteria reflecting best market practice. These rules have promoted the standardisation and comparability of securitisations across multiple jurisdictions.

2. Regulators must build on this foundation to reduce burdensome and complex elements which create barriers to entry, recognise the high quality of STS securitisations in the liquidity ratio rules, correct punitive capital rules which discourage issuance and streamline the capital relief approval process.

Finally, let’s not forget that CMU and Banking Union complement each other as both aim to create a true single market for financial services. Completing the Banking Union, is essential to unlock resources, including the fungibility of deposits across Europe. For that, a European Deposit Insurance Scheme (EDIS) should be put in place. This will help European banks to increase scale and gain efficiencies, allowing banks to offer the same products and services across Europe. It is about further European integration, financial stability, and benefits for consumers.

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CLEARING POLICY PRIORITIES



KLAUS LÖBER

Chair, CCP Supervisory Committee - European Securities and Markets Authority (ESMA)

2022 Priorities of the ESMA CCP Supervisory Committee

2022 will bring a change of emphasis in the ESMA CCP Supervisory Committee (CCP SC). While it will continue delivering on its recurring tasks and the workstreams launched in 2021, the CCP SC will aim at developing a more forward-looking and risk-based supervisory perspective to further enhance supervisory convergence and address on-going and emerging risks.

2022 holds a number of key deliverables, which the CCP SC will address with high priority. First, the CCP SC will be looking to finalise the tiering assessments and the reviews of recognition of third-country CCPs (TC-CCPs) already recognised by ESMA and to complete the review of the underlying Memoranda of Understanding with the relevant third country authorities by end of March

2022. It will also assess pending and new requests for recognition by June 2022, depending on the adoption of new equivalence decisions by the European Commission which remain a precondition for CCP access to the EU market.

June 2022 also marks the end of the original temporary equivalence and recognition decisions for the UK CCPs. While the CCP SC and the ESMA Board of Supervisors have concluded at this stage that the costs of non-recognition outweigh the benefits, they have also identified a number of risks and vulnerabilities for which mitigating measures should be considered. In this respect, it has been suggested to develop incentives for EU members to reduce their exposures to UK CCPs, but also enhancing ESMA's powers in crisis-management situations, as well as in recovery and resolution. The CCP SC will continue to work closely with the European Commission and the relevant national authorities on follow-ups to the assessment and the Commission's decision on extending the temporary equivalence.

In the meantime, the CCP SC is pursuing a deeper and more risk-based supervision of Tier 2 CCPs aimed at identifying and addressing any actual or potential risks, using the supervisory tools introduced under EMIR 2.2. It will also follow a data-driven approach to closely monitor relevant developments for other TC-CCPs, in particular where heightened risks for the Union may exist.

Looking to the EU-CCPs, the CCP SC will continue to work towards enhancing supervisory convergence, conducting mandatory reviews of NCA decisions and validating significant changes to CCP risk models and parameters. Moreover, it will also increasingly focus on cases of supervisory divergence across the Union, assessing where follow-up measures may be necessary to ensure greater supervisory convergence.

As already initiated last year, the CCP SC is continuing to develop its annual heat map of major risks faced by the EU with respect to CCPs – with operational risks, including cyber risk, expected to remain high priority. ESMA will soon be finalising the analysis of the results of the 4th stress-testing exercise and the 2021 Peer Review, which should

help the CCP SC in developing a common view to address certain operational risks.

The CCP SC is also starting novel work with an upcoming consultation to better understand how climate risks impact CCPs, what can be done to address identified risks, and which specific components ESMA could integrate in its stress-testing exercise to have a more complete view on the resilience of EU and Tier 2 CCPs.

Other areas of risks which will receive increased attention are those linked to financial innovation. While technology-based innovations may bring advantages in terms of efficiency gains, careful consideration will be brought both to whether certain new products based on digital assets (e.g. cryptocurrencies or stablecoins) are suitable for clearing and how new technologies may further affect the clearing market structure and potentially its integration with other key functions, such as trading and settlement.

Finally, while interconnectedness is often raised as an important source of risk faced by CCPs, certain aspects may merit more attention. One such aspect results from the same broker-dealers acting as clearing members to multiple CCPs around the globe and concentrating considerable risks among the top 20 clearing service providers. This raises questions in case of multiple member defaults, regarding contagion effects to non-defaulting clearing members, their clients (e.g. access to clearing and porting) and the non-centrally cleared space more generally. Similar considerations may apply concerning certain third-party providers given the increasing reliance of CCPs on the outsourcing of certain services across the globe (e.g. cloud-based activities).

To address these horizontal and multi-faceted issues, ESMA will continue strengthening its cooperation with EU and national banking and market supervisors, and also connect with other relevant authorities in the field of climate risk and cybersecurity. The increasing degree of interconnectedness and cross-border nature of CCPs also entails that ESMA is further strengthening its engagement with relevant global standard setting bodies in 2022.



JOHN BERRIGAN

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

Building an attractive EU clearing framework

Before the departure of the United Kingdom from the European Union, the City of London became the main financial hub for the trading and clearing of derivatives in the European Union. The build-up of such a concentrated position was made possible because the United Kingdom was part of the Single Market and therefore subject to a set of commonly agreed stringent rules. BREXIT was a fragmenting event, with consequences in terms of financial stability. Even though the UK has so far faithfully transcribed EMIR – the European framework for CCPs – into common law, UK CCPs now operate outside of the Single Market and the EU's regulatory framework.

In mid-October 2019, the European co-legislators adopted a set of targeted amendments to EMIR to strengthen the supervision of CCPs in light of their growing systemic importance. The objective of the compromise reached by the co-legislators was mainly to improve the supervision of third-country CCPs that provide services to EU firms according to the risk they present for the stability of the EU financial system.

The new rules enhance the supervisory role of ESMA and EU Central Banks over third-country CCPs. The amendments introduced a new category of third-country CCPs that are systemic for the financial stability of the EU ('Tier 2 CCPs'), and that will become subject to specific requirements and direct supervision from ESMA. These CCPs could also be recommended to be relocated if ESMA determines that they are so systemic that joint supervision would not be enough to mitigate the risks they pose. ESMA has assessed the super systemic nature of the Tier 2 CCPs and has found that some of their services were indeed critical to the financial stability of the Union. It has concluded however that at this point in time, the costs associated with a forced relocation were too high compared to the benefits it would bring. Accordingly, it seems appropriate to take necessary steps to build the EU's own capacity for clearing and reduce an excessive reliance on UK CCPs.

In September 2020, the Commission adopted a time-limited equivalence decision for UK CCPs until 30 June 2022 to avoid the financial stability risk an abrupt disruption in the access of EU participants to UK CCPs would have brought. In this equivalence decision market participants were urged to take action and reduce their exposures to UK CCPs. The move so far has been marginal and mostly concerned low risk products rather than the more complex and risky positions still cleared in the UK.

**A reduction of exposure
to UK CCPs is needed; EU
clearing market must
evolve to help achieve it.**

Over the course of 2021, the Commission established a Working Group (together with the European Central Bank, the European Supervisory Authorities and the European Systemic Risk Board) to explore the opportunities and challenges involved in transferring derivatives from the UK to the EU. The Commission learnt from this group that a combination of different measures to improve the attractiveness of clearing, to encourage infrastructure development, and to reform supervisory arrangements are needed to build a strong and attractive central clearing capacity in the EU in the years to come. The Commission also found that the timeframe of June 2022 was too short to achieve this and that an extension of the equivalence decision for UK CCPs is necessary.

But this extension of equivalence does not address the medium-term financial stability concerns and the Commission intends to come forward in the second half of 2022 with measures to make EU CCPs more attractive to market participants, taking into account the results of the assessment undertaken by ESMA in 2021 on the super systemic nature of the two Tier 2 UK CCPs.

Firstly, by building domestic capacity: measures to make the EU more attractive as a competitive and cost-efficient clearing hub, and so incentivise an expansion of central clearing activities in the EU, will be needed. In this context, following a targeted public consultation we will explore ways to enhance liquidity in EU CCPs and to expand the range of clearing solutions on offer from EU infrastructures.

Secondly, if the EU is to increase its capacity for central clearing, it is essential that the related risks are appropriately managed and the EU's supervisory framework for CCPs is strengthened, including a stronger role for EU-level supervision.

This proposed way forward strikes a balance between safeguarding financial stability in the short term – which requires taking an equivalence decision to avoid a cliff-edge for EU market participants – and safeguarding financial stability in the medium term – which requires us to reduce this risky over-reliance on a third country. Importantly, this legislative initiative scheduled for the second half of 2022, will focus on enhancing the liquidity and the attractiveness of EU CCPs and will not be anticipating the general review of EMIR scheduled for 2024.



CHRISTINA SEGAL- KNOWLES

Executive Director for Financial
Markets Infrastructure -
Bank of England

The Bank of England's approach to cross-border clearing

Christina Segal-Knowles discusses the Bank of England's consultations on new policies that will shape how it regulates and supervises overseas central counterparties (CCPs).

After the 2008 global financial crisis, the G20 set out to do something quite remarkable. Rather than turning inward to protectionism and fragmentation, the world's major economies committed to work together to address the lax regulation that had enabled the crisis, to repair our financial systems, and crucially, to maintain global capital flows. They set out to make the system safe, but keep it open at the same time.

The G20 put in place reforms designed to make the global financial system simpler - to untangle the spaghetti bowl of bilateral derivatives trades which caused Lehman's failure to spark a global crisis. They incentivised, and for many products mandated, the central clearing of derivative trades. This brought greater stability to

derivative markets by ensuring that if a major financial institution were to collapse, you needn't worry about a domino effect where the failing firm's derivatives contracts could threaten the viability of any number of other firms.

These reforms have worked. The market turmoil in 2020 sparked by the global pandemic could very easily have tipped into a panic and a financial crisis. But thanks in part to derivatives reforms, there was no panic about counterparty credit risk and no tangled web of vulnerability.

The task for regulators today is to ensure that CCPs which are increasingly at the heart of the financial system are robust and resilient, without jeopardising the very reforms that have made the system safer.

In the UK we are consulting on a new framework for recognition and supervision of non-UK CCPs wishing to serve UK clearing members, which we believe will allow us to achieve both safety and openness.

This includes 'tiering', which is the classification of individual CCPs according to the level of systemic risk they could pose to UK financial stability. The framework aims to ensure that the CCPs on which the UK financial system relies are supervised and regulated to high standards regardless of where they are located.

At the same time the framework acknowledges that the reforms which made global derivatives markets safer rely on large, cross border CCPs with deep pools of liquidity. This is a deliberate feature, not a bug. If every jurisdiction which used major global CCPs were to regulate them, they may have to adhere to several dozen sets of rules, regulations and supervision. This would create complexity, with multiple regulators regulating the same entity, or fragmentation, if regulators require the entity to split itself into smaller parts. Both risk unravelling the very reforms that have made our system safer.

Ensuring that cross-border CCPs are safe, and preserving post crisis reforms, need not be incompatible. Two key features of our new approach aim to support openness without sacrificing safety:

First, our proposed approach puts cooperation at its heart. We recognise that the benefits of direct supervision by UK regulators are unlikely to outweigh the potential detriment to post-crisis reforms or global financial stability from having multiple supervisors and regulators of CCPs. For CCPs where

we have a deep ongoing relationship with their supervisor, we would seek to place informed reliance on the home authorities rather than directly supervising the CCP ourselves.

Second, our approach is proportionate. We seek to ensure that the authorities with the greatest interest in a CCP in the event of its failure have the greatest input in its regulation and supervision. This reflects the fact that jurisdictions with firms representing the highest default fund contributions to a CCP will bear the burden in the event of CCP failure.

Where the UK has a smaller interest in a CCP relative to other jurisdictions, the Bank will be more inclined to rely on the home authority. But where the UK has a greater interest in a CCP relative to other authorities, we should expect more assurance that the home authority is delivering robust and equivalent supervisory outcomes, firmly rooted in international standards, and that we have a relationship on which we can rely.

The broader G20 project of repairing our financial systems and maintaining the global flow of capital is ongoing. The system continues to evolve. Safe openness will require tending.

But in the narrower space of CCP cross-border supervision we have laid out a possible path forward, and we are eager to work with jurisdictions to ensure a path that preserves both safety and openness. We envision that our cooperation-centric, proportionate approach will enable us to fulfil our mandate to protect UK financial stability without sacrificing the post-crisis reforms to derivative markets that have made us all safer. The consultation closes on Friday 25 February 2022.



JULIAN REISCHLE

Director General Payments
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Deutsche Bundesbank

Euro clearing to come home – one year after Brexit

One year after Brexit, the clearing landscape has not undergone any dramatic transformation. The amount by which exposures were reduced on a voluntary basis changed only minimally in 2021, i.e. only relatively small clearing volumes were shifted to the European Union. Nevertheless, over a period of four years, OTC Interest Rate Derivatives volumes cleared by EU-based Eurex Clearing have reached a market share of roughly 21%. Even after Brexit, systemically important UK CCPs (Tier 2) could continue to offer clearing services due to an equivalence decision adopted by the European Commission and a corresponding declaration made by ESMA. However, this equivalence decision is due to expire at the end of June 2022 and it was not clear for a long time where the European Union would go from there.

As a result, 2021 was marked by uncertainty for UK Tier 2 CCPs and EU clearing members. Shortly before the turn of the year, ESMA's decision not to recommend a derecognition of UK Tier 2 CCPs and their clearing services to the Commission helped to shed some light on the way forward. In addition, ESMA recognised three clearing

services (one from LCH Ltd. and two from ICE Clear Europe Ltd.) as being of substantial systemic importance for EU financial stability. In sum, ESMA's decisions reflect that, at this stage, the costs and risks to the European Union of derecognising these clearing services would outweigh the benefits. However, the risks and vulnerabilities identified by ESMA with respect to systemically important UK Tier 2 CCPs should be mitigated through various measures explicitly advocated by ESMA. These measures include the consideration of appropriate incentives to reduce the size of EU exposures to UK Tier 2 CCPs in the medium term.

ESMA's decision not to directly push for relocation appears reasonable. After all, the issue is anything but trivial. There are still concerns in the market that relocation would lead to liquidity fragmentation and additional costs e.g. due to higher margin requirements. Moreover, competitive disadvantages for EU participants in a highly global market must be avoided. Therefore, it seems more favourable to incentivise clearing in the European Union rather taking the route of enforcing relocation. It seems obvious that the current situation of EU market actors having large exposures to UK CCPs cannot be considered sustainable. With that in mind, appropriate reflection on long-term implications for financial stability and the integrity of the European market is needed.

The future of EU financial services lies within the European Union.

While the Commission recently announced that it would consider a further extension of the transition period early this year, the time gained should be used to seek appropriate ways to reduce the reliance on UK CCPs. There are two avenues to explore: further enhancing the capacity of EU CCPs and strengthening the powers to supervise CCPs within the European Union.

At the same time, it goes without saying that the success of ESMA's recommendations should not be taken for granted. Only if there are effective incentives for market participants to reduce their exposures they are likely to consider shifting business to EU CCPs, which in turn might result in a strengthening of the EU financial market. I believe that this can be best achieved by further improving clearing

services in the European Union, by bringing additional market volume to central clearing and by ensuring that all relevant EU market participants build up clearing capacity in the European Union. This requires that the industry looks at this topic from a long-term perspective, develops appropriate and robust strategies and puts forward concrete proposals for efficient solutions. This might also include making legislators aware of potential problems and proposing supportive action that legislators can take.

As UK CCPs will remain systemically important to the European Union for the time being, focus should also be placed on close and constructive cooperation with the UK authorities in the coming years. EMIR 2.2 grants enhanced powers to EU regulatory authorities to supervise and oversee UK Tier 2 CCPs and to protect the financial stability of the EU financial system. There is some confidence that there will also be appropriate regulation of CCPs in the United Kingdom, which has been boosted by the recent decision by the country's HM Treasury to implement EMIR 2.2. In addition, there is no need to establish dedicated supervision of EU CCPs at the EU level at this stage; what needs to be done instead is to continue to maintain and strengthen national powers and the cooperation arrangement that already exists for the supervision of EU CCPs.

The future of EU financial services lies within the European Union. If the market is looking for certainty, it should shift its focus towards the European Union and strengthen its clearing capacities, especially for euro clearing, within the jurisdictional boundaries of the European Union.



CLAUDINE HURMAN

Director Infrastructures,
Innovation and Payments -
Banque de France

Sailing in clear waters: building the EU clearing pool

One year after Brexit, the clearing landscape may look like the Channel in some mornings: apparently still from afar, yet subject to high currents underneath the surface. While in Europe the market shares of CCPs have not drastically changed over the past year, the clearing offer is progressing slowly on the continent, yet at an increasing pace. Several EU market venues, infrastructures and participants are proposing new strategies and products relying on continental solutions, to reopen the opportunities that a strong EU post-market sector can bring for the Capital Markets Union.

This paradigm shift does not come from nowhere. 2021 has seen a rising awareness on the unsustainability of a status quo under which EU financial entities would remain excessively dependent on offshore infrastructures. Following the assessment procedure under Article 25(2c) EMIR, ESMA, ESRB and the Eurosystem evidenced that the activities of some UK CCPs on interest rate and credit derivatives in EU currencies are substantially systemic for the Union. While they did not advocate for immediate de-recognition

of these CCPs, they highlighted the financial stability risks to the EU on the medium term, which could especially materialise in a crisis. To reduce such risks, rebalancing clearing exposures towards the continent is indispensable. This implies two main lines of action.

The first one is strengthening the clearing offer in the EU. It is mainly the EU industry's role to adapt to the demand in order to attract EU and non-EU members and clients. In the context of commercial efforts underway, it is time for EU CCPs to challenge current monopolies on particular products such as interest-rate products. EU members need also to anticipate their clients' appetite for EU-based clearing and build on their steering role to enhance the liquidity of the EU clearing pool. By starting to locate in such CCPs their activities which are not subject to global competition, such as ALM, they can deliver progressively on their stated intention to maintain active accounts in EU CCPs.

Micro and macro prudential tools could reward a gradual reduction of exposures to UK CCPs.

The second line of action is taking supervisory measures to incentivise clearing members to clear in EU CCPs. It is now necessary that the market internalises the financial stability requirements linked to overreliance on offshore entities that represent "single points of failure". In this context, the upcoming renewal of the temporary equivalence provides a unique opportunity to set the tone for effective exposure reduction and pave the way for the implementation of prudential incentives, so that continued access to UK CCPs is not seen as a "blank check". More precisely, micro and macro prudential tools could reward a gradual reduction of exposures to UK CCPs. Since such measures would not require any legislative change, they could be triggered in the coming months, and spread over appropriate time to ensure a smooth rebalancing.

On the supervisory aspect, the revision of EMIR, expected in the medium term, may help support these evolutions.

Indeed, as mentioned by the Commission, the supervisory framework of EU CCPs will have to be enhanced as some of them will

become more systemic following the rebalancing of exposures. Two concepts are important in this regard: collegiality and proportionality. One notable feature of EU supervision is that it relies on colleges of authorities with concrete authorisation powers. The European Union is very much advanced in terms of cross-border cooperation on CCPs and any review of EMIR should capitalise on this asset. The powers of EMIR colleges could be reinforced with more binding opinions on key CCP projects. ESMA's influence could be more pronounced and its governance opened to all the authorities concerned by CCP issues. The supervisory framework should also be tailored to EU CCPs' systemic footprint, as in the tiering system applied to non-EU CCPs.

While taking these steps towards growing the EU clearing pool, EU authorities should have a say, not only a look, on how the risks of substantially systemic third-country CCPs are managed – to the extent that they expose the European financial sector-. In its recent report, ESMA made some proposals, inter alia to fix the flawed comparable compliance framework and to require EU approval of recovery and resolution plans. These changes are needed to address critical gaps. Nonetheless, they should not be seen as a substitute for rebalancing the systemic clearing activity towards the Union. This is the only way to ensure the long-term resilience that floats everyone's boat.

Article co-written with Alexandre Garcia, Financial Market Infrastructure Expert, Banque de France



ISABELLE GIROLAMI

Chief Executive Officer -
LCH Limited

Supporting CCP resilience and financial stability

To support financial stability, CCPs manage a wide range of risks. Whilst recent events have proven their resilience facing counterparty and market risk, more is needed to support their operational resilience objectives.

When it comes to financial resilience, LCH was at the forefront of the volatility resulting from the Covid-19 pandemic. Our risk models performed as designed, with no adjustment required to accommodate the heightened volatility and with our Initial Margin (IM) requirements increasing only by about 15% compared to Business As Usual (BAU), most of which was due to increased volumes rather than risk models. Our risk framework, and most importantly, our approach to margin requirements during normal times and our Anti-Procyclicality Control (APC) tools, managed to alleviate pressure by enhancing the resilience of financial markets.

This is complemented by the transparency CCPs provide to the market, clearing members and their clients through the CPMI-ISOCO public quantitative disclosures, margin models, credit and stress testing, volume, and transaction metrics. This transparency is, however, not

matched in the uncleared space, and further work could be done to support better markets understanding for the uncleared space.

An important aspect of a CCPs' resilience is its membership and the markets they serve. Global financial markets best operate when they can freely balance supply and demand supported by highly capable and resilient infrastructures and participants. From a financial stability perspective, the potential reduction in size and diversity of participants poses substantial risks, particularly with regards to default management. Diversified clearing services, supported by greater liquidity and a wide high-quality membership that is subject to different economic dynamics, has strong benefits to financial stability. In that sense, we welcome ESMA's recent statements on the importance for European financial markets of clearing services provided to EU market participants by non-EU CCPs. We also support ESMA's intention to reinforce its supervisory and crisis management toolbox and enhance cooperation with third country authorities.

Clearing remains the safest way to manage ongoing financial risk, which is why equal focus must be placed on new client clearing models developed at CCPs to enable clients' (i.e., funds) direct access to clearing facilities. At LCH we have developed Sponsored Clearing models enabling clients to access LCH's RepoClear as a clearing member through a sponsored bank acting as a sponsoring agent. Such membership models have the potential to overcome liquidity management and operational capability barriers certain clients might be faced with.

**Digital transition
should be fully endorsed
as it supports CCP
operational resilience.**

The operational resilience of CCPs and market participants at large is also core to financial stability and is an increased focus of both regulators and the industry. The industry has made considerable investments over the years across to ensure enhanced operational resilience including to cyber risk. We continue to have operational resilience at the centre of our enterprise risk management framework, supported by effective tools and processes. We believe the right steps are also being taken at the legislative level, including through

the EU Digital Operational Resilience Act (DORA), which we fully support to reinforce EU financial system.

Particular attention will be needed to ensure a calibrated regulation of ICT service providers, specifically cloud providers, which are fast becoming crucial actors in the operational resilience scene. To keep pace with technology developments and increase our operational resilience, CCPs need to access best-in-class technology supported by best-in-class staff, including newly developed applications that might only be available on the Cloud. This often means migrating activities with Cloud Services Providers to leverage their expertise and cyber tools. This digital transition should be fully endorsed as it supports CCP operational resilience, even if this means working collectively to increase tool and controls to support this transition. We need to support innovation to increase operational resilience

All in all, I believe the unexpected Covid-19 crisis has validated the global efforts that took place after the 2008 financial crisis and more recently from a non-financial risk perspective. It has also demonstrated the value of constant, coherent, and timely regulatory coordination, given the global nature of today's financial markets. We encourage regulators to cooperate as much as possible, both at the EU and at the international level, to ensure not only a level-playing field among all market participants but a common and harmonised approach of high standards to support financial stability and address the wide-range of risks it faces, including cyber risks.

The resilience of our system is a key condition to support the real economy and finance the twin green and digital objectives shared across jurisdictions.



ERIK TIM MÜLLER

Chief Executive Officer -
Eurex Clearing AG

Quo vadis EU CCPs? Fostering global competitiveness and strategic autonomy

CCPs' resilience during both the Covid-19 pandemic and in the aftermath of Brexit proved that the G20 reforms have borne fruit, reminding us that efficient and robust risk management as well as a healthy clearing ecosystem are key for preserving financial stability and ensuring a sustainable recovery.

Without doubt, the EU has not only set the global benchmark with EMIR, safeguarding the role of CCPs as independent and neutral risk managers of financial markets, but clearly continues its path of stability and resilience with the implementation of the CCP recovery and resolution framework.

While we take pride at Eurex Clearing in having received the award for the globally leading risk management system, we believe it is of critical importance to continue the EU's regulatory thought-leadership, setting the right incentives for a globally competitive and innovative clearing landscape.

The recent decision to grant an extension to the temporary equivalence

for UK CCPs until summer 2025 is symbolic in this regard, having been accompanied with the announcement for a consultation and subsequent action on measures to support the EU's objectives.

In light of the ESMA CCP Supervisory Committee assessment around Tier2 CCPs, concluding that UK CCPs' business denominated in Euro are of substantial systemic importance to the EU, it does not come as a surprise that the EU has repeatedly stressed the need to reduce reliance on UK CCPs and keep building up clearing capacities in the EU.

A number of elements could prove valuable in this regard, ranging from the ESMA and ESRB recommendation on prudential incentives, over an improved time-to-market for launching new products and services through to an end of the pension scheme arrangements (PSA) exemption, structurally boosting a healthy clearing ecosystem. As part of this broader process, it will be critical to remain conscious of global competitiveness, especially in spheres where EU standards have no equivalent. While EU CCPs have demonstrated a higher level of resilience due to their conservative margin models and anti-procyclicality tools (APC), a level playing field should not only be ensured vis-à-vis 3rd country CCPs but also with the bilateral space. This is particularly important as cases such as Archegos area an unfortunate reminder that we should not waver in our commitment to improve risk management standards and transparency.

**The EU must continue
on its path of "open
strategic autonomy and
resilience" with strong
EU CCPs at its heart.**

Recent work around non-bank financial intermediation and "shadow banking" has emphasized this need to reassess certain market realities further, noting a significant growth of this segment since the global financial crisis and the necessity to review risk management standards more generally.

Moreover, as the EU advances on uncleared margin rules (UMR), Basel III and a review of clearing obligation mandates, ensuring access to central clearing is key. In order to contribute to a healthy clearing ecosystem in the Union, we are committed

to further improving client access models, reducing concentration of client clearing, and maximizing netting efficiency as well as CCP risk management capacities. In this line of thought, we encourage regulators to help us empower clients by removing unnecessary regulatory barriers and avoid disincentivizing CCP risk management.

With the global political landscape increasingly pointing to geopolitical tensions and frictions, the EU must continue on its path of "open strategic autonomy and resilience" with strong EU CCPs at its heart. Let us not forget that the Covid-19 realities are still the decisive factor driving our broader macro-economic outlook - but concrete jurisdictional realities may prove increasingly different, noting that the policy-course driven by the US FED or the UK BoE is not mirrored by the ECB.

Safeguarding the Euro as the most decisive symbol of EU economic and financial integration will remain key for the Union's future but is also an important global responsibility around one of the world's most important currencies. With Brussels forging hot iron and tackling the important next steps on future economic and financial integration, the role of EU capital markets will continue to become more critical, requiring a more strategic approach to match expectations.

Against this background, I invite policymakers and the industry to continue moving the needle together, fostering an innovative and globally competitive EU clearing landscape - and embarking on our joint endeavour to guarantee financial stability as the backbone of sustainable economic growth in the interest of future generations.



HAROUN BOUCHETA

Head of Public Affairs -
BNP Paribas Securities Services

Third-country and EU CCPs: many challenges still ahead one year after Brexit

One year after Brexit, central counterparties (CCPs) continue to raise questions on important matters such as financial stability, monetary policy and competitive landscape. After a significant policy work and an ongoing dialogue between authorities and the industry, joint efforts should be pursued to address the remaining uncertainties.

UK CCPs - new “Strategy on Clearing”

The recent decision from the European Commission (EC) to propose to extend by three years the equivalence decision for UK CCPs should be warmly welcomed.

The extension for this period will leave sufficient time to create a robust, competitive and liquid European clearing capacity and further reduce the exposure on UK CCPs for some EUR denominated instruments. It will also allow to meet the other strategic autonomy objective of the EU to preserve competitive EU financial actors in the European and global markets.

The extension is also highly relevant as it covers all CCPs established in the UK, and not only the most systemic ones (Tier 2 CCPs). While the EUR Interest Rate Derivatives (IRD) segment cleared by Tier 2 CCPs is often seen as the only one, the inability to access to Tier 1 UK CCPs and other non-systemic segments of Tier-2 CCPs raises serious concerns.

The EC is about to launch a new “Strategy on Clearing” to reduce in the medium term the “overreliance on UK CCPs”. An holistic approach looking at all aspects of the market should be encouraged as it includes both:

- a) *Demand side* : increase the size and liquidity of EUR clearing market in the EU by:
 - easing the ability of a broader base of EU market participants to centrally clear,
 - incentivizing the voluntary clearing of EU public institutions,
 - encouraging all EU institutions subject to EMIR clearing obligation to open and maintain an active account at an EU CCP for the clearing of EUR IRD products.
- b) *Supply side* : improve individual EU CCP offerings, enhance technological capabilities, address gaps in products.

If by the end of the equivalence extension period all these actions have not sufficiently reduced the financial stability risks related to non-EU central clearing arrangements, the implementation of legislative measures could then be decided.

To avoid situations where EU members would be hampered to serve their clients solutions are needed.

However, such measures would need to preserve the ability of market making and client clearing activities of EU institutions to engage with all clients including non-European Economic Area (EEA) clients outside the EU as well as EEA clients not subject to the clearing obligation. Prudential penalizing measures affecting these international activities should be avoided as well.

The contingent legislative measures should be framed in advance and their implementation should be done gradually to ensure EU policy would successfully work.

Other third-country CCPs

A growing concern for EU clearing members and for their clients is about conditions of access and prudential treatment in the following situations:

- third-country CCPs (“TC CCPs”) already benefiting from equivalence but not yet recognized by ESMA (US CCPs supervised by the SEC),
- TC CCPs where neither equivalence nor recognition have been granted yet (ex : China, Russia, Turkey),
- TC CCPs which could lose their recognition in the context of the ongoing reassessment process performed by ESMA in accordance with EMIR 2.2 (ex : India).

If no equivalence and/or recognition is granted by 28 June 2022 or alternatively if the Qualified CCP (QCCP) status is not extended further, these TC CCPs will lose their QCCP status in the EU resulting in a massive increase of capital requirements for EU firms. In such a case, EU firms would not remain competitive and would need to exit from these activities, and EU clients will be obliged to clear through non-EU firms for their investment and hedging needs. EU clearing members will be impacted for OTC derivatives but also for cash equity, listed derivatives and fixed income securities.

To avoid situations where EU clearing members would be hampered to serve their clients, including the European ones, on a fairly competitive basis with their non-EU peers, tailor made solutions are needed.

Need to avoid procyclical effects of margins and ensure financial stability in case of recovery or resolution

The recent regulatory developments on margin practices have highlighted that the responsiveness of centrally cleared IM models to market stresses may lead to procyclical effects. Although CCPs should retain the ability to proactively improve their models, there is a need to better disclose CCPs modelling choices to meet legitimate expectations and predictability needs of clearing members and their clients.

Finally, Europe is about to finalise the framework around the recovery and resolution of CCPs which is a key component of the financial stability. Some important issues, like skin in the game and resolution plans, still need to be addressed to avoid crisis in default situations potentially faced by CCPs.

SECURITISATION RELAUNCHING IN THE EU



PHILIPPE BORDENAVE

Senior Executive Advisor
to General Management
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BNP Paribas

Europe must revive securitization

The need to relaunch securitization in Europe has been discussed for quite some time, without significant progress, although there is consensus among experts about what is needed to unlock the market:

- Recalibrate capital charges applied to senior tranches, in line with their risk profile
- Improve the Significant Risk Transfer Assessment process to make it swift and flexible
- Upgrade eligibility of senior STS tranches in the LCR ratio
- Simplify disclosure requirements for private transactions.

However, policy makers and regulators seem to be still unsure about why the long-awaited reform of securitization should be a top priority in the CMU agenda, and how to accelerate securitization while avoiding to create the financial stability risks that led to the

Global Financial crisis. STS reforms have made the market safer and smaller...

Providing a concrete, evidence-based, and non-politicized answer to two questions is essential to unlock the process and reach as promptly as possible an effective “comprehensive review” promised by the Commission.

Have earlier reforms addressed financial stability risks linked to securitization?

Yes. A lot has been done in the post-crisis regulation on this front: retention rules, supervision of rating agencies, systematic assessment of Significant Risk Transfer by the competent authority, etc... It is now time for a drastic change in mindset, from considering securitization as a toxic product when used to securitize badly originated sub-prime mortgage loans in the US, to recognizing that securitization in Europe has been used for healthy risk transfer from banks to educated investors.

Making progress is key to avoid that current regulation and supervision keep slowing down the necessary transformation of the European economy.

Should the Commission be convinced that securitization opponents in the Council and the Parliament are too numerous and too durably shocked by the sub-prime crisis to change their mind, then let's focus on non-mortgage loans. Implementing the few initiatives hereabove to all the other loans (corporate loans, auto loans, consumer loans, etc ...) would already unlock a significant additional financing power without raising controversies: including during the financial crisis, the track record of such securitized non-mortgage products has always been flawless.

Why securitization is urgent now?

The European Commission estimates the additional investment needs in the relation to the green and digital transition at nearly EUR 650 billion per

year until 2030. As banks finance 80% of the EU economy, this would require an amount of prudential capital which is well beyond EU banks' capacity to grow their capital base over the period (and anyway above supervisors' appetite for banks' balance sheet growth!). Even if banks can get abundant funding from ECB and have access to deep and efficient funding instruments such as covered bonds, it does not solve the capital issue, all the more given the impact of CRR3 to be absorbed over the same horizon.

At the same time, banks are best placed to originate these financings, given their proximity to clients, across all Member States, their expertise in credit analysis and structuring, and their capacity to offer clients a full range of financing solutions beyond lending. The EU banking sector has demonstrated its capacity of mobilization during the COVID crisis and is a natural leader in the financing of the green and digital transition. Indeed, capital markets, even if developed under the CMU initiatives, will not have the breadth of access that banks have through their local presence across all Member States.

How to square the circle? Banks should continue to do what they do best, ie provide tailored financing solutions to their clients. But they should have the option to transfer risk to investors, to alleviate their capital charges, in a cost-efficient way. If well originated and structured, securitization is a win-win-win transaction: win for the issuer, who reduces its residual risk and associated capital requirement, win for the investor, who accesses a portfolio of assets, with some credit protection depending on the tranche, and win for the borrower which can benefit from bigger risk appetite from banks and more competitive pricing.

Making progress is key to avoid that current regulation and supervision keep slowing down the necessary transformation of the European economy. This technical subject requires pooling the expertise across the various authorities involved: Commission, ECB, EBA, ESMA, EIOPA, ESRB, EIF, etc... Indeed, only a coordinated effort to rebuff conservatism and rebuild the securitization ecosystem can deliver results, after 15 years of anemic markets.

Let us not miss this step, as 2022 is probably our last chance to deliver on a policy goal endorsed... in 2013!



**ALEXANDER
BATCHVAROV**
Structured Finance Expert

Weak EU securitisation will slow down the greening of the EU economy

More than a decade after GFC, the EU securitisation market falls short of full recovery in size and reputation. Placed volume has crept up to reach just €90bn in 2021, which is a far cry from the €270bn+ volumes issued annually before the GFC and the current EU capital market needs. Post crisis, covered bonds unabashedly cannibalised RMBS, the mainstay of securitisation. Reputational recovery is slow despite the decade-long PCS and industry efforts. The EU-only introduction of STS brought on average €26bn supply per annum since its adoption in 2019, mostly from long-established auto ABS issuers. Broad negative statements about securitisation abound, disregarding positive EU securitisation market track record over many years. Proven credit resilience under multiple market trials is considered a weakness of EU securitisation, while the lack of real-life test and favourable regulation are considered a strength of covered bonds.

The slow EU securitisation market recovery is in stark contrast with its post-GFC rebound and growth in other geographies. Excluding agency

product, 2021 securitisation issuance exceeded €740bn in the US, €420bn in China and €38bn in Australia; on a GDP-weighted basis, it was five-to-six times higher than that of the EU. Yet, the EU boasts the most detailed securitisation regulation, the only (bar the UK's transposed one) STS regime in the world with detailed criteria and external verification, the most stringent transparency requirements and a central data repository. The conclusions are self-evident: EU has the most prescriptive rules and the weakest securitisation market among comparable economies. Consequently, EU securitisation cannot deliver for the EU economy, including in the transition to sustainable finance and ESG capital markets.

In the aftermath of the GFC, clarity in regulation is needed, but so is proportionality; supervision is necessary, but so is flexibility. It is unclear to us what data and assumptions were used to calibrate capital and liquidity for securitisation, what cost-benefit analysis was performed, what consideration to a level-playing field across capital market instruments was given. A decade after the GFC, the available performance data for EU securitisation does not justify the high capital charges, unless they were calibrated on extreme outliers in EU context or on data from other markets. Academic research does not support the discrepancies in the liquidity treatment of securitisation and covered bonds, the massive differences between the capital charges for STS and non-STS securitisations especially under Solvency II, and the capital charge differences (the quantum of non-neutrality) between securitised and non-securitised exposure.

**EU has the most
prescriptive rules and the
weakest securitisation
market among
comparable economies.**

The data used then does not reflect the enforcements embedded in EU securitisation regulation post-GFC now - retention, disclosure, third-party involvement, regulatory supervision, etc. We find support for our views in the EU securitisation default and impairment studies by the rating agencies (close to zero and affecting mostly non-investment grade tranches of securitisation), in the rating transition comparisons between

RMBS and covered bonds, in the recent recalibration of regulatory capital for securitisation for US insurers, in the performance of the securitisation purchase programmes of the Australian government, etc. We believe that the alleged risk of steep rise of the current annual RMBS issuance of €25-€35bn is immaterial when compared to the annual half-a-trillion issuance of covered bonds, unless EU banks' bail-out and bank-sovereign nexus are as good as guaranteed.

EU securitisation markets have been tested under heavy duress and without external support for several decades now. And they have performed broadly in line with expectations. Meanwhile, the EU securitisation framework is constantly evolving adding new layers of rules and costs, occasionally opting for new tools, which negate proven practices and threaten to unravel the EU securitisation fragile recovery. Such lack of stability, not observed in any other comparable securitisation jurisdiction, is unsettling and costly to the EU securitisation markets.

The review of securitisation regulation by the EU Commission is a chance to take a comprehensive look at all regulations affecting securitisation introduced in the last decade and pending now, and at the ensuing level-playing field distortions. The principles of retention, transparency, due diligence, STS, risk-based capital are, without doubt, necessary and widely accepted. It is how they are implemented in daily practices in line with historical performance, proportionality, optimal cost-benefit balance, efficient securitisation execution and so on, that will make the difference between a middling and a thriving, financially and environmentally beneficial to the EU economy, securitisation markets. Europe needs a thriving securitisation market now.

6

DIGITALISATION AND PAYMENTS

ISSUES AT STAKE

Digitalisation and new technologies such as DLT, AI and cloud services are key drivers of innovation, agility and efficiency in the EU financial sector. These innovations also bring many changes in the financial ecosystem that raise new questions in terms of competition, financial stability and consumer protection and also create new challenges for supervisors.

The Digital Finance Strategy (DFS) proposed by the Commission aims to support this transformation by adapting the financial framework to this increasing digitalisation, removing potential obstacles to digitalisation and also addressing possible new risks and level playing field issues related to these changes. The DFS is part of a broader Digital Finance Package that includes measures targeting crypto-assets (MiCA), DLT market infrastructures (the DLT pilot regime) and instant retail payments (the retail payments strategy), as well as a framework for digital operational resilience (DORA).

An ever-faster development of internet transactions and payments also challenges traditional payment arrangements and related legal frameworks with new interoperability, integration, cooperation and fair competition issues. There is also a need to adapt the current framework to the forthcoming adoption of CBDCs.

These challenges impact cross border payments of different values at the global level. They are also relevant in EU retail payment markets, which remain fragmented along national borders, while non-EU card schemes are dominant notably for cross border EU transactions, creating dependency concerns in the EU that might be reinforced by the arrival of BigTechs.

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Q&A

ROBERTO VIOLA,
Director General, Communication,
Networks, Content and Technology -
European Commission

Europe's Digital Strategy and the Financial Services Industry

What is the ambition of the EU digital strategy, what are the main objectives to be achieved by 2030 and the key initiatives conducted? Which elements and initiatives are most relevant for financial services?

The European Union's Digital Decade is our vision for the future of Europe where digital is the key for prosperity, sustainability and inclusion. Our ambition is mirrored in concrete targets for Europe's digital transformation by 2030.

For example, we want to ensure trustworthy and sustainable digital infrastructures for everyone. At the same time, we are working on the digital transformation of businesses, ensuring that Europeans have the skills to match the technological developments and finally, we want all key public services to be available online. These goals are connected, because to advance on one goal we have to advance in all of them.

The Commission has put forward a policy programme that aims to make this vision for 2030 a reality, by providing the Union with governance mechanisms and concrete instruments, which are necessary to strengthen the capacities and European strategic competences.

This ambition is underpinned by bold strategic policies proposals like the new European Chips Act, Digital Service Act and Artificial Intelligence Act. Our digital policy is moreover supported by a strong funding programme in all stages, starting with research and taking it to the deployment of advanced solutions.

Financial services are a part of our digital ecosystem. This is why in the DIGITAL Europe Programme we are also funding setting up the common European financial data space to boost the use of data for innovative technologies such as AI and new services for users of financial data.

All of these ingredients will ensure our goals are met and I hope surpassed. We have shown in the past that Europe can

be a leader, that we are curious, innovative and successful when we work together. So, our Digital Decade is about us working together towards defining our own rules, making autonomous technological choices accordingly and putting competitive European solutions on the global market.

What can be expected from the implementation of a European Digital Identity for the digitalisation of financial services and for the customers of financial institutions operating in the EU? What is the timescale of delivery of the project and what are the key actions to undertake in this regard?

In its October 2020 conclusions, the European Council called for the development of an EU-wide framework for secure public electronic identification by mid '21. The Commission proposed on 3 June 2021 a Secure and Trusted European Digital Identity framework. This framework should be available for everyone to prove their identity, attributes linked to identity and share electronic documents from their European Digital Identity wallets to facilitate access to online services with their national digital identification, which will be recognised throughout Europe.

Together with the legislative proposal, the Commission also adopted a recommendation on a common Union toolbox for a coordinated approach towards a European Digital Identity Framework.

The Commission has proposed pilots for several use cases, including for the payments sector. The European Digital Identity wallet would offer a neutral solution for the internal market where banks are not dependent on the solutions offered by Big Tech but tenant of a Wallet with strong governance at European level and with pan-EU scale.

The use of the European Digital Identity Wallet would offer the possibility to use a common certified infrastructure including a secure and trustworthy solution for onboarding and for online and offline payments. Similar as today when banks use wallets or third party providers for payments, proprietary branding and specific interfaces would be determined by the specific technical solution and use-case. It is our ambition to deploy the European Digital Identity Wallets towards 2024.

What are the objectives of the EU in terms of digital sovereignty and what does it imply?

Europe must be able to act independently in the digital world. We aim to become a global standard setter across the key digital value chains of tomorrow. In this respect, secure 5G connectivity, cloud and data services and microelectronics are focus areas.

The financial sector is among those sectors where Europe can do better in terms of digital sovereignty. Our objective here is to help actors develop a new generation of technologies that can compete globally in the future. Not in a protectionist fashion, but with the objective of presenting a more comprehensive offering on the EU market, resulting in more competition.

The digital transformation of the financial sector is of paramount importance for competitiveness. Financial institutions should have solid digitalisation strategies in place. For instance, building multi-cloud strategies should become a standard part of the ICT risk management framework of financial institutions, in line with the Commission's proposal for a Digital Operational Resilience Act (DORA).

Funds from the Digital Europe Programme are deployed to strengthen institutional capacities to meet the requirements of NIS and NIS 2, our cyber security legislation. This is especially critical for SMEs, and to enable them to develop the methods, organisational and management practices, awareness and skills dedicated to cybersecurity.

To increase Europe's digital sovereignty, including in healthcare and finance, we have adopted a two-pronged approach.

On the one hand, we are setting the rules that technologies, such as cloud services, should comply with in Europe. We do that with legislative proposals on market power (the Digital Markets Act and Digital Services Act proposals), data (the Data Governance Act and the forthcoming Data Act, and European Health Data Space proposal) and security (the revision of the NIS Directive, the forthcoming Cyber Resilience Act and a forthcoming EU cloud security certification scheme). The European Cybersecurity Competence Centre and the Network of National Coordination Centres will enhance our digital sovereignty through large-scale cybersecurity projects in areas such as Cyber Threat Intelligence, Cyber secured hardware and operating systems, and security certification.

On the other hand, the Next Generation EU Fund provides funding to support the next generation of digital services which are competitive, secure, trustworthy, fully interoperable and resource efficient. To ensure that planned public investments are paired with equally ambitious private investments, Commissioner Breton has also recently launched several industrial alliances, for instance

in the area of cloud and microelectronics. To build up true digital sovereignty, Europe should act collectively and in a concerted way.

How are increasing cyber-risks related to digitalisation being tackled at the European level? What are the factors of success of cyber-security measures in a fast-evolving environment?

The financial sector can take pride in being one of the most digitalized sectors in the economy. While much has been done to increase the resilience of the financial sector against shocks like the 2008 global financial crisis, we are today also facing challenges to safeguard the operational resilience of our ICT infrastructures.

Currently, we have a general cybersecurity horizontal framework at Union level, the NIS Directive, which is now under revision. It applies to key critical sectors, including certain types of financial entities. To streamline and enhance the existing EU rules and tailor them to the financial sector's needs, the Commission also presented in September 2020 the Digital Operational Resilience Act (DORA), which is also building on top of the currently existing NIS Directive horizontal framework.

DORA lays the foundations: finance must remain safe when it goes digital. At the same time, DORA moves away from the traditional quantitative approach in addressing operational risks, such as capital charges or buffers. Instead, it focuses on the qualitative aspects of digital operational resilience, such as for instance the capabilities on identification, detection, protection, response and recovery from disruptions, as well as on strategies, tools, and procedures that financial entities need to implement in order to be more resilient from a digital perspective. DORA brings opportunities for financial firms, supervisors but also to consumers and investors.

Financial firms will be operating in a more secure and resilient financial ecosystem, as DORA sets out a minimum "cyber hygiene" bar applicable to all. The reporting of major ICT-related incidents is streamlined and harmonised, and financial firms are expected to experience less burden when reporting incidents.

In terms of third-party risk management, DORA grants supervisors new powers and tools for monitoring systemic risk resulting from critical ICT third party service providers, identifying points of failure and concentration risk.

The rules the Commission proposed in DORA are robust, consistent and proportionate. They enable innovation while addressing the risks in terms of operational resilience. We have a great opportunity but also the responsibility to improve our financial regulatory framework for digital technologies, so that our financial sector is resilient against digital disruptions without jeopardising financial stability.

TECH IN FINANCE: OPPORTUNITIES AND CHALLENGES



MARCEL HAAG

Director, Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union - European Commission

Regulating digital finance – what next?

It has been one and a half years since the European Commission presented the Digital Finance Package. We have made good progress, in particular with the ambitious legislative agenda we have set ourselves in digital finance. But the next steps will be much more challenging.

So what have we achieved so far? First, following a swift agreement by Member States and the European Parliament, our pilot regime for market infrastructures based on distributed ledger technology will start running later this year. Market players will have a safe space to experiment with issuing, trading and settling shares or bonds using blockchain technology. We count on them to use this opportunity. This will be key to give the EU's capital markets a much needed push, but also to help supervisors and the Commission identify areas in which the rules might need to be adapted to enable long-term development in this field.

Second is our proposal for a framework for markets in crypto assets, including stablecoins. New rules will provide legal certainty to foster responsible innovation in this rapidly growing asset class, while putting safeguards in place to protect investors against fraud, abuse and theft and to preserve market stability. Member States have reached a common position and negotiations with them and the European Parliament on a final agreement will begin soon. This fast-moving market will not wait for European players and the many retail investors attracted to crypto assets deserve to be effectively protected. We really have no time to lose.

Thirdly, our proposal for new rules on digital operational resilience for financial firms has also advanced. Member States and the European Parliament have started negotiations that should soon lead to a final agreement. Adopting this piece of legislation is a vital step: as the financial system becomes ever more dependent on IT systems and digital processes, we need to ensure that all financial entities in the EU have the necessary safeguards in place to mitigate cyber risks and other threats to their digital operational resilience.

There is more to come. Later this year, the Commission intends to table a proposal for an open finance framework. A key part of the European Financial Data Space we are building, this framework will empower retail and business clients, giving them control over who has access to their data and how it is used. We believe that this will lead to innovative

financial products and a better consumer experience. Preparatory work on this initiative is already underway, involving experts, including from the financial industry.

However, as the financial system keeps changing, we as regulators need to take a hard look at our approach. How do we ensure that we anticipate developments rather than merely trying to catch up with markets and technological advances? How do we regain the initiative in a financial system that is now much bigger, more complex and that moves much faster?

The traditional regulatory approach of focusing on clearly defined entities, sectors, activities or products seems increasingly ill-suited in a world where established business models are disrupted, value chains broken up and decentralised finance is gaining ground. Our action will need to be structural, rather than focused on intermediaries or transactions. This will include looking at businesses and developments outside “traditional” financial markets. At the Commission we have started to do this as technology firms—big and small—have become more active in the financial system. Based on an analysis the Commission has recently received from the European Supervisory Authorities, we will need to see whether legislative action is needed here. This kind of cross-sectoral work has much further to go.

**As the financial system keeps changing,
we as regulators need to take a hard
look at our approach.**

And it is just one example of how regulators will need to adapt and to redefine their role. Building up new skills and expertise is another. A lot is in flux but one point is clear: it is becoming harder for regulators to detect and manage risk, guard financial stability and push markets towards allocating capital to activities that are economically productive – and in the interest of society. All the more important that we get it right.



AKASH SHAH

Chief Growth Officer -
BNY Mellon

The future of capital markets: digitalization and democratization

Emerging from the pandemic and an unequal economic recovery, several interrelated forces are transforming the way global capital markets work. As the world's economies rebound, market participants broadly recognize a need for reforms to the established modus operandi, to build resilience, to remain competitive in the face of innovation, and to retain their customers' trust.

At this defining moment, the core of this transformation is digitalization. With an innovation-focused financial industry and enormous amounts of processes yet to be digitized, the trend will continue to be a large theme in financial services in the years ahead.

Market participants must now act with a sense of urgency to overcome hurdles, innovate, and adapt to the digital future. To instill confidence in the evolution of capital markets, we believe there are a few key areas that will help ensure digitalization occurs in a thoughtful, regulatory-compliant and safe way:

1. Concerns around data and cyber security

Capital markets processes have become more digital as market participants demand faster execution speeds and seamless access to information. These technologies accelerate changes in the industry, but also raise concerns around cybersecurity and data protection.

Data is emerging as its own asset class, as a record amount of data flows through the global financial system.

Through this transformation, data management infrastructure is a key growth area for traditional financial firms. Institutions are actively seeking ways to leverage analytics to remain nimble and promote growth.

Questions remain around how firms can innovate safely, benefiting from a more agile use of data while mitigating risks.

2. New roles for financial firms

Some functions traditionally performed by large financial firms are being performed by a new set of competitors. As a result, institutions across the value chain are redefining their roles, taking on new responsibilities, partnering with new technology providers, and introducing new ways of operating in order to keep pace with their clients' needs.

As of 2020, 250 of the top private fintech startups internationally had raised nearly \$50 billion in aggregate funding. These platforms often provide complementary services to those offered by legacy institutions, presenting

new chances for collaboration and integration. While industry stakeholders have made substantial progress in understanding how consumer-facing fintechs are reshaping financial services, the role of fintech in institutional capital markets is less well understood.

One of the most significant emerging trends in the financial industry is the rise of retail investing and market transparency. Blockchain and distributed ledger technologies have the potential to disrupt core functions within capital markets, including trading processes, settlement systems, payments, and capital raising, all while increasing transparency. Digital assets and decentralized finance, now buzzwords across the industry, are becoming increasingly mainstream through institutional support. At the same time, regulators and lawmakers are increasingly vocal about concerns around cryptocurrencies as a store of wealth, raising important questions around their future viability as an asset class.

Market participants must now act with a sense of urgency to overcome hurdles, innovate, and adapt to the digital future.

3. Transparency around ESG

ESG is a top priority for financial firms. Financial firms including BNY Mellon are leveraging advanced data analytics tools to help market participants customize investment preferences and portfolios according to ESG factors, while also demonstrating impact.

Still, the industry lacks a universal ESG framework. As investors, asset owners, and corporations navigate their roles in supporting the transition to net-zero and stakeholder capitalism—including adopting consistent reporting standards around ESG metrics—significant questions surround what market structures and tools are needed to support sustainable investing. Why now?

We are living through a unique moment in history. The COVID-19 pandemic has forced reflection and accelerated change. Capital markets will continue to evolve and increasingly digitize, and they must do so urgently, in an inclusive and collaborative manner, in order to retain public trust.



TSVETELINA PENKOVA

MEP, Committee on the Internal Market and Consumer Protection - European Parliament

Tech in finance - seizing opportunities and mitigating risk

The digital transformation is the new reality and we are trying to foster and promote innovation in all policy areas of the European Union. Our consumers want faster and more convenient services while innovative companies provide adapted and timely solutions for their needs. In addition, the COVID pandemic forced much of the world to move online. Today we see high increase in the use of digital applications, including financial applications, where this trend is developing even more rapidly.

Financial companies invest massively in their digital transformation, which on one hand is changing their business models and on the other is bringing a completely new spectrum of processes and services, focusing both on innovation and consumer protection. The use of cloud services and big data, AI, DLT and the internet of things have become viral for the way traditional financial actors adapt to the new reality, as well as for new comers that are disrupting the established market.

In this context, the European Commission has released in September 2020 a European digital finance package. As co-legislators, the European Parliament and Council, we are actively working on these initiatives, where on part of the legislative proposals the trialogue negotiations phase has already started. Our aim is to support the digital transformation of the financial sector and the development and use of new financial products in the EU, while at the same time safeguarding the consumer rights and financial stability.

The package consists of the EU digital finance strategy for the next five years and three legislative proposals regarding digital operational resilience, markets in crypto-assets and a pilot regime for market infrastructures based on DLT as well as a proposal for a directive to amend certain EU rules regarding financial services.

The Commission proposes a framework on crypto-assets to bring innovation in a way that preserves financial stability and protects investors. Our political family would like to see this framework as a tool that would better protect investors against fraud. We believe that third-country based providers should be subject to rules when marketing their tokens to EU consumers. We also see a prominent role for the ECB in the authorisation process for crypto-assets and asset-referenced tokens. Finally, we should be cautious with crypto-assets whose creation or usage would generate additional energy usage.

The increasing digitalisation of the financial sector brings additional ICT risks to the ecosystem. The Commission therefore put up a proposal for digital operational resilience rules - a sector-specific legislation aiming to ensure that

all actors in the financial system put in place the necessary measures to mitigate cyber-attacks and ICT-related risks. Moreover, the proposal introduces an oversight framework for ICT providers, such as cloud computing service providers.

The European Parliament is currently negotiating this proposal with the European Council and the Commission. We should focus on the core operational functions of financial institutions and be objective towards operational risks. The risk management framework should take a risk-based approach and consider the size, complexity and risk profile of each entity. We are affirmative that critical third-country ICT services providers should have a legal entity within the EU.

We should aim for the right balance between prescription and flexibility.

Finally, we should aim for the right balance between prescription and flexibility and ensure the coherence of DORA with other EU legislations, such as the revised NIS Directive and the GDPR.

New technologies are evolving rapidly, they are disrupting the market but at the same time they are preferred by the consumers. Cybersecurity must go hand in hand with this process. The regulatory framework must also be updated at a similar pace to ensure the protection of consumers and their data, but not at the expense of innovation and progress.

We should aim for a technology-neutral and innovation-friendly EU financial services framework that ensures fair competition among all actors and guarantees data and consumer protection.



GEORGINA BULKELEY

Director for EMEA Financial Services Solutions -
Google Cloud

The Future of financial services is in the cloud

Across EMEA there are several trends which we are seeing evolve in the financial sector, many of which have been accelerated by the COVID-19 pandemic and the overall shift to digitisation.

Firstly, companies are applying cloud technology's scale and flexibility to process large volumes of information which they can bring together from different siloed data stores. The insights they can derive from this consolidated data create tangible business outcomes, enabling banks to have a better understanding of their risk profiles, segment their customers to drive seamless customer experiences, track market movements and also develop new financial products and services.

Banks that use cloud will ultimately gain a competitive advantage in an increasingly competitive market. The power of cloud technology enables financial services providers to not just meet customers' needs, but to anticipate and exceed them. This new focus on technology powering business outcomes can also be seen in business model evolution. We see the trend of embedded finance accelerating in the next 3-5 years as customers increasingly seek hyper-personalised, digitised experiences with financial services embedded seamlessly, making transactions and interactions convenient, simple, and continual. We anticipate this will lead to further partnership ecosystems evolving across sectors, such as finance and retail as an example, as they become ever more integrated from a customer experience perspective.

Data-powered innovation can draw insights from multiple points of customer interaction. For example, our AI solutions (CCAI and Dialogflow) can help call centres optimise the customer experience while allowing the call centre representatives to focus on higher complexity cases. Google Cloud's Apigee can create an API network for the greater ecosystem, resulting in improved banking experiences, and our Document AI solution analyses written documents and synthesises the data into a structured data source. All of these solutions are focused on improving Customer experience.

We also see this evolution of technology powering business outcomes with our capital markets clients that have embraced cloud computing across their entire value chains. In capital markets, cloud services are becoming ubiquitous for data delivery. In fact, 93% of exchanges, trading systems and data providers globally offer cloud-based data and services. Moreover, 100% of those surveyed intend to offer new cloud-based services, such as derived data, in the next 12 months. (Source: Coalition Greenwich research 2021 "The Future of Market Data" commissioned by Google Cloud).

Some capital markets companies are also tapping the cloud to develop entirely new services. CME Group recently signed

a 10-year partnership with Google Cloud to transform global derivatives markets through cloud adoption. Under the agreement, CME Group will migrate its technology infrastructure to Google Cloud beginning next year with data and clearing services, and ultimately moving all of its markets to the cloud. The partnership will focus on delivering significant benefits to all market participants by expanding access, creating real-time data and analytics capabilities, introducing new products and services, increasing efficiencies, and driving resiliency in the financial markets ecosystem.

A final trend which we see as a cornerstone to the industry is the new and deepening focus on purpose for financial services companies, particularly how they can use data to better understand their societal and climate impacts. This is an area where technology can help financial services companies analyse impacts and emissions with data analytics. Migrating platforms and systems to sustainable, carbon-friendly cloud infrastructure can also improve the impact on the planet.

**Cloud technology enables companies
to not just meet customers needs,
but anticipate and exceed them.**

All of these changes in the market, of course, are being accompanied by evolution in regulatory regimes that seek to create norms and mitigate risk, like the Digital Operational Resilience Act (DORA) in Europe. This regulatory evolution presents a great opportunity to enhance understanding, transparency, and trust among market participants and ultimately stimulate innovation in the financial sector in Europe. It also facilitates robust stakeholder engagement that helps ensure that the right balances are reached when designing new policies and regulations.



MÄRTEN ROSS

Adviser, ECOFIN & EFC -
Ministry of Finance, Estonia

Balancing risks and opportunities in building European digital finance

Have the measures of the EU Digital Finance Package (DFP) allowed the European financial sector to seize the opportunities created by digitalization?

The package is obviously rather young and as the regulatory innovations are mostly in the pipeline its effects haven't yet been proven. But even with this in mind one should note that over the last years we've seen progress in many of the digital strategy priority areas. Most notably it is manifested in clear step forward in uptake of several forms of digital payment services within Europe. But there is also a clear initiative to achieve a unified legal framework on many sectors attributed to digitalization, from crypto-assets and digital operational resilience – to more recently, anti-money laundering regulation and amendments to existing securities regulations.

For sure, these tendencies are not just the result of the DFP or other (and earlier) regulatory initiatives. Much of the job is done by other and from finance point of view partly remote factors. In particular, as a side effect of the covid pandemic, there has been quite a push for broader digitalization in many areas of life. No wonder then that also digital finance has seen its fair share.

Keeping these aspects in mind one should conclude that main elements of the DFS remain valid targets. And these are not just narrower financial aspects, but include welcome focus on data handling aspects on the single market and also broader infrastructure elements like anti-money laundering initiatives.

Is the balance right in the EU digital finance frameworks between risk mitigation and supporting innovation?

There is hardly any single risk metrics that could cover the whole digital finance space. So, the picture is probably a bit diverse on this question. Cyber risks are not generally anymore underestimated and those additional risk handling elements that are or will be introduced (like DORA) are rather balanced and add to the overall credibility.

However, there might be areas, for example data privacy and analytical technologies, e.g. use of artificial intelligence where this balance between risk mitigation and innovation support is either questionable or needs further testing.

In addition, not all (or even most) of the factors influencing creation of single digital finance market are related specifically to narrowly digital issues. And the same goes to risk mitigation and innovation support balancing. In many cases factors hindering smoother integration of the (digital) capital markets or overcoming practical constraints for

region-wide single payment market are still related to non-digital factors, like fragmented business registries, fear of data misuse or diluted anti-money laundering practices.

Is there a risk that digitalization may lead European financial institutions to become excessively dependent on tech third-party and third-country-providers?

In network-type industries, including much of the financial sector, the market integrity and competition issues are quite frequent. And these problems are (or at least are conceived to be) more problematic once these concerns appear from actions that drift control of services away from the regulatory perimeter. Therefore, it is not particularly surprising that the potential risks of financial stability and infrastructure security are further magnified in the areas or services, where third-party or third-country providers positions are expected to be prominent or even worse – prone to become monopolistic.

**In many cases factors hindering
integration of the markets are related
to non-digital factors**

Therefore, one could argue that while this stage of digitalization is not totally new, shifts in market structure or data control may be at least perceived to be excessively risky. That concern is quite serious when additional broader (geo) political layer happens to enter the stage. But as before, one should not in regulation nor in supervision mix up stability or market integrity concerns by actions only happening to hinder competition.

What is fascinating here is that digitalization has shown us both of its sides. While the question implies as if digitalization tends to aggravate the problem, on the other hand we have clear examples where it actually provides answers to support competitive environment, such as in the areas of EU's mutual efforts to regulate crypto-assets and set out common rules for AML prevention.

NEXT EUROFI EVENTS

THE EUROFI FINANCIAL FORUM 2022
7, 8, 9 SEPTEMBER 2022
PRAGUE – CZECH REPUBLIC

THE EUROFI HIGH LEVEL SEMINAR 2023
APRIL 2023
SWEDEN

CYBER AND DIGITAL OPERATIONAL RESILIENCE POLICY PROPOSALS



DOMINIQUE LABOUREIX

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

A much-needed comprehensive cybersecurity framework for the financial sector

Before the Digital Operational Resilience Act (DORA), the European financial regulatory framework regarding information and communication technology (ICT) and third-party/outsourcing risk management was multi-layered, scattered across multiple binding regulations (EMIR, PSD...) and non-binding guidelines of the ESAs, with undue variations across sectors, however exposed to the same risks. DORA, becoming the unique reference regarding digital operational resilience requirements for regulated financial entities, will greatly simplify and improve the framework.

DORA is being designed to set the right balance between two competing objectives: embracing some specificities from the huge diversity of regulated financial entities and promoting harmonization. It will above all address an important shortcoming of the current supervisory architecture of the financial sector: competent authorities and ESAs will have direct oversight of critical ICT services third-party providers. That will provide them with the means to act upon the main ICT providers which play an essential role for the financial sector, and therefore generate systemically operational risks.

However, during the last part of the negotiation process in 2022, it will be essential to avoid any watering down of the ambition of DORA, in particular regarding the ICT risk management requirements and the oversight capabilities of the newly created Oversight Forum. Besides, some provisions will still have to be complemented and clarified in level 2 texts, to enhance DORA's efficiency, in particular regarding the oversight of critical providers. First, on ICT risk management, some relevant requirements in ESAs existing guidelines, not included in DORA, will usefully be taken on board in the foreseen delegated regulations, such as the content of the ICT security policy.

Second, the requirements applying to "fourth-party risk" will need further specification, in particular to determine the conditions to secure subcontracting of critical functions are.

Lastly, there is still some leeway in sketching out properly the new institutional arrangement and the future Oversight Framework of critical third-party ICT services providers, beyond what DORA already provides for. In particular, we need to work out how each participant authority will cooperate within the Forum and what information the joint examination teams will be able to require from critical

providers. It is of the utmost importance to provide to the authorities all operational and legal means to act upon critical providers, including non-EU BigTechs.

Once adopted, DORA's success will also depend on how it is implemented and how the cyber systemic risk is addressed.

Indeed, as of today, despite existing rules, supervisors note that financial institutions still have significant efforts to make to improve their operational resilience. For instance, their information systems are not always sufficiently secured, whereas the massive use of remote-working due to the Covid-19 pandemic creates new vulnerabilities in the face of increasingly sophisticated cyber-attacks. In parallel, the Oversight Forum's capacity to function effectively will depend on the involvement of the designated critical providers. Thus, based on the new framework, a strong commitment by all stakeholders will be necessary to ensure that DORA is consistently implemented across the whole financial sector.

DORA's success will depend on how it is implemented and how the cyber systemic risk is addressed.

Finally, the operational resilience of financial institutions at solo level is not the end of the journey, as the systemic dimension of the cyber risk remains a challenge for regulators. On this matter, DORA encourages more cooperation between authorities at the European level. In its recent report, the ESRB identifies the need for the establishment of a pan-European systemic cyber incident coordination framework (EU-SCICF) to mitigate the risk of a coordination failure¹.

Public authorities and financial institutions will need to commit to put in place this improved mechanism, which implies to overcome some legal, practical and political obstacles in the future.

[1] *Mitigating systemic cyber risk, ESRB, January 2022*



JOSÉ MANUEL CAMPA

Chairperson - European Banking Authority (EBA)

Promoting Digital Operational Resilience across the EU financial sector

As the legislative procedure on the proposed Digital Operational Resilience Act (DORA) is ongoing, the European Banking Authority (EBA), the other relevant authorities and the financial sector are getting ready for the implementation of the new legislation. Assuring digital operational resilience of the financial system is a common goal to be pursued.

DORA is also the first concrete initiative to address the complex issue of the dependencies on critical ICT third-party providers (CTPPs) in the financial sector. The high-degree of interconnectedness across the financial sector in Europe is clearly materialised in the activities of many of these third-party providers. A small number of them seamlessly provide core services across the financial sector (and beyond) and across member states (and globally). The manner to ensure effective oversight to these services poses a challenge to the EU regulatory framework structured along a mix of European and national supervisory authorities and sectorial mandates. If successfully implemented, DORA could provide a pathway to a broader oversight in the future.

The proposed regulatory and oversight framework for CTPPs should come to complement and reinforce the existing framework for operational resilience of supervised entities. This should neither undermine nor diminish the efforts expected by financial entities to further focus on their digital operational resilience.

On the regulatory side, the European Supervisory Authorities (ESAs) are expected to jointly develop a significant number of Technical Standards to further specify the technical implementing details of the legal requirements. During the development of these mandates it would be important to ensure consistency with the existing sectorial guidance to avoid unnecessary burden to the financial sector.

DORA also proposes the establishment of an oversight framework at EU level for ICT CTPPs. The role of the ESAs (as Lead Overseers) is limited to the ICT risks which CTPPs may pose to financial entities. It will neither imply direct supervision of CTPPs in the provision of those services to financial entities nor oversight across their full range of activities. Additionally, the oversight responsibilities will be shared across the three ESAs with one of them acting as the lead supervisor for each CTPP. Therefore, the future structure of this oversight model for CTPPs will need to be carefully crafted to ensure coordination and homogeneity in the oversight. This will require enhanced coordination among the ESAs.

The outcome of the oversight work will inform the micro-prudential supervisory work as the main objective of the oversight work is to strengthen the stability and security

of the ICT services provided to financial entities. This will require strong coordination between the Lead Overseers and the supervisors of financial entities as efficiencies should be explored to avoid duplicative, or even inconsistent, tasks. The proposed legal text also empowers such close coordination as supervisors will be able to take measures concerning CTPPs only in agreement with the Lead Overseer. That coordination will need to be made operational. It should be also noted that the proposed oversight framework is not expected to shift in any way the responsibilities of the financial entities to properly manage their ICT third-party risks.

Implementing DORA will demand enhanced coordination among European regulators.

A regular communication between the Lead Overseers and the CTPPs would be envisaged to support the effectiveness of the oversight conduct along with the respective communication between the Lead Overseers and supervisors. Moreover, it will be important to maintain a strong relationship between the financial sector and the other sectors covered by the Network and Information Security Directive (NIS2) for the exchange of information. This could be achieved by participating in the discussions of the NIS Cooperation Group and by exchanging information and cooperating with the single points of contact and with the national CSIRTs under the NIS2 Directive.



MARGARITA DELGADO

Deputy Governor
Banco de España

Regulation and digital operational resilience challenges in Europe

Given the importance of the banking sector in the economy, banks' profits are a fundamental source of capital to support economic growth and preserve financial stability. The low interest rate environment and digital disruption are two of the main challenges currently facing traditional banking. Digital transformation is key to underpinning institutions' profitability, efficiency and new business activities. Moreover, it is necessary to ensure banks remain competitive and can offer their customers personalised services in an agile, efficient and innovative way. But this transformation comes at the price of huge investment and the risks associated with the large-scale use of technological solutions.

The goal of DORA is to mitigate the risks of digital transformation in the EU financial sector by establishing a common framework for enhancing digital operational resilience. It contains provisions for institutions on technology risk management, incident management and reporting, digital resilience testing, third-party risk management and information sharing. Furthermore, to tackle the increasing dependency of the financial sector on third party services, DORA establishes a framework for the direct oversight of those technology service providers that become critical for the EU financial sector as a whole.

All in all, DORA is an ambitious proposal that could be a game changer in making the EU financial sector more operationally resilient. However, it also poses important challenges that need to be addressed.

The scope of DORA is wide, covering institutions of different sizes, business models, risk profiles and complexity. Therefore, when the level 2 regulation is drafted it will be crucial to take into account proportionality, without impairing DORA's goal of establishing a minimum level of resilience even for smaller or simpler institutions. Given the current regulatory fragmentation, some types of institutions will already be compliant with most of the provisions in DORA, while others will need to make a significant effort to comply. Although the text includes some exemptions for smaller institutions, it should be further refined to take into account criteria other than economic size, which is not necessarily directly related to the level of technology risk.

Notably, DORA requires an unprecedented level of coordination and cooperation amongst authorities. Recognising that cyber threats are cross-border and cross-sector, DORA establishes several mechanisms through which authorities will have to exchange information and work together, not only within the financial sector, but also with the cybersecurity authorities in the NIS^[1] ecosystem. Establishing clear roles and responsibilities and building trust amongst stakeholders to ensure secure and timely

information sharing is, without doubt, another challenge. DORA offers a unique opportunity to build cyber threat intelligence in the EU financial sector, a very powerful tool to enhance its resilience.

As mentioned already, DORA proposes a novel EU framework for the direct oversight of critical technology third parties. This is a completely new set-up with complex governance arrangements, in which it is crucial to ensure that all stakeholders participate effectively and efficiently. In addition, to be able to oversee highly sophisticated technology providers, competent authorities will have to consider whether they have enough resources and technical skills. This is also the case for the European Supervisory Authorities, who have a prominent role to play.

DORA offers a unique opportunity to build cyber threat intelligence in the EU financial sector.

Once in place, the oversight framework will have benefits not only for financial institutions, but also for the affected service providers, by creating a single framework to replace the current fragmented regulatory and supervisory regimes. At the same time, it will allow competent authorities to monitor those providers on which the sector is highly dependent.

To seize the opportunity provided by DORA to enhance the operational resilience of the EU financial sector, financial institutions, third parties and authorities will have to cooperate and work together even more than they do already.

[1] Network and information systems. See Directive (EU) 2016/1148.



JENS OBERMÖLLER

Head of Directorate IT Supervision, Payments, Cyber Security
Federal Financial Supervisory Authority, Germany (BaFin)

DORA - gearing up to become digitally resilient!

In today's financial world, information and communication technology (ICT) is no longer a secondary requirement for generating income, but forms the fundamental infrastructure for nearly all processes and digitalisation and technological innovation in the area of financial services are still gaining pace. This brings many advantages to financial entities but has also made the industry more vulnerable: financial entities, which people entrust with their money and their most private data (including medical data), are among the most popular targets for cyberattacks. Such attacks can cause significant distress to individual companies – and to the market as a whole, even beyond national borders.

Supervisory requirements are one of the most important tools in our arsenal for improving cyber resilience in the financial sector. Due to the highly interconnected nature of this industry, such requirements should apply beyond borders, wherever possible, and should be as consistent as possible throughout the European Union.

By providing sound and effective rules for the management of ICT risks, the DORA legislation establishes a harmonised framework for improving the cyber security of all financial entities at the European level. What is more, as a Level 1 regulation, DORA will send a clear signal that digital operational resilience is just as important as financial resilience.

In Germany, BaFin strongly believes in the benefits of harmonised requirements for the management of ICT risks, and has been following a similar approach since 2016, when it published its Supervisory Requirements for IT in Financial Institutions. This format has since then been replicated for insurers and asset management companies as well as payment service providers – making use of the same terminology and harmonised requirements.

Still – since nowhere in Europe there are as many small and medium sized entities in the financial sector as in Germany – the principle of proportionality is particularly close to our hearts, as German supervisors. While applying the principle of “the same rules for everyone”, its proportional approach means that the rules take into account an entity's risk profile. This is essential, particularly in the highly diverse European financial market.

BaFin also greatly appreciates the principle-based foundation of DORA – ensuring technological neutrality and a sufficient degree of flexibility. Still, whatever measures are taken with regard to ICT risks, the fact remains that our efforts to ensure ICT security will never be complete; technology moves far too quickly for that. Something that is considered completely safe today could be a weak point exploited by cyber villains

tomorrow. Supervisory requirements need to keep pace with technological change.

Traditionally, the value creation processes at the majority of financial entities took place under one umbrella. Nowadays, an increasing number of processes are performed by third-party service providers. This trend is likely to gain further momentum. Therefore, it is of utmost importance that we, as European supervisors, gain a comprehensive and global view of the outsourcing ecosystem so that we can respond to the potential challenges posed by critical ICT third-party service providers in the financial system. The Oversight Framework established by DORA represents a crucial step forward in tackling these challenges. Given the complex nature of value chains in today's financial sector and the sheer size and global footprint of some ICT service providers, the underlying oversight architecture needs to be carefully designed to ensure that it is both effective and efficient. Moreover, there is a red line that must not be crossed: tasks can be outsourced; responsibility, on the other hand, cannot. It must remain where it belongs: with the financial entities' managers.

**Digital operational resilience
is an ongoing process: there
is no finish line!**

Finally, we should not forget that digital operational resilience is an ongoing process: there is no finish line. Even if financial entities met all of these new requirements perfectly, would we ever be able to say our task is complete? Could we ever really claim to be completely resilient? The answer, unfortunately, is probably not.

In an interconnected world, dealing with ICT risks as well as ICT third-party risks will always remain a challenge.



JASON HARRELL

Managing Director and Head of External Engagements -
The Depository Trust & Clearing Corporation

EU Digital Operational Resilience: the path to enhanced resilience

Today's financial services industry increasingly leverages technology and ICT providers to extend financial services to excluded or underserved individuals, increase efficiency and lower transactional costs, and diversify financing. To provide greater assurance of a level playing field across Member States and increase the safety and soundness of financial markets, the DORA framework must establish an oversight framework that meets these stated goals. The European Parliament (EP) issued its amendments to the European Commission (EC) text which it will use to enter negotiations with the EC and Council of Ministers. The EP has made significant strides to strengthen the EC's proposal. I believe that this text will ultimately deliver on its expected goals. However, there are areas where further improvements may increase clarity for financial entities.

Operational Resilience Principles

During the DORA negotiations, financial entities and authorities worked to develop operational resilience principles for use by supervisors when developing rulemaking. In 2021, the Basel Committee on Banking Supervision (BCBS) published its Principles For Operational Resilience. These Principles, developed in collaboration with the private sector, defines operational resilience concepts such as critical operations, tolerance for disruption, mapping of interconnections and scenario testing. These activities are to occur at the financial entity's business operations level. DORA has taken these terms and integrated them at the technology level which may lead to financial entities being unclear on their requirements.

As an example, the BCBS Principles require financial entities to map the people, process, technology and suppliers needed to deliver its critical operations while DORA may require that these mappings include technology systems configurations. In addition, DORA requires impact tolerance for ICT disruptions while the BCBS Principles require impact tolerance at the business' critical operation level. Further guidance will clarify financial entities' operational resilience expectations.

Intragroup / Third-Party ICT Relationships

The Proposed Text includes intragroup relationships in the definition of third-party ICT relationships. While intragroup relationships may be external to the covered entity, the parent-to-affiliate relationships deliver numerous common services which may include: IT services, cyber risk, and audit. Further, these relationships provide consistent governance, resource management, and technology alignment that simplify technology service delivery and enhance resilience. The inclusion of intragroup ICT relationships in the definition

of ICT third-party relationships by the EP text extends requirements that may not promote stronger resilience.

- **Exit Strategies**

By changing this definition, financial entities will be required to develop exit strategies for their intragroup ICT relationships. Exiting intragroup ICT services may interrupt other tech-supported services by the parent organization and remove the ability of the parent to provide sophisticated cybersecurity services which enhance the cyber preparedness of the covered entity

- **Supervision/Oversight**

Given the breadth of services offered by the parent to the affiliate for daily operations, the parent organization may be considered a concentration risk by the Joint Committee. In the Proposed Text this may further allow oversight of the parent organization by the ESAs. This may create supervisory issues between the national authorities who oversee the parent organization and the ESAs who are expected to oversee the ICT third-party relationships that sit outside of the institutional protection scheme.

While DORA is the first step in a multiphased effort, a solid foundation will serve to support resilience and provide the flexibility needed for Europe's digital finance goals.

Public/Private Partnerships

I believe that sound rulemaking requires feedback from the industry. This allows subject matter experts from both sectors and their unique points of view to be reflected in rulemaking. This creates rulemaking that is fit for purpose and enhances the implementation of measures that promote resilience. EU lawmakers should envisage consultations with the industry to develop technical standards.

It is my hope that clarifying these matters takes a front seat in these discussions. While DORA is the first step in a multiphased effort, a solid foundation will serve to support resilience and provide the flexibility needed for Europe's digital finance goals.



SCOTT MULLINS

Global Head, Financial Services -
AWS Worldwide Financial Services (AWS)

DORA must support digital innovation across the EU financial services industry

The European financial services industry is rapidly digitalising with financial institutions and their customers reaping the benefits of cloud technology, including increased resilience, improved security, and innovation at scale. The EU proposal for a Digital Operational Resilience Act (DORA) aims to introduce a new regulatory framework that will impact how EU financial services institutions work with cloud providers and other critical third parties.

The pace of change in the financial services sector is unprecedented. Financial consumers' expectations are changing at the same pace and new technologies are enabling firms to adapt quickly to address these new needs. As a result, the financial ecosystem is constantly evolving, with new players entering the market and established ones re-thinking their business models. Institutions of all sizes are redefining their approach to business to provide customer focus, agility, and services they need to be competitive and grow.

The cloud has become a critical component of this approach. It allows financial institutions to experiment with new ideas and launch new products and services without the need to invest in expensive and outdated infrastructure, which in most cases cannot deal with the challenges of an increasingly digitalized financial services sector.

Best-in-class technology

In its Digital Finance Strategy, the European Commission is encouraging digital innovation across the sector and many organizations are responding by using cloud technology to transform their businesses. DORA will play a significant part in the Commission's drive for digital innovation, while raising the bar for security, resilience, performance and reliability. Ensuring EU financial services firms are able to access best-in-class technology is absolutely key to delivering this.

It is crucial that the final DORA framework is fit-for-purpose. It must reduce the fragmentation within the EU and across jurisdictions, while supporting innovation and encouraging the adoption of innovative ideas. It must also be robust in managing technology risks. Achieving this will support EU competitiveness in financial services in the long term. A globally interconnected financial system requires coordination and harmonization across jurisdictions. And a similar principle applies to technology. Fragmented requirements will create friction and delay the adoption of the best technology by the financial services sector.

At the same time as DORA is being implemented, the whole sector faces an increasingly complex cyber-threat landscape for which technology is crucial. DORA must harmonise and raise the bar regarding security requirements within the EU.

In turn, further efforts are needed at the international level to ensure financial firms don't face duplicative and/or conflicting regulatory regimes.

Vital role for the cloud

The cloud is a crucial enabler for EU firms to develop capabilities in AI, machine learning and other technologies. The cloud model is based upon the highest security standards, meaning all customers benefit from a secure core infrastructure that no single firm would be able to achieve on its own.

AWS is committed to working with the financial community on the implementation of DORA while enabling institutions to deliver agility, seamless interactions and above all innovation.

EU financial firms must have access to the same cloud technology as global competitors in order to maintain a level global playing field and benefit from the highest levels of security available. Cloud technology enables EU financial companies to be resilient and efficient, and supports the digital transformation of the sector.

The work of European policy makers to introduce DORA is a positive and welcome step. AWS is committed to working with the financial community on the implementation of DORA while enabling institutions to deliver agility, seamless interactions and above all innovation. We will continue to support our customers in the EU and globally as they innovate and develop new products and transform their businesses while adhering to the highest security and resiliency standards.



LAURENCE MOLINIER

Director, Risk Advisory - Deloitte

Looking towards the implementation of the EU's Digital Operational Resilience Act

The finalisation of the EU's Digital Operational Resilience Act (DORA) will be an important regulatory development for the financial services (FS) sector this year. Given its breadth and ambition, firms cannot afford to wait for the political process to conclude but should already be considering what successful implementation requires.

The DORA will introduce a new approach to the operational resilience of the sector that streamlines a framework that had previously only existed as a patchwork of EU Regulations and guidelines¹. This development is in line with a worldwide trend of FS regulators creating dedicated rules for strengthening operational resilience of firms in the sector². The DORA will also introduce the world's first comprehensive oversight framework for Critical ICT Third Party Providers (CTTPs) serving FS clients.

With the EU co-legislator negotiations ongoing, we see several important considerations with regards to compliance challenges and building resilience.

Thinking through implementation in practice

Although the DORA will provide a unified set of requirements for ICT risk management, reporting, testing and third-party risk management, the precise scale of the compliance challenge for firms cannot be fully understood until there is more clarity as to how authorities will implement the new rules.

While many larger firms will have already put in place similar practices for operational resilience or cyber risk management based on existing guidance (e.g., from the European Supervisory Authorities), the DORA goes further. Supervisors may also expect the quality of the work from these firms (for instance, on mapping and identifying vulnerabilities in systems that support critical functions) to be higher due to the systemic role they play in the financial sector. This indicates that the expected two-year implementation period will still be a tight deadline, even for firms with more mature cyber and operational resilience capabilities.

Firms and their supervisors must engage early to discuss not only how they should comply with the DORA's explicit requirements, but to reach a mutual understanding on the desired level of resilience that could be sought for critical functions and business services by the end of the implementation period and after. In our experience, this understanding will be crucial for firms to plan the level of resources and investment needed to meet the expectations of supervisors.

These discussions will also help firms pinpoint areas where building their resilience to the desired level will be more

difficult. In a recent executive survey, identifying and managing third party vulnerabilities was highlighted as the most important challenge faced by FS firms in implementing operational resilience requirements.³ In addition, firms will have to think carefully about medium-term investment decisions, especially in relation to legacy systems, to support their expected level of resilience.

Ensuring international coordination

The operational vulnerabilities and cyber threats that FS firms face do not stop at national boundaries, so regulatory frameworks and operating models should ideally work together. Much has already been done to facilitate this by the Financial Stability Board and the Basel Committee on Banking Supervision (BCBS), and the DORA contributes to this effort.

While this is an important point for the rulemaking process, much will again depend on how supervisors implement the framework and whether work undertaken in one jurisdiction can contribute to meeting requirements in another.

As the DORA moves towards finalisation, FS firms and regulators need to be mindful of the scale of the challenge.

An important case of this will be the approach taken in the ECB's supervision of banks. While the ECB will supervise banks' compliance with the DORA, it is also expected to implement the BCBS's March 2021 Principles on Operational Resilience, an outcomes-based framework more similar in approach to the UK's supervisory-led regime. The 2020 ECB, US and UK authorities' statements, committing to deliver a globally joined-up approach to the supervision of operational resilience⁴, demonstrates encouraging cooperation.

While it is natural that regulators with different priorities will put more relative emphasis on the resilience of different operations, there is still significant opportunity for alignment across borders. For instance, it will be important to see to what extent the "important business services" identified by a cross-border firm for its compliance with the UK rules will be allowed to match with the "critical operations" it must identify under the DORA.

Regulators should also work together to ensure that they take compatible approaches to the oversight of Cloud

Service Providers and other CTTPs providing services in the FS sector. While the EU moved first (as the DORA will be the first design and introduction of such a comprehensive oversight framework), the UK and US approaches are due, and may differ in the detail.

Our view is that cross-border FS firms will gain efficiencies when they adopt a consistent approach to operational resilience group-wide and modify it in each jurisdiction as far as necessary to meet specific requirements. Differences between jurisdictional frameworks should not be an insurmountable problem if regulators remain committed to facilitating such an approach and strengthen their coordination of supervisory activity.

The importance of acting... now

As the DORA moves towards finalisation, FS firms and regulators need to be mindful of the scale of the challenge. While a two-year implementation period may feel tight,

with a proactive, practical, and collaborative approach there is a real opportunity to implement the DORA in a way that contributes to a more operationally resilient sector overall.

1. *Most prominent among these include ICT Risk Management Guidelines from the European Banking Authority and the European Insurance and Occupational Pensions Authority as well as the Cyber Resilience Oversight Expectations from the European Central Bank.*
2. *Deloitte, EMEA Centre for Regulatory Strategy, International regulatory alignment on operational resilience.*
3. *Deloitte, EMEA Centre for Regulatory Strategy, 2022 Financial Markets Regulatory Outlook.*
4. *European Central Bank, Banking Supervision, Statement regarding supervisory cooperation on operational resilience, 2020.*

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DLT IN SECURITIES MARKETS



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Rethinking financial supervision of EU securities markets in a DLT world

Technology is a fundamental catalyst for change, shaping a landscape where digitalisation covers large swaths of our societies – and the pandemic has further increased the pace of transformation. In the financial sector, tools such as data analytics, machine learning, and cloud computing are set to play a greater role in the future as they are proving every day that they can bring faster, more transparent, and possibly cheaper services to consumers and investors.

The spotlight will also be on Distributed Ledger Technology (DLT), which presents several benefits with respect to the integration and even the competitiveness of the Capital Markets Union. Indeed, tokenisation associated with the use of DLT based platforms may reduce transactions costs, enhance the exchange of illiquid assets, help

new asset classes emerge and foster cross-border trading.

At ESMA, our mission is to understand and monitor these trends to ensure that the European regulatory environment stays fit for purpose. A poorly designed regulatory framework would hinder the development of DLT-based market infrastructures, i.e. trading platforms or settlement systems. At the same time, it is our main duty to prevent investors, especially retail investors, from embarking on a journey that is too risky for them. In our view, the challenge is particularly acute as the current set of EU rules has not been built with innovations such as DLT in mind.

To address it, we are convinced that the approach taken by the European Commission and endorsed by EU policymakers to setup a pilot regime for DLT market infrastructures is the appropriate one. In essence, this temporary “regulatory sandbox” will create, under certain conditions, exemptions from specific requirements foreseen in EU financial legislation, such as MiFID or CSDR. In doing so, it will offer a safe space for market participants and supervisors in the EU to experiment and acquire expertise on the technology. This will promote the uptake of DLT in the trading and post-trading areas while ensuring investor protection, market integrity, and financial stability. In other words, the DLT pilot regime may become an example of how regulators can oversee innovation with flexibility.

The DLT pilot regime may become an example of how regulators can oversee innovation with flexibility.

Furthermore, we believe that the implementation of the DLT pilot regime will be an opportunity to rethink existing financial reporting channels, as well as to adapt market surveillance mechanisms. That is the reason why, even though the text of the DLT pilot regime Regulation is not yet finalised, we have decided to launch a Call for Evidence to assess whether

the Regulatory Technical Standards (RTS) developed under MiFIR relative to how certain pre- and post-trade transparency and data reporting requirements need to be amended so that they can effectively be applied to securities issued, traded and recorded on DLT. Based on stakeholders’ feedback, we will reflect whether refinements to the RTS are necessary and submit our recommendations to the European Commission.

This process and further reflections are still ongoing. However, given that supervision of DLT market infrastructures under the pilot regime – and under the more stable legislative improvements that will perhaps result from the experiment – should be data-driven, we may already point to the limits of the traditional reporting approach under MiFIR (“push approach”) for DLT market infrastructures to gather the data required to perform both policy and supervisory mandates.

At ESMA, we would see merit in granting all EU regulators with direct access to the data recorded on DLTs. This would allow them to extract the information they need from the DLT market infrastructures (“pull approach”), instead of remaining passive recipients of data reported by different market participants. All EU regulators would thus be able to conduct effective market surveillance, by being able to reconcile buy and sell transactions executed on trading venues. By embracing this so called DLT embedded supervision, they would also manage data stored on DLTs in a more efficient, secure, and cost-effective manner, while preserving quality, usability, and comparability of information.

Gains associated with DLT will only be reaped if we manage to strike the right balance between maximising the innovation potential and addressing supervisory and regulatory challenges, while avoiding market fragmentation. The DLT pilot regime is one significant step in the right direction, but we expect the European Commission to come up with additional proposals in coming years, for instance in the area of Decentralised Finance or Artificial Intelligence. As always, ESMA will be eager to contribute to the design of a regulatory framework suited to the digital age.



BIRGIT PUCK

Managing Director Securities
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A level playing field for innovation, investor protection and market integrity

Crypto-assets and the underlying distributed ledger technology (DLT) display potential for financial markets and their infrastructures. Tokenization of traditional assets, for example, has led to the emergence of new financial products. The fragmentation of assets, such as real estate or works of art, by means of tokenization has enhanced tradability and fungibility to a level that is comparable to that of traditional financial instruments, and has created new classes of rather complex derivative financial products and has changed the nature of traditionally less regulated investments e.g. qualified subordinated loans. However, they also come with risks, including high volatility, fraud schemes and operational shortcomings and vulnerabilities of crypto-asset services and exchanges, due in part to a lack of market transparency and integrity.

Such risks have constantly highlighted the urgent need for effective regulation and supervision of business activities in the crypto sector. Numerous crypto-asset related services remain widely unregulated, in contrast to regulated

traditional financial instruments with crypto-assets as underlying or asset (in particular exchange-traded notes or investment funds but also security tokens as transferable securities) that are subject to existing European capital markets law.

In response, the European Commission published a Digital Finance Package last year, including several legislative proposals, with the DLT pilot regime and the Markets in Crypto-assets Regulation (MiCAR) at their core. The latter will introduce a variety of regulatory obligations and licensing requirements. For example, crypto-asset service providers will be subject to both prudential and conduct of business rules inspired by the MiFID II. In addition, similar obligations for issuers of crypto-assets and related white papers will also be imposed to those in the Prospectus Regulation along with authorisation requirements for certain crypto-assets that derive their value from fiat currencies and/or other underlying assets ("asset-based tokens" and "e-money tokens"). While MiCAR will lead to further market adjustments within the crypto-sector and will help to establish a level playing field, a number of issues arise from the current draft. The issue of decentralized finance, which is a major driver of the crypto market, remains completely unaddressed by MiCAR, giving room to potential investor protection risks.

**MiCAR and the Pilot
regime will provide
a framework that will
help to create a level
playing field.**

The DLT pilot regime, on the other hand, is intended as a temporary regime - similar to a sandbox - to allow market participants as well as regulators to gain experience with the use of DLT. The work on the pilot regime represented a considerable effort for both European legislator as well as national and European supervisory authorities. Emphasis was placed on carefully weighing up the changes brought about by the pilot regime to minimize possible risks, while also further fostering (European) innovation. The pilot regime aims at creating a harmonized legal framework for market infrastructures using DLT. It addresses gaps and issues in the existing regulatory framework when applied to crypto-assets. In doing so, it will help both companies and regulators

to "learn" in a controlled environment and will enable market participants operating DLT market infrastructures to benefit from DLT by providing legal certainty through establishing uniform operating requirements.

DLT systems allow direct participation of end-investors. This could help to minimise costs and bring potential efficiency gains as all processes of a security's lifecycle may be provided via a single platform. However, the question remains about its impact on traditional CSD-centralised settlement and post-trade systems. One could argue that such end-investors, especially natural persons, have not previously been eligible as members of traditional trading venues and CSDs under MiFID II and CSDR. Consequently, the possibility for a DLT MTF to be exempted from the specific requirements for MTFs and to allow natural persons as members or participants of the DLT MTF, contrary to the existing rules, represents a significant paradigm shift, which must be balanced by appropriate safeguards.

Both MiCAR and the DLT pilot regime will provide a regulatory and supervisory framework that will help to create a level playing field allowing European businesses and investors to benefit from crypto-assets in a fair and transparent environment, thus contributing to making the EU a key player in the development of new financial services.

While several open issues and potential areas for improvement may exist in both legislative proposals, they nonetheless ensure a much needed high degree of investor protection and help to further strengthen the resilience and integrity of the European financial system.



JÉRÔME REBOULL

Head of the Regulatory Policy and International Affairs Directorate - Autorité des Marchés Financiers (AMF)

An EU framework to encourage the uptake of new technologies in financial services

With the development of automation, artificial intelligence, blockchains and the increasing use of the cloud computing, financial services are undergoing structural changes. Further, the global pandemic has dramatically accelerated the pace of digitalization in our daily lives. As regulators, we have to keep up with these changes, to stay in touch with the markets, so as to guarantee investor protection while fostering innovation to remain internationally competitive. In this respect, the AMF, through its legal analyses, specific regulation and position paper on financial innovation, has made a significant contribution to the European Digital Finance Package.

In particular, in a context of growing interest in the issuance of financial instruments on DLT, the AMF welcomed the proposal to set up a Pilot Regime Regulation (PRR) for market infrastructures based on DLT Infrastructures

wishing to trade and settle transactions in financial instruments in the form of a crypto-asset.

In France, the use of DLT in securities market is promising with the development of multiple projects providing investors with services to issue and manage digital-native financial products registered on the blockchain.

The potential gains to be expected from DLTs applied to market infrastructures can be significant as the adoption of DLT-based solutions could be driven by projected cost savings and efficiency gains throughout the value chain (e.g. reduction of intermediaries, or automation, resulting in faster, cheaper and frictionless transactions). This potential stems mainly from two features of the technology: (i) the ability to record information in a safe and immutable format; and (ii) the capability to make this information accessible in a transparent way to all market participants. Nevertheless, the use of DLT would entail similar challenges as those raised by conventional technology (e.g. fragmentation and interoperability issues) and would potentially create new ones (e.g. cyber risks).

This will promote competition, giving Europe the maximum chance in the race for technological progress.

Discussions on the PRR in the Council and Parliament have significantly improved the European Commission's proposal by

- (i) opening up the exemption regime to all types of players, including new entrants, without relaxing the constraints that will weigh on the projects. This will promote competition, giving Europe the maximum chance in the race for technological progress;
- (ii) by raising the thresholds proposed by the European Commission if necessary to ensure the financial equilibrium of projects likely to participate in the experimentation;
- (iii) by not prohibiting from the outset certain business models that would be based on public blockchain technologies.

PRR has been approved by the European Council last December 2021 and should enter into force by the end of 2022. It can be confidently assumed

that the discussions on MiCA and DORA regulations will move in the same direction quickly as the Council is also close to reaching agreement on both texts.

On the MiCA regulation specifically, a lot of attention has been paid (quite rightly) to the stablecoins in the Parliament's ECON Committee and in the Council. However, other crypto assets also present significant challenges and deserve attention. Though it seems now unlikely that direct pan-European supervision of activities by ESMA will be retained, consistency in supervisory practices will be an issue.

In addition, trilogies may be useful to define i) investor protection measures better suited to the crypto-asset environment; and (ii) to introduce transaction reporting requirements for exchanges that have reached a certain size.

The requirements contemplated for the financial industry with MiCA and PRR need to be coordinated with the broader framework of the Digital Services package in order to create a safer digital space for users and where a level playing field for businesses is established. Considering that there is still no common definition of financial instruments across the EU, the dividing line between crypto-assets and tokenized financial instruments should also be further clarified.

The AMF is confident regarding the outcome of the ongoing European negotiations and will continue to strive to strike a balance between investors protection and the promotion of innovation in Europe.



SARAH PRITCHARD

Executive Director,
Wholesale Markets -
Financial Conduct
Authority (FCA)

DLT applications in UK securities markets: turning challenges into opportunities

New financial technologies play an increasingly pivotal role in delivering innovative services and products to consumers. They can provide easier and better access to financial products, improve on those currently on offer and support the needs of markets. Distributed Ledger Technology (DLT) is an example of a rapidly developing technology that may offer such opportunities, but also some challenges.

The FCA has set out to be a more innovative, assertive and adaptive regulator. One that is outcomes focused and data led. We want to support innovation, but as a regulator, we need to be satisfied that innovation happens in a way which protects consumers and upholds market integrity, including minimising risks of financial crime.

Through our Innovate initiatives, including the (much replicated) regulatory sandbox, TechSprints and direct firm support, we have gathered unique hands-on experience of a wide

range of DLT-focused business models. Last year, we supported 43 firms with cryptoasset or DLT-based innovations in our sandbox, allowing them to safely test and experiment in the market with real consumers. The sandbox has been successful in providing firms with the assurance and clarity they need to apply for authorisation. We are now seeing more DLT-based businesses at our authorisation gateway.

Our regulated firms also use a variety of DLT systems to run their businesses. These systems show potential promise for improving financial services: more efficient and resilient processes, reduced costs and enhanced transparency, and accuracy and clarity regarding the ownership of digital assets.

DLT can offer a variety of cyber security benefits as encryption is in-built into every record on the network. The use of consensus mechanisms amongst participants means that DLT could enable firms to pinpoint the threat in case of an attack by malicious third-party actors, ensuring a faster response.

The technology has the potential to profoundly change the post-trading landscape and further enhance the integration and efficiency of capital markets. The UK Treasury proposes to create a new joint Bank of England/FCA Financial Market Infrastructure (FMI) sandbox regime, which we support. The FMI sandbox will support firms seeking to use DLT to provide FMI services such as securities issuance and settlement, allowing them to safely test their solutions against revised rules that account for the development of new technologies.

The technology has the potential to profoundly change the post-trading landscape.

As regulators also know, new technologies can present risks to consumers and market integrity.

DLT in financial services, especially at a large scale, may trigger operational risks that would in part, depend on the specific circumstances of each application. These risks might include, for instance, coding errors, stability risks with newly developed technology, interoperability risks, as well as scaling, latency, security and cyber risks.

From our perspective, such risks and potential system failures compromise

the orderly functioning of markets and deprive consumers of access to financial services. We have a variety of requirements to remedy this and ensure that regulated firms' IT and cyber arrangements are vigorous and proportionate to the nature, scale and complexity of their business.

Another example relates to data protection. With the use of new technologies, firms will need to manage risks around their data effectively and be clear with their clients about how their data is being used. At the FCA, we have also been investing in our analytics and data science capabilities. This will ensure that we can use data and technology to identify, predict and prioritise risks across all sectors.

Ultimately, specific technology risks will in part depend on the actual application of DLT. We expect firms to ensure they are able to plan, test and demonstrate robust decision making when implementing new solutions. DLT networks should establish mechanisms to ensure that appropriate levels of encryption are maintained, and that careful consideration is given to availability, private key storage security, integrity, and other risks of harm to consumers and the market.

While we see that DLT has the potential to reduce financial crime risks by enabling more effective transaction monitoring and data sharing, we expect that relevant controls are in place to counter financial crime risks including fraud and market abuse through hidden identities.

Finally, the importance of working collaboratively should not be underestimated. Enabling innovation by directly supporting firms is an important aspect of what we do. However, we also need to ensure our requirements support a thriving and healthy ecosystem, and this doesn't happen in isolation.

Many of the new innovation challenges we face are global in nature. DLT solutions are being developed simultaneously in various financial markets, and it is therefore crucial that we work together closely and share expertise with our international counterparts.



JENNIFER PEVE

Managing Director,
Head of Strategy and
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The Depository Trust & Clearing
Corporation (DTCC)

Golden rules for successful DLT implementation in the post trade space

Since distributed ledger technology (DLT) was first hailed as a cure-all to solve operational challenges in financial services about five years ago, expectations have tempered as firms have come to realize that its true value is more discrete. That's not to suggest enthusiasm in DLT has diminished, because the technology still holds great potential to reimagine and transform how markets operate. At DTCC, we are leveraging DLT across a number of innovative projects to improve how the market functions, and we remain excited by the opportunities to lead meaningful technology advancement for the industry.

As we consider ways to further improve post-trade processing using DLT, we are guided by two foundational principles which help inform our strategy and guide our decision-making.

First, we believe that initiatives which feature the use of new or evolving technologies must take into

consideration that market participants have different levels of digital sophistication and capabilities. For market infrastructures, this is an even more important consideration because we need to ensure that our solutions are accessible to all industry participants and provide, at a minimum, the same level of risk mitigation as legacy products and services.

Second, we scrutinize the problem we're trying to solve and take a rigorous approach to defining the goal of the implementation. While technology is an enabler of our strategy, it's not always essential to delivering greater value to our clients. The reality is that new and emerging technologies may not be ideal in certain post-trade applications due to the complexity of financial markets and the level of risk that an implementation could pose to existing processes and systems. Therefore, we believe optimal implementations should be focused on:

- Whitespace or greenfield opportunities where innovative solutions could be implemented to drive growth, mitigate risk, reduce costs or enhance efficiencies for clients and the wider industry
- Initiatives that could be enhanced by bolting-on products and capabilities enabled through DLT to existing services using legacy technology. This approach delivers new capabilities while preserving all the benefits of the current, proven system.

Market infrastructure use cases where DLT delivers added post-trade benefits.

Our recently announced Digital Securities Management (DSM) platform is an example of greenfield innovation because it solves a lack of centralized infrastructure and automation in private markets. DSM will streamline the issuance, transfer and servicing of private market securities using cloud-based architecture to enable the book entry record-keeping of securities leveraging DLT. It will also support the digital asset ecosystem by providing the option to create tokenized representations of a security. The platform will be delivered via central and distributed infrastructure, enabling clients to access the service in the way that suits them best, depending on their level of technological capability.

Building upon this, to ensure that new technology projects are accessible

to all clients irrespective of their digital sophistication, we increasingly leverage APIs to support efficient connectivity, while also allowing the consumption and processing of data for clients that are not as far along the technology curve as others. Our Project Ion initiative, which is an alternative settlement platform for US equities that leverages DLT to support T+2, T+1, T+0 and extended settlement, will enable clients to benefit from a new DLT solution that delivers value-added functionality leveraging APIs. At the same time, the service relies on existing core infrastructure and platforms while bolting on value offered by DLT. The first phase of the Project Ion platform will support bilateral deliver order transactions that will be initiated by pilot participants through client nodes hosted by DTCC. Once launched, the transactions will be processed through the Project Ion functionality and then passed to DTC's existing systems for settlement processing.

New technologies like DLT can deliver tangible post-trade benefits when applied to specific use cases that meet strict criteria. Market infrastructures can play a critical role in identifying these opportunities, and through industry-wide collaboration, can lead innovation that brings increased efficiency and risk management capabilities to financial markets.

By applying our foundational principles to every project and technology assessment, we are able to ensure our strategy and approach ultimately aligns with client needs and propels the industry forward.



ISABELLE DELORME

Deputy Chief Executive Officer,
Belgium, France & Nederland -
Euroclear S.A.

DLT will bring the EU post-trade market to the next level. But not magically

As a financial market infrastructure, Euroclear has always been supportive of the development of new technologies that could make the financial markets safer and more efficient. Like many market players, we believe DLT can bring substantial benefits to the securities markets. Throughout 2021, several CSDs have been actively experimenting with this technology.

- Euroclear successfully led a consortium of banks under the auspices of the Banque de France to test the issuance and settlement of French OATs on a DLT platform using CBDCs.
- Clearstream tested together with the Bundesbank a settlement interface for digital securities (the 'trigger' solution) and announced the launch of their D7 platform.
- SIX went a step further and launched its own DLT settlement platform (Six Digital Exchange - SDX).

If some considered that European CSDs were reluctant to change and

were not interested in taking part in this DLT evolution, 2021 started to prove them wrong.

Our experiment with Banque de France confirmed that this technology is suitable for post-trade market operations, something we all expected. But it also demonstrated that the value of blockchain technology does not lie in replicating 'as is' the management of securities settlement operations. The full benefits of DLT will be harnessed through a market reorganisation and increased direct participation. Having the custodians and the underlying clients together on one single blockchain platform will allow custodians to reduce (or even remove) reconciliation workload. It will also increase transparency, facilitate the identification of end investors and ease the registry management for issuers.

Another benefit of simplifying the intermediation process and removing the need for reconciliation between systems is that DLT will help in reducing the trading settlement cycle to T+1 or even T+0. The current T+2 settlement cycle is indeed driven by those traditional market challenges rather than by technological constraints coming from the legacy market infrastructures. CSDs could indeed switch to near instantaneous settlement with their current technology.

Trusted Third Parties could create trust in the market and ensure investor protection.

Furthermore, CBDC and security tokens can be easily transferred across different blockchain platforms because of their atomicity and simplicity, which makes them ideal for cross-border purposes (fungible across platforms and lower cross-border reconciliation processes).

In the Banque de France experiment, a permissioned blockchain was used as we concluded only this model would allow participants to benefit from all the blockchain features without losing the benefits provided by market operators (CSDs and Central Banks), which would continue to run the required controls. As highlighted by the High Level Forum on the Capital Market Union (CMU), in the context of crypto/digital assets, Trusted Third Parties could create trust in the market and ensure investor protection in, where appropriate, controlling access/

admission, setting rules for participating nodes, addressing potential conflicts of interest, controlling compliance with "know your client"/anti-money laundering requirements, and applying risk management measures.

With the DLT Pilot Regime, European authorities confirmed their intention to position the EU as a key player in the development of DLT for the EU capital market. While this initiative may lead to some necessary learnings, it will not be sufficient to make the adoption of DLT a success. DLT, like any technology, will not solve the existing barriers to further integration of capital markets and post-trade services (often referred to as the "EPTF barriers"), for which the CMU Action Plan foresees specific actions. Regulatory authorities should also not forget that if the market reorganisation triggered by DLT is done without the end-purpose of benefiting the EU capital market as a whole, it could end-up reversing many progresses made over the last few decades in terms of market fragmentation, competitive dynamics and financial stability risks. DLT is not a magical solution to all the inefficiencies and harmonisation challenges in the area of securities post-trading.

We are well aware that there are still many challenges that need to be overcome before we can envisage the implementation of such blockchain platforms in a 'production' environment. One of these challenges will be the development of a safe settlement asset such as a wholesale CBDC, which will be essential for a secure and efficient EU digital securities market. Despite these difficulties, the trend is positive, and analysis continues across the market to come up with solutions.

We are proud that our Banque de France CBDC experiment has contributed to the journey that will eventually bring blockchain to the capital markets.



DANIEL KAPFFER

Chief Financial Officer &
Chief Operating Officer -
DekaBank Deutsche
Girozentrale

DLT will be a reinvention of the securities markets - Ready for revolution?

The relevance of DLT to securities markets has changed significantly in a short period of time. While securities were exclusively tangible objects in many jurisdictions until recently, digital securities in particular will make the post-trade chain look completely different.

However, the potential of technological innovation goes far beyond simply digitizing the status quo:

DLT offers proof of stake, is near time and less vulnerable to fraud through the representation of the transaction in multiple ledgers. It has thus evolved from a fascinating new technology without application to one of the most important digital technologies in the securities markets. Via DLT investors gain access to new asset classes and are able to invest in existing asset classes in smaller lot sizes, for example real estate. In addition, investors will be able to look at their holdings in near time.

Also, the settlement of securities will be much easier, as there will be no need to go through a CSDR with its associated costs. A key benefit of recording all securities in a decentralized ledger is that it opens up a wide range of possibilities for both trading and post-trade activities, especially the possibility of merging trading and post-trade activities. Real-time (or near real-time) settlement would reduce settlement fails, eliminate the need to reconcile information across different systems and, ultimately reduce the number of transfer orders requiring SFD protection, not to mention cost savings and efficiencies.

Finally, DLT will be a key enabler for the European Capital Markets Union as it will significantly simplify cross border transactions. In this sense it will also be important for Europe's position in the global capital markets.

DLT is the tipping point in the financial market – action is needed: Let's make a bold move!

To promote DLT, four criteria should be considered:

First and foremost, member states need to modernize their national definitions of securities - this could be one area where the EU could still have a positive impact on standardization. A common tech-neutral taxonomy would also improve clarity in terms of the regulatory framework.

DLT is the tipping point in the financial market – action is needed: Let's make a bold move!

As a consequence, digital securities must have the same level of investor protection as traditional securities in order to increase confidence. In this context, it is very welcome that MiFID already defines digital securities as financial instruments. However, the custody of digital assets is still subject to national law. This leads to a certain reluctance in the market to hold a significant portion of assets with small technology providers or providers in regions of the world that feel at least inadequately regulated as a result. Confidence is an essential prerequisite for the further expansion of digital assets.

Second, client identification needs to be improved. This point is somewhat

covered by the application of MiFID. Nevertheless, there is still a part missing which relates to KYC/AML; for example in Germany this is covered by the application of the regulation on information for transfers of funds to crypto assets.

And third, solutions for digital payment must be accelerated. In the short-term we need trigger solutions to central bank money and in parallel efforts for a digital euro including wholesale CBDC need to be accelerated. Otherwise, there is a risk that the settlement process will be near time for the security leg but will have to be delayed because of the cash leg to ensure delivery versus payment.

Last but not least, the scope needs to be broader than just digitizing the certificate and leaving the rest of the process as it is. We need to enable truly decentralized securities that lead to the full benefits described above. Therefore, we very much appreciate the pilot regime based on DLT. Negotiators have sought to strike a balance between innovation and preserving financial stability. Now we should have a discussion from the outset that the project must become permanent.

Furthermore, the DLT infrastructure should be expanded into a European DLT through the introduction of CBDC. Leaving the infrastructure up to many decentralized activities will not lead to a pan European harmonized capital markets infrastructure.

In short, it's clear that digital securities are on the rise! Their application at the heart of capital markets is the real game changer - not some coins where the drivers of substance are unclear.

In Europe, we must seize the opportunity to enable a Capital Markets Union and strengthen Europe's position in global capital markets. We need to prepare now. Policymakers have taken important steps, but some pieces are still missing or are only addressed at the national level. We should also be bolder in allowing decentralized and crypto securities.

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**ROBERT
OPHÈLE**

Chair - Autorité des Marchés
Financiers (AMF)

DeFi: opportunities and challenges from a regulatory perspective

Decentralized finance (DeFi) is one of the most significant emerging technological evolutions in global finance. DeFi platforms use blockchain technology and crypto assets, possibly stable coins, to create a decentralized, digital and open source alternative to traditional financial services; a kind of financial metaverse with very tangible implications. The various activities in DeFi reproduce traditional banking and financial activities including lending, exchanges, asset management or derivatives and, in some cases, offer new and innovative services. As any new technology, DeFi brings about its share of opportunities and challenges.

The DeFi ecosystem has rapidly grown in recent years with total value locked in these applications increasing from \$500 million in 2019 to \$100 billion today. Compared to traditional finance, it is still small but volumes are growing quickly, partly driven by the steep rise

in the capitalization of crypto-assets, which has reached around \$ 2 trillion.

At this juncture, Decentralized finance is not (yet?) ready to overtake traditional finance. First, the DeFi ecosystem is geared predominantly towards speculation, investing and arbitrage in crypto assets, rather than real economy use cases. Secondly, it suffers from certain limitations that stifle user experience as tools allowing for interaction with DeFi services are not easily accessible to the general public. For example, management of private keys to access crypto assets wallets, in particular, is today a major barrier to the adoption of these crypto-asset services and a brake on the widespread adoption of crypto-assets in the real economy. Lastly, several frauds or irregularities have been highlighted in recent years and there is a general concern that individual and institutional investors cannot yet entirely insure against the technical and management risks underlying these protocols.

The risks that it involves should trigger a closer regulatory look.

The growth of this ecosystem and the risks that it involves should trigger a closer regulatory look at the decentralized and nebulous nature of the DeFi architectures. Based on the principle that activities displaying functionally the same risks should be subject to the same rules, an appropriate regulation of this ecosystem is inevitable if one wants to provide security and confidence in these protocols and to avoid an unhealthy competition to traditional finance. This may be achieved either by applying existing rules to DeFi platforms or by establishing an ad hoc set of rules. In any case, the current self-regulation is not sustainable if the DeFi phenomenon continues to grow.

Part of the DeFi could be regulated through the stable coins on which its protocols rely. However, the most widely used stablecoins, including Tether and USDC, do not really qualify as DeFi services since the reserve assets backing these stablecoins

are held by a centralized provider. Instead, DeFi operates algorithmic or crypto-collateralized stablecoins, which are not kept stable through the maintenance of fiat currencies reserves by a legal person.

Through the forthcoming Regulation on Markets in Crypto Assets (MiCA), the EU will establish a framework for stablecoins as well as a harmonised regime to enable the EU-wide cross-border supply of services by Virtual Asset Service Providers (VASP). At this stage, the draft regulation focuses on so-called “centralized” crypto-assets activities only and does not include any regulatory treatment of DeFi services. DeFi seems therefore to be a topic left in store for the review clause of MiCA 18 months after its entry into force.

In the meantime, it does not mean that DeFi is completely out of reach of any kind of supervision. Interestingly, the Financial Action Task Force (FATF) guidelines published in October 2021, while leaving wide discretion to national authorities, suggests an approach to decentralized finance protocols. While acknowledging that DeFi protocols (i.e the decentralized applications themselves) are not VASPs, the FATF suggests that where a legal person has sufficient influence on the operation of the protocol and the provision of services offered by it, then such person may be considered a VASP.

In any case, the challenge ahead is to start considering what appropriate framework could be devised to regulate DeFi in order to protect it from abuse, enhance trust and transparency and support its potential for transformation and technological innovation. In particular, authorities will need to outline a proper interpretation of the concept of “sufficient influence”, exploring in more details the situations in which a person could be considered to exercise such influence on the operation or governance of a DeFi protocol.



IOTA NASSR

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DeFi: Why it matters to policy makers and recent developments

DeFi is the latest development in the crypto-asset space, and claims to replicate traditional finance in an open, decentralised, permissionless and autonomous way. Not all distributed ledger technology (DLT)-based financial applications are DeFi, and not all self-proclaimed DeFi projects are truly decentralised. Composability, non-custodial nature and community-driven governance are some of its key defining characteristics.

Evolution of the DeFi market

The DeFi market started making headlines in the summer of 2020 and has experienced spectacular growth: The total value of crypto-assets locked in DeFi applications built on Ethereum peaked in November 2021, exceeding USD 110 bn – a more than 50-fold increase in a year, albeit from a low base. This does not account for an increasing number of applications built

on alternative blockchains. Important feedback loops exist between DeFi and the wider crypto market, and the high volatility of mainstream crypto (Bitcoin, Ether) intensifies DeFi's fragility.

DeFi risks calling for policy consideration and action

DeFi has been attracting an increasing number of retail and institutional investors in an environment that lacks any of the traditional safeguards for investor protection and market integrity, existing across the board of financial services regulation, giving rise to risks that call for policy consideration and action.

Such risks are associated with excess volatility, unregulated leverage and other forms of regulatory arbitrage, governance-related weaknesses, risk of market manipulation and new forms of concentration risks. The risk of illicit finance or outright fraud is high given the pseudonymous nature of participation.

DeFi is giving rise to risks that call for policy consideration and potential action.

Institutionalisation of crypto-assets and increasing interconnectedness between DeFi and traditional finance

Investors joined the DeFi market for fear of missing out, driven by speculation and in search for yield in an –until recently- ultra-low rate environment. Traditional financial service providers are getting into crypto and have even piloted the refinancing of tokenised assets in DeFi.

Increasing institutional investor adoption of digital assets and the mainstreaming of crypto are making the boundaries between DeFi and traditional finance more porous. The recent sell-off and previous crypto market downturns have induced automatic liquidations of collateral pledged in DeFi through their margin call mechanism. Such liquidations, together with crypto-asset futures liquidations, could have a domino effect on investor holdings. Investors exposed to losses in DeFi may also have to close positions in traditional markets, propagating the shock.

The central role of stablecoins

The use of major stablecoins as collateral or as the bridge between DeFi

and traditional finance constitute one of the greatest points of vulnerability of the DeFi market and a potential channel of risk transmission to the traditional financial markets.

The market cap of stablecoins issued by the largest issuers exceeded USD 150bn at the end of 2021 (c. 500% increase over the last year) and is largely dominated by two issuers.

In a scenario where a major stablecoin 'breaks the buck' due to solvency issues related to the reserves backing the stablecoin or its under-collateralisation, decentralised exchanges would go under severe stress and liquidity pools would be forced to mass liquidations.

Such risks are exacerbated due to limited trustworthiness associated with the auditability and reporting around their reserves, as well as with the composition of such reserves and stability of the custodian of such reserves.

The role of policy makers

Supervisory authorities and international standard-setters have a role in assessing risks involved in DeFi, exploring ways to enforce existing rules in decentralised structures, and addressing any regulatory gaps. DeFi's decentralised nature requires policy makers to reconsider the conventional oversight framework that was built with intermediaries at its core, given the absence of single regulatory and supervisory access points and the absence of defined jurisdiction and geographical location for their operations.

Nevertheless, the level of innovation involved in DeFi is remarkable. DeFi impels us to consider what value decentralisation or the use of DLTs can bring to investors, consumers, traditional financial market infrastructure and the existing processes of delivering financial products and services.

The OECD and its Committee on Financial Markets remain committed to exploring how to foster the benefits of digitalisation for financial markets and their participants, while proactively addressing the prudential and potentially systemic risks emerging from applications such as DeFi at a global level.

For more on DeFi see
<https://www.oecd.org/finance/why-decentralised-finance-defi-matters-and-the-policy-implications.htm>



JOS DIJSSELHOF

Chief Executive Officer -
SIX Group Services AG

DeFi at a crossroads - Between business opportunity and institutional readiness

The market for decentralized finance [DeFi] is very dynamic and increasingly gaining traction. DeFi is used as an umbrella term for a variety of financial applications in crypto aimed at automating business processes without relying on a central party through the use of smart contracts running on decentralized networks. Today, two types of DeFi applications have gained popularity:

- Decentralized exchanges [DEXs]
- Lending platforms

DeFi – A Perspective

In January 2021, the combined volume of DEXs, such as Uniswap, Sushiswap, ox, Curve, Serum, and Balancer, surpassed USD 150bn, compared to a combined monthly DEX volume of approximately just USD 5bn in July 2020 – an astounding increase of over 3,000%. Although the combined volume of centralized exchanges [CEXs] – e.g., Coinbase, Gemini, and Kraken, to name a few – was considerably higher at USD 1.04tn in December 2021, DEX volume is catching up with a current volume ratio of 11.7%, up from 4.6% in July 2020.

On the back of these developments, SIX has been closely following the evolution of the DeFi space and has started executing Proof of Concepts [PoCs] and pilot projects. One example of an initial PoC was the successful implementation of an Automated Market Maker on Corda. At the same time, we are exploring with our partners and clients ways to develop cryptocurrency market offerings leveraging DeFi functionality and insights.

Challenges

However, DeFi is still undergoing the pains of rapid expansion and growth, in part stemming from the fact that it is built on cryptocurrencies that exhibit extreme price volatility. We believe that decentralization without accountability is a major impediment for wide-scale institutional adoption of DeFi and Decentralized Autonomous Organizations.

While DeFi is creating notable economic opportunities for borrowers and lenders in the financial ecosystem, further investigation into key aspects is required to achieve broader adoption in the institutional space. Some of the most significant bottlenecks include regulatory uncertainty, lack of verifiable identities, compliance, transparency, the steep learning curve, and smart contract risks.

At present, many DeFi protocols exist in a regulatory gray area as they facilitate the exchange of potentially unregistered securities and movement of funds between anonymous parties.

**Instead of just “Faster,
Better, Cheaper” DeFi will
develop entirely novel
ways of doing business.**

Market participants need to perform their own due diligence and risk analysis to determine which protocols do not violate securities or money transmission laws until such time that regulation catches up with DeFi development. Furthermore, DeFi protocols possess an additional risk that the underlying smart contracts may not perform as intended during times of stress or could be poorly controlled (e.g., developers with administrator rights making unauthorized or harmful changes to the underlying smart contract).

Securities Regulation is about to make its imprint on crypto and DeFi. As such,

one could make the assumption – and build infrastructure and propositions accordingly – that global standard will develop and that regulatory [jurisdictional] arbitrage will diminish over time. Building blocks for a comprehensive regulatory environment are among others: Know Your Client [KYC], Anti Money Laundering [AML], Know Your Token [KYT] and Transaction Monitoring across the entire customer journey, including on/off ramp into CRYPTOLand.

Over time, most coins and tokens will be considered and regulated as securities or a new form of regulated asset.

Another challenge to tackle is the design of some Automated Market Makers [AMM] which can limit institutional adoption. For example, certain AMMs are subject to impermanent loss that can put liquidity providers' capital at risk.

Outlook/ Perspective

First Institutional initiatives addressing some of the challenges mentioned above are entering the market, e.g., DeFi protocols experimenting with permissioned pools. As an example, Aave Arc is using Fireblocks for whitelisting while decentralized governance continues to control protocol decisions. Participants in these pools will need to be legally identifiable and accountable, which helps to manage and mitigate risks.

SIX will continue to monitor the DeFi space. True business model innovation goes beyond simply replicating the same underlying business on a new technology platform. Instead of “Faster, Better, Cheaper” we will develop entirely novel ways of doing business. For example, integrated trading and clearing models provide both centralized and decentralized exchange models with an opportunity to create more capital-efficient derivative trading models that offer a more cost-effective way to obtain cryptocurrency exposure.



DELPHINE D'AMARZIT

Chief Executive Officer -
Euronext

Decentralised finance: finding the balance

Decentralised finance (DeFi) proposes a fully disintermediated approach based on Distributed Ledger Technologies (DLT). It aims to replicate core financial market functions such as insurance, asset management, lending and borrowing, price formation and transaction processing, and perform them peer-to-peer, removing the intermediary that traditional finance relies upon. This disruptive model is gaining both users and value: today, more than \$100 billion is locked in DeFi applications, 400% up on last year, although this represents just 0.1% of the money deposited in banks globally.

With its promises of borderless access, transparency, auditability and programmability, the concept of DeFi is leading established institutions to question the way they operate. But it's not without its challenges.

The ambition to replace oversight with a decentralised technology, while attractive, is open to technological shortcomings that can impact performance and security. Take latency: Solana, the fastest blockchain to date, executes transactions in a bit less than one second. This is a long way from the 15 microseconds it takes on average to execute an order on Euronext. Likewise,

the argument that DeFi transaction costs are more advantageous for the user, precisely because of this absence of intermediary actors, is a moot point.

We expect technological improvements in this sector but the paradigm remains challenging. Financial instruments are critical assets that channel savings into economic growth. Can markets for these assets be operated solely by relying on technology, with no party accountable for potential shortcomings? This notion of oversight is the most challenging aspect of DeFi. To ensure market integrity, financial markets rely on investor protection measures, the strict definition of ownership rights, systemic risk prevention and overall safeguards. They depend on strict enforcement mechanisms, relying extensively on regulators and regulated parties that can be held responsible. Should we replicate effective oversight in DeFi, or rely exclusively on the discretion of non-regulated parties in running and operating in a parallel financial system? There is a dilemma between embracing innovation and defending the existing oversight model, which has demonstrated its ability to feed investments towards the real economy and let new entrants in.

**There is a dilemma
between embracing
innovation and
defending the existing
oversight model.**

The EU's DLT pilot regime and proposed Markets in Crypto-Assets (MiCA) regulation exemplify the intrinsic difficulty of a middle-ground approach. By permitting the use of DLT in financial services and providing a regulatory home for crypto-assets, they are testament to Europe's openness to innovation and desire to build a strong local industry. However, both texts introduce material changes to the framework currently applicable to the provision of services in financial instruments, removing key MiFID's standards, such as best execution, market integrity safeguards, or the strict distinction between order matching and transaction execution functions. Under the DLT pilot regime, supervisors will have to ensure exemptions are not at the detriment of the principles of investor protection, market integrity and transparency. MiCA will have to respect similar principles and ensure there is no

potential arbitrage with existing regulations. The boundaries between the qualifications of crypto-assets and financial instruments can often be blurred and have to be made clear. In recent months, the existing ambiguity has been illustrated by the varying regulatory responses given to proposals by pure crypto exchanges to offer exposure to stocks, without financial instrument services provision licences.

DeFi challenges existing functions such as borrowing, lending, exchange of assets, and forces traditional intermediaries and market infrastructures to reassess their core value proposition. At Euronext, we are actively monitoring the sector's evolution and opportunities. We have invested in a post-trade Blockchain provider, LiquidShare, and in the tokenisation sector via Tokeny Solutions. We are assessing the value of leveraging DeFi to enhance liquidity and operational efficiencies in some specific segments of our markets. Since June 2021, we have enabled indirect exposure to crypto assets with the same security and resiliency standards as for other instruments, via now more than 30 carefully whitelisted Exchange Traded Products. We also recently took part in a successful experiment to validate the payment of a stock transaction against a Central Bank Digital Currency issued and managed by Banque de France.

Our position is thus both active and exploratory, at a time when the regulatory framework for DeFi remains to be structured and the value proposition confirmed. DeFi is a fascinating space and while we recognise the need to embrace innovation, we feel that its appeal does not exempt it from the same level of expectations in terms of investor protection, systemic risk prevention and fair and orderly markets.



SWEN WERNER

Managing Director,
State Street Digital -
State Street Bank and Trust

A new asset class: asset servicing of Decentralized Finance (DeFi)

In the recent past, we have seen an increased emergence of asset managers launching digital asset investment products, so far focusing on crypto currencies and derivative products, such as Bitcoin futures. Some of these instruments are traded on-exchange. However, due to regulatory investment restrictions, UCITS (Undertakings for the Collective Investment in Transferable Securities) funds are currently prohibited from investing in crypto currencies. As a result, the available products tend to be either marketed to professional investors or are structured such that they do not qualify as a collective investment.

The market is developing rapidly since the first EU crypto investment product started trading in 2015. Whilst the investment approach used to be focused on single currency investments, asset managers are increasingly offering basket funds tracking multiple crypto currencies or deploying long-short strategies involving derivatives. It is no surprise that alternative fund managers are also exploring Decentralised Finance (DeFi), which involves the lending or 'staking' of digital assets, in order to earn interest-like returns.

Stablecoins, which would be regulated under the proposed Markets in Crypto-Assets Regulation (MiCA), will emerge as a critical component of this ecosystem.

Yet there are many other areas that DeFi applications are used for, e.g. trading, market-making or derivatives. What is common to all these activities is that smart contracts are used to enforce financial obligations between counterparties. Changes to the smart contracts are governed proportionately in decentralised processes, e.g., voting rights that are equivalent to investments held. This structure and the lack of a clear regulatory framework applicable to DeFi constrains the involvement of regulated financial institutions.

What are the DeFi-related opportunities in the securities markets?

Blockchain technology has the potential to be the most significant industry disrupter since the internet. Crypto currencies are an important use case of the digital assets universe. Tokenization, the process by which financial instruments are issued and settled in a blockchain system, could lead a transition towards more peer-to-peer markets that are characteristic for blockchain driven solutions.

DeFi will create a need for custodian banks to contemplate how they can safeguard the assets.

DeFi would be the next logical evolution for markets leveraging tokenized securities. The dynamics of such a model could be appealing: interest could be paid intraday for example and automation through smart contracts presents significant efficiency potential for asset managers. It would allow the automated exchange of collateral, lending and other financial securities transactions without the need for traditional centralised market infrastructures. The original code design and management needs to begin with a responsible party, although the ongoing maintenance could be managed more collectively. This would allow regulators to identify a responsible party that could be subject to some form of supervision.

What are the challenges?

DeFi investment requires participants to allocate their crypto assets to a pool of assets from which counterparties

can borrow through decentralized exchange mechanisms. This requires the ability to move and segregate crypto assets while they are on loan. DeFi will create a need for custodian banks to contemplate how they can safeguard the assets through wallet solutions and support clients in accessing such protocols.

Crypto currency networks are typically anonymous and permissionless thus presenting unique challenges for regulated financial institutions with respect to anti-money laundering (AML) obligations. Work is underway by various blockchain providers to create networks that provide better control about the actors allowed to participate in these transactions.

What are the regulatory implications?

Although the 2020 EU Digital Finance Strategy does not mention DeFi (and neither does MiCA), a number of areas that are needed to enable tokenized securities in the EU under the digital finance strategy will be equally relevant in assessing the impact from DeFi. This includes progress in digital identity solutions to support meeting AML obligations, progress in digital payments solutions such as Central Bank Digital Currency (CBDC) or wholesale cash tokens, and clarity on how asset management needs to evolve e.g. how to manage investment limits and related risks stemming from DeFi smart contracts. Regulators have an opportunity to support the market developing a trusted DeFi offering of the future, which would in turn allow regulated financial institutions to participate.

DeFi is currently a crypto-centric activity but there is no reason why tokenized financial instruments could not be used in such structures in futures. Investor protection will be advanced if there would be a legal framework applying to both the DeFi protocol and its participants in future.

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OPEN FINANCE: POLICY NEEDS



DENIS BEAU

First Deputy Governor -
Banque de France

Open Finance: moving beyond payments to embrace the current digital transformation [of financial services]

The pandemic fostered the adoption of new digital habits and spurred a dramatic movement toward online financial services. With so much more of their lives spent online, Open Finance holds many promises for consumers and SMEs, notably by helping them manage their finances more effectively and benefit from improved products and services. At the same time, users of financial services must be protected against new risks stemming from increased reliance on digital finance.

The European Union pioneered Open Banking with the second Payment Services Directive (PSD2), which triggered the development of open banking services in the EU by giving a legal status to account information

service (AIS) and payment initiation service (PIS) providers, and established the free access to payments data held by banks.

However, while the PSD2 gives European citizens more control over the data they choose to share with third parties than they ever did before, the path to Open Banking –and more broadly to Open Finance– has not been fully achieved and many use cases are yet to mature.

A key priority should be to support the creation of a European financial data space, including enhanced access to data and data sharing. These are prerequisites that will encourage the creation of innovative products for consumers and businesses, while supporting broader policy objectives, such as the creation of a single market for data. It will also contribute to facilitating access to data needed to channel funding in support of sustainable investments, notably for the Capital Markets Union.

Europe should seize the opportunities of the data-driven revolution to move forward as a global digital player.

It is therefore both appropriate and welcome that this priority stands at the heart of the EU digital finance strategy. Nonetheless, as supervisors, our number one priority remains to ensure that data openness develops within and across sectors in compliance with data protection, AML and competition rules, data ethics and consumer protection measures. For consumers, having a clear understanding of where and when their data is used, with whom it has been shared, and the ability to withdraw their consent when they wish to do so is absolutely paramount. Moreover, while Open Finance promises new opportunities and more modern payments, increased data sharing also makes the risk of soaring scams, cyber attacks and fraud very real. Hence, putting appropriate safeguards and regulations in place, as well as having a clear understanding of what happens when data is misused, is a crucial point for us.

Yet it is up to the industry to reap the full benefits of this on-going data revolution.

Though necessary to guarantee security, a level-playing field and an orderly implementation, open data regulation is only a means to an end, as Open Finance will only bear fruits if the whole industry embraces it. Fortunately, there is a strong awareness in Europe of the strategic nature of data in today's economy. Indeed, APIs hold great potential to improve customer experience and streamline back-office operations way beyond payments, in areas such as mortgages, securities, or pensions. Combined with e-ID, or push payments prompted by Request-to-Pay services for instance, Open Finance may unlock unexpected consumer benefits while balancing the potential risks.

As of now, I note with satisfaction a progressive paradigm shift from a passive regulatory approach to a more proactive and market-driven outlook: specifically on payments, the development of new frameworks building on – but moving beyond – PSD2 will contribute to creating a fully integrated market, for instance through the SEPA Payment Account Access scheme which intends to incentivise all stakeholders to cater for new market needs and maturing services. With such examples in mind, and seeing our vibrant fintech ecosystem, I am confident that the coming years will open exciting opportunities for European economic actors and renew central bankers' challenges.

European authorities have to support this digital transformation of finance in the coming years, while regulating its risks. Embracing the ongoing data-driven revolution proactively is key to move Europe forward as a global digital player.



**ONDŘEJ
KOVÁŘIK**

MEP, Committee on Economic
and Monetary Affairs -
European Parliament

We must embrace the innovation wave to help Europe's financial sector grow

As we look at the landscape for payments, open finance and banking, it is clear that the traditional models will have to adapt, and there are already some new players in the financial services field doing just that. Don't mistake me, I still see a role for traditional banking and finance, as there will be many of our citizens who will not be comfortable with online banking or interacting with an automated voice rather than a person when they wish to place a stock order with their chosen financial service.

I see some realistic scenarios playing out in the coming years, and some ambitious scenarios, which may work and unlock huge potential in financing in Europe. Equally, they may not, and we need to be ready to deal with those scenarios that fail.

In a realistic scenario, there will be always the need for high street banks, high speed trading floors and traditional local services such as mortgages, car loans etc. These would in my view

fall more towards the traditional and currently existing financial services models. The risk with these types of traditional models is that they are crowded out by the more trendy and appealing banking services, which offer products beyond those even considered by traditional retail banks.

These more ambitious financial service providers, those companies which like to take risks with their financial services models, not simply by creating online digital banks in Europe, but also by scaling their services up from simply banking to include investment, savings and portfolios (including crypto assets). They could also entice clients through advantages such as discounts at certain retail stores, lounge access at airports, online shopping discount and more. The ambition of innovative financial services knows no bounds and the sky is the limit.

The question is, what happens if the sky comes falling down, or regulators come calling down to highlight some questionable practices or a simply unforeseen event brings all the ambition crashing to the ground. This may or may not happen, but with the risks that these companies are taking, and the plethora of new financial services regulation targeting specifically digital banking models, these seem like scenarios which could well be plausible in the coming years, and indeed scenarios that we as legislators have to address to the best of our ability.

**A personal digital ID
in financial services
would encourage
more cross-border
bank accounts.**

DFS have a large range of use cases, from e-money accounts and crypto wallets, to digital financial identification. I could go on, but let me take a moment to focus on what I see as important for cross-border investment and banking in Europe. That is a digital ID in the financial services field. A personal digital ID in financial services would encourage more cross-border bank accounts, both traditional and innovative. Financial service institutions would have access to information from clients from across the EU at the touch of a button, or in this case the reading of a card. The digital ID card will contain the essential financial information needed in order for consumers to set up a bank account in any country in the EU.

I believe that existing financial institutions need to begin to adopt a more innovative approach to finance. We are seeing examples of some traditional banks taking on new initiatives, using new technology such as DLT in order to speed up transactions while making them more secure. Customers throughout Europe, especially on a local level trust their own bank. As long as these banks are able to modernize their services through banking apps, exchange services and also investment services which would cut costs for clients, I believe that they still have a strong role to play and can attract new customers as well as more traditional customers.

We also need to be cautious when it comes to regulating the innovator, We are currently dealing with legislation which sets the framework for how to manage the entry of crypto and big tech companies into the world of financial services. These pieces of legislation are the 'Markets in Crypto-Assets Regulation (MiCA)' and the 'Digital Markets Act' (DMA). These regulations look at how best to integrate financial models into technological models and vice versa. When it comes to MiCA, we've been examining how to deal with big tech companies opening wallets for their customers to use to acquire goods or services. We've been working on ensuring that the tech and crypto companies are sufficiently supervised, while consumers adequately protected.

For the DMA, we have been considering how financial services companies can be adequately supervised when they are processing transactions of billions of Euros per day across not just Europe, but the whole world. What these two regulations have in common are that they will have a global reach, and we will need to work closely with partners from across the world to ensure that the markets are well regulated, consumers are well protected and the legislation is a success. This applies to all open finance and payments markets as a whole.



JOSÉ MANUEL CAMPA

Chairperson - European
Banking Authority (EBA)

Open finance: what prospects and policy needs

The revised Payment Services Directive (PSD2) set a global precedent in establishing a legal framework governing the access to customers' data, including the related security measures. The requirements aimed to enhance competition in the payment services market vis-a-vis banks. Three years after the application of PSD2 more than 400 non-bank third party providers are now authorised to provide the new services based on access to payment accounts held by banks (and other account servicing payment service providers).

These services, so-called payment initiation and account information services, have allowed for the introduction of alternative payment solutions and the development of value-added services based on customers' data.

At the same time, the safety of consumers' data was ensured by the requirements for strong customer authentication (SCA), identification of third-party providers through the use of qualified certificates under the eIDAS Regulation, the provision of services based on user's explicit consent and others. Evidence exists that the security measures appear to

be achieving the effect envisaged by the Directive. The preliminary analysis of payment fraud data of 2019 and 2020, which the EBA published last month, suggests that fraud rates were 40-60% lower for transaction where SCA was applied compared to those where SCA was not applied. Furthermore, SCA requirements were not fully enforced during this period across all 27 Member States and we should expect further improvements in security once enforcement has become widespread.

The next natural step will be to move from open payments to open finance. Opening access to a range of banking and financial data that goes beyond payment accounts data to cover data on savings, investments and insurances. Such an extension would allow customers to seize the benefits of new and innovative services based on customer's data that can be offered by market challengers.

As the EU Commission is progressing with this work, it will be crucial to clearly define the specific scope of data that could be accessed, the process for providing consent for the data access, and the applicable security measures. It will also be important to carefully align the Level-1 text with the EU General Data Protection Regulation in order to ensure data privacy and to mitigate associated risks. In addition, future regulation will need to set out clear requirements for the interfaces that firms are to use to access the data, or possibly explore the viability of a single EU-wide interface.

**Moving from open
payments to open
finance, we need strong
security and account
access standards.**

Other, wider topics, that any EU proposal will need to consider are the potential need for further enhancements of security measures to mitigate the most recent types of fraud, the potential use on EU-wide electronic identity for customer identification, and the education of consumers to make them aware of these developments. EU policy makers should leverage on the knowledge and experience accrued through the implementation of PSD2.



CHARLOTTE HOGG

Executive Vice President
and Chief Executive Officer -
Visa Europe

The future is open

Over the past two years, we have seen consumers and businesses adopt digital solutions to manage their lives and their businesses through a changing maze of Covid-19 infection waves and social distancing and operating restrictions. As businesses move to e-commerce, they are less dependent on people passing their door and deciding to come in and shop, and consumers are able to manage a much greater proportion of their lives without having to leave their homes.

The financial ecosystem has risen to the challenge, with banks and payment networks offering new products and services and creating more seamless experiences through the use of digital solutions. Open banking puts consumers in control of their financial data, creating more tailored and relevant financial products and services such as enhanced individual credit scoring and tailored financial management tools.

Perhaps for the first time, consumers will be able to aggregate their financial lives in one – virtual – place and make decisions about how they want to pay, save, borrow and prepare for their financial futures with that information in hand. In what has been an uncertain

external environment for so many, open banking offers consumers the ability to be in control and armed with a much more complete set of information.

However, the discussion about open Banking often centers around financial services like account switching and payments. It tries to define open banking in traditional financial services terms. But by doing so we are looking at the world through the wrong end of the telescope and putting our thumb on the lens.

A foundational element of open banking is that it empowers consumers as they make their own choices to bring their data together from multiple sources, and then use that information to make plans, structure their financial decisions, or streamline processes. With the consumer's consent, uses of that data can be myriad, while the data shared is dependent on the use case.

As Visa, our participation in the open banking ecosystem is guided by our data values.

The regulations that facilitate open banking have more impact on day-to-day consumer and business services than may initially meet the eye. For example, the revised Payment Services Directive (PSD2) allows businesses to upload payments data to their accounting software to reconcile their invoices and bills and better and more quickly figure out their cash flows and profits. The use of permissioned bank data can digitise the mortgage application process for consumers as well as improve a merchant's or bank's ability to quickly assess a consumer's potential to borrow and pay in instalments at point of sale.

Open banking, through use of open standards, holds the opportunity to remove barriers to entry for those who can create compelling new solutions for consumers and businesses. We can see these beginning to emerge, as there are now about 500 Account Information Service Providers (AISPs) and Payment Initiation Service Providers (PISPs) across the EU serving many different needs. However, open banking does still face barriers that need to be addressed.

Firstly, open banking's success depends on resilience and continuous availability of APIs. In this always-on digital world, our expectation is that services always work. However, open banking APIs

may still cause reliability problems for third party providers and consumers, with services either unreliable or ultimately abandoned. As a leading global payments network, we are contributing to the development of API standards that meet high performance and availability requirements, crucial for the development of new business use cases.

Secondly, consumers need to gain confidence in the use of their data, and it should be clear how value is being delivered. In that regard, it is fundamental to have an efficient, scalable and forward-looking approach to obtain consumers' consent to use their data. That is why we are leading the development of industry-wide consent management specifications that set high security and transparency thresholds for consumer consent dashboards that will contribute to informed consumer consent and enhance consumer trust in the digital ecosystem.

Thirdly, security of data sharing is key for trust in open banking services. Open banking and more generally the move towards open finance presents an increased risk of fraud if consumer data is held by firms with poor system security. This is an area where trusted partners, such as Visa, can leverage experience in cybersecurity, encryption technology, tokenisation technology, fraud and risk monitoring to drive security and trust in the open payments' ecosystem.

As Visa, our participation in the open banking ecosystem is guided by our data values. We are committed to using data responsibly and ethically, in a way that protects and respects consumer privacy and gives them control. A key element of this is our belief that consumers should benefit from data-driven innovations, and it should be clear to consumers how that value is delivered.

As we work towards unleashing the full potential of open banking within these core principles, we see Europe leading in the development of open standards and clear outcomes. The vision of enabling consumers and businesses to have more control, more security and more choice in financial services is one we can all aspire to, and in an increasingly digital world, one we need to move expeditiously towards.



JAMES MOFFATT

Business Development Senior
Project Manager,
Strategy Development -
Zurich Insurance Company Ltd

The journey towards Open Finance

As part of its ambitious Digital Finance Strategy the EU is committed to developing a data driven financial sector. Legislation to deliver Open Finance due later this year will be a key part of that strategy and offers an important opportunity to encourage innovation and development of new products and services for consumers across the financial sector, including insurance.

From easier cost comparison to more bespoke personalized insurance products, there are already a range of customer benefits being provided through the use of Application Programming Interfaces (APIs). With the right regulatory framework in place, to reinforce customer trust, protect market integrity and ensure fair competition, the pace of innovation will accelerate, and new opportunities will emerge. To realize that goal, it will be critical to get the design of the open finance framework right.

In addition, it is important to recognize that Open Finance is just one element of wide set of European legislative initiatives aimed at delivering the benefits of digital transformation through the creation of clear and trusted framework for data exchange and flows within the economy.

For example, proposals such as the upcoming Data Act will be critical in defining the broader framework for data exchange in Europe, whilst Operational Resilience requirement will underpin resilience and trust in the system. Ensuring that Open Finance is aligned with this wider framework of data regulation will be essential if the initiative is to be successful in encouraging innovation.

With that in mind, there are three key principles that Zurich believes should be enshrined in the upcoming legislation:

1. Consent and transparency must be secured: Open Finance data sharing should rely on the principle that customers control the data they supply or directly generate. Access or sharing of such data requires the customers' explicit consent and a fully transparent governance process. In order for a consent-based approach to work there will need to be a clear distinction between 'raw' customer data which are portable and 'processed' or enhanced data which are not portable and where financial services firms have invested their own intellectual property. The framework for use of non-personal data to provide guidance on how non-personal data can be shared, under which conditions, and on who can decide on it will need to be enhanced. Further, in order to ensure efficient interoperability, there will need to be a centrally agreed framework of minimum API standards.

With the right regulatory framework... innovation will accelerate and opportunities emerge.

2. Trust in the integrity of the market must be protected: Trust must be preserved throughout the value chain. Trust is at the core of the customer relationship in financial services and therefore the user must be at the center of the data framework. This also means that the party working with the data must be able to rely on its integrity and accuracy but must itself be able to deliver security. To achieve this, the future regulatory framework should establish and apply industry-wide common security standards for data exchange and set-up common incentives to protect data effectively including clear liability allocation. The Financial Services industry will be subject to robust cyber

risk security standards under the Digital Operational Resilience Act legislation, and it will be important for obligations introduced under the Open Finance initiative to be compatible with those obligations.

3. Incentives to innovate must be preserved: Data sharing within the financial sector and across sectors should be driven by consumer propositions and use cases. Investment in data sharing should be linked to credible commercial ends rather than carried out for its own sake and the costs of obligations under the new framework must remain proportionate. Also, if investment in innovation is to be encouraged it will be important there is regulatory level-playing field for both financial and non-financial firms and competitive distortions avoided.

Adopting these principles should ensure that Open Finance is effective in delivering innovation, but this approach will need to be embedded in a broader context given digital transformation will not stop at the EU's borders. With data flows becoming the lifeblood of economies – whether advanced data analytics, parametric insurance, or smart contracts - addressing the governance of data access across borders will also be necessary. A global digital rulebook covering cross-border data flows may still be somewhat off, but it will be needed if economic promise of Open Finance and the wider digital transformation is to be realized.



ARNAUD MISSET

Chief Digital Officer -
CACEIS

Digital Banking is no longer a “digital topic”

As part of the Strategic Plan - A Europe Fit for the Digital Age - the Digital Agenda, published in September 2020 by the European Commission, sets out 4 main priorities:

1. Removing fragmentation of the Digital Single Market,
2. Adapting the EU's regulatory framework to facilitate digital innovation,
3. Promote data-driven finance, and
4. Addressing the challenges and risks of digital transformation, including strengthening the digital operational resilience of the financial system.

Aware of the issues at stake, the banking sector has been taking ownership of digital topics and addressing these priorities for years. It has in fact become a top priority for most of them. If we take a look at the expected benefits from both bankers and clients sides, they are pretty clear. On the one hand (banker), an opportunity to differentiate yourself from the competition via customised client experiences, an increase in operational efficiency and security via the use of cutting-edge technologies and finally a new showcase including subscription tools for your products and services. On the other hand (clients) time and cost efficiency, self-care opportunity

and an increase in the accessible service range. Now, let's face the truth, Digital Banking is no longer a “digital topic”. This might sound easy but having a look at what happened on the tech side over the past few years, we can clearly see that the path to full digital banking is now paved with a lot of powerful and reliable digital solutions.

Fintechs' and digital solutions' offers have never been so large, the whole value chain is now covered and open finance leads the way to seamless interconnections between the involved parties. Consequently, the question slides from ‘who is able to provide me with a solution?’ to ‘who has got the lead on what?’ and ‘who is responsible for what?’ This situation, where there is no more one single producer but a fragmented ecosystem, highlights risks and compliance issues for the one that is client-facing. No doubt that end-clients are expecting this full digital journey but what happens when we start talking about data ownership, data protection and responsibilities at every step of the process?

From our perspective there are 3 main drivers to respond to those questions: transparency, standardisation and regulation.

Question slides from ‘who is able to provide me with a solution?’ to who is responsible for what?

Transparency: it is now common that for a given product or service, multiple parties will provide different parts. Just like in other industries, if one plays a leading role assuming the global relationship with the client, full transparency on the sub-contract chain is mandatory to define limits and responsibilities. It is of high importance for the end-client to fully understand who will access and manage his or her data and who will be responsible if something goes wrong. Full disclosure and transparency is also participating in the harmonisation of processes between the producers, everyone being aware of who is doing what and, who relies on what to deliver its service. In a nutshell, digital and open finance disrupted the full in-house model to bring what a few years ago we use to call “the best of breed model” back to the fore.

Standardisation: Directly linked to transparency is standardisation. We are

all aware that for each new tech promise a lot of differing standards will compete and only a few will survive to finally define the basis the whole industry is going to work on. Don't get us wrong, we are not saying that products have to be standardised but we believe that tech layers do need it. Standardisation of technologies and protocols is the best way to avoid breaches in service delivery and ensure continuity. In case of a default by one of the providers, if tech layers are standardised it shouldn't be painful to find an alternative solution but for a full proprietary model it could lead to data losses and service interruption. It is also obvious that standardisation is helpful when we consider audit and controls.

Regulation: when talking about digital, regulation is needed as both a door opener and an enabler for adoption on a global scale. It is important to keep in mind that technology and regulation are not evolving at the same pace. The sandbox approach certainly contributed a lot to bridging that gap for the adoption of new solutions, allowing some kind of “test and learn” opportunity at scale. The role to play for regulation is now much wider and will definitely form the cornerstone and the final piece of the puzzle. Trust, in the end, is not only a question of technology but much more of clear guidance and sets of rules commonly shared by all parties. Simply put, for financial players to move towards and increasingly digital future, it is essential to understand what is permitted by regulation and what is not.

In that area, we expect a lot of guidance from incoming regulations such as AI regulation, the MiCA regulation, the Pilot Regime regulation, and the Digital Services & Markets acts.

AI ACT: IS THE EU APPROACH THE RIGHT ONE?



OLIVIER FLICHE

Head of FinTech Innovation
Department - Autorité de
Contrôle Prudentiel et de
Résolution (ACPR)

AI in finance: from regulatory guidance to technology- enhanced supervision

A confirmed trend toward broader adoption

Artificial intelligence (AI) plays an increasingly important role in the financial sector. The ACPR's latest studies on digital transformation, published this January, confirm this trend: AI is the most commonly adopted category of new technology. Use cases range from internal productivity tooling, customer relationship management, all the way to compliance processes or anti-fraud scenarios, including a limited integration of machine learning (ML) into regulatory Basel or Solvency models.

The financial industry nevertheless proceeds at a cautious pace on this path to widespread adoption of AI-

based systems. A plateau might even be reached due to the persistence of legacy systems, to the difficulty of measuring the net benefits of AI, and to regulatory uncertainty.

A complex risk mapping

This wide range of AI use cases should nonetheless be broken down according to the criticality of the corresponding process and to its impact on consumer and financial stability. For example, a chatbot enabling a customer to navigate an insurer's website presents far less significant risk than an automated claims management process relying on AI to deny or triage incoming claims. The European Commission has considered this risk gradation – from a slightly different perspective – in its “Proposal for a regulation laying down harmonised rules on artificial intelligence” (AI Act). The project seeks to establish a fair and balanced framework for developing responsible AI while guaranteeing fundamental rights.

Indeed, the AI Act explicitly adopts a risk-based approach and classifies all use cases according to a four-level scale. However, the level of risk associated to an AI-based system depends not just on the use case, but also on its technical implementation, starting with algorithmic design. The distinction is thus far missing from the Commission's proposal. This blind spot may be attributed to the AI Act's very broad definition of AI (intended to cover all present and future techniques), which does not accommodate any differential treatment, for example, between a very large deep neural network and a single decision tree.

Similarly, the AI Act acknowledges the need for a “human in the loop” within any AI-based system. The principle is easy to understand. Yet, poorly implemented, it may reveal illusory: a human ill equipped to control the results of an AI algorithm could be subject to complacency or less vigilance. In order to provide tangible guarantees, human intervention must be relevant with respect to the process actually implemented. This will probably be one of the most important areas of investigation in the coming years.

Supervisory roadmap and challenges

Within the financial sector, the draft AI Act grants the sectoral authority the

responsibility to supervise the use of AI by industry participants. This will ensure that the requirements derived from the AI Act are consistent with sector-specific requirements on internal control and governance. In particular, financial regulation includes not only client protection measures, but also measures designed to ensure stability and trust in the sector. The risks of AI in this sector should therefore be considered in both regards, while the project focuses mainly on fundamental rights.

Making cross-sectoral and sectoral perspectives mutually consistent will be at stake for the forthcoming work by European Supervisory Authorities (EBA, ESMA and EIOPA), which over the coming years will be required to draw up a set of guidelines on the use of AI in the financial sector.

Such high-level guidance will be necessary but not sufficient. A major challenge for supervisors is to ramp up their AI auditing and evaluation capabilities at a pace and a scale proportionate to the adoption by the industry. This means overcoming a number of technical and methodological issues: for example the absence of standard metrics for assessing algorithmic equity, or the lack of maturity of existing explanatory methods for AI – not to mention generally-applicable AI audit frameworks. The ACPR launched several initiatives around these questions, which called for the industry as well as academic, technical and regulatory experts to co-construct a methodology for evaluating and auditing AI-based systems.

One such initiative aimed to study how state-of-the-art AI explainability methods enable to understand the behaviour of “black box” algorithms. The ACPR hosted in summer 2021 its first Tech Sprint on the explainability of ML-based credit scoring algorithms to various kinds of audience (from financial services consumers to internal and external auditors). Explainability was one of the pillars on which the ACPR had built its AI governance principles; the Tech Sprint confirmed at a very practical level that it is also a key enabler for supervisors to guarantee that AI-based systems satisfy ethical standards, internal control and consumer protection requirements.



PETRA HIELKEMA

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AI governance: Ensuring a trusted and financially inclusive insurance sector

Without question, artificial intelligence – or AI – plays a vital role in Europe’s digital transformation and is already having – and will continue to have – considerable impact in all areas of financial services.

This is certainly true for the insurance sector, where data processing and mathematical models are at the core of any insurer’s business and are used to determine underwriting decisions, pricing policies, settle claims, as well as to prevent fraud. For example, the use of historical customer data and survey data is used to inform new products at the product development stage and micro segmentation and personalised pricing based on non-risk individual behavioural data to estimate price elasticity and churn propensity at the pricing and underwriting stage. Other examples include virtual assistants and chatbots that use natural language processing communicate with consumers as part of the sales or customer service process, and the automated segmentation of claims

by type and complexity at the claims management stage.

In a thematic review published by the European Insurance and Occupational Pensions Authority (EIOPA) in 2019, some 30% of respondents indicated that they were already actively using AI in their business, with a further 25% at proof-of-concept stage. Given the impetus that the COVID-19 pandemic has given to the digital transformation, the figures will have certainly increased during the last two years.

This is no bad thing. The use of AI in the insurance sector benefits both providers and consumers. Providers can expect cost efficiencies across the entire insurance value chain as AI improves prediction, accuracy and automation. Consumers also see benefits: A wider choice and better tailored products. In addition, they may notice the cost efficiencies from providers transformed into more competitively-priced products.

It is essential to ensure, however, that AI does not lead to any exclusions. This is particularly relevant given the trend towards increasingly data-driven business models, where the need for high quality data that is free from bias becomes all the more important so as to avoid discriminatory outcomes of AI systems, often disproportionately affecting vulnerable groups.

The use of AI in the insurance sector benefits both providers and consumers.

Such issues have been highlighted by EIOPA’s consultative expert group on digital ethics in insurance. The principles developed by this multidisciplinary stakeholder group take into account the specificities of the insurance sector and lay down the key governance pillars for the ethical and trustworthy use of AI in insurance. The group’s report on AI governance principles provides guidance to insurers on how to implement key principles in practice throughout the lifecycle of an AI application, which at the same time needs to be adapted to concrete AI use cases.

Transparency and explainability of AI algorithms play a key role here, especially in customer-facing AI applications. Indeed insurers must be able to meaningfully explain how their algorithms work and be

accountable for their systems, enabling consumers to have access to adequate redress mechanisms.

This is where regulation and supervision can help to ensure good consumer outcomes.

Legislation also needs to adapt to the digital age. In this regard, the European Commission’s legislative proposal for an Artificial Intelligence Act will provide a legal framework for the use of AI in the European Union. EIOPA supports the Commission’s risk-based approach reflected in the AI Act. Indeed, not all AI systems pose the same opportunities and risks and hence the need for proportionality.

In itself, the insurance sector is already highly regulated. Sector-specific regulatory frameworks, such as the Solvency II Directive and the Insurance Distribution Directive, already cover the use of AI. In addition, cross-sectoral frameworks, such as the General Data Protection Regulation (GDPR) provide a sound basis for AI in the insurance sector. Further regulation should also take into account AI use cases in insurance.

Finally, the fast pace of technological development worldwide, coupled with growing global interconnectedness underlines why international coordination is so important. EIOPA works closely with colleagues at international level, in particular in the International Association of Insurance Supervisors (IAIS) to ensure a common coordinated approach at global level.

To conclude, AI is transforming the way people live, touching all aspects of daily life from education to the workplace to the home. This is why its use must be ethical, fair and without bias.

Developing a sound AI governance framework is therefore essential for a well-functioning, trusted and financially inclusive insurance sector and EIOPA will continue its work in this field to ensure good outcomes for policyholders.



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Future of the financial services: artificial intelligence, data and open finance

It might be challenging to argue that current regulation of financial services does not cover all of technological innovation. Or that fundamental rights are absent from the supervisor's focus. Yet if you are looking for the evidence of the importance of the data, its processing, interoperability and portability you don't have to go any further than Artificial Intelligence ("AI") to understand that we are talking about one single digital world. And, though having only one set of rules (why not activity/performance-based?) or at least supervision would be ideal, let's focus on the extent of what is already working and what is possible. Regulatory sandboxing is a part of the proposed AI Act and one of the financial sector's innovation supporting measures. Identifying technological and regulatory gaps might be much easier in a data sandbox.

Data is at the core of any AI or machine learning model, and quality datasets are the key component required for such innovation to flourish in a responsible and productive manner. Policy makers

are thus focusing on data management policies and practices, also emphasized in the European Commission's proposal for the AI Act, laying down special rules for data and data governance in relation to AI use cases.

Data sharing initiatives

The European Union recognizes the potential of data and has already proposed various policies on data sharing, most of them applying also in finance. The Digital Finance Strategy aims to establish common financial data spaces, with a view to integrate European capital markets, support innovation and efficiency. The Digital Finance Strategy proposes disclosure of all the data in a standardized and machine-readable format, supports RegTech and SupTech initiatives and put forward a framework for Open Finance. The Commission's Data Governance Act supports the establishment of European data spaces, one of them in the field of financial services. It emphasizes the importance of data sharing for the public interest and creates the base for data sharing and data access in the financial services sector.

**Identifying technological
and regulatory gaps
might be much easier in
a data sandbox.**

Development of Open Finance Ecosystems

The highly anticipated Data Act, will set the rules for business-to-government and business-to-business data sharing and ensure its fairness. The next step would be to encourage the development of a full Open Finance Ecosystem on the basis of data portability and sharing standards.

Open Finance bears many advantages for all stakeholders: customers, businesses and governments. Open Finance ecosystems can promote the re-use of data and also their good structure, authenticity, integrity, interoperability, machine-readable format and enhanced cybersecurity.

The development of Data Sharing initiatives in the context of such Open Finance ecosystems would allow, for instance, portability of SME credit files, which in turn that will make it easier for SMEs to access financing, addressing financing gaps for small businesses - one of the main policy challenges

of many European members. It will also enhance lender transparency in a safe environment, promoting better quality offering for clients. New and alternative data sources and advanced analytics can be harnessed to allow for better access to finance, promoting greater and fairer competition from new financial service providers, including FinTechs. Insurance undertakings can benefit from better predictability of insured events models and effectively detect insurance frauds. Credit services providers can also profit from portable data when assessing the creditworthiness of prospective clients with AI-based techniques.

Data Sandboxes

Data sandboxes are one efficient and inclusive way of materializing these benefits. They can allow Fintech SMEs and start-ups to test their innovative financial services and help with their faster introduction to the financial services market. Governments can benefit from the assurance that new Fintech solutions are complying with the legal requirements, such as data protection, privacy or future AI standards.

The European Union understands the potential of open finance and plans to unlock this through the issuance of a legislative proposal for a new Open Finance Network by the end of 2022, as announced in its Digital Finance Strategy.

The Czech Republic has delved extensively into the issues of AI, data portability and digital assets, pushing for international legal framework. More initiatives will follow in line with the progress of the European Commission's agenda and sandboxing is part of the Czechia's recovery and resilience plan.

The future of financial services provision lays in the establishment of an Open Finance ecosystem, and it will be necessary to consider and adopt legislative proposals allowing this crucial area to fulfil its potential without undermining financial customer protection.



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AI for finance: from financial inclusion to compliance

Artificial intelligence (AI) in finance has grown rapidly in recent years. The IDC estimates that revenues generated from AI will reach \$156.6 billion in 2020, up by 12.3% from 2019. Similarly, the AI FinTech market is predicted to grow to \$22.6 billion by 2025 with an annual growth rate of 23.37% between 2020 and 2025. Given the staggering growth in its market share, there is little doubt that AI in financial services is here to stay.

The growth of AI in financial services

Over recent years, AI tools from machine learning (ML) to natural language processing (NLP) have transformed financial services. A survey by NVIDIA found that 83% of respondents agreed that AI is important to their financial institution's future success, whilst 34% agreed that AI will increase annual revenues by at least 20%. The potential of AI to transform financial services is derived from its improvements to the effectiveness and efficiency of financial services. A report published by the Alan Turing Institute identifies a range of benefits in the use of AI in the form of improvements to financial inclusion, better performance of investments, and consumer empowerment.

Inevitably, the emergence of new technologies also increases the risk of potentially adverse consequences. One source of such risks is the entry into the market by a range of new players with technology-focused offerings. A recent report by the World Economic Forum (WEF) on technology innovation and systemic risk identified this and other concerns as potential causes for systemic risk. Financial market infrastructures may not be able to cope with the ever-evolving demands. Importantly, the report identifies a number of solutions to concerning developments around systemic risk, including the use of regulatory technology (RegTech) and supervisory technology (SupTech) solutions.

RegTech and SupTech: AI for regulators

As the prevalence of technology in financial services grows, so too does the use of supervisory and regulatory technologies. A 2016 research paper by Douglas Arner, Janos Barberis, and Ross Buckley discusses the potential for RegTech to revolutionise regulatory reporting, anti-money laundering checks, capital assessments, stress testing, and many others. Andy Haldane is quoted in the paper as describing his vision for financial supervision with a series of screens displaying "a global map of financial flows, charting spillovers and correlations."

**Data standardisation
empowers firms
to deploy ML and
NLP tools for
regulatory reporting.**

More recently, a 2021 book co-edited by William Coen and Diane R Maurice discusses opportunities for RegTech and SupTech for the years to come. From the development of open-source data standards like FIRE to regulators' initiatives such as BIRD, data within financial institutions is one key requirement for effective RegTech and SupTech solutions. In the book, Abur and Dyck discuss how thanks to data standardisation firms can deploy ML and NLP tools for regulatory reporting. Regulators that use such tools find themselves in a position where they can effectively evaluate the data received from established financial players and new entrants into the market and take any remedial action in a timely manner. Nonetheless, the WEF's report notes that appropriate regulatory responses directly addressing AI may also be needed.

The EU's AI Act

One example of a prominent regulatory development in the AI space is the EU's proposal for an AI regulation. The EU's proposed AI regulation is a welcome development in setting standards for best practice on AI. Its risk-based approach offers a promising means for protecting stakeholders without adversely impacting innovation and research and development. It is worth noting that many of the proposals regarding actions to be taken for providers of high-risk AI tools are already standard practice for many AI developers. The Singaporean government's model AI governance framework raises the importance of a human-in-the-loop approach to developing AI tools and even goes so far as to highlight the benefits to developers. Similarly, auditability and explainability are key not only to users of the tools but also to developers that continue to work on expanding the capabilities of their AI tools. Combined with the entity-based model of financial services regulation, the EU's AI act should foster stakeholders' confidence in the use of AI in financial services.

The future

There is little doubt that AI in financial services is here to stay. From financial inclusion through FinTech to compliance through RegTech and SupTech, AI has improved efficiencies across the spectrum of financial services. Regulatory models should continue to develop with this growing market to ensure stakeholders can maximise the opportunity.

CBDC OPPORTUNITIES AND CHALLENGES



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Key considerations regarding scope, design and distribution of a digital euro

The Eurosystem is investigating the opportunities, challenges and design features of a possible digital euro. This investigation will run for 24 months and aims at analysing and concluding on key issues regarding the scope, design and distribution of a digital euro. The overarching objective of the work is to establish whether a digital euro could meet the needs of Europeans while at the same time help prevent illegal activities and avoid any undesirable impact on financial stability and monetary policy. The Eurosystem has not yet made any commitment or decision on its issuance.

There are a number of scenarios in which the Eurosystem could decide to issue a digital euro accessible to all citizens and businesses for their

payments. As many digital processes in communication, consumption, industry and commerce are closely interconnected with payment processes, a digital euro could be an option to make these processes more efficient and thereby facilitate the digitalization of the European economy and strengthen its strategic independence.

The digitalisation of payments has been accompanied by a declining use of cash. Thus, central banks need to be prepared to offer an alternative to cash to preserve the co-existence of commercial bank money and central bank money in retail payments. This co-existence - and the two-layer monetary system based on the promise to convert a deposit in commercial bank money "at sight" into central bank money has served societies well, and there is no reason to doubt that it should be preserved in a digital age.

Payments are a network activity with economies of scale. Thus, payment markets are typically dominated by a few large market actors. A digital euro available to individuals and businesses would establish an alternative to private sector market actors with a dominant market position and the potential to abuse their market power at the expense of consumers and merchants. Last but not least, a digital euro could also meet the challenges that may emerge from the issuance of private sector forms of money and/or digital currencies issued by other central banks.

The Eurosystem will work closely with the financial industry for the development of prototypes and more conceptual work regarding a digital euro. Close collaboration with the industry is also essential to ensure cohesion on the broader aspects of retail payments and ultimately ensure that Europeans are offered front-end payment solutions which can be used anywhere in Europe.

Overall, privacy is considered an important feature of a digital euro by both citizens and professionals. Users of digital central bank money may expect the same degree of privacy as with cash. However, in the digital sphere, privacy should not be confounded with full anonymity. Users will likely have to identify themselves when first accessing digital euro

services. Furthermore, regulations on anti-money laundering and combating the financing of terrorism are likely to imply restrictions on anonymity. The European co-legislator will have to clarify the applicable rules that have to be taken up in the design of the digital euro.

Central bank digital currencies (CBDC) have the potential to enhance the efficiency of cross-border payments. However, this requires co-ordination and agreement on technical usage and appropriate standards across central banks. As the cross-border use of CBDC might also facilitate capital flows, there must be common rules to enhance efficient international payments without undermining global financial stability.

To address financial stability risks and challenges to the role of banks in financial intermediation, both limits and tiered remuneration should be considered. The functional specifications which need to be established during the investigation phase should probably encompass several such tools.

I personally hope that if and when the digital euro will be issued in a few years, it would not have to be subject to strict individual holding limits but rely on tiered remuneration. Tiered remuneration would ensure that there are disincentives to large holdings of digital euro through a remuneration which makes digital euro less attractive than other liquid and highly rated investment assets. The central bank must not become a large-scale investment intermediary. At the same time tiered remuneration could ensure that a basic stock of digital euro held by citizens to cover their payment needs is never remunerated less attractively than banknotes.

Finally, it has to be stressed that there are no monetary policy intentions behind the investigation of a digital euro. The potential introduction of a digital euro is not intended as a monetary policy tool to move beyond the effective lower bound. In conclusion, a digital euro should be designed in such a way that it becomes an attractive means of payment, while its use as a form of investment and the associated large shifts from private money (for example bank deposits) to digital euro are discouraged.



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Setting the course for sound digital innovation in financial and payment markets

Central banks have a key role to play in promoting sound and sustainable innovation, particularly in the field of payments and market infrastructures, where digitalisation brings both opportunities and risks.

In this context, the Banque de France is actively working within the Eurosystem on a Central Bank Digital Currency (CBDC). This work aims at assessing whether and how a new, digital, form of central bank money can help in maintaining in the digital era the critical role central bank money plays as the stabilising anchor of our financial system both in the wholesale and retail space. Following the 2007-2008 Financial Crisis, this critical role was set in stone in the Principles for Financial Market Infrastructures at international level, with the strong encouragement to use central bank money to settle financial transactions to avoid credit and liquidity risks.

On the wholesale side, the Eurosystem has been spearheading innovation and the integration of financial markets in Europe in the past twenty years, notably

through the Target services. Nowadays, growing market interest for new technologies, such as DLTs, along with the emergence of tokenised versions of tradable assets, raise the question of the availability of central bank money in a tokenised form directly on a distributed ledger to optimise settlement. As part of a learning by doing approach to understand new technologies' implications for the financial system, the Banque de France is conducting an experimentation programme, whose first part was completed at the end of 2021.¹ The programme involves a variety of actors from the private sector (banks, Fintechs, post-trade industry actors, etc.) as well as public institutions (other central banks, public issuers).

Among the lessons learned so far from that programme in the field of securities settlement and cross-border payments, new technologies can improve the efficiency of financial markets with wholesale CBDC maintaining safe settlement in central bank money and preventing market fragmentation. Secondly, interoperable CBDC arrangements across jurisdictions can help make cross-border payments faster and cheaper, provided there is a fruitful international cooperation. The upcoming second phase of the experimentation programme will focus on international transactions and address remaining questions, such as scalability and operational resilience of a DLT infrastructure or the complementarity with current market infrastructures.

New technologies can improve the efficiency of financial markets with a wholesale CBDC.

On the retail side, the issuance of a CBDC suited for everyday payment needs could help ensuring that the growing digitalisation of payments develops in a secure and efficient way without jeopardising an open, level playing field in payments, and monetary sovereignty. The Eurosystem has started working in that perspective on a digital euro, with the launch of an investigation phase last July. It will provide the Governing Council with all the necessary analysis to make an informed decision on opening a realisation phase at the end of 2023, including a proposal for the design of a digital euro and a comprehensive view on all the implications inferred by its issuance.

In any case, a digital euro should complement, not take over, existing

and future payment solutions, being public or private, and be interoperable with them. It should also leverage the private sector's role and expertise as part of the distribution of a digital euro and the provision of value-added services, while ensuring that a digital euro does not trigger disruptive effects for financial intermediaries with financial stability risks and impediments to the conduct of monetary policy.

It should however be clear that issuing a digital euro is not the only and the most pressing public policy tool to activate, in order to create a confidence-prone framework in which the opportunities brought about by digitalisation can be reaped in a sustainable way.

A regulatory framework that is clear, fair and balanced to foster both innovation and stability should indeed be seen as a priority. In that context, *Markets in Crypto-Assets Regulation and Digital Operational Resilience Act* are timely, welcome, should be implemented swiftly and complemented in due course to address new risks stemming from emerging ecosystems, such as Decentralised Finance.

1. Wholesale central bank digital currency experiments with the Banque de France, report by the Banque de France, 8th November 2021.



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A digital euro: digitalisation of EU economy to enhance pan-EU retail payments

Digitalisation is profoundly transforming financial services in many ways. Crypto-assets, i.e. assets that depend primarily on cryptography and distributed ledger technology (DLT), have a significant potential in that respect. While they come in many forms and functions, they may be used for payment purposes in particular. The rapid development of stablecoins has further bolstered this potential. Stablecoins aim to stabilise the value of the coin against an underlying asset. By aiming to address the traditional weak point of other crypto-assets – significant volatility – they may accordingly become particularly widely used for payments. These privately issued coins raise the question of the role and form of money in a digital economy.

In parallel, the pandemic has further accentuated the trend of a decreasing use of cash and an increased demand for digital payments in all Member States

and globally. These developments have therefore triggered a debate on how a digital currency issued by a central bank – such as a digital euro issued by the European Central Bank – could help people have ready access to a simple, safe and trusted means of payment in a digital economy. The European Central Bank and the national banks of the Eurozone are currently investigating a digital euro project.

A digital euro could have several benefits. It has the potential to maintain the supply of public money in digital form in the face of the declining use of cash, to enhance pan-European retail payments, to support the digitalisation of the European economy, to protect Europe's open strategic autonomy and to increase the international role of the euro. However, the extent to which a digital euro would achieve these objectives also depends on its design.

The development of a digital euro takes place against the backdrop of implementing already agreed policy initiatives set out in the Commission's Retail Payments Strategy^[1] and Digital finance strategy, both adopted in 2020.^[2] The actions set out in those strategies will further improve the efficiency and competitiveness of European payment and digital financial services. They would notably promote the development of safe, efficient and secure payments, support innovation and the roll-out of instant payments across the EU, and as such, would reduce Europe's reliance on foreign players.

A digital euro could support digitalisation of EU economy to further enhance pan-EU retail payments.

A digital euro would further spur innovation in the financial system and beyond in a digitalised economy. A digital euro could possibly over time support automated machine-to-machine payments, smart contracts, streaming and micro-payments that support innovative technologies. Furthermore, it could be explored to combine a digital euro with the future European digital identity. This would lay the foundation for the European digital economy and new and innovative digital financial services.

In retail payments, a digital euro could reduce the fragmentation of the EU payments market, while

being designed in a way that avoids crowding-out private sector investments and solutions. The design of the digital euro should therefore ensure complementarity and a high level of synergy between private and public initiatives.

A digital euro could also support the euro area's monetary sovereignty and the EU's open strategic autonomy by providing a European public digital money alternative to private digital assets such as stablecoins or foreign central bank digital currencies.

Furthermore, to protect users, the digital euro would need to ensure privacy and comply with the existing *acquis* for example in terms of data protection and anti-money laundering (AML). Users should benefit from a high protection of their personal data. At the same time digital public money must not become a safe haven for money laundering and terrorism financing.

To safeguard financial stability and competition in the financial sector, the design of the digital euro should also address concerns related to disintermediation, i.e. large shifts of deposits to digital euro.

The digital euro could potentially also support financial inclusion in offering access to digital payments to the broadest public possible, including groups for whom commercial and legal limitations prevent the access to some of the existing digital means of payment.

A digital euro cannot be created in a day. It needs to be well-designed and stand on solid legal ground. The Commission is cooperating closely with the European Central Bank in analysing the related legislative implications.

[1] https://ec.europa.eu/info/business-economy-euro/banking-and-finance/consumer-finance-and-payments/payment-services/payment-services_en

[2] See text and factsheet.



ANNA BREMAN

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Sweden: the role of a CBDC in a near cashless economy

Sweden is becoming a cashless economy. A majority of Swedes use cash a few times per year or not at all. Instead, cards dominate and innovative mobile payment services are growing, with some 80 per cent of the adult population subscribing to the most popular one. Demography fuels this development, as younger generations rarely use cash. Even banks are becoming cashless, in the meaning of not handling cash at their branches. Covid-19 and e-commerce have accelerated these developments further.

The transformation to a cashless economy is not without friction and some groups in society suffer from it. Without strengthened legal support for the acceptance of cash and related withdrawal and deposit services, access to central bank money will, in practice, be restricted to banks (reserves). As a result, the general public would only have access to private bank money. This implies a limited convertibility of privately issued krona into krona issued by the Riksbank. Limited convertibility may threaten the unified monetary system where all types of Swedish krona have the same value.

Another aspect of the emerging cashless economy is that the new

digital payments landscape is highly concentrated and fragile. The backbone consists of a limited number of centralised IT systems managed by a few agents such as the central bank, clearing organisations, commercial banks, FinTechs, IT service providers, etc. These systems are often interconnected. As a consequence, there are single points of failure where technical problems or cyber attacks can lead to severe disruptions.

The Riksbank has been exploring a central bank digital currency, the e-krona, since 2016. Currently, a proof of concept is being developed to assess and test the functionality of a possible e-krona. With an e-krona, the general public would have access to a new form of central bank money even in a cashless scenario. However, it is important to emphasize that an e-krona is not a substitute for cash, rather a complement.

Not a silver bullet

The e-krona should meet three main objectives: it should give the general public access to central bank money; it should strengthen the robustness and continuity of the payments market; and it should promote competition and innovation. This would involve the public and private sectors in a balance, in order to deliver the desired policy outcome. The Riksbank's current thinking on the e-krona is a two-tier model where the Riksbank should be responsible for the core infrastructure and the rulebook. Banks and FinTechs could act as intermediaries and distribute e-krona to their customers and build and provide e-krona payment services.

An e-krona should be viewed as one tool among others that are complementing one another.

An e-krona should be viewed as one tool among others that are complementing one another. While investigating the e-krona, the Riksbank is also arguing for a strengthened legal support for physical cash for two main reasons. First, an e-krona, being digital, may have limited potential to help those who today have limited access to digital technology, or have a limited ability to use it. Second, the robustness of the retail payment market needs to be strengthened in the digital era. Cash

is therefore a necessity in times of disruption and/or crisis. The e-krona team is also attempting to build functionality for offline payments. This would only work for a limited amount of time but could enable consumers to buy basic goods such as food and medicines in times of crisis.

In addition to the e-krona, the Riksbank is also developing new settlement services for both instant payments and for large-value payments. The Riksbank has also joined forces with other central banks and with international organisations to address the shortcomings in the market for international payments, e.g. the G20+ based Committee on Payments and Market Infrastructure (CPMI) that is investigating building blocks for more efficient international payments. As a possible tool among others, an e-krona must co-exist with privately issued money and not undermine the central bank's ability to conduct monetary policy and promote financial stability.



MARION ROUSO

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Is a digital euro really a must-have and if yes, which “persona” should it have?

There is nowadays a conundrum related to CBDC for most central banks around the world.

We are facing a fad similar to the dot.com era in the early 2000s, so that no central bank today can escape having a CBDC project ongoing. More seriously, the threat on monetary sovereignty and structural evolution of usages stemming from decentralized finance, BigTech’s experiments like Diem/Libra and the rise of the mighty e-Yuan need truly to be accounted for. Unfortunately, it is unlikely that the digital euro may solve all the issues that are wishfully assigned to it from finding an alternative to the decline of cash, tackling monetary sovereignty concerns, and supporting the digitalization of the economy along with cross-border money transfers and financial inclusion.

Due to multiple constrains, the digital euro cannot be a one-size fits all solution. Hence, the question for Europe is which digital euro “personae” are we looking for?

A CBDC for the euro zone could have, at least, three different personae:

1. Digital euro persona #1 is a true retail replacement to cash and allows citizens to continue using cash-like payments in a digital way.
2. Digital euro persona #2 is the currency of choice for cross-border payments and to potentially extend the influence of €uro beyond geographical Europe.
3. Digital euro persona #3 is innovative, programmable and allows to pay in specific situations that were not possible before.

Still, when looking at the features of a digital euro, these three personae are not compatible with one another in terms of privacy, time-to-market, reuse of existing payment infrastructures, geographical reachability, scope, ambition, KYC procedures, impact on financial stability, contribution to innovation and financial inclusion, technical architecture and, last but not least, ECB’s influence and relevance.

The digital euro cannot be a one-size fits all solution.

Persona #1, the true digital retail euro, would require anonymity and could become, thanks to the banks’ KYC, a quasi-cash equivalent in the euro area as early as 2024. However, its impact on banks’ deposits and ultimately on financial stability would be significant, weakening further European banks versus their worldwide competitors, thus adding complexity in a low interest rate and Basel-regulated environment... for very little added value compared to existing payments means and services.

Persona #2 would need some kind of traceability features and could not leverage much of existing payment infrastructures. It could probably not be launched before the late 2020s and while it may strengthen the overall global influence of the euro and the ECB, it would require somewhat of a global interbanking network both for KYC and distribution of this cross-border digital euro.

Last but not the least, while innovative persona #3 would have to build on a

new type of DLT architecture (such as blockchain) and infrastructure and its impact on financial stability would remain marginal, its “niche” positioning would certainly fall short of any grand ambitions for the European CBDC.

While we need to remain concerned about the loss of sovereignty and/or influence of the Euro, we must not let the fear of a potential risk hasten the threat to our already challenged European banking system. Even if they are not yet fully unified, payments in Europe are truly affordable, reachable, efficient and secure. If the ECB were to launch a digital euro tomorrow, a prominent question would be to which extent would it make the life of European citizens easier. There is also a risk that it would not simply affect the P&L of banks but also the coverage of their cost of capital, which today may prove difficult to meet (mainly due to negative interest rates).

Commercial banks are already fully involved in making sure that the euro zone is a seamless and user-friendly payment area. They will undoubtedly continue to both cooperate and distribute a potential future CBDC if the relevant economic and operating conditions are met and if their existing payment assets and infrastructures are not jeopardized overnight.

Obviously, their involvement would be most useful for the KYC, distribution and monitoring of a future true digital retail euro (persona #1) to their clients both during the launch and the run phases. Still, the ECB would need to propose strong mitigation measures to counterbalance the loss of deposits and the resulting shrinking of credit offering.

Lastly, as far as competition is concerned, commercial banks need that level playing field be applied across the whole spectrum. Innovation should not become a synonym for recklessness and institutions distributing digital euros should all be treated at arms’ length, be it “bankable” systemic banks, fancy unicorns or fintechs.



KRISTINE BRADEN

Europe Cluster Head & Chief
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CBDCs, bank coins, stablecoins – is fragmentation at the end of the journey?

With the growth of digital assets and, more recently, stablecoins, Blockchain is building its proposition to offer a 24/7 global settlement infrastructure. With its ability to store and transact on the same infrastructure any digital assets such as tokenised money, securities, art in the form of non-fungible tokens (NFTs) etc., blockchain provides the financial services industry the opportunity to breakdown legacy operational friction currently existing between the various financial instruments and their settlement systems.

Looking only at the payments landscape, more than 80 central banks are now exploring blockchain technology and its promises for issuing a central bank digital currency and some, like Nigeria, are already live. Banks are working on tokenised commercial bank money to facilitate internal processes but also to offer better service to their corporate and retail customers. The total market capitalization of stablecoins, despite the

uncertainty in regulatory frameworks, is now USD 150 billion and growing, with some social media platforms and credit card companies gearing up to be the next issuers.

There is an emerging risk, however, that the enthusiasm leads to fragmentation and ironically undercuts the benefits blockchain offers. The explosion of independent and bespoke tokenised money offerings coupled with competing and often domestically driven regulatory approaches, is giving rise to the risk of liquidity, regulatory and infrastructure fragmentation.

To counter this potential risk, some initiatives have emerged to promote interoperability and harmonisation. The Bank of International Settlement Innovation Hubs are, for example, bringing central banks together to experiment on multi-CBDC constructs such as m-Bridge, involving the central banks of China, Hong Kong, Thailand and United Arab Emirates, or Dunbar with the central banks of Singapore, Malaysia, Australia and South Africa. Regulator forums such as the Financial Stability Board (FSB) or the Financial Action Task Force (FATF) have been working on harmonized regulatory recommendations. The International Standardization Organization (ISO) community is also establishing standards around blockchain and digital assets. These global efforts should be continued and supported.

**The RLN is an invitation
to embrace the future of
money in an orderly way.**

We must ask ourselves, however, will these efforts be enough? Unregulated or more lightly regulated alternative financial ecosystems such as Decentralized Finance (DeFi) networks are booming, now representing a staggering USD 250 billion dollars of total value. These alternatives are introducing interesting new financing and asset exchange models that all banks should explore. But they are today largely fueled by unregulated stablecoins running on multiple bespoke ecosystems. Considering the speed at which the DeFi industry is growing, regulated liabilities such as central bank money and commercial bank money are at risk of being challenged by private alternatives run by non-regulated entities.

Now is the time for the regulated community to work together in

leveraging the promise of blockchain and tokenisation through the building of a Regulated Liability Network (RLN). A RLN is a global blockchain or set of interoperable blockchains where central bank money, commercial bank money, e-money and regulated stablecoins can co-exist in a fungible way. Within the payments industry, there is recognition of the value the can and should be realized by building a global 24/7 settlement system that banks, payment providers and financial institutions operating within regulatory perimeters can leverage to issue and transact regulated assets. Establishing an RLN platform to enable domestic and cross-border flows, in compliance with each country's respective and hopefully harmonized rules would make digital money and other regulated liabilities fungible across issuers or exchangeable with one another instantly.

SWIFT demonstrated in the 1970s that commercial banks and later other financial institutions could work together toward a common non-competitive goal. The RLN initiative calls for similar collaboration, this time involving central banks and the whole regulated community. Dozens of banks, central banks, and major technology providers have already endorsed the RLN. The European banking community would be welcomed to join these efforts.

The RLN is an invitation to embrace the future of money but in an orderly way to avoid fragmentation and worse, an inability to seize the benefits this new technology offers the global financial system.



ALEJANDRA KINDELÁN OTEYZA

Head of Research,
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CBDCs: finding the right way forward

Different central banks might have distinct reasons to issue a CBDC depending on the efficiency of their payment systems, economic and financial development in its jurisdiction or even their citizens preferences. Central banks might decide to issue CBDCs as a response to other central banks or bigtechs issuing digital currencies that could compete with its sovereign currency, challenging monetary sovereignty and financial stability.

Central banks should examine the case for creating a CBDC of their own. But as they do this, they must be crystal clear what the purpose of CBDC is; what tangible benefits it offers; and ensure that its design is appropriate to meet those goals and avoids any negative impact.

Focusing on Europe, I believe there is not an immediate need in terms of payments that would require the issuance of a retail CBDC. We have a well-functioning payments market; financial services – especially payments – are being transformed by innovation. It is on cross-border retail payments

where there is the greatest room for improvement, but the issuance of isolated domestic CBDCs does not seem to be the optimal way for improving its efficiency.

Neither is financial inclusion a problem. According to World Bank data, more than 95% of the Eurozone's adult population have a bank account. Many in Europe argue, however, that a digital euro is needed to ensure the sovereignty of the euro, as cash is going out of use and the euro can lose its monetary anchor role. However, cash remains the main payment method in the Eurozone (73% of payments were made by cash in 2019 and despite some decrease due to covid, it remains being the main method). Before embarking on creating a single currency, it should be ensured that there are no other means to safeguard the sovereignty of the euro.

Regarding competition with private stablecoins, there are many regulatory initiatives on the way that should prevent those that become systemically important from enjoying a better regulatory treatment, in detriment of competition. With respect to other CBDCs, as the BIS has highlighted, multilateral collaboration to agree on design principles will be key to avoid an “hegemony competition.” Wide political commitment is also needed to make them credible.

CBDCs must have a clear purpose, offer tangible benefits and avoid any negative impacts.

If it is decided that a CBDC is required, the ECB should work closely with the financial sector and others to carefully consider the profound implications a retail CBDC would have on the financial system. This is especially important for the Eurozone, due to the importance of the banking sector. Banking assets represent 220% of GDP in the Eurozone, compared to 95% in the US.

Fabio Panetta is right to say that the digital euro must be successful enough to be adopted by users as a means of payments but not so successful to crowd out private solutions if it becomes a widely used store of value. Yet this is a very difficult balance to strike. To reach this, I see four issues that should be considered and that will condition the design of the digital euro:

- The digital euro should not become a new form of investment or store

of value. CBDCs could be easily understood as a safer store of value than the money held in commercial banks, particularly in times of uncertainty or crisis. Could CBDCs end up becoming an alternative to bank deposits? Imposing limits on the amount that each citizen could hold, negative remuneration rates and central banks providing alternative sources of funding, could mitigate the potential impact to banking intermediation. However, there is a clear risk of increasing the funding costs of banks and, therefore, increase the cost and reduce the amount of available banking credit.

- According to the ECB's consultation, privacy is the most important feature of a digital euro for both the public and professionals. However, as the ECB correctly points it should not be confused with anonymity. It is key that any CBDC design protects the system with anti-money laundering controls, even if it limits its comparison with cash.
- Access to payments data is essential to analyse risks better and provide credit to customers more accurately and at better price. Intermediaries should be allowed to use data in a responsible way and in accordance with customers' consent.
- The digital euro should be competitive compared to other CBDCs or private stablecoins, but this could present trade-offs between being competitive and minimize financial stability risks. Within the design features of CBDCs I see programmability as one of the most promising opportunities to innovate.

I believe that the opportunity for CBDCs in wholesale markets is much more significant than for retail markets for example in terms of liquidity management. That is one of the reasons why Santander is one of the founders of and shareholder in the Fnality International consortium.



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CROSS-BORDER PAYMENTS: SUCCESS FACTORS AND CHALLENGES



ULRICH BINDSEIL

Director General, DG Market
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Moving into implementation phase – From analysis to action

The G20 roadmap for cross-border payments encompasses a variety of actions through 19 building blocks to enhance cross-border payments. The FSB presented the progress during the first year of the roadmap implementation in a recently published progress report^[1].

This report positively assesses that most of the milestones set for 2021 have been successfully completed or are close to finalization. The level of achievements so far lays a good foundation to progress on the forthcoming goals. While 2021 focused on taking stocks and analysing the issues at stake, we are now moving into the more concrete implementation phase.

This move will more than ever require extensive engagement with all relevant private and public

sector stakeholders. An appropriate engagement and governance for the practical implementation of building blocks will considerably increase the potential that these have in redesigning the international payment landscape. This is the case for those building block focusing on ambitious solutions such as directly linking payment systems across borders (BB13), but also for compliance matters and a more efficient and effective implementability of AML/CFT (BB5).

BB13 is seen as a promising means in improving overall cross-border payments and there are several existing initiatives exploring this field. That's where also model Nexus comes in - an ambitious project aiming to investigate the overall feasibility of connecting the real-time payment systems across the globe. The Nexus ongoing proof of concept is experimenting with connectivity of TARGET Instant Payment Settlement (TIPS, the Eurosystem pan-European service that settles payments in central bank money around the clock in real time) with similar systems under jurisdiction of the Malaysian Central Bank and Monetary Authority of Singapore. With regard to enhancing current payment system arrangements, it should be mentioned also that the ECB and the Sveriges Riksbank in collaboration with the Banca d'Italia are working on how TIPS can support efficient payment transactions across different currencies.

All these projects (if) once operational have the potential to be transformative and deliver meaningful economic progress around the globe enabling cross-border payments becoming cheaper, faster, more transparent, and more widely accessible.

But one cannot remind often enough that the efficiency and effectiveness of the implementation of AML/CFT rules needs to be further improved. We noted that even within the euro area, "cross-border" (say between France and Germany) instant payments have a significantly higher rejection rate than "domestic" (e.g. within France) because of AML/CFT false-positives. The Commission is taking up this issue in the EU context, and also Nexus has identified this as an issue for BB13 at a global scale. But the issue is not only relevant for instant payments, but for any cross-border payments.

Embracing transformation in new cross-border environment will impact the way banks, both large and small, conduct their payments business in the cross-border space today. Furthermore, it will affect many different systems within payment service providers' infrastructure with complex changes to data, processing and applications. The scale of change required will be extensive. Therefore, banks and payment infrastructures in general should start considering what these changes to cross-border payments might mean for their own technical and operational processes. This will require preparing concrete migration plans by considering internal systems' readiness to support the move to this new environment. Moreover, all relevant players will need to start also considering budget and investments to implement these changes. While the overall effort and investment is undeniable, they are expected to be outweighed by the global benefits they would incur.

Both the public and private sector need to start preparing for these much needed, and transformative changes. Their implementation will take time but the highly recommended FSB report on quantitative targets^[2] has set a clear expectation to guide our work namely to reach the targets at end 2027 (except for the remittance cost target). Regardless of whether all targets will be reached precisely on time, this FSB report is important and unprecedented as it forced us to think through what we want to achieve, what we can likely achieve, by when, and how we can measure it.

End of 2027 is an ambitious timeline for achieving all the targets but with all relevant public and private players' commitments and firm actions I stay confident that we will deliver. We at the ECB stay committed to the work and will do our part.

[1] G20 Roadmap for Enhancing Cross-Border Payments – First consolidated progress report: <https://www.fsb.org/wp-content/uploads/P131021-1.pdf>

[2] Target published in the report Targets for Addressing the Four Challenges of Cross-Border Payments: <https://www.fsb.org/wp-content/uploads/P131021-2.pdf>



BURKHARD BALZ

Member of the Executive
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Improving cross-border payments: there's light at the end of the tunnel

Although slowed by the COVID-19 pandemic, globalisation is a continuing trend. With increasing cross-border trade, cross-border payments need to follow suit in order to continue to ensure economic efficiency. At present, cross-border payments generally remain slower and more costly than domestic transactions, which is why they have drawn the attention of the G20. This international body is currently working on a "Roadmap for enhancing cross-border payments". With regard to regulation, the European Union has taken significant steps towards a fully harmonised landscape. After the introduction of the single currency laid the groundwork, further regulatory initiatives like SEPA and PSD2 built on this foundation to create an innovative and open payments market in the EU, including beyond the countries of the euro area.

On a global scale, regulatory harmonisation is currently lacking, especially in the fields of know-your-customer (KYC) and anti-money-laundering (AML) measures. This leads to high compliance costs and longer transaction times. Furthermore, the variety of prevailing standards makes

it more difficult to automate payment processes across borders. This is why the harmonisation of KYC and AML standards plays an important role in the G20 roadmap, which envisions globally harmonised standards enabling straight-through processing of cross-border payments, thus making these transactions faster, cheaper and more transparent.

However, it must also be ensured that the technical back-end infrastructures are able to communicate with one another. In the Eurosystem, TARGET2 and TIPS form the basis of an interoperable back-end infrastructure, which is the main prerequisite for frictionless payments. By allowing other instant payment clearing houses to hold accounts on the platform, TIPS has positioned itself as a pan-European hub for interoperability. With the completion of the final wave of migration this February, full interoperability of SCTInst payments will be achieved within the Eurosystem.

Its design as a multi-currency platform also enables TIPS to cater to the needs of non-euro countries. With the RIX-INST service, it will be possible to settle transactions in Swedish krona via TIPS starting from May 2022. It is expected that the Danish krone will follow by November 2025. While cross-currency transactions are not possible at the moment, the Eurosystem and Sveriges Riksbank are in the process of evaluating whether to enable these kind of payments, with Denmark's Nationalbank also expressing interest in this functionality. Nevertheless, the inclusion of other currencies in TIPS is an important step for European integration.

To improve cross-border payments, adjustments to regulation and infrastructures are key.

In order to further extend the reach of TIPS, additional links to payment infrastructures outside of Europe could be envisioned in the future. One possibility may be to link up with a global hub that connects faster payment infrastructures. With its Nexus project, the BIS Innovation Hub in Singapore has presented a promising concept for the interconnection of faster payment systems around the world. While the Nexus Network provides the standards and gateways, the platform would rely on banks to provide liquidity in the connected jurisdictions. This could

further strengthen the role of banks in cross-border payments, as they would continue to be an essential part of the global payments chain. The efforts to harmonise the exchange of payments data globally could further help to make cross-border payments more efficient.

While TIPS already operates on the ISO 20022 standard, TARGET2 is currently in the process of converting to the new standard as part of its consolidation project. The new messaging standard will enable banks to send and receive more information in a structured form, facilitating straight-through processing and the automation of payments. This may prove helpful for cross-border payments as well. Harmonised ISO 20022 messages may be able to transmit harmonised KYC information across borders, thus enabling automated checks to prevent money laundering and the financing of illicit activities for cross-border payments. Considering the fact that SWIFT is aiming for global migration to ISO 20022 by 2025 at the latest, this will allow TARGET2 to be interoperable with other real-time gross settlement systems around the world and will be another step towards global harmonisation.

Banks are expected to play an important role in cross-border payments as well. However, they may have to keep evolving in order to stay ahead of the competition. Most importantly, they need to play an active role – both in the development and implementation of the G20 roadmap – and must be active participants in the payment infrastructures of the Eurosystem. This way, adjustments to both infrastructures and regulation will benefit from the valuable input from experienced market players.



MARC BAYLE DE JESSÉ

Chief Executive Officer -
CLS Bank International

Stemming the settlement risk tide: widening access to PVP in the FX market

The FX market widely recognizes that payment-versus-payment (PvP) is the most effective way to eliminate FX settlement risk in cross-border payments. Despite this, the proportion of FX trades not settled on a PvP basis has increased in recent years, leaving market participants more exposed to settlement risk.

This rise in settlement risk is predominantly driven by an increase in turnover of trades involving currencies not settled through PvP services. Analysis conducted with settlement members by CLS – which operates CLSSettlement, the world's largest multicurrency FX settlement service – supports this assertion. The findings demonstrate that the majority of addressable settlement risk lies with currencies that are ineligible for CLSSettlement. Results of the Bank for International Settlements 2019 Triennial Survey show that trades involving a non-CLSSettlement-eligible currency amount to circa USD1.25 trillion. This is an increase from approximately USD930 billion (or 35%) since the 2016 Survey. The US dollar (USD) and euro are on one side of the vast majority of these

trades, but without PvP settlement, both sides carry settlement risk for CLS settlement members and other market participants.

While clearly safeguarding the ecosystem, the current regulatory regimes applied to financial market infrastructures (FMIs) like CLS place significant barriers to entry for adding new currencies into CLSSettlement. The solution may lie in developing an alternative PvP mechanism for a specific set of currencies that offers similar benefits to CLSSettlement, including capital and liquidity efficiencies, and is tailored to market needs. PvP services, like CLSSettlement, significantly reduce the funding requirements to settle FX transactions compared to gross settlement or less standardized bilateral netting arrangements.

Other benefits of adopting PvP settlement would include maximizing the advantages of straight-through processing to deliver operational efficiencies and minimizing associated costs. In addition, a PVP settlement mechanism would enhance market participants' ability to reach a broader network of trading counterparties and use their existing credit capacity more efficiently, leading to potential business growth opportunities.

A public-private approach is the optimal model for an alternative PVP solution.

Wider PvP adoption would also support policy recommendations to mitigate settlement risk, as outlined in the Financial Stability Board's Roadmap to enhance cross-border payments and the FX Global Code. CLS has been exploring the opportunity to develop an alternative PvP mechanism,¹ and has established a working group of 12 banks with global operations to evaluate market demand and explore approaches. As part of this initiative, an industry pilot is underway to evaluate the impact on liquidity and settlement risk of potential models.

The PvP model under consideration would complement CLSSettlement by enabling asset managers, corporates and third parties to participate directly. Possible features may include settlement windows aligned to periods of peak liquidity, an adjustable model for jurisdiction-specific dynamics, support for same-day funding of trades, settlement sessions for each target

currency (versus USD and/or euro) and funding based on multilateral netting.

The initiative has considerable industry support and momentum. However, any new market infrastructure solution must prioritize safety, stability and scalability. For such a solution to succeed, factors such as account structure, legal framework and local market practices and regulations must be considered, and sufficient time allowed for appropriate implementation. Central bank support and engagement is also required to ensure that any solution aligns with each central bank's domestic and international priorities for the currencies under consideration.

To optimally address public policy and industry challenges, e.g., by expanding access to settlement risk mitigation, an FMI must invest heavily in its products, risk management and controls and respective underlying technology on an ongoing basis. CLS has the highest operational standards and has invested heavily in its resilience, cybersecurity and three lines of defense. It also successfully completed a significant phase of a multi-year technology investment program that includes upgrading CLSSettlement hardware and data centers as well as migrating the service to a state-of-the-art technology platform, which will enable CLS to adapt its PvP solutions more easily to the needs of the FX market.

Developing an alternative PvP mechanism for the FX industry is crucial for mitigating rising settlement risk. To ensure that CLS's alternative PvP solution receives the requisite industry investment and support for success, CLS is collaborating with both the public and private sectors. This public-private approach enabled CLSSettlement's success at scale since its launch 20 years ago, and thus proves an optimal model for developing the alternative PvP mechanism.

1. Subject to all necessary approvals.



MASSIMILIANO ALVISINI

Senior Vice President & General
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Western Union

Cross-border payments: building a relationship of trust with our customers

For more than 170 years now, millions of customers across the world choose Western Union because they know they can trust us to send their Money Transfers quickly – often in real time – and safely across the world. We have earned their trust through our focus in covering their needs and our investment in our leading, cross-border, cross-currency omni-channel platform. More than that: we are proud of our role in global financial inclusion and working for migrant communities. We believe that our strong social character and purpose does set us apart in the industry.

Trust then lies at the heart of our relationship with our customers, but at the same time it poses unique demands, especially when we operate a global network that reaches almost every part of the world, in more than 200 countries and territories, and dealing in more than 130 currencies. In this vast network, moving money means

complying with dozens of regulatory regimes, laws and regulations. Importantly, when moving money, we must ensure that we always know our customers, know our agents, and that every single cent is not the result of fraud or money-laundering - with close to zero margin of error.

As a company, we have always been at the forefront of technological and social changes. To continue building and expanding this relationship of trust with our customers, and ensure safe Money Transfers, we then constantly invest in technology, including in Artificial Intelligence and predictive analytics, that can assist in implementing responsive controls while also improving customer experience. The use of AI and Machine-Learning to combat ML and TF does improve effectiveness and efficiency dramatically.

Trust, especially with the emergence of new technologies and new players in the industry, is a priority for our sector as a whole, and for policy makers globally, as the safe and seamless flow of cross border payments is truly vital, especially as the world looks to build back better post-pandemic. Against this backdrop, Western Union welcomes the G20 Roadmap from October 2020 for enhancing cross-border payments. That said, we believe that the implementation of the respective building blocks of the Roadmap will need to reflect the unique nature of the various payment providers and business models. There cannot be a 'one size fits all approach' or the reliance on just one standard.

Western Union welcomes the G20 Roadmap from October 2020 for enhancing cross- border payments.

Western Union welcomes in particular the following measures of the Roadmap:

- We believe it is essential that, in the interest of a level playing field, non-bank payment providers have access to intra-bank payment systems, clearing and settlement infrastructure. Within the EU context this means acknowledging that the non-bank payment sector delivers settlement finality under the meaning of the Settlement Finality Directive.
- We support a harmonised anti-money laundering framework

within the EU. AML is one of our largest cost when doing business. Despite our sophisticated AML risk mitigation techniques, we are often confronted with decisions by banks to de-risk from the remittance sector. It is essential that non-bank payment providers have access to bank accounts to conduct their business and access correspondent banking arrangements.

- In this context we also strongly support the use and interoperability of cross-border digital e-KYC and e-KYCC solutions. The EU rules need to incentivise us to continue to invest in the most sophisticated AML and fraud prevention solutions available.
- Similarly, data privacy rules should not be in conflict with AML compliance. We would ideally like to see more international consensus on defining the appropriate access to personal or non-personal data subject to the correct safeguards and consent. This will be critical for the development and application of future-orientated technology solutions, such as AI, DLT or data analytics.

Customers will use different means of payment for different purposes. New technologies and market entrants always challenge existing players by reducing costs, moving to faster payments. We believe that a collaborative approach between consumers, the users and providers of payments infrastructures and policy makers can optimise innovation in payments and ensure greater transaction safety. Consumer protection and transparency should always be key in defining regulations. However, such requirements should encourage innovation which will allow the industry to provide for the payments solutions consumers are looking for.



BRETT LOPER

Executive Vice President
Global Government Affairs -
American Express

In pursuit of the next generation of EU payment rules

Over the past decade Europe has emerged as a global pioneer and a standard-setter in payments, driven in large part by the introduction of the second Payment Services Directive (PSD2), considered by many as one of the most groundbreaking pieces of legislation in decades, not least in its requirement to allow banks and other financial players broad access to customer data. This element alone has doubtless boosted significant innovation in the payments sector, and we are only starting to recognize the initial impacts. Even greater transformational changes are certain to come.

Nevertheless, here we are once again – slightly older, wiser and ever more experienced with the ecosystem that PSD2 helped to create – looking to review and perhaps update the rules that were deemed so revolutionary only a few years ago. What, then, are the lessons and the warnings from the last round we should take into the next? What are the key ingredients we should keep in mind for the next generation of payment rules as we begin the review of PSD2?

Implementing all of PSD2's worthy objectives – among others, to create a

more integrated European payments market, improve competition, make payments safer and of course introduce greater consumer protections – has proven harder to achieve than many would have thought. The birth pains of PSD2 were numerous, but we believe it is incumbent on us to try to address at least three recurring themes that could and should be resolved.

First, the difficult rollout of Strong Customer Authentication (SCA) exemplifies the difficulty in designing market-driven processes.

Second, open banking, specifically the complex technical implementation of access to data for new market participants (known in the industry as APIs), has proved difficult to achieve and is in need of regulatory and legislative clarity.

Finally, the topic of surcharging illustrates a general lack of harmonization in the EU's legal framework which causes significant hindrance of competition in the market.

**The architects of
new rules must learn
from the past while
promoting regulatory
harmonization.**

We have learned, that only maximum collaboration and communication between industry participants and policymakers will give us the chance to avoid SCA-like turmoil, where despite multiple warnings from the former, the effects of the rules were largely underestimated by latter. We believe that an outcome-based approach would have served European consumers far better and, not least, would have encouraged more innovation, just as policymakers wanted. In more practical terms, requiring the payments industry to lower fraud rates and – as the industry repeatedly suggested – allowing the different players to achieve this in their own way would have likely been a more efficient and considerably less painful approach than prescribing the rules with which the payment sector would need to comply to reduce fraud levels.

We also realized from the open banking rollout that ambiguity in the rules must be avoided at all costs, in both level 1 and level 2 texts, and that guidance on the rules from the competent authorities needs to be consistent. The

innovations and standards (APIs) that enable open banking are the building blocks for open finance, and even an open data ecosystem. However, before Europe truly ventures into the world of open data, clearer rules, and further prescription of which types of data are in or out of scope, would reduce ambiguity and excessive API iterations. More specifically, an API standardization would lead to further developments and innovations in the field and avoid inconsistent customer experiences that differ wildly across products and providers.

Lastly, rules that actually discourage competition due to the lack of harmonization in the EU's legal framework should be reexamined as part of the PSD2 review. This should first and foremost include examining the current differential rules on surcharging. These rules include inconsistencies that diminish competition and cause significant confusion among consumers and merchants alike. Moreover, they force consumers to “pay for paying” and mislead them as to the true price of goods and services. A full ban on surcharging is the only solution to help protect consumer rights and encourage transparency.

In short, the architects of new rules must learn from the past while promoting regulatory harmonization. These guiding principles will elevate the next generation of payment rules, promote cross-border payments and ensure a smoother payment experience within the EU, which in turn would contribute to the successful rollout of cross border EU solutions.



THIERRY CHIROSÌ

Head of Business Development,
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2022: a pivotal year for payments in Europe and beyond

2022 is set to be a pivotal year for the payments industry. In November, the eurozone's high-value payment systems – T2 and EURO1 – will adopt the ISO 20022 data standard, aligning the roll-out of a common standard for all payments in the bloc. 2022 will also see adoption of ISO 20022 for high-value payments in the UK (CHAPS) and the standard is gaining traction in many other markets, notably the US, where ISO 20022 is already in use for instant payments and will be adopted for high-value payments (CHIPS and Fedwire) in 2023/4.

Recognising that many cross-border payments originate or terminate in domestic systems, in November the payments industry will begin a three-year migration to ISO 20022 for cross-border payments, adding the final puzzle piece to complete the picture of a global common standard end-to-end for international and domestic payments.

A common interoperable standard promises a variety of benefits for end-users of the payment system, such as new and innovative digital payments services for individual citizens; and efficiencies that will benefit global corporations, such as invoice-

processing efficiencies and cash-flow improvements. It provides economies of scale for service providers and users, enabling them to deploy common technology across different markets and payment types, driving down cost and increasing automation efficiency. It enables new business opportunities for cross-border, including facilitating direct interconnection of market infrastructures. And the richer transaction data supported by ISO 20022, combined with the assurance that rich data will be propagated end-to-end without truncation, opens up a wealth of opportunities for smarter, data-based payments products.

Indeed, the FSB/CPMI roadmap to enhance cross-border payments, endorsed by the G20 in October 2020, sets out a number of 'building blocks' to address challenges in cross-border payments, and improving interoperability is a common theme. Building block 14 specifically targets harmonisation of ISO 20022 message formats.

And while alignment to a common standard represents a great step, it's not the end of the story. To fully realise the interoperability benefits, implementations need to remain aligned in terms of processing, data, business rules and service levels. Facilitated by SWIFT and the Payments Market Practice Group, public and private sectors have already coalesced around common and interoperable ISO 20022 implementations for high-value, cross-border and instant payments. SWIFT has long championed the cause of interoperability, in 2015 issuing a widely supported Harmonization Charter, which calls on MI operators to align implementations and maintenance processes.

**The years ahead are
critical and will reinforce
the call for collaboration
and partnership.**

SWIFT continues to provide practical support and facilitation for interoperability initiatives – and we're working to ensure that the financial industry can adopt ISO 20022 as seamlessly as possible. In-flow translation is key to enabling a smooth transition to the rich data standard, while allowing the industry to keep its existing systems running smoothly and enabling financial institutions to adopt the new standard at their own pace through the industry-defined transition phase up to November 2025.

Interoperability and inclusiveness have always been of paramount importance to SWIFT, as ultimately our strategy is to ensure that value in all its forms can move around the world quickly and securely for as many people as possible.

The years ahead are critical and will reinforce the call for collaboration, partnership within and beyond the European landscape.

INSTANT PAYMENTS AND EPI



BURKHARD BALZ

Member of the Executive Board - Deutsche Bundesbank

SEPA reinforced: restart retail payments for the benefit of European society

The SEPA project has substantially transformed the European payment landscape over the last two decades. Cross-border euro payments have become faster, cheaper and more efficient. Such an extensive transformation has only been possible thanks to a coordinated effort on the part of both private and public players. With TARGET2, the Eurosystem created a reliable basic infrastructure that became essential for the settlement of individual payments across Europe in central bank money. Furthermore, the additional TIPS service now enables euro retail payments to occur within a matter of seconds.

The EPC, an association of payment service providers, developed basic SEPA instruments. Mandatory migration from previous national instruments to SEPA credit transfers and direct debits

accelerated adoption. Moreover, with PSD2, a uniform European regulatory framework was established.

While the SEPA approach has worked well for credit transfers and direct debits, national card schemes have not made it across borders. Only in combination with one of the international schemes are buyers able to pay with these cards outside of their home country.

Moreover, some domestic online, mobile and P2P payment schemes based on instruments such as cards or instant payments have emerged. While international bigtechs are either gaining an increasingly large market share or already enjoy a strong incumbent position, these domestic schemes will lack the scale to effectively compete in the medium term.

Given the experience gained with the SEPA project, the apparent shortage of viable European payment options and the increasing influence of international competitors, what can be done to reinforce SEPA and facilitate digital payments that both promote economic development in the EU and make it easier and safer for European citizens to pay?

One important decision has been already made: to update the basic European payments infrastructure. Not only will TIPS develop into a cross-currency instant payment platform – even more prominent is the launch of T2 in November 2022. It will replace and modernize TARGET2, which started in 2007.

With T2 and TIPS, a novel, reliable infrastructure that allows for efficient and secure payments in Europe will be in place. Now, appropriate payment instruments and solutions based on common standards are needed in order to take advantage of this.

The EPC's SEPA instant credit transfer scheme is one such instrument. Although it has been in place since November 2017, only about 70% of euro area PSPs have joined the scheme, and only 10% of credit transfers are instant at present.

SEPA instant credit transfers represent an opportunity for the European payment industry to jump into the digital age and support both individuals

and firms in meeting their daily payment needs. For payment service providers, instant payments can foster customer relationships by focusing on direct account-to-account transactions rather than being fragmented across proprietary solutions, card schemes and bigtech platforms.

For instant payments to become the new normal and for us to reap the benefits of this, mandatory measures similar to those implemented for the first SEPA instruments might be worth considering.

That being said, payment service providers must think beyond pure processing. But at the same time, they must recognize it as being the core of innovative payment solutions. New standards such as request-to-pay messages jointly developed within the EPC are building blocks towards reaching these ambitions. Common APIs based, amongst other things, on the rules of the PSD2, or, going beyond this, the development of premium API services, may also help to realize the vision of frictionless payments that are integrated into everyday life whilst also being easy to manage, safe and transparent.

A number European banks came together in the EPI to develop a European payment solution that would utilize the building blocks described. It intends to offer an EPI wallet based on instant payments and an EPI card based on European standards such as CPACE. At the end of the first quarter of 2022, the participants will decide whether to launch the market entry of these solutions.

Despite the tremendous progress made in the European payments market, another even more profound change is already on the doorstep. Bigtech firms have announced their intention to come up with their own stablecoins based on DLT, which may potentially be usable on a global scale. In response, central banks around the world are weighing up the option of issuing their own digital currencies. Since July 2021, the Eurosystem has also been exploring the possibility of implementing a digital euro. If this comes to fruition, it could complement the existing SEPA infrastructures and build upon European payment solutions for the benefit of European citizens and businesses alike.



TUOMAS VÄLIMÄKI

Member of the Board -
Bank of Finland

Instant payments and standards to enable new pan- European payment methods

Single Euro Payments Area (SEPA) has benefitted us a great deal. With joint standards and rules, credit transfers are transmitted uniformly within a country or from one country to another, even with same fees. Technological developments and the fact that we, the consumers, expect everything to take place in real time are also reflected in our expectations for the next steps in the evolution of payments.

However, processing payments is much more than just instant messaging: a payment message means nothing if there is no embedded mechanism to transfer the associated credit. And there is much more. Risk management, authentication, KYC, AML and sanction screening are functions that need to be performed when conducting payments. Payments industry is responding to the growing expectations. Automated Clearing Houses have developed their cycles to transfer credit faster. Often this takes place within the same day. In addition, we have the instant payments, which in SEPA are implemented via the SEPA instant credit transfer scheme (SCTInst). Payments that are made

under the scheme are transferred from the payer to the payee immediately 24/7.

SEPA Instant payment scheme was introduced in November 2017 and its implementation still continues. A lot has been done, but we can see also many shortcomings. Not all SEPA countries yet meet the regulatory requirement for coverage. And fulfilling the regulation doesn't tell all about the actual situation. For example, in Finland, good progress has been made in general as banks have built capabilities to receive instant payments. Although this meets the requirement of the regulation, full benefits can only be gained when incoming and outgoing payments are treated the same way in all relevant participants. This development takes time, and it is understandable that banks are moving forward according to their own business decisions. There are numerous development streams that fight for the resources in banks.

The current situation is not optimal for the users, i.e. consumers and businesses. How to promote instant payments, if there is no certainty of the relevant parties' capability to treat payment instructions according to the same rule book? Achieving full benefits of instant payments requires both the payer and the payee to be aware and trust when they can expect the funds transferred to be available to the payee.

**We need a common
real time electronic
retail payment method
that is available all
around Europe.**

There can be many rails for instant payment and not everything has to be transferred along the same channel. Still, standardization facilitates expansion. The Eurosystem has set full deployment of instant payments as one of the main goals in its retail payment strategy. We see real benefits in instant payments. To support implementation, the Eurosystem also launched the TARGET Instant Payment Settlement (TIPS) system. With the recent changes in TIPS, the Eurosystem facilitates pan-European reachability of instant payments by enabling also ACHs as clearing members.

Instant payment infrastructure will be of particular importance in the future as it can be used as a foundation for new payment services to end customers. When money can be transferred in real-time across the Europe, new innovative solutions can be built on top of it.

According to the Bank of Finland's annual consumer survey, card payments have grown strongly over the years at the expense of cash. However, the use of mobile payments is becoming more and more popular and the summit of card payments may already be behind us. Mobile payments still often involve the use of card payment rails. But it doesn't have to stay like that. Smartphone applications can be developed to link the payer to payee and the established connection can be utilized to send instant payment transactions to banks for settlement. This development would create competition in the payments market and benefit payers and payees both with enhanced service level and with reduced costs.

Before this will be reality, there are challenges that need to be overcome. Banks' interfaces via which the new payment apps could send and receive transactions, are inconsistent and non-standardised. New services need to have uniform rules and a business logic which benefits all parties in the payment chain. To overcome these hurdles and to enable pan-European development, we need European coordination and joint efforts. Payments is a business where economies of scale are significant, and it naturally leads to market concentration. These efficiencies may not trickle down to end users if market concentration means non-existing competition.

The euro area deserves more than facilitating the interoperability of some aging technology based national payment methods to complement the role of cash as a true European retail payment method. That is, we need a common, real time or instant electronic retail payment method that is based on the latest technology and could be used everywhere in Europe, both in physical stores and in e-commerce.



PIERO CIPOLLONE

Deputy Governor -
Banca d'Italia

Connecting fast payments system to improve cross- border payments

Advancing the G20 Agenda on cross-border payments was a priority of the Italian G-20 Presidency.

There are many ways to address the current difficulties in retail cross-border payments but the current state of development of the CBDC and the trends observed in the corresponding banking models suggest that the most promising way forward is to tap into what we already have and put interoperability of the fast payments system at the centre of our considerations.

To move money smoothly across jurisdictions, we need to address the three dimensions of interoperability – technical, semantic and business-related. Despite the fact that central banks command only some of the levers needed to reach effective solutions, much can be done by orchestrating a well coordinated common effort among all the actors involved, namely governments and private-sector operators.

Central banks have much experience with retail and wholesale payment systems, and have all the technical

skills not only to set up brand new interoperable payment systems but also to figure out solutions for connecting existing infrastructures.

The Bank of Italy, in coordination with the Eurosystem, has spent a lot of time studying both how to enlarge the scope of a payments' platform and how to connect fast payment systems in different jurisdictions. It might be useful to reflect on a couple of experiences.

The first case refers to the use of TIPS by Sveriges Riksbank, which is planned to start in 2022 for the execution of instant payments in Swedish krona. In addition, a solution to the problem of cross-currency settlement, i.e. where euro and krona are both present in the same transaction, is now being investigated. From an engineering perspective, sharing the same platform allows us to exploit common technical and semantic elements. From a legal viewpoint, the Eurosystem concluded a Currency Participation Agreement (CPA) with Riksbank in which mutual rights and obligations are defined. Our common European Union membership has minimized the need for adaptation, thanks to comparable legal backgrounds.

Other European jurisdictions, some not belonging to the EU, are working with the Bank of Italy and with the ECB to explore the possibility of replicating this model, and TIPS is a recognized benchmark for those countries aiming to join the EU.

**The most promising
way forward is to put
FPSs interoperability
at the centre of our
considerations.**

As members of the Eurosystem, we should be bolder in engaging with neighbouring jurisdictions, especially - but not only - those belonging to the EU, in order to replicate this model.

The second case refers to the successful experiment of a connection between Fast Payment Systems (FPSs), namely Buna and TIPS. BUNA IPS is the system corresponding to TIPS operated by ARPCSO, an independent entity owned by the Arab Monetary Fund (AMF). During the experiment, a number of cross-currency transactions were settled in both TIPS and BUNA IPS, by debiting a bank's TIPS account in EUR

and crediting another bank's account in BUNA in Jordanian dinar (JOD). The average end-to-end response time for these transactions was approximately 15 seconds.

This second experience goes beyond what has been done in other cases of FPSs between two interconnected jurisdictions, since with a single link we were able to connect the 19 TIPS countries with the 16 Buna jurisdictions.

This experiment points to a key dimension of cross-border payments: the role and local importance of regional systems. Developing regional fast payment systems among countries whose legal and technical frameworks have many commonalities can preserve local customer relationships and banks' internal procedures and preferences, thereby facilitating broad political consensus for the interlinking. At the same time, these interlinked systems could represent an intermediate step on the path to a common platform able to connect everybody by means of a single link.

The Nexus project, which the Banca d'Italia has recently joined, is one such example. It aims to connect national payment systems to improve the speed, cost and transparency of cross-border payments. A single connection to the Nexus platform should allow a fast payments system to reach all the other countries participating in Nexus.

To leverage this technical expertise, central banks should assign the highest priority to projects where technical interoperability would per se permit the smooth flow of funds between different jurisdictions. In terms of priorities, the next one should be our efforts to connect regional fast payment systems as they maximize the returns for both citizens and firms that both stand to benefit from the interoperability of payment systems, while limiting the number of links needed to ensure their interoperability.

As for business interoperability, we must accept that our mandate falls short of this need, since the government and the private sector occupy the driver's seat in this process. But we should also be cognizant of our power of advocacy and stand ready to use it.



ERIC TAK

Global head of the Payments Centre - ING Group

Paving the way for EPI - a Dutch perspective

While the EU continues to strive for a single market, payments remain a largely national affair. Fragmentation caused by regulatory differences, national payment solutions and local culture and payment habits continue to make the EU payment landscape complex. As most national cards and alternative payment methods still do not work across borders, a truly European payment solution is missing. When you add dependencies on foreign players and the increase of Bigtech entering the market, the importance to start working together on a unified pan-European solution becomes clear. This is needed to have sufficient scale to invest, to stay relevant and to ensure usage across borders.

For many years, the Dutch payment system has been among the most efficient and advanced in the world. At the end of 2020 85% of all Dutch payments with Debit and Credit cards were contactless, predominantly with contactless payment cards and increasingly with a smartphone or wearable.¹ For e-commerce purchases, iDEAL is the market leader in the Netherlands. iDEAL is an online payment method developed by Dutch banks that enables consumers to pay online through their own bank. In addition to webshops, other organisations that are not part of the

e-commerce market, like utilities or public use-cases, also accept iDEAL. Almost 70% of Dutch consumers use this method to pay for their online purchases,² of which 85% is handled through a mobile device.³ In order for such a market to switch to a European alternative, it would have to be at least as convenient and safe as already existing methods. Not an easy task, but nevertheless we believe it to be an important one.

The European Payment Initiative (EPI) aims to create this truly European payment scheme (covering P2P, Point of Sale and e-commerce/m-commerce) for the EU to regain sovereignty in payments, push the single market further and provide a European choice to its citizens. For banks such a scheme can mean a more scalable solution that is focused on innovation and better facilitates cross-border usage and ultimately global acceptance.

For the Netherlands specifically there are a few obstacles. Currently the local Interchange Fee for Debit cards is capped at € 0,02 while the EU cap lies at 0,20% of the transaction value. The proposed scheme fees for EPI will reflect the real costs of processing transactions and are based on de European interchange levels. Therefore it is less attractive for Dutch players to use the EPI card-scheme. For a truly European approach it would be important to eliminate the Member State options for the Interchange Fee that are already distorting cross-border acquiring but now also complicate the participation in EPI. Also the emergence of Debit cards that can be used for e-commerce necessitate a rethink of IFR caps in Member States.

**EPI is not an easy task,
but we believe it to be
an important one.**

This is especially important as processing costs for e-commerce purchases are generally higher due to fraud mitigation and the need for 3DS security. As we see more e-commerce Debit card solutions coming up, an interchange fee of € 0.02 would not be sufficient to cover the costs. Furthermore, while we believe that EPI is an important step in strengthening Europe's payments landscape, we would encourage that this is developed leveraging existing best practices. We believe iDEAL is such a best practice and can provide a good basis for an EPI solution.

The challenges that have led to the creation of EPI go beyond payments and also touch upon the future and relevance of banks. Such a trustworthy interoperable EU-wide architecture, together with initiatives like the EU electronic identity wallet are important stepping stones for regulatory developments like a much needed Open Data framework to facilitate a data driven economy. Therefore it would be important to keep the lessons learned from PSD2 in mind: i) safeguard real technical standards; ii) ensure supervisory harmonization; iii) make sure the system is trustworthy and privacy sensitive e.g. think about data minimization and the use of consent dashboards.

The challenges of today's payment landscape require an holistic approach and cooperation among all the different actors involved, but getting it right would mean a future-proof solution that would reclaim the EU's sovereignty in this field.

[1] Betaalvereniging Nederland - <https://factsheet.betaalvereniging.nl/>

[2] Betaalvereniging Nederland - https://www.betaalvereniging.nl/wp-content/uploads/Infographic_Thuiswinkel_Markt_Monitor_2020.pdf

[3] iDeal - <https://www.ideal.nl/actueel/nieuws/explosieve-groei-van-ideal-in-coronajaar-2020/>

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- 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
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OUR OBJECTIVES

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

OUR APPROACH

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two-yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proved over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

OUR EVENTS AND MEETINGS

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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