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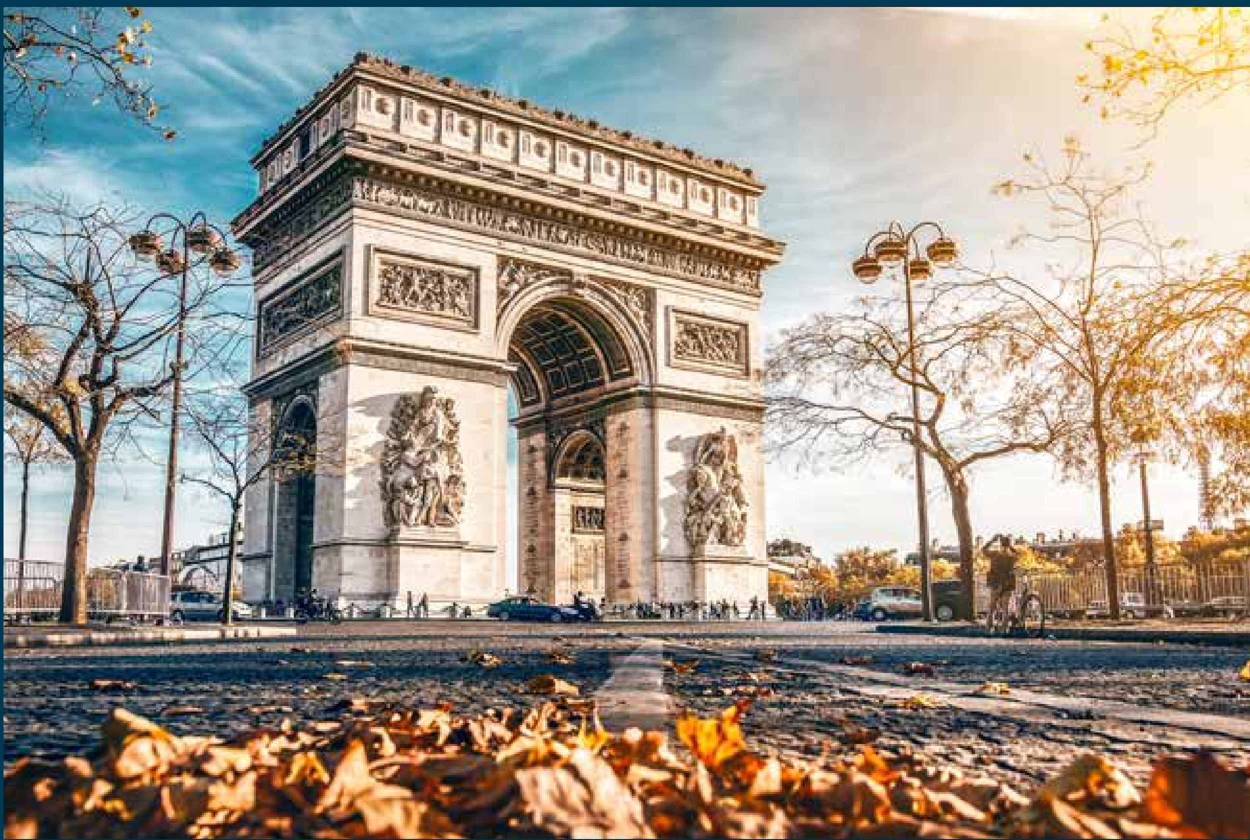
HIGH LEVEL SEMINAR
PARIS - FEBRUARY 2022

Organised in association with the French EU Council Presidency

Summary



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Editorial

The Eurofi High Level Seminar took place physically in Paris on the eve of the informal Ecofin meeting and was organised in association with the French EU Council Presidency. The 40 sessions of this Seminar involved 230 speakers from the EU public authorities and the financial industry and were followed by more than 900 participants from the public and private sectors.

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

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

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I

POST-COVID ECONOMIC PROSPECTS AND REFORMS

Ensuring EU growth and financial stability with over public indebtedness

Even before the Covid crisis, global debt was at a record since the 1950s also due to accommodative monetary policies in advanced countries over the past 20 years. The debt situation has been worsening with the Covid crisis.

Several points emerged from this discussion: Firstly, in the current environment characterised by the return of inflation, the continuation of a monetary policy of very low interest rates in the euro area would intensify its negative consequences on growth, employment and financial stability. Secondly, effective macroprudential policy is essential for financial stability and ensures that monetary and fiscal policy can play their respective roles. Thirdly, the increase in public debt and unlimited money creation can result in a dangerous spiral for our economies. Increasing public spending and debt in highly indebted European economies can lead to economic underperformance. Structural issues can only be resolved by structural policies and economic growth.

1. Lasting ultra-loose monetary policies discourage productive investment and growth in Europe

1.1 Persistent zero interest rates damage productive investment

An expert stated that low interest rates or negative interest rates have not fostered productive investment. For the last 20 years there has been a lower capital base in terms of productive investment. Productive investment has receded and decreased over the last 20 years. In advanced economies the level of growth of non-residential investment in tangible assets has declined significantly over the past two decades, from 14.1% of gross domestic product (GDP) in 2000 to 11.5% in 2019. One of the reasons is the liquidity trap. If interest rates are zero or even negative, then the rational reaction of a saver is to keep their money in liquid forms. If the evolution of household financial assets is observed over the last 20 years there has been a steep increase in the share of liquid instruments held by households.

1.2 Loose monetary policy coupled with expected low returns on earnings drive a preference for liquidity

An expert explained that the liquidity trap is a major phenomenon which is never analysed in the reports of big institutions and central banks, but it is absolutely central. The more someone has a propensity to hold assets in liquid forms the less they can have long-term investments. The inconveniences and the drawbacks of a policy of zero or negative interest rates are absolutely enormous. If a company has to choose between a risky project over 20 or 30 years or one in order to buy back their shares, in an environment of zero interest rates it is going to do the latter.

1.3 Remuneration is a key driver for contributing to sustainable growth

An expert added that remuneration is important in contributing to growth. Someone does not choose an investment project only because of the return they are going to get on it, but if they know that the return is going to be zero or even negative then they are not going to do it. Inflation is worse than forecast, and now is the time to act on it.

1.4 Persistent loose monetary policies have led to negative economic and financial consequences

1.4.1 Lasting zero or even negative interest rates have been a disincentive for many Member States to undertake structural reforms

An expert underlined that one of the big drawbacks of too easy a monetary policy is that it allows governments to delay structural actions. Europe has reached some limits on the easy borrowing policy that it has been pursuing in recent years because of inflation and high fiscal deficits and will have to move towards structural policies. These policies cover labour markets, research, development, the inequality problem, and energy policy. Energy policy is going to have to significantly change. Europe will need much more electricity, which is a significant investment. That investment will be done by the public and private sectors. If Europe wants the private sector to invest in those types of investments it is going to have to give it remuneration, which monetary policy with zero interest rates is not going to be able to do.

1.4.2 Persistent loose monetary policies may lead to negative economic and financial consequences

A Central Bank official highlighted the importance of acknowledging the problem with negative interest rates. It is necessary to incentivise risk-taking by a positive real return on investment. If this is not achieved, then the result will be low investment. The savings of households and non-financial companies will be channelled towards liquid and non risky assets, thus leading to companies being highly liquid but are not investing. When looking at the overall picture the inequalities are increasing. Indeed, lasting low interest rates and unconventional monetary policy instruments have tended to increase asset prices which have benefited the wealthiest segment of society. So, Europe is trying to be kind but is actually being unkind towards people on low incomes.

The Chair thanked the Central Bank official for referring to the inequalities as the side effects of a large amount of liquidity put in the market.

An industry representative added that inequalities will be a key credit driver in future years. It links to the theme of structural reforms because some of the lack of structural reform is coming because of insiders trying to protect their position, often to the detriment of outsiders. It is extremely important to keep older workers in the labour force.

2. Macroprudential policy protects both monetary and fiscal policy from financial dominance

Effective macroprudential policy is essential for financial stability, which is vital for price stability. It ensures that monetary and fiscal policy can play their respective roles.

2.1 Macroprudential policy is needed to prevent financial stability risks from emerging

A Central Bank official stated that the joint responsibility is to make sure that Europe has a stable financial system, stable public finances, and stable prices. The economy is facing structural change. This requires a resilient financial system – especially as it is also undergoing structural change, e.g. due to digitalization. During the pandemic, the financial system functioned quite well in providing liquidity to the real economy. Still, vulnerabilities have continued to build up over this period, e.g. in the form of a higher NFC leverage in some market segments. Macroprudential policy is the first line of defence against financial stability risks. It is particularly important in a monetary union and essential for making sure that fiscal and monetary policy can focus on their main mandates.

A Central Bank official added that resilience of the financial system is fundamental for the resilience of the real economy, financing investment and growth. Many challenges lie ahead. Finding answers to problems posed by digitalisation and climate change have been added to central banks' tasks. Geopolitical risks and their effects on structural change are adding additional uncertainty. To manage all these challenges, a resilient financial system is needed. Three elements are important: adequately financing the transition, awareness of the emerging risks, and an efficient framework for the entry and exit of financial firms into financial system.

2.2 Macroprudential risks should not be underestimated

A Central Bank official highlighted that the fiscal measures for the real economy also indirectly protected the financial system during the Covid crisis. In that sense it was different from the global financial crisis, where there was targeted support to financial institutions. But vulnerabilities have increased in the financial sector. Indeed, banks have increased exposure to interest rate risk and assets are potentially over-valued. There is a concern notably that macro risks are currently being underestimated by financial institutions. In past decades there was usually an increase in corporate insolvencies during a recession. However, in the past two recessions, caused the global financial crisis and the pandemic, corporate insolvencies in some countries did not increase by much or even decreased even though GDP sharply declined. Looking ahead, correlations between credit risk and macro risks could return to their previous patterns, leaving financial institutions with too little risk provisions if they take low default rates (enabled by ample fiscal support) for granted. To ensure that fiscal policy can focus on its tasks, we need strong macroprudential policies and appropriate buffers in the financial system to strengthen resilience against macroeconomic risks.

2.3 Effective macroprudential policy ensures the stability-oriented financial sector policies and monetary policy are aligned

A Central Bank official added that Stability and Growth Pact is an essential instrument for aligning stability oriented fiscal and monetary policies. Without it, fiscal policy could be overly expansionary, eventually leading to fiscal dominance: A necessary monetary tightening may be delayed if it raises concerns about the sustainability of public debt. The macroprudential policy framework complements the Stability and Growth Pact (SGP) by disincentivising excessive private borrowing which may lead to "financial dominance", in which a necessary monetary tightening may be delayed if it puts the stability of financial institutions at risk. Hence, macroprudential policy is not just a topic relevant for technocrats, supervisory institutions and central banks, but for the entire society.

3. The fiscal policy response to the pandemic was appropriate, but increasing public spending and debt in over-indebted countries would lead to lower economic performance

3.1 Significant fiscal deficits were necessary during the Covid crisis

A Central Bank official noted that in this pandemic government support took a central role. The accommodative monetary policy was accommodating governments in increasing their deficits and debts, all for a justified reason. The financial crisis was a big shock which too required governments to give their all, which meant higher deficits, to be followed by a debt crisis. The pandemic then hit. Governments wanted to give the economy its full support. So one can say there is always good cause to spend, especially when monetary policies are accommodative. When there are no fiscal governance regulations any cause gives governments a blank cheque to spend on whatever they require.

A Central Bank official agreed that the fiscal policy response to the pandemic was well targeted and necessary. With the large decline in GDP that Europe saw due to the pandemic and the associated lockdown measures it was important to protect the real economy.

A policy-maker stated, from a personal capacity, that regarding the appropriateness of the fiscal policy response to the Covid crisis, while it is never easy to respond to crises, the response to the Covid crisis should be assessed very positively. In particular, if the fiscal policy response for the Covid crisis is compared to the one for the financial crisis, then most people would agree that Europe got it badly wrong in some respects for the first crisis and did a much better job for the second crisis. A simple illustration of this is provided by the fact that the deficit increase has been higher in this crisis than the great financial crisis, but the increase in the debt to GDP ratio has been lower. The reason is that the damage to growth has ben contained in the case of the Covid crisis, while it has been persisting in the case of the financial crisis, in particular in the euro area.

Supporting the real economy and the financial system during the Covid crisis did not raise moral hazard concerns. A Central Bank official observed that the moral hazard effects were more acute in the global financial crisis than in the Covid crisis. The pandemic was an unexpected global shock that -contrary to the financial crisis- was not the result of wrong incentives and a build-up of debt and risks in some sector, as in the financial system before the global financial crisis. On the contrary, during the pandemic fiscal policy measures helped prevent spillovers from a distressed real economy to the financial system. They protected firms and households against losses in income and therefore shielded the financial system from macroeconomic risk.

3.2 Sustainable fiscal policies are required to deliver a flexible and competitive economy

3.2.1 The divergence in public debt levels across EU member states is a concern

The Chair noted that earlier at Eurofi an expert stated that one of the ideas for the future of the SGP is to examine what countries do in a more tailor-made approach with an Article 4 IMF.

The Chair asked a policy-maker what a significant change to NextGenerationEU (NGEU) means from inside the European Commission, as for the first time Europe has both the money to invest and a strong incentive for structural reform, and technical support for states that want to receive support.

This policy-maker remarked that, while, as noted, the level of debt has increased less than it could have done if the policy response had been botched, the level of public debt is significant and cause for concern. One could have questions. The first question is whether the level of debt is too high for the Euro area as a whole or if it is too high for Euro area countries. The Euro area as a whole does not stand out among developed economies for its high level of debt. The second and most important question is the one of divergence of this public debt across Member States. This is probably the most serious concern, given the incompleteness of Economic and Monetary Union. A downward trajectory in the next few years for public debt in the EU due to high(er) inflation is a very uncertain prospect.

3.2.2 Fiscal rules are needed in a Monetary Union; the economic governance of the EU needs to be strengthened

A policy-maker added that there is clearly a problem of divergences in debt and debt levels that are too high in some countries, which leads to the issue of the fiscal framework. Fiscal rules are necessary, especially in the monetary union, as only relying on the market will not work. It is important to recognise the dilemma of supranational fiscal rule, and that imposing fiscal rule on fiscal sovereigns is a potential intractable problem.

An industry representative stated that the Covid crisis has highlighted that the economic governance of the European Union and Eurozone was insufficient and needed reform. The first moves that were taken by the authorities once the Covid crisis broke out were to suspend the SGP and introduce NGEU. Europe needs to be very careful not to lose the opportunity to rethink economic governance once the impact of the Covid crisis is over.

3.2.3 Addressing the tensions between EU fiscal rules and national fiscal policies

A policy-maker was of the view that Europe may have been too ambitious about what can be achieved with supranational fiscal rules, as the rationale for supranational as opposed to national fiscal rules is essentially to deal with EU wide externalities. Much of the work of those who have been reflecting on fiscal rules has been about coming up with some clever formulas for debt reduction, where it is now recognized that the current one is too harsh. There is a temptation among specialists to create some kind of algorithm and deduct from this algorithm a certain pace of fiscal adjustment. There are doubts that this may work.

More respect for national preferences in exchange for a more binding orientation of fiscal policy at national level could be a way forward. One question about the working of fiscal rules is whether EU fiscal rules have an effect on national fiscal policy or whether the fact that countries respect fiscal rules, or don't, reflects other variables such as cultural variables in the broad sense. The 3% seems to have an effect: it has become a sort 'Schelling coordination point' for fiscal policy. The other solution is to potentially give a greater role on sustainability analysis to set the band of what is permissible to countries depending on their fiscal position, or to shorten their level of debt.

3.2.4 Efficient fiscal policies must be incentivised at each and every public administration level

A Central Bank official explained that it is important to have EU rules and to deal with externalities, but the incentives to have appropriate public policies and efficient spending policies have to start at the national level. Apart from the important SGP macro narrative, it is also important to think about what incentives exist at the national or regional level. The European Commission plays an important role in establishing frameworks for dealing with public policies and public finances.

4. Only domestic supply-side-oriented reforms can foster productivity and growth

4.1 Europe is not unique in facing growth challenges

An industry representative stated that slowing long-term growth rates are taking place across the advanced economies. Differences in the levels are because of geographic location. If a country is close to a fast-growing country, then it is easier if they are a major trading partner. There is a very different risk appetite across countries, which has an impact on long-term structural growth trends. Europe is not alone. A 2021 International Monetary Fund (IMF) paper discussed South Korea and the challenges that it faces with slower growth going forward.

4.1.1 The most acute investment challenges vary by country

An industry representative highlighted that Moody's thinks that Canada has a long-term structural growth rate of about 1.9%. In a European context that would be on the high side. Sweden has growth potential in excess of 2%; one of the reasons that Moody's thinks that Sweden is able to grow more quickly is also because the labour force participation rate is high, including among older workers. The industry representative added that the chart that Moody's and other market participants use thinking about the divergence in total factor productivity growth between the US and Europe in the years following the global financial crisis is striking. One of the driving factors behind that divergence in total factor productivity (TFP) growth lies with structural reform.

4.1.2 Facing the secular stagnation

An industry representative noted that there are questions about the fact that investment is simply not enough. This is a huge problem, and the European answer is unclear. A lot of evidence has recently been produced about the R-Star story and secular stagnation. Issues causing the more superficial macroeconomic dynamics are driven by long-term drivers such as demography, distributional elements, and a fall in productivity in major sectors. The structural agenda needs serious consideration, as well as asking what the right policy mix is. There is a tendency towards secular stagnation, which by itself represents a limitation to policy space and monetary policy. Therefore, that constraint needs to be lifted in terms of getting an R-Star, which is higher in the longer-term. There is a great deal of structural measures to implement in order to unleash policy space for monetary policy and other policies.

4.2 Highly indebted countries need structural reforms

An industry representative added that higher and sustained growth are needed to remove the debt trap. There are several ways in theory to get rid of debt, but only one can be recommended. The only one that is left is more growth. Structural reforms are needed in order to get more growth. The question then turns into why Europe does not have enough structural reforms.

A Central Bank official noted that governments always try to use just causes to spend more. High debts and big deficits are opposed because they remove the restraint on governments to go into productive investment. The quality of expenditure turns poor because there is a lack of discipline. Highly indebted countries need structural reforms. Europe has a problem with the withdrawal of senior people and immigrants from the labour force due to the pandemic. Europe needs regulations and the SGP for productivity. Governments have to be pushed towards undertaking structural reforms. The benefit of the NGEU fund is not in spending more. The NGEU is an appropriate contribution for the digitalisation and climate change challenges and to incentivise structural reforms.

A Central Bank official (Claudia Buch) stated that if structural reforms are going to succeed, firms with an unsustainable business model should not be protected but rather leave the market. The pandemic has shown that Europe's insolvency frameworks might not be ideal. Of course, workers need be supported and enabled to migrate to new businesses. For a long time there a higher labour-market turnover in the US than in Europe.

4.3 Labour market reforms are critical to boost productivity and reskill workers

An industry representative underlined that younger workers need to be included in labour market reforms. Structural reform can help to address the duality in the labour market. The number of permanent contracts issued in France has dramatically changed in recent few years following the labour market reforms. An important area of a younger worker's productivity gains is learning by doing. The data is clear that investment in training and development of staff on temporary contracts is not the same as for permanent contracts.

4.4 Improving the incentives for domestic structural reforms

An industry representative stated that when looking at the structural reform story, eventually the problem becomes the unavailability of the private sector or the public sector to launch a structural reform programme that is serious. The political incentives for structural reforms are weak. Benefits from structural reforms only come to the medium and long term, immediately showing the lack of incentive for a policy-maker to enquire into something which usually brings costs up front and benefits in the future where they cannot be exchanged for political benefit. It is important to ask what can be done in order to improve the incentives for structural action. One answer is the NGEU, which links the structural reform agenda with the investment agenda and to the resources available for that agenda.

An industry representative added that there is a lot that the private financial sector can do. The amount of private money needed to implement the strategic actions to invest in digital and sustainable growth is much larger than the amount of money that the public side can put on the table. The financial system comes in when thinking about how to mobilise private money to do that. The main purpose of the financial system is to link savings to investment, which are very high, especially in Europe. It is vital to direct that to investment needed to complete the transformation.

4.5 The structural reforms agenda in Italy is up to the challenges

An industry representative noted that the list of reforms is very long, so priorities need to be chosen. The current list that the Italian government is working on includes civil justice, public administration, competition policy, and an addition of measures to boost innovation. The requirements agreed with the Commission have been met. This is important for Europe, because it would show that a European system of governance, of which NGEU is part, can work.

4.6 NGEU offers opportunity for debt laden countries to address structural reform challenges

An industry representative stated that structural reforms are one of the essential elements of the NGEU. When talking about NGEU for the largest recipient countries in southern Europe it is thought about as being a once in a generation opportunity due to the structural reforms that are contingent on receiving the funds. Debt matters. If debt is left to one side there are four ways a country can reduce debt: inflation, growth, fiscal consolidation, and interest rates. That is where structural reform can potentially come in. When thinking about structural reform or government debt, the difficult time is during the good times, not in times of crisis.

The Chair noted that the success of the NGEU in Italy is a precondition of any decision to make a permanent fiscal capacity. It is important to show that it works. It is also important to note that when transferring the money between countries it is impossible to have completely different tax systems and completely different retirement ages.

Sylvie Goulard invited all panellists to read the Monetary Scoreboard published by Eurofi. EU fiscal rules are needed within the EU. One of the difficult issues for monitoring an economic union is that Europe has excluded the Court of Justice, which has never been the case for the single market.

Relaunching productive investment in the EU: is NGEU the gamechanger?

1. Europe is in a vulnerable situation and is facing a challenging monetary and financial environment at a time when it must achieve considerable investments related to the energy and digital transition

1.1 Europe is vulnerable

The Chair stated that Europe is in a vulnerable situation, not only due to Covid, but also because between 2008 and 2020 most advanced economies accumulated piled-up debt, both public and private. Moreover, real gross domestic product (GDP) growth and productivity gains in the euro area have failed to catch up with the US, China and Japan over the past two decades. Productivity gaps across member countries remain significant.

He added that global debt was at an all-peacetime record even before Covid. The debt situation has been worsening with Covid. Public and private global debt, public and private debt of advanced economies, and public and private European debt are higher than before the Lehman Brothers crisis. This vulnerability is occurring when Europe is at an inflection point regarding the green transition. The savings glut will be over after several years. Indeed, Europe has so many investments to produce that the probability of having an excess of savings is very meagre.

1.2 A challenging monetary and financial environment

The Chair observed that Europe has a change regarding the monetary and financial environment. Inflation is back in the US and Europe, with the probability of having inflation entrenched for a number of years. It has consequences in terms of real rates because of the progressive evaporation of the savings glut in terms of inflation, which will be much higher than in the past. Nominal interest rates should be higher. Europe, the advanced economy and the global economy are in a very, very demanding financial environment. There is not much importance to the fact that the pickup of inflation puts the real short term rates very low.

1.3 Medium to long-term growth depends on today's level of investment

A public representative stated that private investments remaining at a standstill would hamper future growth potential and the EU's economy risks entering a vicious circle. Lower growth potential would cause tighter fiscal rules imposed to governments, leaving them less space to spend and forcing them to cut investments. Higher rates of bankruptcies would generate higher levels of unemployment, making social expenditure more important and generating even more pressure on public productive investments. The rise in unemployment would produce a loss of human capital, hampering the economy's growth potential even more. It is important to act fast.

1.4 The growth impact from the green and digital transition may be too optimistic

An official noted that the results from the European Investment Bank (EIB) investment survey suggest that the expectations towards the more permanent growth impact from the green and digital transition may be too optimistic. Regarding green investment, firms require clarity on the decarbonisation path at the national and EU level. The fact that very few Member States committed to structurally change incentives for the green transition suggests that there is room to attract private investors to green activities. It is important not to oversell green investment and digitalisation. Europe's economy is at a critical junction. There may be a tipping point where the savings glut reverses because certain generations will start to retire and draw on their savings. Investment is needed into the green transition and digitalisation; green investments do not add to the capital stock but change the composition of the existing capital stock. That increases inflationary pressure.

An official explained that the second element is timing. By overselling the need for green investments and selling or having incentives that may be right but not well timed, Europe may run into a situation where it underinvests in conventional energy forms. That will create a scarcity, but at that time Europe may not have the capacity of green energy production to fill up the gap. That will create an increasing inflationary push and a problem for European companies needing cheap energy sources.

1.5 It is time to accelerate the green and digital transition

A public representative observed that investments into the EU green and digital transition are estimated by the EU Commission at nearly €650 billion per year until 2030. The green transition is complex and has to be taken very seriously by private and public investments. If Europe comes to a situation where it is faced with an energy crisis then the situation will be worsened if it does not have enough alternative sources because it has delayed investment for too long. Europe should not keep delaying the transformation towards a transition.

An expert emphasized that the key challenge is global warming. One of the major dimensions of the European long-term strategy designed by NextGenerationEU (NGEU) is climate. NGEU cannot be disassociated from the Fit for 55 package. Decarbonisation of the planet requires a huge amount of long-term investments. In sectors like steel, petrochemicals, and fertilisers it is urgent to put agreements in place at the global level to phase out refrigerants and important threats on climate change.

2. NGEU: a decisive European policy response to the crisis which needs to be completed

The Covid crisis has been tough but the economic policy response has been remarkable. However, the NGEU recovery plan will not be enough to meet the huge amount of investments required for the energy and digital transition. Accelerating private investment is key to make Europe ready for the future. Therefore, the main barriers to investment such as the availability of skilled staff, labour regulation and energy costs need to be addressed. A new EU strategy is also required for financing these investment needs.

2.1 NGEU is a unique opportunity to push ahead with structural reforms and fill investment gaps

An official remarked that the crisis response in Europe was forceful and exceptionally successful. Europe saw a strong rebound in 2021, and despite the Omicron wave and global tensions, a strong recovery into 2022 and 2023 is planned. This is an exceptionally good development when examining labour market issues. The NGEU fund has been one important element of the recovery effort. In the short term the NGEU fund helps and supports aggregate demand, fills the investment gap and supports public investment. The NGEU fund also focuses on green and digital transformation. The green and digital transformation of the economy is extremely important. It is expected that there will be an increase in productivity and potential growth. It is estimated that the output levels will be pushed up by 1.5% of GDP in the long run, but the difference will be seen in productivity.

An IFI representative agreed that the EU response was appropriate, relevant, and well designed. The first phase of the response to the crisis was focused on national governments bringing support to companies and providing a backstop to the economy when everything had been shut down and there had been a real risk of collapse of the economy. The EU recovery package focused more on the long-term, key structural issues such as climate, digital and inclusion. The significant challenge is to well implement the package and to use the money well. The EBRD is very active in EU member states in the central and eastern Europe (CEE) region, especially in countries where productivity is lowest and are among the largest recipients of EU recovery funds as a percentage of their gross national income (GNI), such as Greece, Croatia, Bulgaria, and Romania. In 2021 the EBRD invested €2.9 billion in its 12 countries of operations in the EU, almost 100% of it in the private sector.

2.2 The implementation challenges NGEU faces remain huge, particularly in CEE

An IFI representative noted that CEE's capital markets are still fragmented, illiquid and 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 underserved sectors will be less effective without better technical and digital solutions and further significant capital market reform. The EBRD is well placed to support capital market development and efficiency. It is assisting CEE countries 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 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.

An IFI representative added that the transition to low-carbon economies will be particularly felt by CEE countries, who 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 CEE countries will be supporting a transition that is ambitious but fair. In CEE close to 80% of the EBRD's investments support the green transition.

An IFI representative suggested that NGEU must 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.

2.3 The creation of an EU Climate Investment Fund (CIF) should help countries meet their common climate goals (CCGs)

An official stated that the undertaking of public investments needs to be executed, including at the national level. When fiscal space becomes thin and when political headwinds flow there may be a step back from public investment. As part of the new fiscal rules framework many people have proposed to protect public investment in green and digital through a golden rule, but a better proposal is to have an EU CIF. A CIF will allow identification and coordination of cross border investment with the highest rate of return where the investments should go. It will protect investments achieving the fastest reduction at the lowest cost. The CIF should have borrowing capacity, because the curve of public investment on climate should be frontloaded. This borrowing capacity will help to protect member countries in their fiscal space and will continue to increase safe investments. Europe needs a strengthening of green public financial management systems.

A participant noted that it is vital to channel more savings and investment into climate and infrastructure as fast as possible. He asked an official to what extent he sees value added to the existing, efficient institutions which are channelling that on behalf of the EU, such as the EIB and the EBRD, and whether setting up a new institution or fund will take time. The official explained that the concept of a CIF and how it is formed are two different things. When countries are being confronted with a political headwind and a lack of fiscal space then public investments may not materialise, so the advantage would be to think about a more central organisation.

2.4 More is needed to meet investment needs, as well as additional steps to include private investment

An official noted that the NGEU has a focus on climate, but it is insufficient in terms of supporting the climate transition. Total annual investments of 3% of GDP are needed for the foreseeable future. Most of these investments will come from the private sector, totalling 2% to 2.5%, and the incentive structure for those investments needs to be in place. 0.5% to 1% of GDP annually is expected to come through public investments from the public sector. NGEU has a 0.2% annual contribution for five years.

Another official underlined that 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. Clarity on the path towards CO2 reduction and appropriate tax incentives are key to capitalise on the stimulus from NGEU.

An IFI representative observed that it is important to avoid crowding out the private sector in the implementation of the package. Last year's EBRD transition report shows that a return to the state is being seen in many countries. A last resort financer is needed, but Europe needs to be careful that it is not crowding out the private sector. Public money is important but private sector financing is also needed. Europe needs the development of capital markets, which is a very important theme in the context of Eurofi.

An IFI representative added that the EBRD is intervening in countries where financial market financing is very limited. The focus is to develop the policies, but also to intervene in terms of how small and medium-sized enterprises (SMEs) or private-sector companies can be supported to access the market and have capacity through equity. More equity is needed. The EBRD also intervenes in financing bail in-able debt, because that is a huge obstacle for implementing the banking union regulation and post 2008 crisis regulation in many countries.

2.5 Addressing the main barriers to investment is critical

An official explained that he has directly talked with industry and private companies in trying to find out what is creating obstacles for companies to engage in productive projects. To make a project profitable and to show some return, several factors are needed. Factors that are deterring companies at the moment include inflation, especially in raw materials, inputs becoming too expensive, energy, a lack of skilled labour and supply bottlenecks.

2.6 A new EU strategy is required for financing the huge investment needs

A public representative stated that everyone wants to move in the same direction but a different strategy may be needed. At the beginning there was an impetus driven by certain emergencies when the Banking Union was created, but in the past few years it has come to a standstill. Europe has a huge need of investments. When the pandemic started Europe realised how impossible it would be for many sectors to move forward without a certain degree of digitalisation. Urgent policy objectives are in place. NGEU was made to support these processes. Investments needed for the ecological transition and digital transition are in the range of 600 billion per year, of which 125 billion is for the digital transition. Europe needs to think about how to fill the gap in investments and about ways to continue supporting governments and public investments.

A public representative added that the approach should be focused on the problem and the objective, and not only on the instruments, on the tax and on the labels that have been dividing Europe in recent years. That has been seen with the NGEU and with the Recovery and Resilience Facility (RRF). Europe has billions and billions in savings that can be channelled towards these objectives, but it is vital to find the ways to use it and to create the infrastructure. Incentives are needed to channel these resources.

3. How to relaunch investment if savings are not remunerated or even taxed?

An expert does not see the incentives to push investment in the coming years. Long term interest rates in Europe are very low. 25% of bond stocks are still negative in terms of remuneration. If Europe maintains a very low interest rate environment it is difficult to see how the private money will come in. The key question is to get private money in those large investments. Finance is always a balance between risk and remuneration. The higher long term risk, the more a company has to receive remuneration. Buying back shares does not produce anything in terms of long term investment.

An official noted that what was just described is a version of the liquidity trap. Risk premiums are so compressed that it does not make sense to invest in risky projects because the returns are not commensurate. The situation is changing, which should also change the yield curve. Regarding the Capital Markets Union (CMU), Europe has investigated whether a bank based system or a market based system is better for growth, but there is no conclusive evidence one way or the other. If an economy wants a lot of risky, innovative firms that people invest in then a market based system does the job better, but a bank based system is better at intergenerational risk and return smoothing.

An official added that Europe will see a decompression of risk premia with the normalisation of monetary policy. However, real interest rates have decreased for the last 30 years. Lower real interest rates are expected for the future, but the decompression of the risk premia through the normalisation of policy is something that is also expected to happen.

The Chair is unsure whether real interest rates in the next 30 years will be where they were in the last 30 years. The real fall of real interest rates is more recent.

The central banks of the advanced economy had to cope with exceptional circumstances in the last 12 years, but the US and Europe are now in a different universe. The purchase of credible securities will stop at the end of March in the United States. There will be a more normal financial environment with the combination of inflation of real interest rates potentially picking up.

An expert observed that one of the most complicated issues for economists is how the interest rate is formed. The interpretation given by both economists and policy makers is that Keynes stated there was a lack of investment and a savings glut. That approach led to demand push and consumption push policies, meaning that there must be a reaction when there is a downturn.

4. The price of carbon over time is a key success factor

4.1 The need for a stable and predictable price of carbon

An expert stated that the EU has set a model for the world to fight climate change as it intends to put in place a carbon border adjustment mechanism (CBAM). The European platform for climate is of major interest for the EU because it creates the best environment to launch long term net zero investments. One of the most important conditions for success is to have a stable and predictable price of carbon over time. It is not possible to exclude the scenario of an economic downturn and downward pressure on the price of carbon. The EU should not allow the price of carbon to go down; the best policy for climate change would be for Europe to maintain the long run price of carbon at €100 per tonne. The European CBAM needs to be put in place by 2026 in order to be the trigger for the rest of the world to adopt a similar device for decarbonisation of the main carbon emitting industrial sectors in the world.

An official noted that CO2 pricing is a way of dealing with externalities as it employs market forces.

An IFI representative agreed that the energy transition will be extremely difficult without a carbon price, because that is the market mechanism that makes investment bankable. If there is no carbon price then subsidies are needed, which Europe cannot finance.

The Chair emphasized that it is important to be practical and not to create a complex scheme that will not work with the private sector. All speakers have observed that pre Covid Europe had a high level of savings and a current account surplus, but that is not the kind of investment that would fit with the excess of savings that has been observed. Europe had an excess of savings but did not do what it should have done.

4.2 The Carbon Border Adjustment Mechanism is an essential tool for climate change

An expert underlined that more public investment for climate is needed. If Europe does not find the right incentive for the private sector to be mobilised very decisively then it will fail. There are constraints on public finance, given the level of public debt. There will always be reasons to limit the amount of public investment, even for climate. The problem with climate is that it is a very long-term problem. It is vital for the European Commission to use the CBAM[1], as it can be a lever of extreme strength to push the rest of the world in the sectors concerned to go in the right direction of making an investment to start decarbonisation.

An IFI representative highlighted the challenge of being alone in this field in terms of competition, which is why the CBAM is vital. The CBAM is very technical and complicated. The practical impact is uncertain, but in countries such as Turkey and Ukraine a discussion about CBAM creates a strong incentive for companies to adjust, to improve their energy efficiency and to deal with this issue in order to be ready.

The Chair thought more discussion would have taken place regarding medium term impacts such as monetary policy changing in all advanced economies, real interest rates picking up due to the functioning of the global economy, and inflation being entrenched at a higher level. The hope is that in the medium term the advanced economy will be at 2%, because that is the joint definition of price stability by all important central banks in the advanced economy. In Glasgow the International Sustainable Standard Board (ISSB) was created to address environmental, social and governance (ESG) standards. It is important to have a consensus of the international community on the ISSB, which would be located in Frankfurt, Montreal, Beijing, and Tokyo.

1. Designed in compliance with World Trade Organisation (WTO) rules and other international obligations of the EU, the CBAM system will work as follows: EU importers will buy carbon certificates corresponding to the carbon price that would have been paid for the goods been produced under the EU's carbon pricing rules. Conversely, once a non-EU producer can show that they have already paid a price for the carbon used in the production of the imported goods in a third country, the corresponding cost can be fully deducted for the EU importer. The CBAM will help reduce the risk of carbon leakage by encouraging producers in non-EU countries to green their production processes.
The CBAM will initially apply to imports of the following goods: cement, iron and steel; aluminium, fertilisers and electricity. To provide businesses and other countries with legal certainty and stability, the CBAM will be phased in gradually and will initially apply only to a selected number of goods at high risk of carbon leakage: iron and steel, cement, fertiliser, aluminium and electricity generation. A reporting system will apply from 2023 for those products with the objective of facilitating a smooth roll out and to facilitate dialogue with third countries. Importers will start paying a financial adjustment in 2026.

Normalizing monetary policy in Europe: way forward against the threat of stagflation

The Chair underlined that monetary policy since the great financial crisis has been characterised by a very expansionary characteristic. Standard measures of core inflation are now elevated across the globe The panel discussed the causes and expected duration of the current inflationary environment as well as the priorities and the calendar regarding the normalisation of the ECB monetary policy.

1. There are many causes of high inflation

Inflation has risen sharply in many countries in recent months. The complex causes include lasting supply chain bottlenecks and supply and demand imbalances. The relationship between the growth rate of money supply and inflation was also discussed during the panel.

1.1 The acceleration of inflation reflects two supply-side shocks

A Central Bank official stated that the panellists mostly observe supply side inflation and the acceleration of inflation mainly reflects two interrelated supply side shocks. There was a series of pandemic shocks and then there was an energy shock. Finally, the confrontation over Ukraine is a supply side shock with stagflationary implications in the short term and deflationary implications in the long and medium term, depending on the resolution of the uncertainty.

With the reopening of economies and relatively robust household incomes, global and regional demand rebounded strongly. An excess of demand over supply was witnessed. This led to supply chain bottlenecks and shortages of different goods and caused soaring prices. This has happened not only in the euro area, but also in much of the world. The excess demand has pushed up the prices of energy products. Natural gas prices have also been significantly affected by the confrontation over Ukraine, and they are likely to increase in the future. It is not a coincidence that the oil price shock has occurred alongside the Covid shock.

1.2 The deflationary tendency that was witnessed for a number of years in the euro area before the pandemic has not turned into an inflationary one

A Central Bank official offered reassurance that the Governing Council will do whatever it takes to achieve its medium-term price objective. If it sees approaching inflation in the medium term, it will act in March or later, but it will review the evidence carefully. The ECB does not want to repeat the mistake of tightening too early and killing the recovery at its start. This is also true regarding the Ukraine uncertainty.

Secondly, it is impressive that the credibility of monetary policy is very high after so many years of quantitative easing (QE). Inflation expectations are 2% or below and labour wage contracts are very much consistent with the ECB's 2% inflation target. There is currently no question about the credibility of the ECB.

A Central Bank official stated that the ECB cannot control real interest rates. Central bankers cannot control real magnitudes. It is not advisable to forget where the equilibrium real interest rates determined by market forces are. Before the pandemic, the panellists all talked about negative R star. A Central Bank official is not convinced at all that fundamental forces have increased R star. Acceleration of inflation is due to a number of supply side shocks.

A Central Bank official noted that policy-makers in the widest sense are facing the issue of the need to normalise macroeconomic policy in Europe. The ECB cannot determine the movement in R star. Considering how to normalise macroeconomic policy is a fairly significant issue in the medium term for governments in particular.

1.3 Why did inflation rise so much?

An industry speaker explained that 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 due to rising asset prices. Thirdly, the pandemic disrupted supply chains, creating shortages of some key components such as semiconductors and subsequent spikes in the prices of those goods. Supply was being disrupted as demand was rising, creating a classic mismatch that could only be resolved with higher prices.

1.4 The causes of inflation are varied and complex

An expert emphasized that it is somewhat meaningless to declare that inflation is being caused by supply problems, which are temporary by nature and will quickly calm down. Firstly, there is the old problem of inelasticity of structural potential growth because of labour market rigidities, lack of qualified labour and poor productive investment behaviour over the last 20 years. Secondly, it is advisable to be careful not to underestimate the durability of high energy prices because moving to decarbonised, more expensive energy will push them up significantly. Thirdly, it is advisable to be mindful of the relationship between the evolution of money growth and inflation. In the central banks of the Fed and the ECB, not much attention is paid to the fact that inflation is also an inflationary monetary problem.

He added that pronouncements on the rapid elimination of inflation should be founded on careful economic and objective analysis. More action should not be delayed. If it does not happen the markets will act, and central banks will be behind the curve.

1.5 The relationship between the growth rate of money supply and inflation

A Central Bank official stated that the relationship with money supply is not stable and has broken in the past. Despite the very rapid rise in M3 or M0 in the last few years, inflation expectations have stayed below 2%. This is extremely important, but the Central Bank official does not belong to the class of economists who neglect the money supply. The economy is being governed by demand and supply forces. Money is part of the aggregate demand forces and sometimes matters.

The liquidity trap has been mentioned. There are cases of the effective lower bound under which money supply does not matter too much. The Mundell Fleming model is known, but there are different conditions under which money supply matters. A Central Bank official advised against being dogmatic. In the long term, inflation is determined by the money supply. However, the long term is very long.

Finally, it should not be forgotten that monetary tightening in the eurozone will start in June 2022 with the likely repayments of the targeted longer term refinancing operations (TLTRO). There are no delays.

2. Should high inflation persist longer than previously expected?

Many speakers, but not all, agreed that high inflation should last longer than expected.

2.1 Inflation should converge to 2% in the next two years

A Central Bank official noted that the supply disruptions will diminish as the end of the pandemic approaches. Combined with the envisioned style of fiscal stance, the excess demand has been eliminated slowly with a reduction in global excess demand. The second supply shock, which is the energy shock, is likely to subside depending on the resolution of the Ukrainian crisis. The ECB's projections and the forecasts of major financial institutions see inflation being reduced to 2% in the next two years. This is why forward measures of inflation such as the so-called 'five year-5-year inflation linked swap rate' as well as the euro area ten-year government benchmark bond yield are consistent with the 2% medium term inflation target.

Finally, there is not yet any evidence of sizable secondary effects in the labour market. Inflation will remain elevated for longer than the ECB predicted but is expected to decline to levels compatible with the price stability definition in the medium term. Monetary policy can tackle supply side shocks, but only at a high cost to output and employment. So far, the ECB has chosen the correct monetary policy path. It is going to continue reviewing the evidence in March 2023 and decide on the normalisation of monetary policy.

A Central Bank official stated that the green transition is one of the megatrends that the ECB has observed. In the medium term, green energy will produce lower energy prices than fossil fuels. But in the short term, there are transition costs related to the fact that storage capacity for electricity produced from green energy has not been secured. This is the reason for so much dependency on natural gas. As a consequence, the transition to green energy will cause a relative price change, elevating inflation for the short term.

2.2 Inflation is back and should not decline as quickly or by as much as projected

A Central Bank official suggested splitting the whole period into what has happened and what can be expected in future months. It is fairly widely accepted that the drivers of current inflation are related to the past crisis: energy prices, the initial shock of sharply declining prices and reversal to the previous levels. There are disturbances related to the spending patterns of people and businesses. Some very concrete measures were adopted during the crisis and before we put an end to the pandemic, its economic consequences had gradually unwound. However, the share of prices that increased has widened and is not related only to specific groups anymore. The range and pool of prices that are growing faster and faster is increasing.

A second important factor is related to expectations of citizens and firms. Due to more prolonged shocks as compared to initial expectations, different dynamics and different contributors to inflation as opposed to the initial phase can be expected in the following months.

A longer spell of higher inflation increases the danger of it becoming more entrenched and broader based. In addition, expectations of future inflation are highly state dependent and tend to react strongly to current inflation. Higher inflation could therefore result in a feedback loop through higher wages and increased inflation expectations.

A Central Bank official emphasized that, when talking about normalisation, it is necessary to answer three questions about uncertainties. The first is related to inflation, the second is related to the security situation and the third is related to the question of being too early or late.

Regarding inflation or the origins, there is a supply and demand side, but the demand side has been underestimated in the sense of major changes in the composition of demand moving from hospitality to hardware. If this hits a high, the question in the inelastic supply side is whether it is demand or supply side. The argument might not fully hold.

Secondly, when someone says there will be price increases in the short term in green energy, but they will go down in the medium term, one has to change the notions of short and medium term. The short term will be around 20 years or so, and then there will be a decrease in around 30 years.

A Central Bank official underlined that he could talk for the whole day about Ukraine, but there is a great deal of uncertainty. It also depends on how much Europe will 'give in' again.

2.3 Russia's invasion of Ukraine would cause a surge in inflation

A Central Bank official stated that he is not sure how the Ukrainian crisis will develop. Most scenarios acknowledge that the current crisis will have an additional negative (in the sense of connotation) impact in terms of prices, meaning that additional pressure towards higher inflation can be expected. There is also a small possibility that matters will turn in other directions, at least in the short term.

3. When should central banks act in the shorter term?

Some speakers explained that the continuation of very low interest rates in the euro area would intensify negative consequences for financial stability and growth. Others were more cautious and stressed that the ECB is aware of the risks of both being too early and being too late.

3.1 It is time to change gears

The dangers of normalisation are currently smaller than those of accepting persistently high inflation. Waiting too long will not make life easier for central banks or the economy.

3.1.1 Pushing too hard and too long on the monetary pedal has severe negative economic and financial consequences

An expert explained that monetary policy is said and known to help to avoid depressions and the seizure of the financial system. However, continuously stimulating and ultra loose monetary policy has increased the vulnerability of the financial system. It has led to asset bubbles and low or negative interest rates, which are detrimental to growth and investments.

With inflation soaring to record heights of 5.3% on an annual basis in Europe, normalising is urgent. The paradox is that there are constant discussions about the dangers of tightening, but monetary policy is becoming looser and looser. With 5% inflation, the interest rates are now -5% or a little more; this was not the case a few months previously. It is necessary to accept that monetary policy has not only not heightened; it has enormously loosened, and this can shed some light on the question.

He added that, if the ECB does not start to increase interest rates meaningfully, albeit gradually, there is a risk that inflation will be entrenched, and corrective actions will eventually have to be much sharper. The risk is that hesitation could later force central banks to tighten credit far more abruptly.

The ECB's very accommodative monetary policy has not been able to solve major issues. The inelasticity of the supply side of the economy shows that there are three major problems: energy is moving towards more decarbonised forms, the ECB has been restricting the share of wages in its economy to the detriment of wage earners and there are investment issues. Investment as studied by the International Monetary Fund (IMF) has declined in real terms by around 3 percentage points of global gross domestic product (GDP) over the last 20 years.

A Central Bank official stated that some of the unintended consequences of monetary policies are raising financial risks. In a low yield environment, investors are seeking yields in riskier segments of the markets or pushing the prices of some investment alternatives into levels where abrupt repricing could pose a threat to the macroeconomic environment. Furthermore, maintaining favourable financing conditions across all sectors and jurisdictions during the pandemic has contributed to increased debt levels in these sectors. The longer the highly accommodative policy is maintained, the more pronounced these risks become, and the more painful the normalisation process might have to be.

3.1.2 The dangers of normalisation are smaller than those of accepting persistently high inflation at present

An expert noted that the Governing Council and all policy-makers have to take short term and long term views and balance them. On the short term side, it is really necessary to look at the data for 9 and 10 March, what will happen to the wages and how much the inflation will really creep into it. Furthermore, it is necessary to consider the ECB projections.

There is also a long term view. Fortunately, the ECB is very far away from a deflation scenario. Secondly, it really needs to ask for the reason for further purchases. There is a question around why monetary policy support is necessary due to the current position on a longer projection. The war is a structural issue that will have inflationary tendencies.

An expert underlined that he strongly believes that the dangers of normalisation are currently smaller than those of accepting persistently high inflation. He also fails to see that the ECB cannot have a first interest rate set before stopping all of its QE. The credibility of monetary policy is of utmost importance, but it still does not have to be exactly in that order. It is necessary to look at it in the short term and long term. Should the data not change, and the influence of the war not change the panellists' minds, the way towards normalisation currently makes the most sense.

3.1.3 Waiting too long will not make life easier for central banks or the economy

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.

An industry speaker stated that the point is the 'when' question. He believes the answer is 'as soon as possible'. Due to how negative interest rates are, the direction of monetary policy is clear. The markets understand what needs to happen. However, the longer the wait is, the faster it will be necessary to move later on. If inflation keeps increasing and spreading into other sectors, then that option will be limited, and it might be necessary to move much more dramatically.

An industry speaker agreed that it is not advisable to wait too long before having to move too aggressively later on. This is the trade off. Moving gradually earlier before seeing the market response and incoming data seems to be the correct sequence; that is more important than finetuning asset purchases versus interest rates. It can be done either way. The precise sequencing is less important than sending the message that a regime shift is happening. The ECB has signalled the aforementioned to the markets, so that element of surprise and uncertainty is not really present. There will probably be relief when the process begins. Now is the time to begin a gradual move higher in rates; the markets are well prepared to intermediate the risk from that change.

The Chair stated that there are no negative interest rates in the US. However, Europe's negative interest rates have a relatively serious implication for financial stability. The worst possible asset price bubble is one in the real estate market. It is not possible to remove real estate market price increases without removing the negative interest rate.

An industry speaker added that the US has negative real interest rates. This discussion can apply equally to the Fed due to that reality. The Chair agreed, although added that negative nominal has an even stronger psychological effect on people.

3.2 We will be at the curve

The ECB is aware of the risks of both being too early and being too late.

A Central Bank official stated that the Ukraine issue is not only in the news; it should also be on the table in terms of policy-making. It is serious and is not happening far away. It is a huge structural shift, and it will not go away. Its implications will not be limited to where inflation is seen, at least in the short term.

He added that this will be inflationary in the short term in terms of energy prices, food prices and increasing risks of this route into the system. It will most likely have a negative impact on growth. The medium term and longer term outlooks are still uncertain, but the short term outlook is very clear. The problem will not go away in terms of inflationary dynamics or financial stability. The issues that Klaus Knot mentioned in the morning, including cyber resilience, are not an invented future scenario. If the panellists have been asleep, it is time for them to wake up.

A Central Bank official underlined that he does not believe that central banks are falling behind the curve on the inflationary story. However, the ECB should be aware of the risks of being too early or late. The ECB's forward guidance consists of three conditions that must be met before deciding to act on rates: inflation must reach its 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 there should be sufficiently advanced progress in the observed underlying inflation. The way the ECB operates is very well suited to addressing these problems.

A Central Bank official emphasized that soft budget constraint or too much debt is never a good idea. It leads to bubbles, reduces willingness to reform and reduces growth potential. What has happened in Ukraine has added much more to the uncertainty, but the direction is very clear. It is reducing the monetary policy support that has been necessary. It has been very ample, but it is necessary to start rebuilding policy space.

3.3 The ECB needs to pursue a clear, determined, data driven, gradual normalisation

A Central Bank official stated that it is very easy to say that the inflation number is very high, and it is necessary to act. However, the ECB Governing Council is very aware that its decisions to control inflation could kill the economy. The trade off should be understood.

On the other hand, the path to normalisation has become clearer. On the budget constraint point, a Central Bank official completely rejected the proposition that there is fiscal dominance. It is incredibly important for the ECB Governing Council to focus on its price stability mandate. It has to communicate and set out its analysis, thinking and understanding clearly so that everybody in the markets and elsewhere understands what it is doing. The ECB must follow through on what it says.

On the fiscal side, the ECB's monetary policy framework in the euro area is sound. However, that does not mean it will stay the same forever. The ECB performed its strategy review in 2021 and arrived at some changes. It will probably arrive at some changes during its next strategy review in 2025, but the heart of the framework is sound. The ECB said in its strategy review that fiscal policy can help to stabilise the economy.

A Central Bank official added that the ball is in the governments' court to decide on how to support the stabilisation of the economy, how to modernise the stability and growth pact and what decisions they are going to make to address the budget constraints. The ECB has to continue to focus on price stability and making the right decisions at the right times.

4. How should central banks act in the shorter term?

The sequence of monetary normalisation was actively debated.

4.1 An increase in interest rates before the end of the pandemic emergency purchase programme would have a much stronger effect

A Central Bank stated that the major question is around whether the ECB is entering too early or too late. There are three items for normalisation, but only two are normally addressed. The first is when to stop the purchase of assets, the second is when and how much to go for the rates and the third is when to think about starting to reduce the balance sheet. The latter has not entered the discussion yet in Europe.

The first question is whether it is advisable to first move out of the liquidity part or increase the interest rate. In the ECB's forward guidance, it has a sequence. Since it has fulfilled the forward guidance, it is free to decide what comes first. Economically, it is difficult to say that it has the correct answer or sequence.

If the ECB first removes additional liquidity, then it can start to consider increasing rates there. However, the broad public, and even many economist colleagues who are not central bankers, have never understood what the purchase of the assets should do economically. For them, stopping assets will not create the kind of urgency that would mean taking it seriously. An increase in the rates here, e.g. moving the deposit facility rate towards zero, has a much stronger signalling effect than the prices there.

A Central Bank official added that another element is which direction the ECB would want to move in if it moved with the rates first, or even later on. In the US, the Fed clearly signals the estimate of the equilibrium interest rate in real and nominal terms; it is also important for the ECB to think in this way. It is important to keep optionality, but not the small parts. It is about the long term, and it would also be important to signal the direction in order to inform the financial markets.

A Central Bank official noted that there might be disagreements in terms of sequencing. He believes that the current sequencing is appropriate, and the first step is to stop asset purchases. This is a fairly near term decision.

A Central Bank official explained that his next disagreement is on the rate increase because he does not believe that the ECB should tie its hands in terms of announcing a specific calendar. Instead, it should look at how the economy develops and the impact from Ukraine before making decisions. It is most important that there is an increased understanding that it is necessary to weigh both risks, but the situation of inflation being unacceptably high is clarifying the need to move fairly soon.

A Central Bank official underlined that the ECB should follow through on what it has said. It needs to pursue a clear, determined, data driven, gradual normalisation. It started on that path with the ECB's December decision, and the current question is to what extent it is lifting its foot from the gas pedal.

4.2 'Gradual' does not mean 'slow'

A Central Bank official highlighted the case of Latvia. Inflation is above 7%, which is in the current top five in the euro area. Latvia is small in terms of economic size. There is a target of 2% over the medium term for the euro area. National policies should join in to avoid the labour market overheating.

Monetary policy is an important, and in times of crisis critical, element. It can move quickly, but it is not by any means the only one. The ECB will be gradual and will not try to 'rock the boat'. It will try to guide the market, be flexible, keep the optionality and be data dependent. 'Gradual' does not mean 'slow'. The ECB will do the best it can and move as soon as possible. It will not happen immediately, but it is necessary to be ready.

4.3 The prospect of less friendly central banks has the attention of market players

An industry speaker stated that markets hate uncertainty and surprise, as do policymakers. However, they are facts of life that have to be dealt with. It is not advisable to be intimidated or stop what is necessary because somebody will be upset or surprised. The sequencing laid out previously does not need to hold based on circumstances and what has been learned. The markets understand that central banks will adapt to circumstances based on the environment and what has been learned from analysis and other central banks. The possibility of surprise should not stop what needs to be done.

4.4 Tapering followed by ending the negative ECB deposit facility rate would be welcomed by the banking sector

An industry speaker noted that the market does not like uncertainty or surprises, and both exist. There is uncertainty due to inflation, and the events of the previous day were surprising. As Professor Klaus Knot said in his speech, the industry really does not want a disorderly readjustment to the new reality.

An industry speaker saw three adjustments as rates go positive. Firstly, credit spread needs to price at better margins because the excess liquidity has distorted credit pricing in the market. Seven and a half years of negative rates and a flat yield curve have increasingly questioned the sustainability of banking in the eurozone. Secondly, real estate prices might have to adjust to reduced money supply in the system. Thirdly, purchases of sovereign debt in Europe will need to transfer into private investments. Policymakers need to provide the path and ensure as little surprise as possible given the heightened geopolitical situation.

He added that these unconventional measures or negative rates and excess liquidity will take an adjustment after seven years. It will be a significant adjustment for financial institution customers and governments. The last few years have been an easy ride from the perspective of balance of payments, financing debt and government debt. That adjustment needs to be made as orderly as possible. From a financial institution perspective, it is still preferable to take away the supply of money before starting to raise rates. The market could then be allowed to gradually normalise.

5. The challenge of fragmentation along the path of normalisation and its consequences on monetary policy decisions

5.1 Monetary policy cannot address structural issues

A Central Bank official emphasized that it is very difficult to solve fragmentation quickly, so it is necessary to be ready in real time. Market fragmentation is largely a sign of macro weaknesses in terms of the cross country comparison, but monetary policy cannot fix macro weaknesses. The incomplete architecture of the European

Union and euro area on the fiscal front and the common fiscal facility are critical. Fiscal and structural policies are responsible for improving productivity growth, and there will need to be a transition. That means immediate overall support from the EU is necessary for specific instances in specific countries. Unless weak economies are able to report strong productivity growth and credibly show that they can grow out of this, there is not going to be a reasonable solution to fragmentation risks.

5.2 The financial fragmentation risk needs to be addressed by domestic structural policies

A Central Bank official underlined that he is intrigued by the comment that it is fine for the time being that central banks have biased the prices of sovereign debt. If the private sector needs to take over, spreads will change implicitly there due to the move out. This is a very important message about fiscal levels. It is part of the fiscal policy to assure that, but it makes the Central Bank official nervous to hear that fiscal policy has to consider something like that because the European Union has already put the recovery and resilience funds on the table. Given that the magnitudes are outstanding, they are fairly high, so they will not bring what the ECB has in mind.

A Central Bank official added that he would provoke the private sector somewhat and say that the ECB considered the interest rate and stopping the purchases, but there was no discussion in Europe about when to shorten the balance sheet of the central bank. It is far away in Europe because there is a major part involving the US. The private sector should know that this is a critical part.

A Central Bank official noted that there is a common monetary policy for the euro bloc of countries, but all other policies are still in the domains of individual states. These structural policies will determine the final outcome. The question of wages is currently missing from the argument that inflation will become entrenched, but this is an issue on the euro area level. The individual country situations might be very different.

The Chair stated that there is a whole new set of interesting questions on wages. Late the previous evening, there was a discussion of how some countries that run high current account surpluses have managed to do so without increasing wages for so long. The currencies have not been appreciating and making workers richer as they have in the past, which means that many of the benefits of the monetary union have not been passed onto the workers. Instead, they have gone into the very high current account surpluses. This issue is one for discussion at the next Eurofi.

Open strategic autonomy: implications for finance

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, this concept of strategic autonomy has found echoes in all EU policies. In the area of finance, Brexit raised the question of our financial autonomy, in particular when it came to market-related economies. It has highlighted a key 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. The real challenge is whether the EU financial system is agile and powerful enough to back the most EU promising entrepreneurs and businesses, to invest in the rest of the world, to deliver attractive returns to savers and to remain at the frontier of innovation.

The session assessed the state of EU's financial autonomy, discussed the prerequisites to progress towards a Europe 's strategic autonomy in the financial area and the priorities to move forward. The speakers also underlined that the Russian invasion of Ukraine reinforces the need for Europe's strategic autonomy.

1. The Russian invasion of Ukraine reinforces the need for Europe's strategic autonomy

The Chair stated that the EU condemns the current war in its entirety. The European response goes beyond the policy of sanctions. For the first time in its history the EU has decided to send war material to a third country. The challenge is firstly energy, but it is also security, economic and financial. It is important to express solidarity with the Ukrainian people. Sanctions have been decided.

An official noted that Russia's attack on Ukraine has a link to what is being discussed. The consequences of what has happened cannot be underestimated. Europe has to stand together. Sanctions are necessary and must be proportionate to the full invasion undergoing in Ukraine. Europe will have to develop a new strategic approach in terms of diplomacy, defence and regarding the economic consequences the shift has.

He added that Western countries and Eastern Asian countries who share democratic values and beliefs will have to cooperate more closely. Europe wants to be more competitive, but strategic autonomy will differentiate and distinguish between relationships with other democracies and Western countries, and societies with social or political models that do not share European principal values and beliefs.

An industry representative observed that Europe is united with people who share fundamental values of freedom of speech and democracy. The way the UK government has reacted on sanctions of Russian assets and investors in London is consistent with the EU's way of looking at the world. It is important to think about what financial market infrastructure Europe wants for the next 20 years. There will be days where Europe will not be aligned with the strategic perspective of the UK, nor with the strategic perspective of the US.

2. The open strategic autonomy in the financial area: the state of play

The Chair underlined that the financial sector is a key area which open strategy can be ensured. The Commission published a communication in January 2021 that outlined EU priorities regarding the EU's economic and financial autonomy. The French Presidency is willing to maintain the impetus created by this communication.

A policy-maker explained that the Commission has based its strategy on three pillars: strengthening the international role of the euro; boosting the resilience of financial market infrastructures and the EU's broader financial sector, mainly linked with the banking union (BU) and capital markets union (CMU); and protecting the EU's financial system against the extraterritorial application of third-country measures. A common sanctions' regime is vital.

2.1 Openness: an advantage for the EU?

2.1.1 Openness is an advantage for the EU

A policy-maker observed that when the Commission undertook the communication on open strategic autonomy last year it was not a theoretical project. Openness is a big advantage for the European Union. Integrated markets and the EU single market are success stories. The European Commission appreciates the participation of third-country operators in the EU financial system because it is good for competition, and for a wide range and quality of services. However, there is a need to reinforce the EU's strategic autonomy by addressing some vulnerabilities linked to the commitment to openness.

2.1.2 Financial Europe has been transformed over the past 20 years into an open bar

An industry representative highlighted that the perception in the financial sector is that Europe has transformed over the past 20 years into an open bar for the rest of the world contrary to the US or China, which do not discuss whether they need an open or a closed door to be innovative and competitive. These countries decide when they open the door and when they close it.

In Europe over the past 70 years there have been big successes that have been built on the business like trade policy, aerospace policy, agriculture and telecommunications not on an open bar. Europe must decide collectively if it wants to exist in certain sectors, if it has a common interest in having financial infrastructure, both for finance-takers and finance-makers and how it uses the culture of the EU to make it happen.

2.1.3 Actions need to be taken to reap the benefits of this openness and mitigate any associated risks

A policy-maker remarked that the global geopolitical situation and the EU financial landscape have dramatically changed in the last years. It is important that the Commission is mindful that Europe may face a challenging geopolitical context, and the Commission should not shy away from the fact that legitimate economic and financial interests have to be upheld and defended.

Autonomy is key. It is important not to become excessively reliant on critical service providers that are not in the European Union. The EU needs to protect its financial industry from the effects of extraterritorial sanctions or other harmful practices where third countries impose sanctions and restrictions related to the use of their currencies or access to their markets.

An industry representative stated that Brexit has created a new challenge and a new fragmentation. The City is moving fast to retain its competitive advantage, notably in equity, and is at the forefront of the innovation that was previously mentioned. London is taking the lead on key innovations like the legal framework for blockchain in trade and is undergoing significant changes in the regulations of company listings in order to promote the City as a financial centre. Open financial autonomy and sovereignty are even more essential.

2.2 Some progress has been made

A policy-maker added that many activities are ongoing since the Commission started to set up the process. An important discussion amongst ministers will take place about fostering the EU's financial autonomy and the euro. The Commission has made progress with the CMU recovery package. The issuing of the EU green bond is a major achievement in the list of activities that contribute to an open strategic autonomy of the European Union, in particular in the context of fostering the international role of the euro. Many projects are ongoing in digital finance, including the digital euro.

A policy-maker noted that the third block of the Commission's strategy relates to the protection aspects, what the EU can do to better protect its system, and where it has to be united when it needs to react to unlawful activities of third countries. The blocking statute is an important piece of legislation, but it creates a dilemma for the industry. The question is whether EU companies adhere to third country sanctions and then get into trouble with the blocking statute, or if it is done the other way around. The Commission has also put forward an ambitious package on anti-coercion measures in the trade area.

An industry representative stated that the financial autonomy and resilience of the EU and its banking system was demonstrated in the face of the economic crisis during Covid. Domestic banks proved essential in reacting swiftly to the unprecedented emergency measures that had to be taken to protect the economy and give liquidity to corporates. In France €140 billion of loans were distributed very quickly to 700,000 corporates, and for the vast majority it was done by national banks. The corporate bond market in the EU functioned well during the crisis, including the high yield. The equity markets quickly recovered, and primary markets adapted very quickly and with great agility to a new world of digital interactions.

The positive attitude of all domestic banks in every major European country restored the image of bankers in the eyes of the general public and with public authorities, and enabled domestic banks to compete with US banks, which mostly did not react in the same way or respond at the same level. This one-off effect should force banks to continue this trend, giving themselves all the necessary elements for their capital markets expertise and investment banking capabilities to be on par with US banks, and to be fully recognised by government, corporates and institutional clients.

The Chair noted that the Commission has a very broad agenda which also goes beyond finance. There are instruments for trade in terms of autonomy. The German coalition agreement indicates that it would support Europe's strategic sovereignty.

2.3 Achieving strategic autonomy would increase Europe's capacity to act strategically and autonomously on the global stage

A policy-maker observed that if the EU manages to stand as a coordinated jurisdiction, especially when it comes to the banking sector and financial markets, it will naturally take on a much bigger role in the global landscape. The EU sees the internal market more as an achievement within itself, but it is important to be aware that it makes the EU very strong in the global landscape. It is important to examine what EU policy-makers bring to the system, but also what are the effects on ensuring better global competitiveness.

An official added that the ambitions will not only increase the EU's financial autonomy by strengthening European financial markets, but also have the potential to shape forward looking and rules based policy internationally.

3. Prerequisites to progress towards Europe's strategic autonomy in the financial area

3.1 Macroeconomic stability is a crucial prerequisite for such autonomy

An official stated that discussion is welcome regarding the open strategic autonomy strategy. Macroeconomic stability is a crucial prerequisite for autonomy in the financial sector. Post-pandemic stability challenges for economies will need to be addressed, including growth, fiscal sustainability, price and financial stability, and the ability of governments to act in a time of crisis, which requires building fiscal buffers in economically good times.

3.2 Strong EU banks and capital markets players are of the essence

An industry representative underlined that it is essential that the rebound is financed, which must also be economically sustainable, to finance the energy transition and to accompany the EU recovery programme. Strong EU banks and capital markets players are essential to finance the innovations and the technology start-ups, and to ensure technological sovereignty in the Cloud. The level playing field must be ensured and promoted by European policy-makers and regulators. Incentive measures could be put in place to compensate the prudential impacts of Basel III reforms, such as by having a green-supporting factor. The CMU must be at the forefront of the political agenda if Europe wants to have all the ingredients of a powerful ecosystem of institutions that are capable of investing in the future, notably in equity and investment banks. Europe's financial autonomy depends on having very strong EU banking institutions.

An industry representative added that there is a need to support strategic autonomy through a resilient, well-risk-managed and competitive financial sector in Europe.

An official observed that strategic sovereignty in the financial sector cannot be addressed without acknowledging that competitive financial actors are needed. The EU has to commit to wanting a competitive industry, but competition must show which business model is best. Regarding the challenges lying ahead for the industry, particularly digitalisation and the enormous investment necessary to roll out digital business products, the EU must provide a better integrated European market. The EU should allow the use of capital and speak about anti-money laundering (AML). Discussions are ongoing with the Anti-Money Laundering Authority (AMLA) regarding a regulation which will better harmonise the rules.

He added that the alternative is that the EU supports economic recovery by facilitating union-wide banking businesses and services, which will not only be a competitive advantage to European industry and a contribution to strategic autonomy, but also a contribution to the economic recovery that is so desperately needed after the pandemic.

The Chair summarised that there is a commitment to financial autonomy, but at the same time there is a need for competitive actors to have a real integration of the market in order to avoid fragmentation.

3.3 Policy-makers need to set the right framework to enable a flourishing financial market ecosystem

An official stated that European markets need to be resilient, dynamic, and well integrated to maintain the EU's financial autonomy. A strong, world leading European financial ecosystem is required that is up to date with recent trends such as sustainable finance, digitalisation, and digital finance. Europe needs to enable and facilitate the free flow of capital and the free use of financial means within itself as one aspect of financial autonomy. If there is a common supervisor, then Europe should trust in its capacity to manage cross-border risks. The infrastructure of financial markets is crucial because dependencies may arise. The clearing of euro-denominated derivatives is an aspect where more sovereignty needs to be gained, and where appropriate proposals need to be worked on. Digitalisation is a key area, and the funding and financing of young, new technology companies needs to be addressed. The Scale-Up Europe initiative is one contribution.

The Chair noted that the previous speaker had touched on a number of initiatives that are ongoing under the French Presidency, but Europe needs strong players for real financial autonomy.

An industry representative reminded the audience that competition in Europe remains intense. US investment banks can subsidise their European activities through the very high level of profitability they have on their domestic and integrated market. They are dominant in the EU in many market segments such as equity capital markets, high yield, technology investments and their perceived expertise. They are supported by their regulators' neutral approach on the final Basel III framework and the market structures in the US, including securitisation, allowing banks to have fewer capital buffers and to be less sensitive to output floors.

3.4 The EU financial sector should not be at the mercy of non-European actors due to Basel III

An industry representative emphasized that a significant question is how clients perceive financial autonomy. During the Covid crisis Europe has seen a reversal of a trend that previously existed around provision of service and financing to European corporates by foreign banks. Up until 2020 foreign banks had been the fastest segment when it came to provision of loans to German corporates, but from the second half of 2020 onwards they ended up being the lowest. Foreign banks saw a 5% yearly contraction of their provision of lending to Germany. Europe is still heavily dependent on bank funding. The Basel III framework will likely see significant impacts by 2030.

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

An industry representative added that it is vital to not create uncertainty or incentives to deal away from the European banking sector. Basel III is forcing corporates to obtain an external rating in order for them to have access to relatively inexpensive funding capital, when 70% to 80% of European corporates are currently unrated. Basel III also increases costs for European corporates to hedge their interest rates activities, credit exposures, and pools that are split between the UK and Europe.

4. Priority measures to move forward

4.1 Closing the gap between European banks (especially GSIBs) and their non European competitors

An industry representative observed that European banking clients are choosing US banks for many of the critical services that Europe will need in the next decade. US banks enjoy advantages that Europe does not yet have. European banks need to be more efficient, more profitable and have available capital. US banks can subsidise services in Europe, do not have to fund resolution funds, and have the ability to transfer very significant amounts of risk to securitisation markets or government-sponsored enterprises (GSE) for their mortgage businesses. The Banking Union and a European deposit insurance scheme (EDIS) that works are critical elements.

4.2 Accelerate the implementation of the CMU

An industry representative stated that the CMU is critical. Steps such as the harmonisation of regulatory and supervisory activities around capital markets are important, as well as having one supervisor instead of 27. The same also applies to a harmonisation of the insolvency regime. If a bond is issued in Europe, then the question is whether 27 experts need to be hired, one for each country, in case insolvency occurs. That makes it prohibitively expensive, particularly for smaller countries. Europe will need a great deal of money in the next decade for repaying some of the Covid costs that have been collectively incurred as an economy and funding a green transition.

4.3 Reducing the EU's exposure to offshore clearing

An official noted that the large amounts of derivatives 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 important for the EU to enlarge its clearing base in order to increase liquidity in EU CCPs and to make clearing in the EU more attractive.

A policy-maker observed that there is a great deal of interest in the issue of clearing abroad. The EU Commissioner made it clear that Europe needs to act now. A positive agenda is needed to see what can be done to make clearing in Europe attractive without creating problems in the end.

4.4 Accelerating the consolidation of the financial infrastructure sector

An industry representative stated that there is no tangible outcome without continuous European consolidation. The amalgamation of the exchanges is a way to show that Europe can build an integrated market through a corporate angle. Europe is very close to being able to have one single form to file an IPO in Europe, because the rules are similar, but they are not identical. In the US it is filed as one.

4.5 Promoting equity holdings with European households

An industry representative underlined that Europe needs to be promoting equity with European households. The finalisation of the CMU must have equity at the heart of its next steps. The European Commission's consultation on the Listing Act is timely. It will be necessary to develop Europe's tech sector, its energy transition and to face the needs of the energy transition. There is a link between finance and energy, and autonomy in energy supply. Brexit can be an opportunity to rebalance the weight of different financial centres and to have stronger financial centres in Europe.

4.6 European companies should contribute to concretely build the strategic autonomy of the EU

An industry representative explained that Euronext has a long track record of building a pan European federal model connecting local companies to global markets. Euronext has tried to build an integrated single liquidity pool or single order book, which represents 20% of the shares traded in Europe, including the UK. It has aggregate market capitalisations of €6.9 trillion, which is about three times the size of the aggregate market capitalisations of the Frankfurt exchange, and twice that of the London exchange. The process of consolidation or integration can work, provided that it has a proper federal governance, that finance makers and finance takers feel at home, and that compromises are accepted. Strategic autonomy is about accepting how to create European champions and building the compromises between national interest and the upside.

4.7 Sequencing the measures will be important

An industry representative emphasized that caution is needed regarding the sequencing of when Europe will have the ability to introduce a stricter stance on some of these measures. A complete ban on European operators accessing UK liquidity for central counterparties or making it impossible for European corporates to access fintechs, providers of artificial intelligence and data analytics suppliers would ultimately not help Europe to move fast enough towards strategic autonomy.

The Chair summarised that there is some convergence from public authorities and the private sector around the idea that Europe should move from the narrative of risk reduction to the competitiveness of its institutions. A strong currency is needed in order to be autonomous. Strong financial institutions are needed. Europe needs to consolidate the resilience and competitiveness of its financial institutions, and sovereignty is needed in its decisions.

Sessions Summaries

II

FINANCIAL STABILITY CHALLENGES AND VULNERABILITIES

MMF liquidity risks: remaining vulnerabilities and regulatory changes proposed

1. Remaining vulnerabilities associated with money market funds (MMFs)

The Chair introduced the discussion by noting that Europe saw a wave of redemptions with 'dash for cash' episodes in March 2020 at the outset of the Covid crisis, particularly in some types of MMFs. Central banks intervened and restored confidence in the market, avoiding systemic risks, but this type of intervention cannot be reproduced for each crisis. Work is underway to determine how to reform the MMF regulatory framework in order to ensure further financial stability and investor protection.

1.1 Vulnerabilities from MMFs identified in March 2020

An official remarked that EU MMFs experienced outflows also in January and February 2022 and explained that MMFs are structurally subject to an underlying tension. This tension is that on the one hand MMFs have deposit-like features, so people would like to use them as liquid instruments to deposit their cash and be able to draw from them at any time, and on the other hand they have fund-like features with a portfolio of assets to manage, which at times can become less liquid. MMFs are exposed to redemption risks every time there is a severe tension in the financial system, resulting in elevated liquidity needs. The strong inflation in the United States and the current situation in Ukraine are creating a new real-life stress test for MMFs. Significant outflows have been taking place in the US.

A regulator observed that there are real-life experiences in the sterling MMF markets that show material outflows in crisis situations but this does not necessarily mean that MMFs are doomed to fail each time there is a crisis. In the 10 or so days of stress in March 2020 there were MMF outflows of about 10%. The assets that are used to back the funds in the US are different from those used in Asia and in different parts of the EU, but there have been vulnerabilities in all regions that have placed these funds at susceptibility to disruptive redemptions. MMFs backed by private assets are mostly the area where regulators need to focus their attention. There were issues with first mover advantage and also the fact that some investors were not fully aware that low volatility NAV (LVNAV) MMFs posed potential market and investment risk.

Another regulator stated that in Belgium, which is an active fund market, there were some redemptions of MMFs and other types of funds, but no major movement. This is possibly due in part to the fact that the Covid crisis was not a financial crisis, unlike the 2008 crisis, but an external event that impacted the financial sector. When looking at the overall EU market, the Covid crisis shows that the risk remains of large redemptions out of funds that provide liquidity facilitation, as do MMFs, but not all MMFs were impacted in the same way. Differences were due to the underlying assets rather than the fund structure. Constant NAV (CNAV) and low volatility NAV (LVNAV) MMFs holding primarily non public debt experienced the highest outflows, whereas those holding mainly public debt experienced significant inflows. This can also be explained by the fact that the stress was emanating from the real economy.

A Central Bank official noted that the regulatory restrictions on MMFs had a cliff effect at the outset of the Covid crisis causing a dash for cash. When looking across the MMF sector and different jurisdictions there was clearly a first mover dynamic. This shows that MMF problems have possibly been 'over-fixed' following the financial crisis.

An industry representative observed that March 2020 was the first test of the MMF reforms implemented following the 2008 crisis and they generally fared well. One of the issues that needs to be addressed is the tying of liquidity fees and gates to liquidity thresholds, which put an excessive focus on maintaining buffers and created a holding back of cash which could have been leveraged into the market. High redemptions are not bad as such, because money in a fund is supposed to be redeemed and MMFs met redemptions in March 2020.

Another industry representative agreed that there was an ill-conceived regulatory incentive to redeem because of the linkage between regulatory liquidity thresholds and the obligation to impose a fee or a gate. If that issue is tackled, that will solve the vast majority of the perceived vulnerabilities associated with MMFs. The MMFs managed by the speaker's company held between 30% and 45% of weekly liquidity that they were not able to use in March 2020, because of this linkage. MMF holders withdrew money to face margin calls and to pay salaries and invoices at a time when no money was coming in from sales.

The Central Bank official agreed that redemptions are not bad per se, but they are problematic when they amplify systemic risk or when there is a sudden stop in funding. That is the aspect that should be focused on. A regulator added that while redemptions are not an issue, the first mover advantage of redeeming investors is problematic, especially in a stress event, because of the cost that is imposed on the investors who are left in the fund, the dilution impact they face, and whether they are aware of this.

A regulator added that it is also important to consider why investors came out of MMFs. A study published by the European Central Bank (ECB) suggests that the need to meet margin calls contributed to this outflow, but there may be other factors which require further analysis.

1.2 Central Bank intervention

An industry representative observed that in March 2020 the support provided by central banks was not driven by MMFs but by the objective to support short-term markets which were facing an external shock. These markets needed to be unfrozen, because the economies were shut down by governments. MMFs are the only transparent part of the short-term funding ecosystem and acted in March 2020 as a symptom of some the problems of the underlying short-term markets, which caused or amplified the liquidity issues experienced by certain MMFs.

An official emphasized that central banks intervened to keep short term markets functioning, including MMFs - i.e. not only MMFs but also MMFs - responding to vulnerability in the financial system. Huge liquidity imbalances in funding markets were indeed observed at the outset of the pandemic that affected entities that run liquidity mismatches, including MMFs. A regulator confirmed that saying that central banks did not do anything to support MMFs would be a misrepresentation. Compared to previous crises, the fact that MMFs had to be included this time in the scope of central bank intervention is a relevant factor.

A participant in the audience observed that the papers of some LVNAVs at least did not directly benefit from central bank programmes because of their characteristics, they were high quality, mostly commercial paper (CP). The central bank intervention was nevertheless critical in allowing a re-opening of primary markets and benefitted MMFs indirectly at a time when the investors who were redeeming out of MMFs needed the cash because they could not issue their own CP the market.

2. Measures proposed to address the systemic risks posed by MMFs

The Chair stated that a number of proposals have been made by ESMA and the FSB for tackling the issues faced by MMFs. These include policy options such as decoupling regulatory thresholds from the activation of redemption gates, the use of liquidity management tools (LMTs) and liquidity buffers, stress testing and reporting requirements, and changes related to the use of amortised cost in some specific types of low-volatility MMFs.

An official outlined that the FSB has approached the tackling of MMF vulnerabilities from a global perspective. As a first step it assessed a comprehensive set of policy options to enhance the resilience of MMFs based on four mechanisms: (i) imposing the cost of redemptions on redeeming investors; (ii) reducing threshold effects; (iii) reducing liquidity transformation in MMFs; and (iv) allowing MMFs to absorb losses. The second step was a recognition that the prevalence of MMF vulnerabilities and the appropriateness and effectiveness of different policy options may vary across jurisdictions, depending on market structures and the use and characteristics of MMFs. A set of policy options has been developed that FSB members have committed to consider in addressing the issues identified in their jurisdictions. The third element was to consider the need to take a global perspective to the financial stability issues associated with MMFs. The FSB and IOSCO will review progress made by member institutions in adopting reforms to enhance MMFs resilience, and look at issues like inconsistencies, cross border effects, and potential regulatory arbitrage. The Chair agreed that policy options need to be adapted to the specific circumstances and that there cannot be a one-size-fits-all approach.

A Central Bank official emphasised that policy thinking about MMFs needs to start with an analysis of the economic purposes that are being served by MMFs, which are the short-term funding of the economy and cash management. There is a strong consistency between FSB proposals made at the international level and the proposals made in Europe. Addressing regulatory cliff effects is essential in particular and needs adequate risk-based reporting. The regulatory approach also needs to be different for MMFs and other open-ended funds, because of the timelines, the pricing and the valuation structures in MMFs.

2.1 Liquidity management tools (LMTs)

A regulator was supportive of a wider and more consistent use of LMTs among the range of options available to address MMF vulnerabilities. Where LMTs were available, there was a very inconsistent application of them, and perhaps not even a proper understanding by all managers as to how they could be used. A regulator noted that there are still obstacles to the use of LMTs at present that need to be lifted. In Belgium for example, fund managers still need to be convinced of the usefulness of these tools and there is still a law to be changed to allow LMTs to be activated in one day without passing through the General Assembly.

An industry representative was favourable to an amplification of the use of LMTs, particularly liquidity fees and anti dilution fees. Swing pricing works when the fund sells portfolio assets in the market to meet redemptions, but does not work when using cash on hand, which is how the MMF structure works. Another industry representative observed that using LMTs is not usually necessary when funds have high levels of liquidity. Regarding swing pricing, although it is always useful to have an extra item in the toolbox, it is unlikely that it will ever be used for MMFs. The only way to use it is after the position of the fund has closed and after all of the price movements have been seen, which will be too late in most cases to adjust the NAV and manage investor payments.

A Central Bank official reiterated that the first mover dynamic is at the heart of the financial stability issues in the fund sector. Although the underlying drivers of this dynamic still need to be fully clarified, it involves redeeming investors externalising the costs of their redemptions on other investors. Swing pricing can solve that problem without having to go to some of the other possible solutions in the open-ended fund segment, such as liquidity buffers and redemption periods. The effective use of LMTs in general however still faces many challenges in terms of appropriate calibration and timeliness and this is the case also for swing pricing. Concerning MMFs it is good to have swing pricing as an option, although further work is needed to define how it may be used in an effective way for these funds.

The first industry representative supported the use of swing pricing for open-end funds in general. There are two different types of first mover dynamics, one is against the market and the other against the fund. No liquidity measure such as swing pricing is going to address a first mover advantage against the market, because when investors want to redeem because the market is moving in a certain direction or because they want more liquid assets in their portfolios, as in dash for cash situations, they will not be stopped by a liquidity measure. Where swing pricing is effective is in limiting the effect of a first mover dynamic on the fund and the remaining shareholders, but in the case of MMFs its operationalisation is not feasible for the reasons previously mentioned and trying to do so would have adverse effects on MMFs.

2.2 Liquidity buffers

A Central Bank official considered that enhancing liquidity requirements is also vital and supported the inclusion of a requirement for the holding of public debt as part of the liquidity buffer of MMFs. The economic objective would be to try to ensure as little disruption as possible in times of stress in the short-term funding of corporates and financial institutions.

An official explained that regulators are generally favourable to the inclusion of the holding of public debt in liquidity requirements, because they want to reduce the features which make MMFs resemble banks and to strengthen those which make them more like investments, also making sure they can continue to perform their function in times of stress without the need for central banks to step in. This is why MMFs need to have a stronger liquidity base and public debt is the most liquid type of asset. Additionally, mandatory public debt holdings may create additional demand for MMFs, since they would become a more liquid and safer instrument. Mandatory debt holdings are one of the measures envisaged in the 2021 ESRB Recommendation on MMFs.

An industry representative observed that the decision of European regulators to stay away from prudential requirements for a capital market instrument such as MMFs was appropriate. However imposing public debt holding requirements does not seem necessary for enhancing the liquidity and resilience of MMFs and may create unintended consequences, because it may hamper portfolio management and embed potential volatility into the fund. Liquidity requirements should not mandate the type of liquidity held by MMFs. In Europe there could be limitations to what types of sovereign could be put into portfolios, which may create other issues. The industry representative added that while building up the liquidity of portfolios is important, the decoupling of liquidity fees and gates from liquidity requirements should be the priority, because this connection did not work in March 2020.

2.3 Reviewing LVNAV funds

A Central Bank official emphasized that LVNAVs are the main type of MMF which needs to be reviewed in the EU. 46% of the European MMFs sector are LVNAVs, and they had a significant impact in March 2020. The benefits they provide, why corporates buy them and what should be the adequate policy approach to them needs to be further assessed. In the 10-day period of outflows in March 2020 the collar requirements[1] for LVNAVs had an exacerbating impact, and increased stress regarding these MMFs. A solution needs to be found to address that issue without leading to the discontinuation of LVNAVs. It is important to think about the characteristics of LVNAVs and their main vulnerabilities, given the redemptions that were observed. The likely solution is in reviewing how the rounding of the NAV is done and how there can be movement away from an amortised cost approach.

An industry representative stressed that one of the options that is being considered for LVNAVs, which is their discontinuation, seems too blunt, because removing these funds from the market would take away an important source of liquidity for which there is no substitute, given the constraints imposed on bank balance sheets. Moreover the March 2020 data shows that LVNAVs met redemptions, stayed within bands, and showed no acceleration of redemptions, which does not justify discontinuing them. A connection is made in the ESMA paper between the amortised cost and the rounding of the NAV, but there is no reason for that. LVNAV funds can be run mark-to-market without using amortised cost.

A regulator proposed removing the possibility of using amortised costs in accounting for LVNAVs, which is an option that had already been considered during the first round of negotiations about the MMFR. The question is what the impact will be and whether it will be a game changer for LVNAV MMFs.

3. Issues raised by the underlying short-term markets

Answering a question from the Chair about the need to reform underlying short-term markets, an industry representative observed that if the underlying markets to MMFs i.e. commercial paper (CP) and certificates of deposit (CD) do not work, then a key part of the ecosystem is not functioning. A more holistic approach is required instead of focusing on perceived vulnerabilities in MMFs, policymakers must improve and enhance the short-term funding markets in tandem with policies regarding MMFs. The first thing to do is to improve transparency.

1. The MMFR sets out a strict threshold for LVNAV funds in the form of a NAV collar. LVNAV funds can be purchased and redeemed at a constant NAV, but this is only possible if the difference between the fund's constant NAV and its marked-to-market NAV is no greater than 20 basis points (the "20 bp collar"). In the event that an LVNAV breaches this 20 bp collar (i.e. its marked-to-market NAV deviates by more than 20 basis points from the constant NAV), the MMFR requires the fund to value its assets using variable pricing.

The second aspect is to enhance automation and harmonisation in these markets, which are at present over-the-counter (OTC) markets with lengthy transaction delays. In addition the third aspect is about the need for deeper and more liquid markets, which requires moving towards an all-to-all market i.e. making these markets enter the 21st century. The fourth aspect resorts to central banks whose function, among others, is to ensure these markets do not freeze when they are most needed; i.e., central banks should put in place a standing repo facility that market players can use.

Another industry representative agreed that more standardisation and transparency are needed in the short-term market, even though it functions relatively well in normal conditions. Moving to an all-to-all trading platform in Europe, in the same way as the US, is a difficult question however, because that means having one central source of liquidity, which can be an issue during times when nobody is buying as in March 2020. Other ways must be thought of to ensure that the market has more sources of liquidity, and also that the interconnectedness of the market is clearly recognised. Because MMFs are the most transparent part of the short-term market ecosystem, they are under the spotlight, but they are only one part of the ecosystem.

An official stressed that the broader ecosystem of short-term markets is discussed at FSB level and was mentioned in last year's report about MMFs, but one needs to be realistic about what can be done. The main point is that actions to increase the liquidity of short-term funding markets can complement measures to address the structural vulnerabilities of MMFs, but cannot be a substitute for them. In addition improving the liquidity of short term markets is quite challenging. The secondary markets for CPs and CDs are structurally illiquid. In addition, dealers have limited economic incentives to make markets in these short dated instruments, even in normal times, as their illiquidity is the direct result of the characteristics of the instruments. Three main areas that could be considered to make improvements to the liquidity in short-term funding markets were however mentioned in the FSB report. These include (i) changes in the market microstructure with e.g. increased standardisation, faster settlements, paperless processes, electronic all-to-all trading platforms, (ii) increased market transparency and (iii) enhanced regulatory reporting that may enhance the ability of authorities to monitor trends and risks across the whole ecosystem.

A regulator stated that MMFs only represent 30% of the total assets of the short-term paper market and this proportion has strongly decreased compared to 2008. This means that it is important to pay attention to the underlying short-term funding market when tackling the systemic issues raised by MMFs. There needs to be a balanced approach, which is quite a challenge at the global level. Regulators need to be able to find the right balance between enhancing the resilience of MMFs and keeping the MMF market alive, and between measures concerning the underlying short-term markets and the MMF product itself. The situation is not the same across jurisdictions and short term funding markets, such as repo markets, CP and CD markets function in different ways, but cooperation is needed at the international level to address these issues. IOSCO is very conscious of these challenges, which is why it will start working with the FSB in the last quarter of 2022 to explore the short-term funding market in greater detail and assess differences across regions.

EU AML/CFT authority: key success factors

1. An ambivalent level of efficiency in a fragmented, though single, market stresses the need for current EU regulatory efforts

The Chair introduced another important discussion on the key success factors for an effective EU anti money laundering (AML)/combating the financing of terrorism (CFT) Authority (AMLA). In summer 2021, the European Commission presented its ambitious package of legislative proposals to strengthen the EU's AML and CFT rules, including the creation of a new EU authority to fight money laundering.

There is surely agreement on the need for a single EU rulebook on AML and CFT, and that we can all benefit from the AMLA. At the same time, there is a question around how to make AMLA operational. The Chair asked what the success factors for effective operation of the AMLA are and what missing elements might lead to a protective AML/CFT framework.

The Chair asked if the current AML/CFT framework is effective and how successful the EU is in fighting AML/CFT as a member of the international community.

An official stated that there is an ambivalent picture of how successful the European Union is. On one hand, the Commission and member states are very ambitious when it comes to regulation. This is also observed at the Financial Action Task Force (FATF). In some important pillars of AML, the European Union even provides the model that other regions strive for.

There is certainly a problem with regulation fragmentation. There is even more of a problem of implementation in Europe as an area in which there is a common market without borders. We must definitely improve in financial intelligence and detect cases much earlier than we currently do. We have fragmentation in both regulation and the application of the rules in the common market, creating loopholes and offering room for regulatory arbitrage. We have no focus point at the supranational level; building this with the new AML package is desirable.

We have a comparatively weak sanctions regime, and we sometimes have weak law enforcement in member states. Last but not least, our companies are struggling with considerable legal uncertainty when it comes to the interaction of AML with other areas of law like privacy.

The points of focus of the EU are welcome

An industry speaker stated that Western Union supports the AML package and the move from a directive to regulation and a rulebook type format. It also supports the establishment of the AMLA. Regarding the main challenges in the current framework in Europe, a positive approach is to give the top five parts of the package that we like. Implicit in each of these are areas with opportunities.

Improved cooperation and information sharing, particularly among national Financial Intelligence Units (FIUs), is addressed by the package and would be helpful. Western Union's investigators have seen instances in which national FIUs and law enforcement in Europe have clearly not been speaking to one another.

The second item that the package addresses is a common Suspicious Transaction Report (STR) template. This will help European law enforcement and those in the private sector to provide information more quickly and efficiently to governments.

The third item is privacy constraints and the occasional conflicts between the General Data Protection Regulation (GDPR) and AML regulatory obligations. When financial institutions encounter this conflict, they necessarily tend to err on the side of privacy rather than providing information to law enforcement.

The fourth item is de risking. This is a big issue for Western Union and other money transmitters, and particularly for agents. However, more needs to be done. Something like the European Banking Authority (EBA) opinion of January 2021 would be helpful.

The fifth item is a review of Electronic Identification (EID). It would mean that digital transactions tended to be less costly, and it would flow through a better experience for the customer.

Implicit in these areas are challenges. There are certainly areas in which the US is behind on beneficial ownership. Work on beneficial ownership was underway eight years previously, and it is only just starting to make progress. Europeans have been far ahead of the US on this.

2. Anticipated points for attention for an efficient AMLA

The Chair asked what the main coordination challenges for the AMLA are and how closely it should cooperate with the national competent authorities (NCAs). A regulator stated that supervising money laundering activities and combatting terrorist financing is a difficult job. The European Central Bank (ECB) has just asked for all of its institutions to be taken away and responsibility for them given to others.

It is necessary to consider some coordination issues. Given the AMLA's history, it would also be possible to say that the AMLA should take everything. However, there are issues.

2.1 One essential challenge is to figure out how to reap the benefits of the enormous efforts made

We did not do well enough in the early teens, but the current efforts from the biggest financial institutions and supervisors reflect that nobody wants to be caught with a money laundering or terrorist financing scandal. We do not have a problem on the authority or big institution side in terms of a lack of effort. Danske was in a deplorable state and still has work to do. It has dedicated 15% of its staff to preventing money laundering and terrorist financing. This is not a lack of effort.

A regulator stated that he is a supervisor who has many questions to ask banks, but it is necessary to determine how to complete these tasks more smartly and avoid duplicating efforts. This is where the AMLA could make the most of its progress. It is necessary to be much better at using technology while cooperating on its use and sharing data between financial institutions and between the public sector and financial institutions.

2.2 Fully learning on the SSM arrangements and experience should help to address the AMLA coordination issues

A regulator stated that much of what a prudential supervisor does consists of the same items that an AML supervisor looks at. There are questions of compliance, culture, risk management and potentially whether people are fit and proper. On a good day, there is a coordination problem; on a bad day, there is a turf problem.

The Chair asked if it is possible to draw similarities between what was achieved for the Single Supervisory Mechanism (SSM) and what is currently proposed in the AMLA regulation in terms of the organisation and articulation of onsite supervision. A regulator stated that there are a number of similarities between the AML package's intended achievements and the SSM. The global financial crisis showed that divergence in the implementation of supervisory practices was detrimental to the stability of Europe's banking sector. An integrated system of supervisory authorities with a strong centre is necessary.

Similar dynamics are at play around AML/CFT supervision and the integration of the European financial system. It was natural for the AMLA proposal to draw on the SSM model from an operational point of view. The most striking similarity relates to the fact that AMLA will use joint supervisory teams (JST) to supervise the financial obliged entities that will be directly supervised by AMLA. Those JSTs, with staff both from AMLA and national authorities working together, will be at least as important in the AMLA context.

Within the SSM, the JSTs have been key for the development of a genuine common supervisory approach for the supervision of significant and less significant institutions. It is possible that the way the AMLA will supervise the institutions it will be in charge of will percolate down to the way supervision of other entities is performed. In that way, it will level up the whole supervisory framework.

There are a few differences between the JSTs currently in place in the SSM and those envisaged in the AMLA proposal. Only one of them is somewhat technical, but it is crucial. In the Commission's proposal, the JSTs will be responsible for offsite and onsite supervision. Within the SSM, onsite and offsite supervisory tasks are performed by different dedicated teams. The combination of JSTs for day to day offsite supervision and dedicated onsite teams for performing those in depth reviews has proved to be highly beneficial. Having dedicated onsite inspection teams gives the supervisory toolkit more teeth.

Although the AMLA proposal rightly draws on the SSM experience, when it comes to the operationalisation of AMLA's direct supervision, there is still room for drawing to a larger extent on the successful SSM experience.

3. AMLA must build up an agile and prospective risk-based approach

Efficient links within the network of FIUs and supervisors and technology should help.

The Chair stated that AMLA borrows a large amount from the SSM. There is still some room. He asked if AMLA needs to embrace an intelligence based approach.

A regulator stated that this is a complex proposition for AMLA and a key opportunity to support those in Europe to be very effective in transnational crime. When considering the complex moving parts of its responsibilities, it will have to select the firms that pose the most significant risk for money laundering accurately. The debates around whether all countries should be included in order to engender a good money laundering supervisory culture are reasonable. However, there is also a proposition whereby they need to work with the NCAs that will eventually do the vast majority of frontline money laundering supervision to ensure an effective, integrated system. There is an overwhelmingly strategic challenge to supervise Designated Non Financial Business and Professions (DNFBP), of which there are more than 2 million. There is going to be a very targeted, strategic approach.

There is a unique opportunity to drive up the effectiveness of transnational coordination with respect to FIUs and the effectiveness of suspicious transaction and order reports (STOR). This must be done in a risk based way, but it must also be dynamic because the typologies will change. People will be better able to identify crimes and be responsive in a timely way only where they are intelligence led. That is a complex proposition. All regulators will coalesce around the ideas of being risk based and targeted to spend rare supervisory resources on the issues of most concern. This would presumably be risk-focused.

However, money laundering is secretive and designed to evade detection. Typologies change over time and with success. Information sharing is at the heart of this, but it is possible to have much information, necessitating a rigorous, structured, systematised risk assessment and targeted deployment of resources. However, it is necessary be dynamic enough to take relevant information from the front line and the participant firms themselves. It is also necessary to work effectively with the FIUs whose core raison d'être is to detect the crime and pass that on to law enforcement, and that must be disseminated well across Europe to raise standards with FIUs. It must be disseminated well with NCAs and the ECB because the SSM is a core supervisor for some of the most important entities in Europe that might pose threats to money-laundering.

A regulator added that it is extremely important to recognise that supervisors play a large role and are supporting actors to a large extent because the real key in terms of the value chain is the link between the financial institution, prosecutors, and the police. It is necessary to support it.

As public authorities and supervisors, it is necessary to monitor the banks well enough, supervise them and contribute to improving this. It comes back to making KYC processes easier. There is currently an explosion in suspicious activity reports because it is the easiest thing to do. There is very little feedback between FIUs, the police, prosecutors and institutions that work on reporting to them. That is the key part of the value chain that supervisors and public authorities need to support.

3.1 Further reinforcing cooperation duties of FIUs should be envisaged

The Chair asked how cooperation could be fostered among national FIUs and if there should be a European FIU. A public representative stated that his view on supervising is similar to those of his colleagues in many ways. On FIUs, the current proposal is not sufficiently ambitious and does not go far enough. There are concerns from the national FIUs along the lines of them saying that they need to control the information and be responsible for inviting others. They believe that politicians and others might find out that they are suspicious about them if information leaks.

While the aforementioned position is respectable, the current proposal does not go far enough. While joint actions are taken by different FIUs, it is very easy for someone to say they do not want to participate in the joint analysis. They do not really have to give more of an explanation. If one FIU asks for a joint analysis, the centre passes it on and does not do anything. It is just process management. Not much value is added by sending out invitations.

The FIU cooperation should not just be voluntary because the AMLA is only adding red tape. It is already possible to simply ask for help via email. The joint analysis should be much more ambitious. The Parliament has asked for the creation of a European FIU in the past, and we should at least move towards the germ of a European FIU. This is difficult because different member states have different resources, but a European FIU would be vital, particularly because this does not have to be about criminal law. Some people understandably say that this is criminal law and Europe has nothing to do with it. However, there is great scope for administrative action, and it is advisable to move forward with this.

3.2 AML requires setting the scope of AMLA supervision appropriately in order to also address non-financial obliged entities, crypto assets and crypto currencies

The Chair highlighted the issue of the optimum scope of the AMLA's supervision. He asked if the so called 'geographical approach' is sufficient and if the non financial sector could also be involved.

3.2.1 Non-financial obliged entities require attention

An official stated that the geographical approach is the concept for selecting entities. If one entity is only active within one member state, or even only regionally within one member state, then it should remain under the supervision of the corresponding national supervisor. The AMLA should support and take care of convergence. If this is becoming a high risk institution then the AMLA can step in as provided for emergence, cases. If an entity has major cross border activities that can lead to blurred responsibility and coordination is hardly managed, the AMLA should be the competent authority.

In terms of the right scope, the AMLA needs a deep understanding and experience of supervision in each member state so that the AMLA has comprehensive coverage of the internal market. For that reason, at least one institution in each member state should be supervised by the AMLA.

It is positive that the AMLA will be involved in the non financial sector at some stage, but this is a completely different story: There are 2 million obliged entities. Many notaries, lawyers, casinos and car dealers can hardly conceive of being supervised on a supranational level. Nevertheless, the AMLA should also start to look at this in a phased approach. However, ensuring that the financial sector is properly supervised first, should be the priority.

3.2.2 Defining priorities is difficult since assessing the risk posed by an entity is challenging

The Chair asked about the selection criteria for direct AMLA supervision. A regulator stated that this is a simple question but a complex issue. Engaging in an entity's AML/CFT risk exposure is less straightforward than measuring the size of its balance sheet. AML/CFT risk exposure is not always commensurate with an entity's volume of clients or activities. Selection criteria for the financial obliged entities that will be directly supervised by the AMLA should be broad enough in terms of activities and geographical extent.

With respect to the type of activities, there should be a single set of criteria for all financial institutions. There is probably no valid reason for differentiated criteria for banks and other financial institutions. Activities performed by means of direct provision of services can also be as exposed as AML/CFT exposure and activities performed through branches, networks of agents or distributors. There should be a single way of treating the free provision of services under free establishment. Selection criteria should clearly address the riskiness and cross border activities in a more neutral way when it comes to the types of entities and the modalities of the cross border activities.

3.2.3 AMLA geographical coverage: pragmatism and consistency

A regulator stated that the AMLA's direct supervision should cover the whole internal market with respect to the geographical coverage. One indirect way to go in that direction would happen if, once an entity had been selected, all the financial obliged entities that belong to the same group would be under the supervision of the AMLA. The JST would supervise the group on an individual and consolidated basis. Another step forward would be that, if a selected entity has a non EU parent company, all the EU based entities sharing the same non EU parent company should also be directly supervised.

There would be a more direct way to ensure the coverage of the whole internal market. The ACPR and the Banque de France believe there would be merit in adding at least one entity in each member state for supervision by the AMLA. This should foster a common supervisory approach and ensure that direct and indirect supervision are not completely separate areas. A close link between the two will also be crucial.

4. Appropriate AMLA governance is essential

A public representative stated that the AMLA governance structure is very important. On the EBA failure, we would not be present without the report of the Court of Auditors on Danske Bank that essentially said the EBA had 'messed up'. The EBA failure was a question of governments. The state voted to stop that sanction. It is known that the EBA even involved the state. Governance is crucial, and the governance in front of us is a positive step forward.

5. Digital innovation raises varied AML challenges

The Chair asked whether crypto asset providers should comply with regulation. A regulator stated that the European Securities and Markets Authority (ESMA) talks about crypto from the perspective of investor protection and Markets in Crypto Assets (MiCA) regulation. It knows that there are concerns from every angle. However, the technological innovations underneath crypto could also bring huge benefits for financial inclusion. The potential for smart contracts is astonishing. Nobody wants to obstruct innovation.

However, when considering the purpose of regulation, macro, micro and investor protection, ESMA only brings regulation forward where we believe that the offering requires some kind of parameter or safety to work well. Looking at crypto, the meaning is unclear because there are so many different types of asset reference tokens. There is no inherent value. The regulator is very comfortable with the proposition that any means of transfer of value should have the same types of requirements as the traditional financial means.

Crypto has been used to facilitate crime and is the payment method of choice for ransomware attacks. It is very high risk from an AML perspective. Truly applying the conventions that necessitate knowing the client, the source of funds and where the money is going seems more like a level playing field, which makes sense.

5.1 Technology should help progress on ID verification, onboarding and information sharing and improve banks' customer experience regarding AML procedures

The Chair stated that AML/CFT risk management is not possible without accurate data and technology that allows for use of the data and drawing all the benefits from it. The Chair asked how to ensure effective private/ public sector data sharing and how big an issue GDPR is.

A regulator offered to present his vision, where it could hit a wall and why. His vision would be a setup in which banks using national electronic IDs could verify customers' identities. There are different stages of national IDs and sensitivities, but they should have security and safety around them so that they can be used to verify customers in all but high risk cases.

The regulator receives many emails and letters from 30 year customers of a bank asking why they need to go there to show their passport. There is a gap between the public's demand for a tough fight against money laundering and terrorist financing and its willingness to do it; this needs to be overcome. The regulator's second aim is for banks to be able to call government lines to ask if a person with a particular ID, is a "politically exposed person" (PEP) or a PEP relation.

An industry speaker endorsed the proposal in the package encouraging technological innovation. He welcomes the European Commission's proposal on EID. It would create a much better customer experience if there were a harmonised, EU wide identity framework. It would also be much less expensive. Those costs are passed on to the customer. We support that. However, we would like to retain the option of a traditional in person KYC for populations like migrants.

A regulator stated that the third element of his vision is that it is advisable to build registers of beneficial ownership that could be used for identification by the banks that on board customers. If these types of actions were taken, it would also work out the issue of de risking.

The regulator would also like banks to share information on risk flags and would like authorities to share more data. If these issues can be addressed smartly across the EU, it will make a substantial difference in fighting money laundering and terrorist financing. The AMLA will have a huge role.

5.2 Facilitating information sharing and interlinking AML entities should be beneficial and would reduce the risk of only focusing on some entities

The Chair asked about the technology part. An industry speaker stated that there are always ideas around beneficial new technology. However, an opt in regime for the AMLA would be more efficient and would place Europe ahead of the US. At present, we register with the

Financial Crimes Enforcement Network (FinCEN) as a money transmitter, but we have 49 states that examine us. Europe would leapfrog the US if we could do that.

If only a small number of financial institutions are designated as high risk, then they could also be named and shamed. We are still trying to determine what will mark someone as high risk. Western Union hopefully does not fall into the new category of super high risk, but it would certainly be classed as high risk, so it would not want to be one of only two or three entities that could be in the category.

The Chair stated that it would be difficult to conclude the discussion. Simple questions received very complex answers. Building an EU wide AML/CFT framework with AMLA at its centre will be a very difficult task.

Lithuania has experienced huge success in technology sector expansion, but all of this success comes at a cost and creates understanding of the risks. In the financial sector a few decades ago, there were extensive discussions about credit risk, liquidity risk and related matters. However, AML/CFT risk management and cyber security are connected top priorities. There is no other way to succeed in the project ahead.

5.3 Leveraging technology to make KYC processes further effective raises GDPR challenges

A regulator stated that the real problem is not lack of effort or supervision; it is the need to work together to provide information for know your customer (KYC) processes and transaction monitoring. The AMLA could make a difference here because many of these items also relate to European legislation. GDPR is a considerable issue. This is where it is advisable to move and cooperate if it is really desirable to make a difference.

Another regulator stated that the entities will have to adopt technology and be network types of organisations in a structured way. If there is a serious money laundering threat, the revocations of licences will happen to entities and other institutions. Two way feedback loops are important. New, anonymised technology can assist that in being more effective. However, there will be a debate about the effectiveness of disclosures for the purposes of advancing money laundering investigations and the undoubtable importance of privacy. More work in this space is necessary.

The regulator stated that she recognises that the Commission is going to do more work in terms of clarification, but this area might prove to be an impediment without further work. We must become an intelligence led organisation.

A regulator stated that privacy issues surround these items along with GDPR. It is necessary to have a public discussion about how far to go in relation to these matters. There is a trade off between fighting money laundering and terrorist financing and privacy. An enlightened discussion would avoid hitting the wall and determine how to prioritise these items.

A public representative stated that it is difficult to envisage a consensus between Parliament, legislators, and countries on the trade off between data protection and intelligence. There is objective alliance between the good and the bad here. The people who support privacy are objectively protecting the people who want to commit crimes; this is the truth of how data protection works. The public representative wants privacy protection, but he agrees that banks should be able to share flags and authorities should be able to share more information. This is the biggest struggle.

Sessions Summaries

III

BANKING AND INSURANCE POLICY PRIORITIES

Basel 3 implementation in the EU: key political stakes

1. Basel III in the EU for better stability of the banking sector

The Chair stated that the European Commission put forward a legislative package with a number of proposals to amend the Capital Requirements Regulation (CRR) and Capital Requirements Directives (CRD) in October 2021. These proposals addressed the final implementation of the Basel III reforms in the European Union. The European Banking Authority (EBA) very much welcomes the Commission's proposal. It believes it is a good step forward in the final implementation of Basel III. Basle III has been so far, a positive step forward in providing stability and resilience of the banking sector in the European Union. This implementation is not just a timely process, but also an urgent one to finalise.

1.1 The role of the European Commission

An official stated that the Commission is fully committed to making this general approach possible if member states want it. All member states seem eager to transpose the Basel standard in Europe without much more delay. The Commission is working hard on this to be one of the first major jurisdictions to transpose the Basel III agreement.

A public representative stated that he welcomes the well orientated proposal. The Commission has introduced many European specificities. Some are not Basel compliant, but even if they are temporary, the Parliament can live with them, at least in theory.

An official stated that the Commission proposal generally tracks the right balance between increasing the resilience in banks and preserving the ability to finance the real economy. All core elements of Basel III are included in the proposal and will be implemented in the European Union.

1.2 The EU's necessary compliance with the scope of Basel III, and the benefits it provides

A public representative stated that European regulation first has to fall in the scope of Basel III. His world will be focused on guaranteeing that what the Parliament and Council approve is fully Basel compliant. Europe has to be a partner in the international arena and banking regulation.

The rationality behind the output floor is important. The risk is a procyclical variable rather than a constant. Basel II reviewed internal models to internalise risk to calibration of capital requirements. However, without an output floor, banking and the financial stability is not as strong as would be desirable. Given that the risk is procyclical, it is necessary to introduce a bolt on to internal models. It is necessary to be aware of this reality and defend the result from Basel III.

An official agreed that it is important for the European Union to remain committed to a faithful implementation of international standards and the final Basel reform package.

An industry speaker highlighted the implementation of Basel III and why the European package should be as close as possible to Basel. He fully agrees with comments of Governor de Cos in his recent speech. Governor de Cos talked about multilateralism and the commitment to it, and the jurisdiction of an industry speaker is also fully committed to full, timely and consistent implementation of Basel III. In addition, in order to compete fairly on a level playing field, it would be useful if it stayed on that international level playing field. As allies, it is important that likeminded jurisdictions stick to international agreements.

An official stated that an industry speaker mentioned a system in Japan for smaller, non internationally active banks and larger banks. There is a different system in the European Union, and there are good reasons to uphold the same financial standards for all banks for a level playing field. That decision was taken in 2006 with the first implementation of Basel, and it is advisable to stick to this approach.

An industry speaker highlighted international comparison and the level playing field. There is a significant increase in the capital requirement for European banks. Following the 22 February 2022 figures of the Basel committee, the implementation of the 2017 Basel agreement would reduce the CET1 ratio of European banks by 300 basis points, which is a huge figure. An industry speaker understands the position of the industry speaker promoting a close implementation of the Basel package since apart from Europe other jurisdictions will have a neutral or positive impact: For America, it is nothing; for the rest of the world, it is -70 basis points. This is a problem. The international comparison is very interesting because it shows that Basel IV will not improve the comparability of bank solvency ratio or the level playing field. Therefore, there is no level playing field and the comparability of the solvency ratio will not be improved by the floor.

A faithful transposition of the Basel agreement would be one that is appropriate to the European context and in view of unifying the European banking market. One of the three overarching principles on the first page of the 2017 package is that it should not significantly increase capital requirements; the implementation of this agreement must observe this objective without a deadline. The speakers proposed in this context that the envisaged level of the output floor would be changed to bring it in line with the non-significant increase in capital requirements mandate.

An industry speaker quoted the result of the 2021 Supervisory Review and Evaluation Process (SREP) cycle published in February 2022. This reflects the resilience of Europe's banking sector amid the strengthening economic recovery. SREP's core remains broadly stable overall with significant institutions maintaining solid capital and liquidity positions and most banks going beyond the levels dictated by capital requirements and guidance. According to the SREP publication, European banks have enough capital. The average Common Equity Tier 1 (CET1) ratio is above 15% with an average requirement of around 10%. This means that there is a 500 basis-point management buffer, and it also explains why the banking sector was so robust during the crisis.

The speaker also stressed that the current framework already hinders comparisons. Indeed, for instance even though JP. Morgan has a higher CET1 ratio (the CET1 was 13.8% for JP. Morgan and 12.9 % for BNPP), at the end of 2021 debt holders considered that

BNPP is less risky than JPM (in February 10th the CDS quoted 58 (JPMC) Vs 39 (BNPP)). Finally, the industry speaker added that the last Basel 3 reforms would further hinder the ability to assess and compare banks' risk profiles. In this respect the speaker first stressed that the evolution of the regulatory framework would not improve banks' comparability since for example the application of the output floor to the residential real estate is expected to double the corresponding risk weighted assets of the French banks. This has the consequence to overlook the level of real risks, since these banks would have the same solvency ratios as higher-risk banks.

In addition, the speaker stressed that although the risk density in the US banks' balance sheet is higher than in the balance sheet of European peers (thanks to Fanny Mae and the securitisation of low-return risks), after applying the proposed output floor, such difference would disappear. Basel 3 reforms may lead to the fact that similar solvency ratios would conceal very different risk profiles.

2. Several remaining challenges

2.1 Finding the right balance while dealing with European specificities

An official stated that this is not a technical package; it is a very political one. The package has a very differentiated impact on banks, business models and member states. The starting point is that member states are coming from very different places, which explains why this is a difficult negotiation. It is also being conducted under the eye of a supervisor with its own views that it has expressed forcefully on certain issues. However, it is also for the colleges to decide, and the economic impact of the package must also be considered. Secondly, the Commission has taken the first step to address this in this proposal. Some Commission proposals are somewhat controversial.

However, the Council is still split on very structural elements of the Commission's proposal. Some member states also asked for a more level playing field between banks in the standard approach and internal model, while others asked for more proportionality. All of this needs to be considered to find a compromise. Taking this into account, there will also be a phase of negotiation in the European Parliament. It is necessary to ensure a compromise that is also acceptable for the European Parliament.

A public representative stated that there are some European specificities, most of which are in the proposal. He can live with them as transitional arrangements. However, other players in the Parliament and the Council intend to keep them permanent. This way, if the Parliament changes or lets the Commission review the current period of the transitional arrangement, there is a high risk of the European regulation not complying with Basel, not only in the short term but also from a structural point of view. This transitional arrangement is tolerable, so a public representative believes as a rapporteur that it should be kept permanently.

An official stated that the situation looks more like a trade off from the financial stability perspective of host countries like Lithuania. This is also the situation when a better capital position of banks at the aggregate level may come at the expense of worsened liquidity situation of banks in host countries. In this case, it is desirable to see not only a trade off between additional capital requirements and financial stability issues, but also some more balanced solutions. Capacity of banks to finance the real economy in host countries is also a key issue. Lithuania would like to have adequate safeguards in place for ensuring financial stability.

An official stated that this is a very positive proposal for the Commission to provide some transitional arrangements with regard to European specificities for the transitional period. This will give European banks sufficient time to adapt to the new regime.

2.2 Strengthening proportionality

An industry speaker suggested that some panellists look at examples showing how the US deals with the proportionality issue. Japan also has a proportionality approach. It distinguishes between domestic banks and internationally active ones. Having different requirements for those two groups helps to ease the tension between the need to cater to regional specificities and the need to keep an international level playing field. Proportionality works and is a good idea.

An official stated that she has three complete examples of where it is advisable to further strengthen proportionality and give comfort to smaller and medium sized banks. First, the Commission plans to introduce new requirements for material transfers. Second, there is a definition for small and non complex institutions from the last banking package. Third, smaller banks should have sufficient time to adapt the standardised approach and updated framework.

2.3 A European package still under construction and the question of capital requirements

A public representative stated that he welcomes the Commission's proposal to calibrate the output floor at consolidated levels. This is a good idea in the process of advancing the banking union, but it is also not possible to advance much on this matter without a truly European deposit insurance scheme (EDIS). The concerns of host countries are understandable when the regulation and supervision are European, but if there is any kind of problem, the national taxpayer will pay the cost through the national deposit insurance scheme. A public representative understands these concerns. Even if the proposal is well oriented, other capital waivers might be introduced in the regulation subject to real advances in the regulation of EDIS.

An official stated that it is necessary in the longer term to find credible solutions to increase the rating coverage to avoid extending the transitionary period. For the moment, it is important to have these types of transitional arrangements to allow the European economy and its banks to adapt with the new regime. Beyond the Basel implementation, the Commission has also proposed amendments to the existing regulatory regime. There is room for improvement in several areas here.

The Chair highlighted the quantitative impact of the reform. Both Basel and the European Council reached an objective that there should be no significant increase in capital requirements for the banking sector. Of course, that objective does not mean that the reform should not have any significant impact on every individual bank. There is also room for interpretation of what is considered significant. The current Commission proposal estimates an increase in capital requirements of between 7% and 8%. This is likely an overestimation because there are existing capital buffers that may be adjusted once the reform is in place, like some Pillar 2 adjustments, and part of the impact has been taken care of through bottom up repair. The Chair asked if the capital increases that may be necessary in some of the banks are intended consequences of the reform.

As highlighted by an industry speaker, the internal ratings based (IRB) repair programme targeted review of internal models (TRIM), combined with the wider context of issues already led to a capital increase for banks. Individual parameters can lead to a credit risk weighted asset (RWA) increase of 5%, or even 10% in some banks. Very small items can have significant outcomes. In the EU banking package, the key questions are whether this is justified; if it is due to risk variability, or if this is non warranted variability and RWA are being reduced.

A public representative stated that he does not buy this potential trade off between capital and loans. No fact can justify more capital representing less loans or less investment to the real economy; this is a fallacy. Basel II reintroduced the risk sensitivities in models, but the risk is not constant. It is a procyclical variable. 'Same risk, same regulation,' means 'Same risk, same capital requirements.' If the risk changes, it will be necessary to change the capital requirements or try to move the risk and the capital requirements.

A public representative stated that he can well understand the concerns in the host countries regarding the Banking Union. EDIS has been blocked for many years, and some countries do not like to take more steps in the banking union without any common insurance. Because the Commission opened this debate with its proposal to calibrate on the capital requirements in the case of the output floor at consolidated levels, there is at least a way to analyse if there is a moment in which to link this option that the Commission proposed to the advances in EDIS.

2.4 Could changes in the banking system have negative impacts?

An official reported the need to be cautious when changes are made in the banking system because this might have a negative impact in some regards. This is why Lithuania is looking with some caution at the Commission's proposal, particularly the issue of calculation of the output floor. Lithuania supports making the banking system stronger and more stable, but is concerned about some deviations from the Basel III standards in the proposal, which could alter the current fragile balance between home and host countries with regard to supervision of banks.

An official stated that he listens to the impact of some of the rules on CET1 if they are applied as they are. There might be a risk of deleveraging the banks, which will not be positive due to what has to be financed. Prior to the negotiation of the Basel III agreement, the G20 and the Ecofin stated very clearly that this new package should not lead to a significant increase in capital requirements for banks. The issue is what is significant.

2.5 An efficient but complex model?

An industry speaker stated that he understands that supervisors, regulators, and others feel uncomfortable due to the asymmetry of information. These are very complex models and there can be a perception that banks have an incentive to underestimate risks. However, these models are going through a very comprehensive assessment.

First of all, there is the approval process, and there has been a targeted review of internal models conducted by the European Central Bank (ECB). There have been 200 onsite inspections at 65 large banks in Europe which have led to, on average, a depletion of CET1 ratio of 71 basis points. The median is 51 basis points. This demonstrates that risk managers are doing a good job on average. This also gives quite some credit to internal models.

Parameters and internal models are also being discussed. In the IRB repair programme and the TRIM results, certain input parameters for internal models are being discussed where supervisors feel they are too aggressive. They are turned to a more prudential number, which is fine. They are addressing internal models directly. Beyond this discussion, it seems the output floor does not fulfil the objective, as highlighted by industry speaker. More capital adds more stability if that is the objective, but the output floor does not achieve an objective of same risk, same regulation.

An industry speaker stated that he agrees on risk sensitivity. Basel IV is very much a return to Basel I and a standardised approach to the application of the output floor to internal models. However, internal modelling was introduced by supervisors in the late 1990s after standardised approaches were found to be insufficient because they masked differences in risks. Following 15 years of implementation in Europe, a validation period of controls by supervisors, a repair exercise by the EBA, positive reports from the EBA on the stability of models, and an in depth review of the internal model by the Single Supervisory Mechanism (SSM) known as the TRIM exercise, it can be affirmed that they represent the most reliable measure of risk in Europe.

3. The steps going forward

3.1 There is room for improvement

An official stated that the financing of a real economy should ensure that European corporates have access to banking services from abroad. The Commission proposal might seriously limit the access of banks and other professional clients to financial services from third countries. The proposal should allow broader possibilities for the German Federal Ministry of Finance to provide cross border services in a balanced way.

Secondly, more proportionality is necessary. The Commission proposal is on the right track regarding the Basel implementation, but it should be more proportionate and contain new elements of the package beyond Basel.

An industry speaker stated that there might be room for improvement to reach the agreement. Once there is an agreement, it is important to stick with it as much as possible.

If the US decides to delay, then Japan is likely to also delay along with Europe and the US. This is positive from a competitive equality perspective, but it might not be from an international agreement perspective. It might be advisable to consider how to improve the process in the future.

An industry speaker stated that the process currently works in a certain way. There are four steps: the Basel committee publishing a consulting paper, the committee reaching an agreement, each of the jurisdictions putting their domestic rule making proposal out for public consultation and the regions reaching a conclusion on the rules. It might be better to switch the second and third steps so that all the necessary inputs have already been considered when the international agreement is being negotiated. This is going to be a choice between a more difficult process with an agreement that might have a better chance of being adhered to and an easier process with a lower probability of an agreement being adhered to.

3.2 Facing new challenges: how to finance the economy going forward (ESG, digitalisation, competitiveness...)

The Chair stated that the French presidency in particular is concerned about having a strong financial sector and a strong sector will help to finance the economy going forward.

An industry speaker stated that the opportunity of the banking package is to finalise the implementation of Basel III. This is a key reform to allow turning to the other elements under discussion and other challenges, such as environmental, social and governance (ESG) and digitalisation.

An industry speaker highlighted the financing of the economy. Huge investments in the future will be necessary due to a geopolitical crisis, digitalisation Europe lagging behind Asia and the US and the climate transition. Capital requirements are a way to oblige banks to deleverage and reduce their risks in proportion to their capital. It is necessary to think twice before implementing this 2017 package.

An official stated that the aforementioned is a key question. In order to sustainably finance growth, a resilient financial sector is necessary, and Basel is an important part of it. However, it is a matter of definition, but it is advisable to be clear that banks need to finance several important challenges ahead. The banks have been important partners of member states in dealing with the pandemics. The panellists are also counting on them to finance the green and digital transitions. For that purpose, it will be necessary to have a very competitive bank.

An official stated that one of the main themes of the French presidency is switching the narrative from risk reduction to competitiveness of the financial sector. This means a more integrated financial sector that completes the banking union. This will obviously consider the concerns of host countries and the Capital Markets Union (CMU) because both work in the same way. Banks and financial markets are working together to ensure a competitive European Union.

An official stated that the main question is how to adapt the economy to apply the rules and adapt to the new programme. The Commission proposal to have transitional arrangements is very positive.

A public representative suggested thinking more about climate and crypto asset risk. This topic will definitely be on the table in the European Parliament.

3.3 Building trust to make progress all together

An official highlighted the lack of trust between different stakeholders. Currently we have a fairly fragile balance between the home and host countries. We should avoid creating a precedent changing that balance as it could aggravate progress in the broader strategic debate on completing the Banking Union and future decisions in this regard. If we want to establish trust between all of the players, we need to agree on moving in all directions at the same time. Fully-fledged EDIS would have a much larger impact on completing the Banking Union while ensuring financial stability than just altering capital requirements.

Improving the global competitiveness of the EU banking sector

The panel focused on the global competitiveness of the larger European banks on the global stage. First the panel considered the question of the causes and consequences of this potential competitiveness gap. Then there was a move to the policy responses that may be required or appropriate if that competitiveness gap is to be closed.

1. Major European banks remain generally less profitable compared to global counterparts

All speakers agree that the major European banks remain generally less profitable and undervalued compared to their global counterparts. Cyclical and structural reasons explain this gap. 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.

1.1 Strength of the European banking sector through the pandemic

An industry representative noted that the European banking sector has been extremely strong through the pandemic and has come out of it with stronger liquidity and capital ratios. Europe should play the resilience of its banking sector to its advantage.

A supervisor agreed that 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.

1.2 Profitability has lagged behind international peers

1.2.1 Facts and figures

A supervisor stated that following the great financial crisis (GFC), despite a significant increase of EU banks' resilience, their profitability 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.

Another supervisor confirmed that there is a gap in profitability between the US and the euro-area banks, meaning there is a difference in competitiveness. The US return on equity (ROE) is five to six percentage points above the one of the Single Supervisory Mechanism (SSM) banks, which comes from three drivers: the net fee and commission income, the net trading increases and differences in the impairments and provision.

1.2.2 European banks are falling behind on both sides of the ledger.

An industry representative stated that European banks are falling behind on both sides of the ledger. Revenue growth has been weak and cost structures remain a major burden. US banks boasted a cost/income ratio roughly 15 percentage points better than their European counterparts in 2021. About 80% of that gap was attributable to support function costs. U.S. banks are getting more out of their technology than European banks due to the scale advantage of the American markets.

1.2.3 The EU has long been attractive to banks which are headquartered outside of the EU

An industry representative confirmed that their bank, headquartered outside of Europe, looks at the whole world and opportunities, and the Americas, Asia and Europe are all always assessed as the regions to deploy capital. International banks 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. 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. However, Europe is often seen as being more complex, more fragmented. The cost to income ratio for a global bank is generally higher in Europe than in the US and Asia.

1.2.4 Non-EU Investment banks are gaining market share in Europe

An industry representative stated that if you look at the role of Global Systemically Important Financial Institutions (G-SIFI) in the European Union, Americans are 2.5-times Europe in fixed income; in equities it is 3-times and in Investment Banking Department it is 4-times. That gap has been growing every year. European banks have more of a compliance mindset than American banks, which have a growth mindset.

He provided two examples related to the climate and digital transition. On climate, the first thing the European institutions ask is what they need to stop financing, whereas the first things the American institutions ask is where the financing opportunity is, how they can finance the transition and get ultra-high-net-worth money into financing start-ups. Concerning digital assets, the work on digital asset strategies for American institutions probably peaked 12 months ago and it is only starting in Europe.

Much of the value creation has actually happened outside the banking system, through payment providers like Square. The big tech firms are key with how they leverage data and turn that into customer-ready value propositions.

1.3 Cyclical causes

Four cyclical reasons contributing to the competitiveness gap between large EU banks and their American and Asian peers were underlined during the session.

1.3.1 The yield curve and interest rate differential between the US and the eurozone

A supervisor stated that there has long been a real difference in the yield curve. More than 50% of EU banks' net operating income comes from the net interest income. Therefore, the interest level matters. Since 2014 the ECB deposit facility rate has also been negative, unlike US rates. Combining all of these conditions on the interest side, there is a large difference, and it is a long-lasting difference.

1.3.2 The US's more favourable macroeconomic environment

A supervisor noted that the macroeconomic situation has been less favourable in Europe than in the US since the great financial crisis.

1.3.3 The legacy of the Global Financial Crisis

A supervisor added that there is also the problem of the treatment of the legacy of the financial crisis, and in particular the treatment of non-performing loans (NPL). In Europe, there is a lack of a genuine securitisation market, for instance for NPLs, so the initiative taken by the Commission recently is welcome.

1.3.4 The corporate taxation rate

A supervisor noted that in the US there was a reduction to 21% in 2018 which is much lower than what the top 10 SSM banks are required to pay.

1.4 Structural factors

The European financial market remains small and most of the financing in Europe is provided by the banking sector. The situation is the opposite in the US.

1.4.1 The fragmentation of the EU banking sector

A supervisor highlighted the low level of concentration and the higher fragmentation of the EU banking sector, which is a source of inefficiencies and vulnerabilities. This situation leads to insufficient risk sharing at the EU level, since 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.

Additionally, there are new competitors. This new paradigm between banking activities and new actors, fintech, big tech, etc, is a challenge in terms of profitability for banks, which are obliged to invest a great deal to be able to compete with these new actors and properly address consumers 'expectations.

The underlying risk requirements can also be very different depending on the US or the EU market. With the French banking system there is a long historical period of lower and less volatile cost of risk. That is fact. When there is a lower and less volatile cost of risk year after year, that reflects a low risk profile on the domestic market, and in particular on residential real estate. With lower risk there are lower interest margins, because there is no need to cover the risks. This can explain a part of a difference in terms of profitability.

Another supervisor stated that the competitive structure differs between the euro area and the US banks, because the euro area banking landscape remains more fragmented. There is a much more diverse nature to the national markets in Europe, and that is due to different attitudes toward credit, the different legal frameworks and the different structures. The most pertinent goal for the euro-area banks is to aim to generate healthy levels of profitability, which function as a buffer against losses. The goal is not for euro-area banks to be compared directly to US banks but to look at how to address the profitability questions. An industry representative agreed that cross border fragmentation and the different regimes in Europe are reasons for the cost/income ratio of European banks being so high.

1.4.2 US banks benefit from a large domestic base

An industry representative highlighted that, when looking at this US market, the consolidation which has taken place and the scale in terms of market share means a very different pricing power. For initial public offerings (IPO), structurally the pricing is different. Even the public guaranteed loans that were put in place were typically much more profitable for the US banks. Cultural differences are also present, and the two major European banking markets are dominated by mutual banks or their equivalent.

1.4.3 The European financial market remains small

A supervisor stated that the capital markets play a very different and much more significant role in the US, and therefore the banks earn more fees from intermediation between the corporates and the capital markets. Even for loans to households, US banks are functioning much more as originators and distributors, while the euro-area banks are holding the loans on their balance sheets.

1.4.4 The absence of a securitisation and a single capital market in Europe

An industry representative noted there are banks that have large balance sheets in Europe, but unlike those in the US they are not able to originate and distribute as much. Therefore, a euro of capital is, by definition, not as productive depending on the side of the Atlantic where the bank is located. Thanks to active securitization, 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. It is an impediment, in particular in light of the Basel IV framework where holding a loan in the balance sheet will be even more expensive than it is currently and knowing that Europe does not have public agencies like Fannie Mae and Freddie Mac in the US, which are like gigantic vacuum cleaners of major amounts of mortgage loans that European banks have to keep on the balance sheet.

Following the Global Financial crisis, the initial purpose of the new EU framework was to say there needs to effectively be a financing of the economy, which would be better balanced between banks' balance sheets and capital markets, with more origination to distribute capacities, but it has not been possible to move forward on the second leg while progress on the first is at about the halfway mark.

One other non-structural element is that the construction of the European banking resolution system is also paid by banks, and the amounts for French banks have become an impediment in terms of profitability. The hope is that it will stop in 2024.

An industry representative agreed that US banks operate on more of an originate to distribute model and that this has delivered a stronger secondary capital market. It also allows a stronger primary market and a funding market for corporates and banks. The competitiveness gap between the main European banks and their American and Asian competitors also exists because of factors like interest rates, the fragmentation of the market, particularly post-Brexit, excess capacity and the fact that the composition of the financial sector in Europe is different from the US. Having deep pools of liquidity that reduce funding costs and allow for cross-border global flows into the European market is something on which the European Union needs to continue to be focused.

1.5 The profitability gap is a threat to the future

An industry representative suggested it is fair to say that the main challenge in term of competition and capacity to compete is on international businesses such as wholesale and investment banking. US banks that have a strong market share in their large domestic market (e.g., the US still represent 50% of the market, with the capitalisation of a company like Apple being $3 trillion, the equivalent of CAC 40), have an extraordinary advantage and a greater capacity to develop internationally.

They are active in Europe and take market share from local competitors. At this stage on retail, it may be seen by authorities as a remote issue, but we should not underestimate their competition in the future. They might try to look at the most attractive part of the retail and wealth management business in Europe. Retail activities might not be immune from that competition forever.

The focus of public authorities was very much on security, which is understandable after the financial crisis. There has not been enough attention put to the competitiveness of the sector, which is also an important feature of a sound banking market.

A supervisor added that 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.

2. The priority for banks to bridge their profitability gap

2.1 Facing the reshaped industry landscape

An industry representative stated that there is a need to push ahead with the Capital Markets Union (CMU). The last milestone in terms of the prudential regulation should be adopted in a less naive way. The European Commission has started to understand what is at stake in terms of competitiveness, but there is a need to remain vigilant.

One of the major issues for banks to compete is the limited capacity to develop start-ups in a regulated banking environment. There is a need to be able to remunerate the entrepreneurs like other start-ups, which is difficult in the current regulatory framework. Exceptions should be granted on this matter.

Banks should try to move as quickly as possible in terms of digital technology, while focusing on areas where they can have a competition edge. Environment, social and governance (ESG) could be an opportunity, but it could be a further burden, if there is not enough pragmatism in this matter.

2.2 Achieving a genuine Banking and Capital Markets Union

A supervisor emphasised that the CMU and Banking Union are strategic imperatives. They are about security, diversification of risk, being prepared for the upcoming digital revolution and being prepared for the climate transition. Achieving a truly integrated European banking market would put banks in a much better position to reap the benefits of scale and scope and to finance the green and digital transitions. 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.

An industry representative stated that the Banking Union and the CMU are key ingredients for creating a simpler and more level playing field across Europe, which would also help foster well-needed consolidation. But what if the 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. 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

2.3 EU bankers need to adapt their strategies to digital transformation and the green transition

A supervisor remarked that Europe has a citizenry that believes in the need for transformation of the economy and to protect the earth, so there is an understanding and a buy-in that there is a need to completely move from preserving the economy to completely transforming it. That means the banking sector needs to be able to finance it. The amount of financial investment that has to take place as estimated by the Commission is around 2% of gross domestic product (GDP) every year until 2050. There is an enormous opportunity for European banks to be enabled, if they have the capital markets capacity. In the US there is not remotely the same level of buy-in, which means the European banks will be competitively positioned to be the global financiers of this activity.

Digitalisation is another strategic imperative. There is a need to move into this technology component and understand that a revolution is occurring. Paradoxically, US banks are at a competitive disadvantage. They have been investing in technology for at least 10 years, but they are facing a different level of competition from big tech. It is not quite the same dynamic in Europe.

European institutions must not only invest in entrepreneurs and embrace the next generation's concept of what banking means; they must also deal with the operational components, the processing which means security. It is management of risk. Tough decisions have to be taken about not continuing to just buttress legacy systems and questions of whether to invest in online banking. What is needed is deeply transformational change in the technology area. The regulatory framework at the European level needs to enable both of these issues.

2.4 Winning banking models will be platforms-oriented around data

Banks have not leveraged the value of the data they have. And most important, they haven't sufficiently appreciated how the process of value creation has shifted. They did not 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.

An industry representative highlighted data as a way to close the global competitiveness gap. There has to be reciprocity, as increasingly many institutions are tapping into banking-like services. For banks it means changing the business model organisation, because banks are still vertically integrated institutions that are organised along product lines, and many of the other institutions, like the big techs, have overcome this by creating joint ventures. Data is a more regulated component in a banking world than it used to be in other institutions. The demand for reciprocity creates a huge opportunity. This sounds difficult but that is exactly what an institution like Microsoft did. Microsoft was in a tricky situation. It was a product factory, with the likes of Windows, and it has changed towards a customer-centric organisation. That was a tricky transformation but thinking through what really closes the gap or creates value, data services usually come with a P/E multiple of about 30 to 40, whereas traditional banking services are perhaps 10 to 15. With the way things are reported to investors and the associated organisational shift there could be a value lever.

2.5 More consolidation is needed

A supervisor noted that to build more scale advantage within the European landscape, in addition to consideration of all that has been said in preparing for the future, more consolidation is needed. The European banking system is made of a series of national assistance. The French case is a good one: the six big groups amount to about 80% of the French banking system, so the work is done. This is not the case in some other European countries, but there have been some big changes. There is the movement of concentration within the jurisdiction and there is a need to go beyond that because there is a Banking union and a European Union. Regulation can help and supervision can assist in implementing the regulations.

A supervisor stated that there has been a great deal of progress. The Eurofi conference 10 years ago was before the single rule book, before the creation of a single supervisor and before the creation of a single resolution authority. It is costly, but it is much better than having 27 supervisory authorities, 27 resolution authorities and 27 rule books. That work is largely done. The Banking Union is not yet entirely in place, but for big players the two first pillars (supervision and resolution) are largely sufficient. The third pillar (EDIS) is not essentially meant for the big players.

Among the small steps that can be taken is the implementation of the waivers by supervisors. They exist in the level 1 text. They should be implemented by supervisors under scrutiny, under control and under conditions. The management of liquidity can be made on a cross-border basis, meaning between two jurisdictions, but within the same area, which is called Banking Union. This is an example about which there can be collective effort.

Going beyond in terms of capital waivers and having minimum requirement for own funds and eligible liabilities (MREL) can then be considered. The debate on home hosts should be moved beyond because the question of the competitiveness of banks is true for all banks. Being a host or a home does not change anything. These are very small steps to be implemented very easily and, it is hoped, quickly as well.

The Chair remarked that much revolved around the question of how to get the advantages of market scale found in the US. Much has been created and much has been harmonised, but it is incomplete. Consolidation can help and can produce institutions with a different level of scale and competitiveness, but the answer to competitiveness cannot just be to become larger and then reduce to oligopolistic structures which then do not benefit the consumer.

2.6 Ensuring competitive funding costs is critical for the competitiveness of global banks

An industry representative stated that their organisation tries to constantly optimise its operations. It needs to be very careful about being efficient and making sure it constantly rationalises its network. In Europe, it has a number of operations, including subsidiaries and branches.

It also needs to be able to distribute funding throughout the group, because it is not in retail in Europe so funding comes either from corporate clients and depositors, or directly from the international headquarters. That requires flexibility. It is important for the organisation to ensure that it has some form of flexibility; that is a policy matter it has been discussing with the regulators, to make sure that it can continue to access the necessary funding at the right cost. Competitiveness for the organisation is also about making sure that, when it comes to access to capital, it is not at a disadvantage compared to EU banks.

2.7 Dialogue between the industry and supervisors on the future of the EU banking sector is required

An industry representative wanted to see more dialogue between the industry and supervisors on what the banking system will be in 10 years' time. There are technology changes, central digital currency, possibly crypto-assets and ESG. This is just the start of a major industrial revolution for the banking sector.

Addressing ring fencing practices in the Banking Union

There are no host supervisors anymore in the Banking Union area but the distinction between home and host authorities and the "national bias" still exists for banks operating across borders in the "Banking Union" under the remit of the Single Supervisory Mechanism. The Chair noted that the session focuses on a very controversial issue in the EU. The home host debate has reached the stage where every legislative file concerning banking runs the risk of getting stuck in it. All Europeans would like to reap the benefits of the single market. The single market in financial services is incomplete; the core issue is distrust between supervisory authorities, as well as distrust between legislators and member states.

1. The Banking Union remains unfinished business

1.1 The Banking Union has achieved progress since its inception

An industry representative agreed that the European banking system has made a significant amount of progress in the last 10 years after the financial crisis. A lot has been achieved in such a 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 BU.

A supervisor stated that the Banking Union (BU) has been a success story in Europe, especially in the context of the last two years with the pandemic. It has been able to foster and create trust and cooperation in the policies that have been put in place, in the cooperation across banking supervisors outside of the euro area, and with monetary authorities and fiscal support measures.

1.2. Only minor improvements have been made since the creation of the SSM and the mutualisation of resources for resolution from the SRM

An industry representative noted that the Banking Union remains largely unfinished, making the present situation partially a regression. According to Jacques de Larosière, subsidiaries of major banks are governed by national rules known as host country rules. This prevents large banking groups from benefitting from the effects of scale that they had a decade ago. The paradox of the Banking Union is that it does not enable cross-border banking groups to emerge.

1.3 The current regulatory framework still largely relies on a territorial approach

An industry representative observed that the current regulatory framework still largely relies on a territorial approach such as the uneven application of cross-border waivers for capital, liquidity 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. The question is how scalable European markets are for large European banks to run an operation that becomes even more profitable and have the same opportunities as some of the US banks or large Asian banks if ringfencing is removed. In order to remove some of the ringfencing quicker the territorial approach should be eradicated. The second aspect is the uneven application of border waivers. The third aspect is intergroup support requirements.

The Chair noted that in the past Europe had a better situation regarding capital and liquidity management in European banks. What happened during the financial crisis led to a reversal. Many Austrian banks were exposed in central and eastern Europe, but it was unlikely that any of them had withdrawn support under the direct conditions. They were also supported by the Austrian supervisory authorities and the government. That took place before the Bank Recovery and Resolution Directive (BRRD) and the resolution rules were in place.

1.4 Financing the green and digital transitions cannot be achieved with fragmented banking markets

A supervisor stated that there is a need to make significant investments in the EU with a crucial role for the banking sector. The estimates on green and digital public and private investments that have to take place for transformation for profitability of the banks is about 650 billion, which is 4.6% of the 2019 GDP, per year until 2030.

2. The root causes of ring-fencing practices

Several speakers indicated that ring fencing practices were caused by a lack of trust between home and host jurisdictions.

2.1 Segregation of capital and liquidity is a problem

A supervisor stated that 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 institutional and structural costs of ring-fencing practices are difficult to quantify but 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). Ringfencing measures are a sign of distrust. However, only if both sides are willing to understand the respective views of home and host authorities, real cooperation can ensue. The Single Supervisory Mechanism (SSM) with the Supervisory Board at the centre is an example of that understanding in action.

The most efficient allocation of capital and liquidity within groups is one that allows for free float. That needs to be in place in the banking sector; not having it puts European banks at a severe disadvantage compared to US peers, who benefit from a much larger and integrated domestic market. The Banking Union and the Capital Markets Union (CMU) are mutually reinforcing policy objectives.

An industry representative noted that segregation of capital and liquidity is a costly problem which limits the efficiency and agility of pan European banking groups.

2.2 The insufficient involvement of host jurisdictions in the resolution strategy of transnational banking groups

An official observed that the internal market offers great potential for EU banks, but this potential has been largely unused even though the opportunities for ring-fencing at the national level have been restricted. EU banks can rely on branches rather than subsidiaries to conduct business in other euro-area countries. For MREL there is no role for the host authority to decide whether the resolution strategy will be a single point of entry (SPE) or multiple points of entry (MPE).

2.3 Banks do not always consider host markets as their domestic market, and the sovereign bank nexus remains a concern

An official stated that from the perspective of host countries it is crucial to maintain the financial stability of the banking sector and ensure fair burden sharing in cases when the bank fails. An important requirement for cross-border integration is that the host banking sector is seen as a home market for European banks, which is not always the case. A vital aim is the Europeanisation of European banks. Europe needs to try and overcome home bias. It is very important to address the sovereign bank nexus which currently exists in the EU. Diversification of bond holdings in bank balance sheets is required.

2.4 The governance of Banking Union institutions does not sufficiently take into account host country concerns

An official noted that the absence of trust is a significant issue. The first reaction when the pandemic started was to close borders, which is why people cannot have trust in the system. It is important to improve the governance of the Banking Union, the Single Resolution Mechanism (SRM), the Single Supervisory Mechanism (SSM), or the Single Resolution Board (SRB) to make them more European, taking into account all Member States concerned. Those three elements can be crucial in the effort to overcome the fragmentation which is currently faced.

2.5 Burden sharing remains an issue

An official stated that a shared characteristic for most 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. It is crucial to maintain the financial stability of the sector and ensure fair burden sharing in cases when the bank fails. Host countries have legitimate concerns about the way possible banking group resolutions may be handled in the EU. This is the biggest concern for Slovakia.

EDIS is important for improving cross border banking integration. Fair burden sharing is needed when a bank faces problems, including common safety nets with loss sharing elements, and ideally with a fully fledged EDIS. The ultimate aim should be to have a fully fledged Banking Union with a single jurisdiction within the eurozone.

An industry representative added that there are some reasons to be less optimistic. A lack of trust between public authorities has been a problem for years, especially when they have a common border. EDIS will not solve everything. Public authorities need to do their job; building trust is their job.

3. Possible way forward

3.1 Ring fencing practices are a public authorities' issue, for which banks cannot be held accountable

An industry representative stated that the issues of ring-fencing and lack of trust are to be tackled at a political level, by taking hindsight from the continental view of the SSM. In fact, ring-fencing practices exist among public authorities, when, on the contrary, at a business level, pan-European banks' relations with local public authorities are most of the time excellent. Since the problems that have been highlighted do not prevent banks from doing normal business with total transparency with public authorities, measures should therefore rather be taken on the public authorities' level.

3.2 The SSM is a strong supervisor and the renewed interest in ensuring financial autonomy of Europe are sources of optimism

An industry representative underlined that the existence of the SSM and the new political goal of EU financial autonomy are two reasons to be optimistic. The system of the SSM may be perfectible, but there has been enormous progress after the Great Financial Crisis and a continental view of challenges and benchmarks is in the course of being established. The SSM is a force in favour of more harmonisation of rules and a shared interpretation of common rules, an evolution that should not be underestimated. Furthermore, the state of mind in Brussels has perhaps begun to change regarding the importance of an efficient financing system to reach the political objective of EU strategic autonomy which could help to make a common financing area a priority.

3.3 Branchification is a route for cross border banking but is not a solution for every problem

The Chair asked a supervisor if banks need to go into host countries via subsidiaries, or whether they could do branchification. If branchification is done, then the burden falls on the home country's deposit guarantee scheme (DGS) and the issue is resolved.

A supervisor stated that branchification is not a solution for every problem, but it could be better taken advantage of by other business models. Third countries are moving forward with a single headquartered European entity with branch constructs across Europe. It is concerning that only competitive foreign institutions are moving in that direction. UBS has created a Frankfurt head office and has branches across Europe. This allows a far more simplified governance framework and the free flow of capital and liquidity across the entire group. European banks are not taking advantage of what is available with branchification. There would be tremendous savings and risk mitigation if branchification was a more utilised construct.

An industry representative also questioned why EU banks are still making so little use of the basic freedoms of the single market and are not converting more subsidiaries to branches. US banks and some large European banks are setting up European corporations for that purpose. It may seem difficult, costly and time consuming to convert subsidiaries into branches, but it will work and an appropriate way to address the issue. For other regulatory measures one possible solution could be the introduction of a binding intergroup guarantee as part of the recovery plans, which could provide assurance for host supervisors.

The Chair added that there are obstacles to branchification, such as legal issues and a soft pressure not to branchify.

A supervisor agreed that there has been pressure not to branchify. If governments are making it clear that business will not be as available to banks if they set up a branch framework instead of a subsidiary framework then some business objectives will be pursued. That is an awful practice. Governments that are doing that are hurting the whole of Europe in terms of the overall opportunity cost that would be available with the investment and the creation of value for citizens in the form of investment and innovation, investment in climate transition, credit being much more freely available, and for continued economic success.

An official noted that branchification is up to the businesses, companies and banks to decide their models. It is not for policy makers to foster or support ways in which entities want to organise themselves. There should be legislative obstacles, but it should be up to those entities to decide on their model.

An official added that home countries have a concern that those entities are operating inside them through subsidiaries. One concern is that entities see host countries, not as their home country, so they still have the possibility for an easier exit. Home countries want to have a real European market when it comes to the banking sector. Host countries do not have the representatives, but they have the professionals. It is important to make use of this experience when it comes to arrangements on the SSM and the SRB. When a discussion takes place on the Banking Union it is important to think about the purpose of the banking sector.

3.4 A review of the current EU legislative framework and a greater use of regulations across the European Union would be an important step

An industry representative stated that a number of supervisory approaches are not yet fully consistent, as evidenced by the imposition of intragroup dividend restrictions during the COVID-19 pandemic and the link between prudential requirements and restrictions on distributions. There is also a lack of a transparent approach when setting Pillar 2 requirements as they can vary from country to country.

An industry representative noted that the absence of common and fully transparent EU practices for the prudential assessment of M&A transactions further adds to the complexity, despite the initiatives taken by the ECB. The level of systemic buffers of other systemically important institutions (O-SII) varying across the EU creates an uneven playing field dependent on where the entity is based. There is also 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.

An industry representative added that inconsistent interpretation and application of the European Banking Authority (EBA) outsourcing guidelines across the EU means that providers and receivers of services work to different regulatory standards. The aspiration is to have a genuine Banking Union, a genuine CMU, and potentially the EDIS. Scalable markets are needed so that operations run efficiently and optimally. Appropriate consideration should be given to the reform of these barriers to further facilitate the formation of transnational banking groups.

3.5 The persistent fragmentation of non-prudential rules needs to be addressed

A Central Bank official stated that the discussion is not only about the Banking Union and EDIS. It is also about non prudential issues such as national insolvency harmonisation at the European level and different taxation regimes. Cross border banking and financing activities will be hindered if those issues are not worked on and only the integration on capital and liquidity waivers are addressed. Host countries are not against instruments like liquidity waiver, but admittance is needed that the situation may change very quickly, especially in terms of illiquidity. A credible and legally enforceable mechanism needs to be created hand in hand with border liquidity waivers, which will ensure that subsidiaries have adequate liquidity in crisis situations.

3.6 EDIS remains a contentious issue, and a fully-fledged EDIS is crucial for host countries

A Central Bank official observed that a fully-fledged EDIS is crucial. But for many leaders of the industry, making the deposit guarantee scheme of the home country responsible for deposit protection function of a transnational group, correcting the uneven distribution of costs of the Single Resolution Fund within the EU and agreeing on target changes to the EU supervisory law should be able to address ring-fencing issues.

3.6.1 For host countries, a fully-fledged EDIS is crucial.

A Central Bank official explained that the BU is currently confined to the boundaries of the euro area, but Lithuania has a foreign owned, fairly concentrated banking system, with a majority of capital coming not from the SSM or the euro area. When referring to the single market the BU needs to go beyond the limit of the euro area and eventually cover the whole EU. This is important for countries where a substantial share of the banking sector is foreign-owned, primarily by non-euro area entities. The parent companies of many of the largest banks in the Baltic States are not supervised by the SSM.

A Central Bank official stated that there are real problems in an EDIS that is not fully implemented, such as when a consolidated transnational bank fails where its requirements are only applied on a group level. The host country has to compensate its deposits for its domestic subsidiary. A complete EDIS functioning at full scale is a very important tool. Correspondingly stronger safeguards are needed as banks become larger. If a consolidated transnational bank fails where the prudential requirements are only applied on a group level, then the host country has to compensate the depositors of its domestic subsidiary. Local taxpayers' exposure to the risk of losses can be substantially reduced with a fully-fledged EDIS in place.

A Central Bank official added that a fully-fledged EDIS is also 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. These risks are even more pronounced when a large entity makes its headquarters in a small home jurisdiction. When home countries refer to capital waivers and liquidity waivers, they are talking about efficiency costs. Issues are raised by host countries on the BU about a deposit insurance scheme that is to be used when the company goes bankrupt, how to resolve a failing company, how to supervise in a way that company is regulated, and how to make sure that company keeps afloat. Host countries are not against capital or liquidity waivers. Host countries want to ensure that the system is functioning, working, trustable, and that there is a real single banking and financial market.

The Chair understood a Central Bank official's point regarding EDIS. When the discussion on the Banking Union started it was stated that centralised supervision can have financial effects and can place the financial burden on member states. A centralised burden sharing is needed. The supervision is in place, but EDIS is not. Regarding liquidity and capital waivers, everyone wants banks to provide the real economy with money, but there is also the issue of the competitiveness of European banks.

3.6.2 There is no need for EDIS to address the home host dilemma

An industry representative stated that the Commission's 2015 EDIS proposal has broken into pieces, and EDIS will not make ring fencing disappear. Andrea Enria has stated that cross border integration is progressing very slowly, and that the global financial crisis and the historical past perspective led to repatriation of assets held in subsidiaries. Before the financial crisis a Banking Union was in place without being regulated or legal prescriptions. It is important to get back to this situation and break the vicious circle of ringfencing in Europe.

An industry representative noted that regulators need to work on the large exposure and liquidity waivers within banking groups set by the administration or supervisors. According to the ECB, €250 billion in high quality liquid assets is ringfenced due to European national provisions. The ECB should start by raising the maximum liquidity coverage ratio (LCR) waiver for significant subsidiaries beyond 25%. A commitment is needed from SSM member states to abstain from ring fencing, because it mainly related to the large exposure override.

3.7 Home country DGS being responsible for the deposit protection function of a transnational group

An industry representative observed that the risks linked to the question of deposit insurance could be addressed much easier by making the DGS in the home country responsible for the deposit protection function of the entire group. A separate consideration of the issues will lead to more timely results. EDIS is necessarily linked to the various aspects of risk reduction, including regulatory treatment of sovereign exposures. National deposit insurance schemes would not be an obstacle to cross border consolidation if European legislators provide for a less restrictive transfer of contributions in case of a merger.

A supervisor explained that the ECB has suggested a small legislative change to facilitate branchification. EDIS is the goal, but for the national deposit insurance schemes (DGSs) there should be a change that does not limit the transfer of contributions between DGSs to only the last 12 months. There should be a much more proportional application methodology, such as the one the EBA has suggested.

3.8 Correcting the uneven distribution of costs of the Single Resolution Fund within the EU

An industry representative stated that the Single Resolution Fund is certainly useful as a tool. However, its costs are unevenly spread and are strongly viewed as unjust and unsustainable by some of the biggest banks in the EU. As an example, French banks pay about a third of the SRF despite representing only 20% of the Euro Area deposits, which is not a sound basis for ensuring minimal support from the industry in favour of the development of a real Banking Union. If this structural imbalance is not addressed, it will continue to undermine discussions and support on the next steps of the Banking Union.

The Chair observed that Europe has half a European DGS, the SRF, because it fulfils many of the functions of the Federal Deposit Insurance Corporation (FDIC) but not all of them. The problem is that Europe does not yet have the other half. The frustration of banks seems to be because they are paying so much for the first part they want to make sure they do not pay a disproportionate share for the second part. There is also an issue of trust involved in what Europe wants EDIS to do and how it wants to design it.

4. Accelerating CMU and the harmonisation of corporate insolvency

4.1 The CMU and BU are interlinked; progress on CMU would help overcome the current BU deadlock

A Central Bank official stated that trust is built by doing the first things first. The EU, its single market, and free movement of good services, labour and capital is beneficial, but if the EU wants to follow that then it needs to build the Banking Union. If the EU puts its thinking in the direction of how to completely avoid ringfencing then it should do the first things first, which is to build the BU and CMU.

An official observed that it is important to have recognition that the CMU is highly interlinked with the Banking Union. These discussions should go into the roots of the problems which are being faced. Slovakia is ready to discuss corporate insolvency and supervisory arrangements, and when it comes to the CMU it means the role of the European Securities and Markets Authority (ESMA). Those issues should be concentrated on if Europe wants to have real results and promote cross border investment and lending.

An official added that Europe should diversify the lending of its banks and promote cross border lending in the EU. Discussions on the CMU are very important. A deepening of the CMU would increase cross border financing of banks, reduce market concentration and dependence on bank financing. Europe needs to combine its discussions on the BU with its discussion on the CMU. An action plan was proposed two years ago by the Commission and was supported by the Council. The most important action is linked to the harmonisation of corporate insolvency, which would address the problem of the financing of the economy in times where European banking groups are in a market which could be considered a single jurisdiction.

An industry representative emphasized that the CMU and the Banking Union are mutually reinforcing initiatives. There is no aim of a Banking Union if there is no common financing area. Both are important for innovation financing, prosperity, and efficiency.

4.2 A genuine Banking Union does not need an entire harmonisation of insolvency rules

The Chair is hesitant to put too many conditions on the Banking Union now there is the reform of European insolvency laws. A Banking Union only needs a separate insolvency regime for the banking sector. Europe is unsure when the CMU will be complete. It is complementary, but the question is whether Europe needs a complete CMU before it can have a Banking Union.

An official noted that the banking sector should take a lead in this discussion. It is important to concentrate on the possible criteria and its measurements. It will be difficult to identify output criteria which need to be achieved because it is not under the control of the sector, but that can be done with frameworks.

The Chair stated that the entire Banking Union debate is reminiscent of the one on the European single market. The term 'single market' only started occurring in the 1980s with the European Single Act. Europe has not arrived at where it is by political design. Europe has the same political economy problems in the BU as it has in the single market.

An expert asked if trust among public decision makers can be created between home and host countries if there are not sufficient economic and fiscal convergence in all parts of the union, in a context where the Covid crisis has accelerated economic fiscal heterogeneities in all parts of the EU.

An industry representative agreed and stated that insolvency laws need to be added to the question. A common aggregate product of corporate debt will not work without a common solvency regime. Insolvency laws are as concrete and important as EDIS, and perhaps even more important in the day-to-day banking operations.

A Central Bank official underlined that it is not the case that the authorities do not trust one another. A more holistic view and approach to an issue is needed.

The Chair clarified that the issue of trust is a 'prisoner's dilemma'. Everyone is individually trying to achieve the best outcome, but it is not the optimal outcome for everyone. The hope is that the Banking Union can free Europe from that outcome.

EU banking crisis management framework: improvement priorities

Having an effective and integrated framework for managing crises is essential for preserving the trust of depositors and the public at large, in order to avoid financial fragmentation and to safeguard financial stability. This session explained why the EU crisis management has not lived up to its initial promise, highlighted the shortcomings of this framework and discussed the way forward for improving the framework for small and mid-sized banks.

1. The EU crisis management framework has not lived up to its initial promise

1.1 The crisis management framework has contributed to maintaining a high level of fragmentation in the banking market

An industry representative highlighted the purpose of the crisis management scheme. It is important to remember the goal when putting this framework in place and assessing if it has proven efficient. This framework should first decouple bank resolution costs from public money. But this has not been the case because public money has been involved and continues to be involved in bank resolution in many cases. As it has failed to be fully implemented and operational for some small & mid-size banks, the EU crisis management framework further contributed to the renationalization of banking sectors across the continent especially thanks to this persistent use of public funds.

The second goal is to improve the competitive landscape and make it sounder. The third goal is to make solving resolution issues possible and predictable. This has not really been the case: banks continue to be sub-efficient while continue to operate and fuel a certain excess of capacity in the European market. This is not positive.

Crédit Agricole S.A. is disappointed that this framework, which has been so costly in terms of contributions and administrative work without generating the expected benefits: a competitive landscape that would be sounder with a progressive exit of the excess capacities seen on the market.

1.2 The inconsistencies between a European resolution and a national liquidation scheme

An industry representative suggested first acknowledging the progress made in the resolution framework that the banks have been working on together with the Single Resolution Board (SRB) in terms of resolvability. This includes improving the loss absorption capacity and the massive minimum requirement for own funds and eligible liabilities (MREL) placing. To an extent, the resilience of the banking sector during the Covid crisis is reassuring.

Recent cases of resolution or liquidation also point to inconsistencies in the framework. Banks with no public interest received public aid, whereas banks that have public interest did not. It might be necessary to be more realistic in the public interest assessment (PIA) and to acknowledge that domestic systematically important banks (D-SIBs) are expected ex ante to have a public interest.

An industry representative observed that consistency is lacking in this process. If an institution proves to be of public interest, all the resolution rules must be applied, and it is necessary to bear the cost and build all the necessary buffers in order to ensure that burdens are shared. But if an institution has not really proven to be of public interest, resolution tools are not there to deal with the situation and liquidation must be applied.

1.3 Any access to external resources must remain conditional on compliance with a stringent burden-sharing requirement

An industry representative added that consistency is lacking in this process. If an institution has not really proven to be of public interest, resolution tools are not there to deal with the situation. Another mechanism is liquidation. If an institution proves to be of public interest, all the rules must be applied, and it is necessary to bear the cost and build all the necessary buffers in order to ensure that burdens are shared.

An industry representative stated that the current rule applicable to access the Single Resolution Fund (SRF) must remain intact and be 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 minimise the burden on sound banks.
- To comply with such a burden-sharing requirement, small and mid-sized banks should build up an MREL buffer that would enable shareholders and creditors to take a hit before resorting to external resources.
- Burden sharing should also be made consistent between resolution and liquidation under a national insolvency proceeding.

1.4 EDIS: The elephant in the room

An industry representative stated that the discussion is focused on the small and mid-sized banks, but broader issues affect the overall consistency of the framework. The European Deposit Insurance Scheme (EDIS) is the elephant in the room, and not much progress has been made.

This is a matter of consistency. Inconsistencies do not last, not even in Europe. EDIS will happen sooner or later. It will also help to address some of the problems being discussed, like home-host issues.

An industry representative noted that all panellists agree that they want to improve the current resolution framework, make it more efficient and search for the pressing points they have to establish for an effective system. However, they should not make the mistakes of turning the current system 'upside down' without convincing all parties involved or trying to implement EDIS via the back door if normal negotiations are not seen as likely to succeed.

2. Addressing the shortcomings in the current system

2.1 Ensuring that the EU framework allows for a consistent and predictable exit of the market for a failing bank

A policy-maker underlined that the outcome of a resolution procedure is fairly clear and harmonised at EU level, but it might also be necessary to work on the exit strategy in insolvency. Banks that cannot be put in resolution need to be able to quickly exit the market.

A policy-maker reminded the audience that progress has already been achieved with the second EU Bank Recovery and Resolution Directive (BRRD) which states that, in the event of failure with no public interest in resolution, a bank must be wound up under national law. However, there are questions around whether normal insolvency proceedings should apply or if any available national procedure is acceptable. One way to deal with 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.

An official stated that a bank does not need to be resurrected if it fails. A bank that fails is essentially restructured if it is a very large one. If it is a smaller one, an orderly exit of the market is necessary.

2.2 The lack of a funding in resolution mechanism is a major flaw in the Banking Union

An industry representative stated that another missing element is a realistic funding in resolution mechanism. Progress has been made with the European Stability Mechanism (ESM) backstop, but it is insufficient because 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). The authorities need to acknowledge that private insurance mechanisms cannot be a substitute for a proper LOLR.

2.3 Uses of harmonising Deposit Guarantee Schemes (DGS)

An official underlined that a harmonisation of the use of DGS is desirable; this could be part of the CMDI review. It would lead to harmonised and clear routes to what a national DGS could do. It would also harmonise the ideas and align them to the BRRD of state aid rules.

It is also advisable to avoid creating a system in resolution and a myriad of other systems around it. There is one resolution framework, and the alternative to this is a hopefully harmonised insolvency one. DGS need to be part of the system to support and fund within reason.

2.4 The potential for home-host frictions can have adverse impacts on cross-border resolution

An industry representative stated that it is necessary to pay attention to the potential for home-host frictions in a resolution scenario. This is especially relevant to those who operate under a single point of entry (SPE) approach, which requires home-host resolution authorities to rely on each other. 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.

Perhaps rather than having a large subsidiary with about €120 billion of assets that is therefore subject to the decisions of the SRB, there could be a smaller subsidiary that was subject to national rules. Those home-host frictions need to be attended to in order to ensure that the resolution framework is made more robust.

2.5 Other areas of improvement in the EU crisis management framework

An industry representative noted that the state aid rules that belong to a world before the BRRD should be revised. There is a need for harmonisation of insolvency regimes, along with items like creditor hierarchy, the public interest assessment, the state aid and use of DGSs. 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. A further harmonisation on the triggers to begin insolvency procedure and the ranking of creditors in insolvency is necessary. The idea for a single administrative liquidation authority is worth exploring but having an EU authority with access to national DGS is another inconsistency.

He added that the resolution framework is too complex in particular regarding MREL definition and calculation. Banks should be able to convey relatively simple and stable resolvability strategies to the markets. It is necessary to streamline some of the processes and to achieve a more pragmatic resolution framework, but it is important to preserve the key role of the bail-in paradigm as a central element of the EU resolution framework.

2.6 A European digital euro could be a useful tool in resolution

An industry representative suggested that there could be a way to harness the concept of a central bank digital currency (CBDC) for the benefit of depositor protection, especially for banks that have a greater reliance on deposits. 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 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.

3. Improving the framework for small and mid-sized banks

3.1 General issues

3.1.1 Level playing field considerations

An industry representative stated that the resolution of small and mid-sized banks is managed by national authorities, giving rise to 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, policy-makers should look for ways in which national insolvency procedures can be harmonised for banks that are not considered to be systemically important.

There is also a two-tier system with respect to single supervisory mechanism (SSM) banks and some D-SIBs. On the other hand, the plethora of national approaches to resolution mean that it is not possible to know whether there will be an intervention.

An official offered to 'spoil the party' on mid-sized banks and thanked the other panellists for being honest about trying to scale them. When people speak about mid-sized banks, they are sometimes talking about big banks' competitors. Some banks are repeatedly said to be deposit funded. They are rich in cash, so they do not try to get MREL on board.

An official stated that she likes the idea of a possible continuum. It was proved in 2021 that banks were able to raise capital at competitive prices, mostly because they were looking firmly at their MREL requirements. However, it is not possible to have a very stringent system for the big banks and an easier one for a middle layer of their competitors.

3.1.2 DGSs could act as bridge financing tools

All speakers agreed that the current framework is not entirely fit for purpose. A policy-maker (Alexandra Jour-Schroeder) stated that the reasons for that lie more with the smaller and mid-sized banks. Based on discussions at previous Eurofi meetings, the European Commission has performed outreach and several consultations.

A policy-maker stated that specific features of the current framework might affect how authorities handle the failure of small and mid-sized banks, in particular for business models funded primarily by deposits and equity. In addition, other private collective sources of funding – such as DGS – might be out of reach in resolution.

Reviewing the EU's framework will put it in a stronger position to manage bank crises. The European Commission needs to ensure that banks' internal loss absorption continues to be the first line of defence. Industry-funded safety nets must also be accessible for all banks, subject to proportionate access conditions. DGSs could act as bridge financing tools.

A policy-maker stated that other changes to the crisis management and deposit insurance framework are required to unlock the full potential of the deposit guarantee schemes and enhance the level playing field. 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. Only changing pieces of the CMDI framework will not work because every aspect that it modifies might have far-reaching consequences on other parts of the crisis management and deposit insurance framework. It is also necessary to work on the definition of 'public interest assessment' but only broadening the scope of resolution, without addressing the issues faced when managing the failure of small and mid-sized banks.

3.2 How to interpret the Public Interest Assessment criteria

An industry representative emphasized that the resolution framework has a very broad definition of 'public interest assessment' that is appropriate for the resolution authorities. Limiting the definition is not advisable because the resolution authority needs the discretion in case of a resolution, and it has to decide over a weekend if an institution falls within the resolution framework. This is not a question of a new regulation or directive. Rather, it is a question of how the resolution authorities interpret the very broad definition. The resolution authorities should change their restrictive application approach in certain cases instead of demanding changes in the general resolution framework.

He advised asking how to handle an institution that would overwhelm the national DGS in a crisis. If a single institution in a crisis would overstress the national DGS, it should also be in the scope of the resolution framework because this would be a classic case of a public interest assessment.

3.3 Small and non-complex institutions should be out of the scope of the EU resolution framework

An industry representative highlighted an issue with mid-sized banks. There are some banks for which it is not possible to be sure if they fulfil the public interest assessment. It is also difficult for the resolution authorities to define which institutions will fall into the scope of the resolution.

Mid-sized banks with balance sheets between 25 or 30 billion are a grey area. On the other hand, a resolution framework for systemic, important banks has been established as a consequence of the financial crisis. Because these systemic, relevant institutions might be a threat to the financial stability in the eurozone, the special resolution framework for small and non-complex institutions has been established. Small and non-complex institutions with a balance sheet below 5 billion would not make any sense to include in the resolution framework because it was only established for real, systemic, important banks. There are different national insolvency procedures and harmonising them is a considerable task.

3.4 The MREL regime

3.4.1 The MREL regime requires careful consideration by the resolution authorities with respect to small and mid-sized banks

An industry representative observed that there is a public interest in promoting the financial resilience of mid-sized banks, but there is also a risk that the imposition of MREL requirements that are too high could have a negative impact on the real economy. Furthermore, the fact that the MREL calibration for small and mid-sized banks is typically decided by national resolution authorities can give rise to further level playing field issues.

There might be a way to grade in an MREL requirement by size so that it is similar to the global systemically important bank (G-SIB) buckets, where someone is looking at a greater proportion of regulatory capital based on the complexity and interconnectedness. It could be possible to apply a similar principle to smaller banks of different progressive sizes. This would notably alleviate the Tercas type situation. There could be a bail-in that could then result in a smaller amount of bail-out money being required.

3.4.2 MREL is a real impediment for banks that have irregular access to the capital market

An official stated that two main problems are rooted in the design and application of the regime. The framework is not appropriate for all banks – it is rather tailored for systemically important banks, and MREL is in some cases a real impediment for banks, especially if they have limited access to the capital market and costs that rise fairly high. There is also a lack of proportionality in the system. The EBA's Advisory Committee on Proportionality (ACP) has chosen recovery and resolution as one of the committee's main topics in the work programme for 2023

3.4.3 The introduction of some sort of proportionality in the current system is necessary

An official noted that the current framework has already reached a sufficient level of complexity. Moreover, it might come at the cost of resolvability because it is very difficult to implement proportionality regarding resolvability. Cutting the current framework into pieces does not seem the correct approach. The introduction of proportionality in the current system is nevertheless necessary.

It might be necessary to go through the process. The Austrian Financial Market Authority probably benefited from favourable market conditions, but the first expected recovery of Heta in 2015 was 46%. In December 2021, the Austrian Financial Market Authority released Heta into liquidation with a recovery rate of 86%. A consequent and coherent application in all Economic and Monetary Union (EMU) Member States would greatly improve the credibility of the system and prove that it could work.

An official fully agreed that a consistent framework is necessary. It has been proven that the winding down of this portfolio is feasible. It should be possible to do something within resolution.

Banking model diversity in the Banking Union: added value and challenges

The Chair explained that, despite banking model diversity in the Banking Union, banks probably face common challenges, including profitability issues. The panel would discuss the sustainability of bank business models, what is at stake and the related challenges, especially in the current economic, monetary and competitive environment, the impact of EU banking regulation and supervision on these different banking models and the role of EU regulation and national and EU supervisory authorities.

The session highlighted the following points:

- The diversity of banking business models in Europe increases the resilience and the financing potential of the financial system and satisfies different types of customers and stakeholder needs.
- All banking business models face the same monetary and economic challenges: lasting very low interest rates, the lack of profitability, the digital and climate transitions. These challenges require ambitious strategies adapted to their specificities.
- Sufficient profitability is essential to all banks, but profitability should not be the sole compass for the supervisors. Proportionality in regulation and supervision is of the essence.

1. Banking model diversity is a European asset

1.1 The diversity of banking business models is a key strength of the Banking Union

A Central Bank official suggested that diversity is welcome because diversity increases resilience and the capacity to satisfy diverse client demands.

Another Central Bank official remarked that different capacities can cover different needs. The system becomes more robust and resilient. There is a need to ensure regulation does not discriminate.

An industry representative observed that the US has almost a banking structure as diverse as there is in Europe. When looking at the figures of banks per capita, Europe almost meets the US average. The issue is the difference in profitability. Diversity increases financial stability and leads to a very efficient market. In Europe, the financing needs of all customers are met due to high competition. With different business models, sizes, and ownership structures there is less of the herd behaviour typically associated with concentration. There is a better chance for parts of the financial system to compensate for the failure of heavily affected banks.

The German Savings Banks are at the heart of this diversity in Germany. The 370 financial savings banks within the group with an average balance sheet volume of approximately €4 billion, provide their services everywhere in the country, both in rural areas and 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.

1.2 The diversity is a strength for funding the economy and ensuring financial stability

A regulator stated that diversity is appropriate for the financing and the resilience of the economy from a regulatory point of view. Regulation needs neutral vis-à-vis business structures, business mixes. He suggested that there are different ways of tackling the subject of business model diversity. One is to look at the asset side and the business mix. Another could be to look at the liability side or at the organisational structures of the banks. There is diversity both in what banks do and also in how they do it and how they organise themselves for doing it. Different EU member states historically had different banking structures and that continued over time, probably because regulation was neutral enough vis-à-vis the business model to allow them to continue to flourish, and this should be retained.

A Central Bank official noted that what is at stake is financial stability because business models, or at least the sustainability of business models, is crucial for financial stability. Unprofitable banks entail large risks. They cannot build up capital. They cannot invest. They may even distort the competition. Over the past years, there has been a fixed group, perhaps a small one, of consistently profitable banks in the euro area, and these banks apply a variety of business models. What is essential is that the bank's risk profile remains well managed.

An industry representative underlined that diversity is also good for adaptability, which can be useful in times of uncertainty. Diversity in business models is good for the financial system, but it is not necessarily something natural. When analysing the financial system as a whole, which is the responsibility of regulators and supervisors, there is reliance on benchmarking, cross-analyses and such. This does not naturally lead to preserving diversity, so effort has to be made.

It is not known exactly what financing a greener economy entails, but what is known is that it is going to be expensive, and that is where banks should play a role, and with more leverage than any public money. On that front, the diversity of banking models can help, because banks with more of a regional approach will finance certain things while others will have more of a social approach to what they finance, or a specific industry focus. It is helpful that various parts of the financing needs are tackled by various types of banks. Banks have to be made solid, but it also has to be ensured that they can fulfil their mission, which is to finance the economy.

An industry representative emphasized that banking model diversity increases the resilience of the financial system. It is not the task of the supervisors or regulators to determine or decide which banking industry structure is appropriate. This should be decided by the markets and by banks' clients. Large, pan-European and globally active banks are needed for certain activities that smaller banks cannot pursue due to their size and access to global markets. When it comes to smaller banks proportionate regulation is paramount.

2. All banking business models face the same monetary and economic challenges

2.1 What is at stake

A regulator remarked that there are old challenges, such as the difficulty to reap profits in a very low interest rate environment while at the same time supporting borrowers' creditworthiness. Additionally, cost-income ratios are relatively high. There are also new challenges, namely digital and transition for the environment. The rapid digitalisation of the financial sector can represent either an opportunity or a threat for banks depending on how they tackle it. Sustainable finance will increasingly drive business decisions and will affect banks' current business models. There is also the political situation, which may not help on top of the exit from the pandemic. It is important for banks to think thoroughly about how they want to serve the economies they operate in and to have long-term perspectives.

2.2 The change of the monetary stance on interest rates should improve the sustainability of business models

A Central Bank official noted, regarding low-for-long, that one question is whether this is also something for the future. It is difficult to make a value judgment about what the right price of lending and borrowing is. If interest rates are structurally low, it needs to be driven by either too low investment or too high savings; it could be a mix of both. A tremendous amount of investment is needed, not least in ensuring energy independence and the green transition. If carbon pricing is installed sufficiently, and there is public investment, there could be a case made that the low-for-long environment may change. Many of the resources now used for importing fossil fuels need to be shifted to energy efficiency and renewable energies domestically. That needs to be produced domestically and the carbon pricing can be refunded to taxpayers.

This all comes at a time of running the economy at full capacity and in an inflationary environment; this can boost things further. The current low-for-long environment would likely not continue forever, and that implies challenges and opportunities for the banking system. It is also about how to make a judgment on how banks should price their interest rates. That is their choice, but in a negative interest rate market environment, banks that are not transmitting those negative rates to their customers will feel a squeeze on interest payments. Deposits are probably among the safest of financial products.

A Central Bank official stated that the business environment has been quite challenging due to monetary policy. The outlook is an increase of interest rates, and that would create an entirely new environment for the European banks. If the monetary policy stance changes, the cost block of negative interest rates disappears gradually. At the same time, the interest margin may rise, so the cost comes down and the revenues increase. In two years there may be a completely different picture, because one effect is that most of the banks undergo very substantial structural reforms.

There are very well-structured banks, which enjoy much more friendly environments for their business models. That may be an opportunity for investment in areas like digitalisation.

2.3 Technology is a game-changer for all business models

A Central Bank official explained that increased competitive pressure from the non-financial sector and COVID-19 pandemic further accelerated the process of digitalisation, creating both new opportunities and new risks. Moreover, the increased speed of innovation and the higher interconnectedness among intermediaries and sectors have contributed to widening the traditional definition of IT and operational risk, thus making the industry and supervisors consider cyber risk as one of the top priorities for specific governance and risk management safeguards.

There are at least three major developments in terms of digitalisation. First is a great deal of digital transformation, with all of the issues in terms of letting the chain with third-party providers and such. The second is developing joint partnerships with unregulated firms, which also raises the issues of the scope of regulation supervision. The third is the establishment of some digital platforms where banks change the nature of their business. Banks may become a product of another entity (e.g. big tech) who provides not only services but also the data that underpins the banking business. In terms of banking business model, this is a relevant development, because open banking, smart contract and more sophisticated technology can be relied on, which opens up many opportunities.

Another development to rely more on is very small intermediaries operating outside the banking scope. This is done to reduce the regulatory burden. They can rely on much more agile governance for the intermediaries, such as credit funds and private equity, which is very good for the economy because it complements the channel of funding for the real economy. On the other hand, this lowers the amount of information available and reduces the supervisory tools that can be used.

A regulator noted that economies of scale and scope have been at the root of financial intermediation so far.

However, technology is a complete game-changer, because banks may achieve the same scale or economies of scope through technology without necessarily being big. That probably means that banks need sophistication by being at the edge of technology, to see how they can best provide value to their customers. That is probably the one thing that is important for banks' business models, if they do not want to lose their specificity and be overtaken by new entrants.

The Commission and the co-legislator's digital finance strategy, in particular the Digital Operational Resilience Act (DORA) and markets in crypto-assets (MiCA) proposals, head in the right direction because new types of activities and new entrants will be covered by the safety net. That means that there will be more equal competition.

3. There is no one-size-fits-all approach to assessing the sustainability of banks' business models

3.1 Assessing the sustainability of banking business models through different criteria

3.1.1 Adequate governance and risk management is critical

A regulator remarked that the key question is about how to assess sustainability. Depending on the organisational structures, banks may have different profit expectations or constraints. Some of them do not have much of a constraint regarding profits in Europe, because their ownership is not exactly profit-oriented. Some of them do not have much of an issue vis-à-vis funding costs because they can enjoy relatively cheap funding costs.

It is very difficult to draw a line and say that banks in Europe should behave in a certain way. There is a need to go beyond the aggregates and look at individual banks when assessing sustainability and profitability. All possible tools are given to supervisors and banks' governance to decide for themselves what is good for the sustainability of their business models and for supervisors to assess that. Having adequate governance and risk management is critical to ensure the viability and sustainability of any business model. Proportionality in regulation and supervision is also essential.

3.1.2 Regulatory headwinds

An industry representative noted that one concern is that the specific cooperative and mutual business model is not sufficiently understood nor taken into account in EU policymaking and supervision. A 'stakeholder value' approach has merits and an approach exclusively based on 'shareholder value' is inappropriate when shares are not tradable.

This has important consequences as shown in two recent examples:

<u>On Supervision:</u> 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 increasingly important for supervision and should be defined in cooperation with industry and full transparency.

<u>On Resolution:</u> 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 issue is how to avoid an inappropriate standardisation of the various business models.

A Central Bank official stated that benchmarking is a tool; it is not a norm, but it is a very useful tool at the European level, because the benchmarking can be adjusted to more situations that are similar.

Like supervision, it should not be a systematic art but an art of application to the different sizes. Supervisors should not have a picture of an ideal banking system. They are not directing the system to an optimal situation. Supervisors are pushing for more prudence and security than will spontaneously evolve from the system, and for this more room is needed for investment and preparing for the future.

3.1.3 Comparing what is comparable

An industry representative emphasised that the sustainability of banking business models should be assessed through their capacity to generate capital through business as usual, their capacity to cope with the growth of risk-weighted assets and to recapitalise in smooth conditions when facing crisis.

3.2 All business models in Europe face the same profitability challenge

3.2.1 Profitability recovery in 2021

A Central Bank official noted that the results for banks in 2021 (thus before the most recent war shock) were extremely good by European standards. A very broad measure of profitability in the markets is return on equity (ROE) for the listed banks in Europe, which are the ones that can be analysed currently, and it has been at its highest level in 2021 since the creation of the Single Supervisory Mechanism (SSM).

3.2.2 Net interest income has lagged this positive development

A Central Bank official remarked that in Europe the cost to income ratio is 65.6%, which is more than six points greater than the average of the American unlisted banks. The contribution of the net interest income, even for the most important results, is lower than in 2019, so the trend of the net interest income diminishing is still there, even with this significant result. It is almost 6% less than at the end of 2019.

Those are two structural weaknesses seen in all parts of the European banking system. There is a high cost of income on average, though there can be a difference for banks and a great deal of reliance on the net interest income, which continues to shrink. The good news, which supervisors should leverage on, is that the net fees and commission income are growing. The increase in fees was broad-based across different business models, as various fee types increased. This explains the good results of the previous year. That is linked to market fees and asset management.

This is a very specific issue that is found across all business models, and it is a weakness of the European banking system, and the ways to address it should be varied. The problem of profitability has to be addressed together. For supervisors that does not mean having an obsession with profitability, because profitability should be linked to risk. For supervisors it is even more important that it is linked to the capital trajectories. Profitability should also be seen in terms of the capacity to retain profit. If there is profit but it is all distributed, then that is not the same as keeping those profits. Profitability is not the alpha and omega, but it is the alpha, and needed in order to get to the omega.

3.2.3 Sufficient profitability is central to all banks

An industry representative remarked that regional or local banks do not have to hide when it comes to profitability. The return on equity of the German Savings Banks is at 5.1%, which in European terms is quite good, and their cost-income ratio is at 67%, which is good. The difference with investment banks is that they have extremely volatile gains. Their profits go up and down but, looking at the average over a decade, DSGV is more profitable. In order to assess an institution's profitability, different time horizons have to be factored in.

With digitalisation banks are forced to adapt because customer needs are developing very quickly. Another challenge is regulation. A recent study by BearingPoint compared the ROE of European banks with the one of the United States. The result was that the ROE of European banks could be 340 basis points higher if they were subjected to the US capital regime instead, and the cost-income ratio could be 260 basis points lower. Supervisors and regulators could work to level those regulatory differences. There is a challenge due to the ECB's interest rate policy. There is now substantial inflation, and the ECB is still applying negative rates and purchasing assets; it is time to return to more conventional monetary policy.

3.2.4 The benefits of bank consolidation in Europe

A Central Bank official noted that it is difficult to assess what the appropriate profitability is. One point on that, related to the structure of banking, is that small banks may face some challenges with respect to compliance and cyber security. It is a kind of business of scale that may hamper their activities and profitability. The term 'consolidation' does not need to be used, but there may be overcapacity and the system may need to be structured differently. That should be market-driven, and a smooth exit should be allowed for banks that cannot keep profitability up in these circumstances.

3.3 Profitability should not be the sole compass for the supervisors

An industry representative emphasised 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 different profit cycles.

An industry representative noted that there is benchmarking against profitability. When comparing profitability ratios, the right indicator should be the bank's residual income after distribution of the current pay-out to equity holders, which is a significant burden on Common Equity Tier 1 (CET1) generation.

Besides, it is not fair to penalise highly capitalised banks which put a much lower part of their balance sheet at risk and therefore display a lower profitability. This implies looking at the capital required as a fair and equal denominator among banks and remembering that risk and rewards are to be balanced.

The capacity of the bank to recapitalise in times of crisis is a third criteria that should be taken into consideration. Cooperative banks present strong assets in such a situation. They have a stronger attractiveness among investors because their shares are not sensitive to stock market fluctuations. Their high level of reserves cannot be distributed to their members, which is contrary to commercial banks, and that ensures stability of value during crises. There is also the non-dilutive nature of their capital in case of capital increase.

The reality is that for some banks return on equity is a very significant criterion, but it is not for others. Profitability is a means, but it is not the aim for BPCE. The profits BPCE makes typically go to its cooperative shareholders for a 10%, but 90% stays inside the group and is there to finance its growth and to create more stability in its equity. Moreover, it is not subject to going out in the distribution of reserves, for instance, as it would be the case for a listed company. For some business models, profitability is important; for others it is not as important, and it could be argued that for cooperative banks it is against their principles because they were created to provide the best services at the cheapest price, and therefore not primarily to make profits.

The suggestion is not that there is anything opposed to diversity, but the fact that there is a habit of benchmarking. That is not bad in itself, but it may lead to pushing people towards a certain business model rather than others, or towards certain criteria that are fit for some businesses but not necessarily for all of them. Attention has to be paid to preserve diversity when comparing, and not to move from a comparison to having one single view of what the best solution is. Diversity means the value of one particular company is not a value by itself. Rather, it is what it brings to the overall system.

The speaker offered another example about benchmarking. He was often asked why BPCE does not reduce its network of branches as it has so many, which must be expensive. A question often asked is why BPCE does not do what some of its competitors do, why BPCE does not reduce its branches by 50% in those remote parts of France where there are not many people.

It would be against BPCE's nature to do it. As a group of regional banks, BPCE stays in those locations because it thinks that is its nature. It has been done for two centuries and hopes to continue for at least another two centuries. It is keeping those networks and it observes that it is gaining market share. It is gaining market share from digital banks and from national banks that are cutting their networks. It is not that what those banks do is wrong. It is probably right for them, but what BPCE does is different and right for it.

3.4 Proportionality in regulation and supervision is of the essence

3.4.1 Proportionality to risk and not to size

A Central Bank official stated that in terms of business models it is clear that, for small and medium-sized banks, huge regulations that are set up for internationally active big banks are not entirely appropriate. However, from the supervisors' point of view, proportionality means proportionality to risk and not to size. There were some examples in Germany last year and the year before where very small banks were very risky. The appropriateness of regulation and proportionality is a function of risk and not of size.

There is digitalisation of the banks themselves and the competitive environment with big techs and such. Another factor that may drive the change of business models is the huge transformation ahead driven by digitalisation, decarbonisation, automation, structural changes after the pandemic and geopolitical changes. These changes bring about huge investments and financing needs, but those financing needs are probably not the same as classical financial needs, because there are bigger risks and long-term investments; it is not bricks and mortar, so there is not that sort of collateral as is classically available.

That can be a challenge for banks with low-risk appetite because they will probably have to take more risks. They probably have to not only issue loans but also provide equity and such instruments. That is also an issue for supervisors, because they will not lower their standards to allow this financing. Indeed, they may even tighten the standards. The issue for everyone should be that the banking system is able to finance the economy in a stage of transition.

A Central Bank official stated that regulations should be driven by, and be proportional to, risk. There is also a permanent obligation in regulation and supervision to be inspired by what works elsewhere. There are questions of how to tune, whether it can be better and how to be more neutral.

Europe, probably more than elsewhere, has a concentration in some parts of the business models that is completely occupied by low-risk activities. These low-risk activities are somewhat stuck in the middle by changes in regulation, which can be tuned, but nevertheless a leverage ratio that will easily bite earlier for low-risk activities than it would for high-risk activities has been introduced. The output floor has been introduced, which implies that there will be increasing reliance on the outcome of the standardised approach, and there is nothing wrong with that.

It has to be ensured that the standardised approach is continually tuned and revised, and if there is further reliance on that then it also needs to be extremely risk-sensitive and assessed repeatedly. The long transition period should be utilised to go deeper into how the standardised approach is calibrated, as that is becoming more important. There are many other issues that may need to be revisited from time to time.

An industry representative emphasised that proportionality should not be based only on size but also on risk. The European Banking Authority (EBA) has defined more than 50 indicators for assessing the systemic importance of banks. They could be applied in the future to define a two-tiered system, like there is in the US, distinguishing large banks, which are pan-European or globally active, from smaller ones operating on a national scale. That would allow for more targeted, truly proportionate regulation. It is not possible to be more profitable and less risky at the same time; there is a trade-off and that should be kept in mind.

3.4.2 There is a prudential limit to proportionality

A Central Bank official shared the concern about proportionality. There is a prudential limit to proportionality, which is linked to the risk and interconnectedness, and now synergy can be achieved just by being part of a digital platform. A very small firm can have access to a data repository and then assess credit risk through an algorithm, so there has to be caution about saying that small is good; it may be good but it may also be risky. There may be major fragmentation in the system if there are multiple small intermediaries, and that would increase the supervisory challenges.

The right direction is being taken with the digital strategy, but it is key to finalise the discussion on MiCA and DORA. These are crucial steps to give stability to the framework and to enhance the supervisory tools to work together with the market in order to develop the new framework.

Solvency II revision: major political challenges and options

1. The recent real-life stress test proved the robustness and efficiency of the brand-new EU insurance Solvency framework, which requires mainly evolution rather than revolution

A regulator noted that a review of Solvency II is ongoing. Solvency II has been in place for almost five years. Parts of Solvency II, including internal models and group supervision, are concepts that were not used prior to Solvency II. The Long-Term Guarantee Package (LTGP) should also be reviewed. The European Insurance and Occupational Pensions Authority (EIOPA) advice was to focus on evolution, not revolution, and ensuring fitness for purpose going forward. The current economic reality must be recognised: low interest rates, inflation, and the need to finance the green transition. Insurers are very long term investors. Some tools in the regulatory box on the macro side are also currently missing. EIOPA is content to see that overall the proposal of the Commission took on board this advice, although there are some concerns.

1.1 An appropriate risk measurement tool

An industry representative stated that their organisation believes that the framework is relevant in terms of risk assessment and risk measurement within companies. It has proven to be relevant in terms of empowering the management and governance bodies of the company to consider the risk dimension and the ability to face any unexpected situation. This framework contributed to the stability of the industry during the Covid crisis.

An industry representative stated that Solvency II has made the industry more resilient. The Covid crisis was a real-life, large-scale stress test, which the industry successfully passed. This is due to some key features of the framework, including the way the risk-free rate curve is designed, with a very stable extrapolation past the 20-year last liquid point. Overall, Solvency II is fulfilling its purpose. It is important to preserve the integrity of Solvency II.

1.2 Undue procyclicality is one area for progress

An industry representative stated that any framework will need improvement. Procyclicality and volatility are not captured well by the framework. In certain circumstances, the functioning of the adjustment mechanism is not adequate, which could provoke some unintended behaviours. When entering the Covid crisis in March 2020, facing the impact of own funds and solvency capital requirement (SCR) volatility, their organisation decided to sell the whole package of equities in its assets in property and casualty (P&C) in order to protect key performance indicators (KPI) and demonstrate stability. This was not intended by the regulation. This decision was taken to provide protection from unintended volatility. Procyclicality is not helping the industry.

An official noted that France holds the presidency of the Council of the EU. The Council agrees that focus should be on evolution rather than revolution, because the Solvency II framework is robust, globally well-functioning and efficient. This has been evident during the recent crisis, where insurers have maintained robust solvency ratios. There is a consensus that the fundamentals of the Solvency II framework should be retained, and attempts made, where needed, to make it more counter cyclical. There have been some procyclical effects during the crisis, so it should be made more counter-cyclical to ensure it is as robust as possible, while improving some supervisory aspects. This could be referred to as reinforcing investor protection, and cross-border aspects may be relevant here.

An industry representative commented that the ability to carry long-term investment should be taken into account for insurance. Unlike most players in the financial industry, insurers are able to have a long-term view with their balance sheet and make long-term investments. The current ability to take this specificity into account in the prudential framework is insufficient.

A regulator summarised that volatility, procyclicality and the ability to recognise long term were all mentioned.

An industry representative noted that some features of the framework prove to be volatile and procyclical, not least of which is the risk margin. This could lead to some counterintuitive and undesirable effects and behaviours by some undertakings and requires improvement.

1.3 Further clarification is needed on the policy regarding insurance undertakings' dividend payments in difficult times

With regard to the ability of insurance undertakings to pay dividends, an industry representative noted that there are already Pillars I, II and III with respective and complementary purposes, forming overall a comprehensive and consistent framework. In addition, there are corporate governance rules and responsibilities. Adding a separate criterion or process determining the ability to pay dividends even though the Solvency II position is robust would undermine the credibility and integrity of Solvency II and can be very detrimental to the long-term role of insurance undertakings.

A regulator commented that the approach to dividends should not be influenced too much by the banking sector. For BaFin it is clear that a prudent approach is necessary. Supervisors challenged companies on if they were able to pay dividends in the difficult situation. If companies were convincing, they were able to pay dividends. This was the European experience, which generally worked quite well.

A regulator stated that the absence of a level playing field with regard to dividends at the beginning of the Covid crisis was not helpful and must be avoided in future. The proposal in the review should provide very good safeguards.

1.4 The framework is still considered insufficiently proportional

A regulator stated that proportionality should be improved. There are some very reasonable proposals on this, including from EIOPA. Good progress has been made.

2. Consistency of the framework with the lasting EU economic and investment long-term challenges should be prioritised

With regard to volatility, a regulator commented that in March 2020 some companies felt forced to sell assets very quickly. But general observations suggest that life insurance companies did not do this so frequently and only under special circumstances. Therefore, in principle the volatility adjustment for life insurance companies worked relatively well. It is important to ensure that life insurers are able to take long term liabilities on board. The new framework of proposals is addressing this. The illiquidity of liabilities is a key driver there.

2.1 The green deal and the digital transition of the EU financing needs should attract the long-term savings held by the insurance sector

An official stated that the Covid crisis had been a real stress test where insurance undertakings proved their resilience. However, the prudential framework cannot be considered in isolation from the real world. The Council has put forward two big transversal priorities, the green deal and digital transition, which will require an additional €580 billion investment per year for the Union. A small amount of public finance could be used, but there must be a reliance on private financing. Fortunately, the European Union is the first jurisdiction in the world regarding the pot of savings. To match the ambitions and the supply and the demand, intermediation is needed. Insurance is probably the longest-term investor in Europe and will need to be relied on to achieve the necessary goals. The Commission's proposal includes some suggestions in this regard and is welcomed. The Council should aim to maintain or even reinforce the fundamentals of Solvency II, while enabling insurers to provide long-term financing for the twin transitions.

A regulator stated that we welcomes the proposal on proportionality. The proposals in the Solvency II review on dividends are also welcome. Europe's ambition for a green transition to a sustainable economy and the financing necessary for this must also be acknowledged. You [Organisations] need to look at what is at their disposal. Discussions should focus on the political and economic priorities, what the framework can do to support the financial landscape that meets the ambitions of the Capital Markets Union (CMU) and the transition.

An industry representative stated that the revision presents a great opportunity to align the political agenda and the big goals the regulation is aiming for. Europe needs massive investment to implement the green and digital transition. The ability to channel investment towards real assets is important. The European Commission's call for massive effort in this field is welcomed. We [Generali] has a pledge to invest in the real economy and finance the European Union economic recovery, as it has the ability to have long-term assets, which is insufficiently recognised at the present time.

2.2 The revision of the Solvency II framework represents a bedrock of the CMU

An official stated that the French presidency has linked Solvency II to the CMU. It is not only about the fore-text of the CMU, European Long-term Investment Fund (ELTIF), Alternative Investment Fund Managers (AIFM) and the Markets in Financial Instruments (MiFIR) review. Solvency II has real-world relevance. It is important to bring capital into capital markets. Insurers are long-term investors. The market needs people to buy things and to participate in the ecosystem. There will be a need for long term investment to finance the twin transitions, for example in infrastructure and in transforming the production system for corporates.

2.3 Various approaches to make the framework more consistent with the deep emerging financing needs, while preserving the risk sensitivity of the prudential framework, are under discussion

An official commented that risks are crucial for a successful transition. Regarding public and private finance, if what states can pay on behalf of their citizens, taxpayers and future generations is capped, the huge pot of savings that is in the European Union must be mobilised. Insurers are part of the solution. Insurers have abilities, knowledge and are able to offer flexibility. Whether the prudential framework should be changed in this respect is a concern. The overall capital requirement frameworks should not change. Ways to enable insurers to take more risk should be considered. There are proposals in the Commission text that are debated at level one that also have to be defined at level two. This is for the Commission to address. The French presidency aims to articulate both levels to provide clarity. If insurers want to be part of the solution to finance the transition, it probably cannot be business as usual as it has been for the past decade. Solvency II is part of CMU.

An industry representative stated that the review of Solvency will be very technical, with some very precise fine tuning, but concrete outcomes are needed. The aim should be to recognise the political objectives of the revision, develop a framework and align it to increase the incentive for investors to contribute. One industry representative's proposal is to create a specific new asset class for the long-term holding of green bonds. This is not greenwashing and would obey to strict, risk-based criteria. The asset class would be recognised as less risky than others, which would translate into a lower charge in capital...Private investors can contribute to the political objectives of the debate. If some of the precise outcomes were the rules of the region, it would be a real success.

A regulator noted the comments on embedding a political vision in a framework and bringing capital to the market. Insurers have capital, but this is what policy holders paid in.

A regulator commented that sustainability is currently the key problem for society to solve. The Solvency regime may not be the most efficient tool to solve these problems. The objective of CMU is too important to get it wrong. It is obvious that the industry is prepared to invest. Risk in a risk based Solvency system has to have a price, which is what the supervisors are advocating for. If the Solvency requirements are not risk based, the substance of the whole framework will be endangered, which will be detrimental for the customer. There is sufficient capital in the market. Supervisors did not want to increase capital requirements in the review. The proposal achieves this. It would be generally welcomed if there was evidence for less risk. EIOPA should be allowed to work on this and will provide professional advice. All supervisors would support a decrease in risk. Risk has to have a fair price. Changing this principle would lead to a revolution towards a different supervisory system.

2.4 The challenge for policymakers is to focus on removing any prudential requirement exceeding those imposed by an accurate risk assessment and to avoid undue parallels with the banking sector

An industry representative commented that the primary purpose of a prudential framework is to safeguard the long-term ability of insurance undertakings to live up to the commitments made to their policy holders. This should not be compromised but does not have to come at the expense of insurers playing a role in the economy. It can be difficult to pursue two political objectives with one policy instrument, but it is not impossible. Focus should not be solely on prudential matters to the point that capital requirements are so stringent that the insurance industry becomes less attractive. This would jeopardise the ability to protect the policyholders. A positive feedback loop must be created where the large balance sheets of insurers are put to work for the economy.

The approach to asset allocation should not be too prescriptive. There are market cycles that may not be fully in sync with the normal political cycles when it comes to signing a framework, revising it and negotiating its implementation. For instance, the push on equity may be at the peak of the market and not look so appropriate a few years into the future with the benefit of hindsight. It is important to avoid fighting the last war. The pool of capital must be unlocked, but ability to discern where to channel it should not be overestimated. It should also be reminded that insurers are not banks. Regarding liquidity, there should not be a read-across from the banking industry to the insurance industry. We [the insurance industry] is not involved in any maturity transformation risk or interbank lending and is not an actor in the payment system. The CMU is crucial to provide a harmonised and consistent regulatory framework for the financial services industry as a whole but should also recognise the specificity of insurers and reinsurers.

3. Possible concrete outcomes and key performance indicators of an efficient review

3.1 A framework factoring in low-risk profile undertakings and requiring a reasonable level of information

A regulator stated that care must be taken for measuring the quality of the review with KPI´s. A A possible KPI could be whether distribution for insurance and life insurance profits for the customers are increasing. A sign of a good review would also be the usage of low risk profile undertakings (LRPU), which would show how much proportionality is really working.

An industry representative commented that information is currently too abundant and so there is a need to be more selective and focused. Reporting on transitory measures is meaningful. It is good to know the landing point therefore without the temporary buffer. On the other hand, there are permanent measures, such as the volatility adjustment (VA), for which there is no rationale for reporting with or without.

3.2 A longer-term view should unlock unnecessary regulatory capital and foster the effective competitiveness of EU insurance undertakings

Regarding unlocking capital, an industry representative noted that the political objective was set out by the European Commission when it released its proposal. A proposal to unlock €90 billion implies that the insurance industry is overcapitalised by €90 billion. However, the proposals did not amount to €90 billion, so work must be done to find solutions together.

A regulator stated that they agree that the €90 billion number should be reviewed.

An industry representative commented that it is very difficult to measure how much capital will be freed up and will allow additional investment. Some assessments are closer to €30 than €90 billion. Measurements impacts on the real economy must be considered, given insurers' direct investments in the real economy. If the aim is to increase the robustness of the framework, the real economy must be fed. Very often, the debate focuses on the standard formula. Regarding the internal model, the debate focuses on the way it is followed up, monitored by companies, and governed by supervisors. Improvements or changes implemented for standard formula do not translate into additional flexibility or improvement in the internal model… This aligns with the idea of avoiding any implementation that goes beyond the letter and the spirit of the European text and is very important if harmony is desired.

An official commented that there is a great deal of political talk also on the UK side. The European side does not appear to be pushing as hard as the UK government. It is not a competition regarding the degrees of capital requirements. The aim should be for neutrality overall. A framework regarding risk is preferred over a top-down approach. It is difficult to be purely science-based and rational in such a complex framework. If the political model is long term, a long-term, less procyclical and more countercyclical view is needed. How and at what time investments are made has an impact.

3.3 A framework combining risk sensitivity and green assets focus

An industry representative stated that the proposal for long-term green bonds does not ignore risk. The idea is to retain a risk-based approach. Currently, the framework does not discriminate sufficiently between asset classes. The financial industry has created many tools and asset classes, so the framework should be refined to be general enough and to capture the long-term nature of the risk and not confuse it with short-term volatility.

3.4 An ongoing monitoring of the robustness and trust in the insurance framework and sector is necessary in the context of the overall stability of the financial sector

An industry representative commented that trust in the risk management system overall and in the institutions must be increased. It is important to share ex ante what the objectives are, in order to measure whether they have been achieved. The objectives should go beyond not increasing the capital requirement. The robustness of the framework and the fact that it is shared, understood, applied, accepted and trusted everywhere could be a good KPI of the success of this review. An additional KPI to measure the success of the revision could be the international competitiveness of the European countries.

An official stated that the aim for five years' time should be robust, resilient insurers, as is paramount for financial stability. It is important that the framework remains resilient, and it should be risk based. Consumer protection improvement should be a focus. Cases that several member states have suffered demonstrate the issue and the need to announce cross border discussions among supervisors. The primary aim is to avoid failures, but the terms and consequences of failures are important. This will remain top priority for the Council. Insurers are only one part of financial stability. If markets do not function well, that is an issue for insurers. A suggested KPI is no drama, no failure if small, and with less consequences, and insurers being able to be there, according to the political language. The political language should mean something, particularly regarding sustainable finance. It is good to have concrete examples. If an insurer can state that it financed a piece of green infrastructure, that may be better than financing a soccer stadium.

A regulator stated that they support the KPI of 'no drama, no failure'. The aim is for robustness that is shared, accepted, understood and used. In addition, the transition must be supported and good results provided for consumers.

Sessions Summaries

IV

THE EU AND GLOBAL SUSTAINABILITY AGENDA

6 years after the Paris Treaty: is the financial sector fully playing its sustainability role?

1. Commitments need to give way to actions – What has been said and done following the Paris Agreement and COP26

The Chair highlighted the importance of the Paris Agreement. The ultimate objective is enormous: to reduce greenhouse gas emissions and limit the global temperature increase. An industry representa-tive noted that from COP26 over 100 banks globally have committed to net-zero objectives, but those commitments now need to be translated into action.

A regulator added that COP26 saw the launch of the International Sustainability Standards Board (ISSB). Ultimately, if one global baseline is needed, a building block approach is required. Climate is the starting point, and carve-ins and carve-outs will have to be accepted. It is about the principle of subsidiarity and the capacity of states to implement this important framework.

A regulator stated that progress in the current year was made in collaboration with industry and part-ners around the world. The COP26 commitments are ground-breaking. There was a commitment from 450 financial institutions in the Glasgow Financial Alliance for Net Zero (GFANZ) for $130 trillion in assets to be climate-aligned. The question is whether these commitments will be translated into con-crete action in terms of investments and supporting the transition. A UK Financial Conduct Authority (FCA) survey of asset managers showed that 75% made a commitment to net zero, but only 38% had a specific target. Likewise, 90% of companies had committed to taking action but only 30% had a long-term quantitative target for reducing their greenhouse gas emissions.

An industry representative noted that the Glasgow Financial Alliance for Net Zero harnesses ambitions and creates an environment where there is pressure and support to set more ambitious targets and then, with those goals, to drive technological innovation and the new financing needed to bring sys-temic change.

2. The financial sector has a major role to play in the implementation of the Paris Agreement

A central bank official stated that the financial sector plays a crucial role in mitigating climate change. An industry representative suggested there are three main areas where that needs to happen.

The first is in the work that banks need to do with their clients to enable the transition to a low-carbon economy. The mobilisation of capital is vital to this, and banks play an important enabling role here, both in helping a wide range of businesses manage the transition and physical risks they are exposed to, and also in realising the opportunities of a transition to a green economy. Banks will play a vital role, and this is where many institutions are now focused on developing their business strategies.

The second area is in managing the transition and physical risks that banks and financial services firms are exposed to through the risk of their counterparties and their clients. That has been a major focus of the regulators thus far.

The third area is transparency. This does not just apply to banks and financial services firms but to all organisations, in particular, those who have made net-zero commitments. There will be increased scru-tiny over for how these organisations are managing the transition to a low-carbon economy, and how they are furthering environmental, social and governance (ESG) objectives more generally.

A public bank representative indicated that the financial sector does not play a sufficient role in incen-tivising households' and firms' transitions. An industry representative added that the financial sector is working to get there, and it can and should be a driving force for a sustainable transition. It can use its position and expertise to help customers move in a more sustainable direction through advisory services, financing and clear requirements.

3. Challenges – Stronger involvement is needed on several levels

A central bank official highlighted three figures from the European Systemic Risk Board (ESRB) and the European Central Bank (ECB) report from last July. First, she noted that 14% of the collective euro area banking sector balance sheets are exposed to high-emission firms. Second, for euro area investment funds, exposure is clearly oriented towards carbon-intensive projects or industries, with over 55%. Third, different studies show the economic impact of not taking ambitious action to miti-gate climate change. Failing to limit global warming could result in a double-digit decline in global gross domestic product (GDP) by 2050. The question is who will finance the transition. Currently, there are not enough financial flows into sustainable companies or sustainable projects.

An industry representative emphasised that the industry is nowhere near where it needs to be. The underlying assets are not there for the banks to finance and for investors to fund.

3.1 The financing challenge of the transition

A central bank official noted that Europe's financial system is mostly bank-based, so the banking industry plays an important role. The transformation hinges on innovation and new technologies. De-veloping these innovations requires a certain risk appetite since only one out of 20 start-ups will suc-ceed. The risk appetite of the banking industry is limited. The question then is who will do the job and where the money will come from. The capital markets will play a vital role. If Europe does not manage to deepen its capital markets, it will not manage the transition.

In emerging and developing countries, the public sector often plays an important role in financing projects. The fiscal capacity of emerging markets is very strained. Here, it is therefore important to create an environment that will be conducive to more private capital for emerging countries.

An industry representative noted that different types of transition financing, like sustainability-linked loans and bonds, are important instruments. They are designed to encourage a move towards a more sustainable economy by rewarding borrowers for improvements in their impact on the planet. An in-dustry representative remarked that retrofitting existing infrastructure and building new, clean infra-structure will require in the range of $7 trillion per year. There is a gap of around $3-4 trillion.

3.2 Risk taking

An industry representative highlighted the considerable financial risk for first-mover companies and financial institutions involved in investments in innovative and sustainable technologies. Projects that are necessary to drive the sustainable transition are often deemed too high risk and are not priori-tised. There is therefore a need to investigate new and innovative financing and risk-sharing measures to overcome this barrier.

3.3 Access to climate and green data

A regulator noted that the financial sector and other investors are in need of more data from compa-nies to understand what they are doing to reduce their emissions and how climate matters affect their enterprises.

An industry representative stated that about 40% of companies out of a universe of several thousand of the largest listed companies globally have a target but only 3% have targets that are aligned with Paris and with net zero. An industry representative emphasised the importance of standardising ESG data and its availability. An industry representative noted that one is on the data side. What the indus-try measures is going to be critical to how it manages, and the quality, quantity and consistency of data is going to be vitally important. There is also the question of how banks and financial services firms are managing this through their data architecture.

3.4 The regulatory challenge

A regulator stated that investors are not interested in countries competing against each other. They want one global set of standards.

An industry representative remarked that whilst there are many commitments on the market it is not the whole market, so there is a risk of a two-tiered economy where large companies have green port-folios while brown assets will continue to be funded by smaller entities without the same commit-ments. There must be a path to take those dirty assets towards the energy transition and to recognise the progress made inside portfolios, rather than an expectation of a binary switching.

A public bank representative stated that prudential rules must be practical. An industry representative noted the potential for regulatory complexity and fragmentation, particularly for global firms. Manag-ing that is not just for legislators and regulators; the industry also has a responsibility to maintain that dialogue.

An industry representative noted the need for clearer national policies, priorities and targets for scal-ing low-carbon solutions along with incentives. The UK is thinking about a climate test for every new policy, which is a good way to put climate at the centre of policy-making and ensure alignment. There are often regulations conducive to more investment in renewables while the same economies also have fossil fuel subsidies. Avoiding this type of misalignment is very important.

3.5 Transparency challenge

A regulator emphasised the importance of disclosure so shareholders, clients and consumers can hold companies to account on their key performance indicators (KPI) and milestones. A government official added that the peer pressure and the competition created by maximising transparency will add to the instruments.

3.6 Letting go of old habits

A public bank representative confirmed that there has been progress, but nothing compared to what is happening at present because this is a transformation rather than a transition. It is not just econo-mies and the finance sector but societies that are transforming.

The industry cannot and shall not behave as if it is business as usual, but most are looking at the situation with a business-as-usual perspective. The real question is whether there is readiness to ac-cept the effect of the transformation on society, which will mean a lower return on investment, much more risk and less money being earned; the finance of tomorrow will not be the same or have the same returns as the finance of yesterday.

An industry representative noted that it cannot only be the greenest projects and activities that are rewarded; there is a need to drive the transition, and this means incentivising households' and firms' transitions from brown to light brown, to light green and ultimately to dark green. An industry repre-sentative stated that the transition is also about creating career pathways for young people joining industry organisations as graduates. There is a real opportunity for them to build their careers in the sustainability space.

Financial services tend to be a relatively insular profession where there is a great deal of technical jargon, and it can seem quite impenetrable to outsiders. The industry needs to involve a broad and diverse range of skills if it is going to make progress in the transformation needed to move to net zero. There should be participation within financial services firms from professions and backgrounds that bankers or asset managers would not normally think of to drive forward the cultural change need-ed.

Several speakers agreed that the other regulatory incentive for financial regulation is CO2 pricing. A central bank official suggested that implementing an adequate carbon pricing scheme is crucially important, while acknowledging that carbon taxation alone will not lead to a carbon-neutral planet. The focus should not only be on ESG labelling. It is not about giving the money to those sectors that are already green; it is about financing the transformation, especially for brown companies. An industry representative emphasised that what is also important, in addition to universal carbon pricing, is a carbon border tax adjustment.

4. A regulatory framework building over time: Starting from scratch with ups and downs because the transition will take time

An industry representative stated that there is significant focus from regulators and policy-makers on standardising and improving the quality, quantity and consistency of data provided into the markets. There needs to be a genuine shared effort across the private and public sectors to ensure that the rules of the game are consistent, transparent and science-based. To succeed in the path to achieving the Paris goals, those rules need to be set in a way that enables the right kinds of competition in the right kinds of areas.

A regulator remarked that the new legislative package on sustainability, comprising the Sustainable Finance Disclosure Regulation (SFDR) and Corporate Sustainability Reporting Directive (CSRD), is very challenging. It is an impressive wave of new regulation and it will take some time to digest. Usu-ally, regulators are asked to develop new regulations following a crisis. That is not the case on this occasion; there is only a very impressive demand-driven exercise. There are perhaps too many expec-tations but the position is one of starting from scratch, which is a terrific advantage.

A regulator noted that the UK has established a Transition Plan Taskforce bringing together scientists, regulators, industry, civil society and academia to develop a 'gold standard' for transition plans, sup-porting the transition towards the ambition to be a net-zero financial centre.

There is also the role of shareholders and of investor stewardship. There is some concern that if regu-lators go too far, all of the assets that need to transition over many decades will be moved into pri-vate markets where there is much less scrutiny. This is where an intelligent conversation with investors is important so they have the ability to vote and add their voices to the transition progress, while rec-ognising it is going to take multiple decades.

A government official noted that their organisation will hand standards and forward-looking methods to its financial intermediaries to provide them with an instrument to identify the global temperature path they are on. Having a measurement other than CO2 was the big achievement of the Paris Agree-ment. Someone with a 3-degree portfolio can ask whether they shape it in a certain way or include the promise of a development path of transition in the portfolio, or query whether it is a hopeless portfo-lio. The aim is to have a system that incentivises the markets to see there is huge potential and to see the benefits to be drawn from a bad portfolio with regards to the future.

5. The need for collective action with a specific role for the public and private sectors

An industry representative highlighted shared action pathways and the need for the whole system, private sector and governments, to move in the same direction.

A public bank representative noted that François Villeroy previously said there is readiness to invest for the long term if protection for the capital is given, and this protection should be provided not only by the public sector but by all. Public and private actors have specific roles and cannot behave alike. The public actors have a leverage role to play, and for that they need to have more room to act.

An industry representative noted that the public sector has a huge role to play in helping to scale new technologies that will be critical for decarbonisation.

6. Disparities in the transition process between countries

An industry representative stated that emerging and developing countries are responsible for approx-imately two thirds of greenhouse gases. As in the developed market, growth in emerging and devel-oping countries has been CO2 intensive, especially over the last 20 years. From 2000 until 2017/2018, the CO2 intensity in emerging markets has increased. About 44% of greenhouse gas emissions are coming from coal-fired power plants in emerging countries.

At the same time, fossil fuel growth has been good for the poor. Hundreds of millions of people have been lifted out of poverty because of this growth, fuelled by relatively cheap sources of energy. The critical question going forward will be how to achieve a decoupling between the cleanness of the growth and the growth itself.

Risk sharing is also needed. There is a great deal of risk in emerging countries. There are many issues related to aggregation. Development finance institutions (DFI), the World Bank, the International Fi-nance Corporation (IFC) and many others have vital roles to play in working with the private sector to look for mechanisms that will allow the mobilisation of finance at scale.

A wider and more consistent framework is required to understand and manage risks and to drive real convergence between the various standards. The EU is an extremely important place for doing that. It has a major opportunity to show leadership, but this needs to be done in line with market expecta-tions and with understanding of the needs of emerging markets, which are not necessarily fully aligned with the EU. The international platform for sustainable finance led by Europe, which is reach-ing out to many important countries like China and India, is an example of the things that will drive the necessary convergence.

7. The phenomenon of greenwashing and how to cope with it

A regulator confirmed that greenwashing is a real problem of significant magnitude which requires collective attention. Public support for the mobilisation of finance to deliver net zero could be signifi-cantly undermined if regulators do not ensure they are ahead of the issue.

One area for which the industry is asking for regulation is ESG ratings, because they are seeing a proliferation of standards and a lack of consistency. Fund managers and boards of funds have been written to in order to ensure they have proper governance around this. This will be a major theme for the next couple of years.

A regulator noted that issues are being worked on jointly which means going into the detail. Regula-tors have to be able to tackle all of the detail otherwise they are not able to discuss with the Financial Stability Board (FSB). If attention is not paid to greenwashing it will be a serious boomerang problem.

One of the sources of greenwashing concerns the mismatch of the implementation of the different regulations at the EU level. ESMA states: 'Regulatory arbitrage linked to the fast-evolving legislative framework aggravate greenwashing risks...' There is a need for caution. The Financial Transparency System (FTS) still needs to be endorsed. This means that there is for now only self-obligatory filing. Once FTS can be enforced it will be.

One of the solutions is to take responsibility and to perform, ex ante, marketing. This is about optics. With very aggressive marketing material when there is a problem of mismatching there can be a seri-ous problem for trust. From this perspective, responsibility has to be taken because it is about trust. That is very important because whenever it is possible to check the quality of marketing materials it means that cases of mis-selling, from a statistical point of view, are reduced. However, it is a day-to-day challenge. Greenwashing has to be managed seriously, because it is about trust. If it is not, that would be a serious issue.

Transition scenarios: expectations and related policy priorities

1. In search of the perfect transition – the goal is clear; the path to get there is under construction

The Chair noted that the transition to net zero requires the financial sector to have scenarios, data and information so that it can plan. It is a complex transition because it requires shifting production processes, moving brown capital towards green capital and to cleaner processes for consumption and production. It requires financing, scenarios to guide agents, goals, targets, data, and a taxonomy.

A Central Bank official noted that the destination is known. However, the detail of the path to get there is not. The good news is that the destination is clear and there is increasing clarity on the pathway. However, this is a whole economy change which will take time, and more detail is necessary.

An official suggested that the transition process has three steps. First is to define science-based targets and interim targets. Second is to define and publish transition plans and achieve them. Third is to annually publish all of the elements to monitor progress.

While it may not be a large, homogenised plan at this stage, it is a step-by-step process. There are plans at the European and national levels. There will be plans from financial institutions and companies. As all of the plans are interconnected, some of the inputs for one plan are the outputs of other plans. In the first iteration there will be gaps between the inputs and outputs, which is normal.

A Central Bank official noted that there should be real, intermediate targets published annually and work from those who are behind to catch up.

2. The financial sector faces growing climate urgency

A Central Bank official highlighted how essential it is, for delivering a smooth transition, that emissions in the real economy reduce. That is not about divesting the dirty and investing in the currently green. Capital has to be directed to those who need to develop and who are developing credible plans to reduce their emissions. Transition financing and not paper decarbonisation that will reduce the risk. That is not straightforward to identify in a world of great uncertainty. Transition plans are inevitably national. There needs to be innovation in investment strategies and financing techniques.

An industry representative stated that banks can help and speed up the transition. They can make it happen in a smoother way and they can move capital faster to the companies that have true transition plans. However, transition is urgently needed from industry. What is needed globally is a framework.

2.1 The taxonomy: a solution to face the emergency?

An industry representative insisted on the importance of the taxonomy. It represents the target for where economic activity should be to respect the goals of the Paris Agreement. The taxonomy is not a transition tool; it is a target tool. It is very difficult to use the taxonomy to follow the right transition of a company. While it is a useful tool, it is not enough. It should be complemented by a transition taxonomy.

A Central Bank official explained that this is about stewarding the economy on a pathway to net zero, and there is a need to be able to distinguish between those that have a plan and those that do not, which is why the transition plans are so important.

3. The need for a clear and precise framework to define adequate transition strategies, prioritise policies and reach a carbon-neutral economy

An official emphasised the importance of predictability and coordination between transition plans to reduce transition risk and cost. ADEME has a tool called the Assessing the low-Carbon Transition (ACT) initiative, supported by the United Nations Framework Convention on Climate Change (UNFCCC). This tool specifies how to set targets and define action plans for the 14 most emissive sectors. It is vital to now publish plans and to rely on them to set net-zero targets. All actors, public and private, should publish their plans, all of the assumptions behind those plans and all of the elements that are needed to achieve those plans.

A Central Bank official stressed the need for banks to put in place transition plans which are compatible with EU policies implementing the Paris Agreement. They should be plans with concrete intermediate milestones to enhance banks' long-term strategies and decision-making. A Central Bank official added that it is important to not despair and do nothing while awaiting clarity on the path to net zero. There is a huge amount to do and everyone needs to increase their understanding of what transition means for customers in the real economy. That means engagement, data and understanding their plans.

An industry representative remarked that, as the end goal is very far away, clear intermediate goals are needed. An industry representative added that climate change is a real democratic challenge, and it has to be framed by public authorities. By establishing a transition framework to transform the economy, the transition risk will be reduced. An industry representative noted that frameworks are needed, and this effectively means cooperation between the public sector and public authorities. A route has to be provided as otherwise, whilst it may happen, it may not. That may imply industries indicating what is and is not possible to achieve.

4. An efficient transition will result from tripartite coordination between the real economy, the financial industry and the public sector

A Central Bank official stated that citizens, firms, banks, and prudential supervisors alike are working towards the climate goals agreed in 2015. The EU and national governments are rolling out policies implementing the Paris Agreement.

A Central Bank official agreed that everybody has a role to play. Decarbonising the entire economy requires transition and structural change on an enormous scale. There is a huge amount of uncertainty about that, because there is a need to look decades ahead.

An official added that financial institutions cannot make this transition by themselves. They are closely linked to the economy. Thinking that financiers can change everything or that they can change nothing are errors.

An industry representative stated that there is a need to cooperate. A work plan is needed to support the transformation of the economy as a whole, and that is the role of the public authorities.

An industry representative highlighted that there is no transition and no decarbonisation of the economy by banks or finance alone. A three-party discussion is needed between the public sector, industry and the financing sector to allow this. Cooperation between the three parties is necessary.

An industry representative added that it is key for financial services to establish an understanding of what is within the remit of the transition pathway. There are questions of scope and what risks may arise from transition and the climate risk itself, but also of what might expose firms to reputational risk.

5. The first actions are already in place

An industry representative noted that organisations with a core custody function cannot control what clients deposit every day. However, they can control their own emissions, both in terms of portfolios and their own activities. Clients can be offered tools to allow them to monitor and work on their transition pathways. An industry representative's firm has developed an ESG analytics app, which allows for transparency and alignment among market participants.

An industry representative noted that banks are now making progress in understanding the physical and transition risks. An industry representative's organisation is trying to provide some guidance for transition financing up to COP27. Discussions to that end could help the financial services sector to think more about what innovations there could be going forward.

An industry representative noted that departments of experts in transition are being created, and experts are being brought in to aid with how to get into new technologies that can help with decarbonising the economy. An official remarked that to achieve the 55% reduction of gas emissions by 2030, viable and existing technology has to be relied on for most of the sector.

A Central Bank official noted that the public sector and the financial regulators are doing their part by providing scenarios to work with. They are not perfect, but they are constantly improving. It is better to be roughly right now than precisely right when it is too late.

A Central Bank official agreed that a framework is required. However, though it is not perfect, there is a framework. It starts with the Paris Agreement. There is a translation of the Paris Agreement into European law. There is also the taxonomy. There are proposals to have obligatory transition plans in the new capital requirements directive. There are corporate reporting obligations. All of that together does indeed create a framework.

6. There remain challenges to face up to at several levels

An industry representative noted that transition is a holistic challenge. Moving to a low-carbon economy is a whole sector issue, from scope 1 to scope 3. It is not an issue just for corporates or for a single company. Companies have to be seen in the context of the whole sector.

6.1 Banks and firms exposed to new risks

A Central Bank official stated that for the European Central Bank's banking supervision, the main concern to address with the transition plans is the level of banks' risk exposures and the effectiveness of their controls. It can be asked whether the exposures have been sufficiently mitigated and whether they are prudent. As climate-related and environmental risks become increasingly widespread and more material, banks will inevitably be exposed to them through both physical and transition risks. Banks therefore need adequate risk mitigation measures in place.

6.2 Transparency: the need for data and information to prevent risks and speed up the transition process

A Central Bank official added that for banks to be able to manage their transition risks adequately, they need to have information on how their customers are performing relative to a Paris aligned transition pack. This is where the European Commission's proposal for a Corporate Sustainability Reporting Directive (CSRD) comes in.

The proposed CSRD is a necessary step to address the gaps that currently hinder the development of appropriate sustainability policy, risk management and risk monitoring frameworks for the financial sector. It will not only explicitly ask large banks to disclose their transition plans; it will ask banks' corporate clients to do the same. This last point is crucial, as it will enable banks to assess their climate-related and environmental risks in their asset portfolios.

A Central Bank official noted there is more data available than may be expected. Proxies can be used, and experiences can be shared. In the UK, through the Climate Financial Risk Forum, there are public/private partnerships to try to share the available data, and this will improve over time. This is about making progress now and not waiting for perfection later.

An industry representative remarked that to support the transition and inter-dependence the quality of data becomes critical. There is some data but clearly there is not enough and much more work is needed. A key area is transparency and showing the results of the investments. Much can come together with regards to new technologies like digital and AI. This has been seen with biotech and how much has been possible to achieve in a crisis.

Data is paramount, and it is one of the main issues seen with clients. An industry representative's firm's clients on the crowdsourcing side of the platform mentioned previously are able to send data back to providers. The amount of data considered incorrect is high. The data lacks transparency, which has created climate anxiety and is making it difficult for people to act in the timeline available, which is short. With some of the crowdsourcing the data is at least there, and it is possible to monitor and understand whether it is good or bad. However, quality becomes a critical factor for accelerating the transition and being able to operate in a way that is more transparent without this risk of perceived greenwashing and that the industry is not doing enough or is not there.

6.3 One global pathway or interdependent pathways?

An industry representative noted that financial institutions are not all the same. Transition pathways are necessarily going to be diverse and depend on the business model of each institution. An industry representative added that the political agenda is defined by the region and countries. The pathway and the scenario will be influenced by factors like political agendas.

An industry representative highlighted that the transition will not be easy for small and medium-sized enterprises (SME). They do not always have a very clear view of what they can do or the reality of their carbon emissions. Experts are needed to make sure these businesses can be aided.

An official noted that the transition plans of financial institutions will rely on the transition plans of their counterparties. The transition plans of the companies will require an appropriate public policy for infrastructure, subsidies, regulation, fiscals, taxation, and such. Public policy also needs a degree of maturity and to support both the public and private sectors with their plans.

A Central Bank official suggested that scenario analysis is key. There is a huge amount of uncertainty looking to the decades ahead, and scenario analysis is a fabulous toolkit for helping to think about what might happen in the future. The locations of the opportunities and where change needs to happen can be revealed through scenario analysis. This allows for an evaluation of the uncertainty. Financial institutions live with uncertainty all of the time but that does not mean they do nothing about it. They explore what might happen in different states of the world, they engage to understand the issues and they get the data and capability to understand that data, which will hopefully help to size the uncertainty and determine the right way forward.

A Central Bank official emphasised the degree of urgency, and recommended as a result everyone should work together to achieve the interdependency and the interrelated transition plans needed to reach the destination.

6.4 The social aspect should not be forgotten

An industry representative noted that transition is necessarily multi-dimensional and based on growth. The social aspect of environmental, social and governance (ESG) is almost as important as and is intertwined with the environmental. That is sometimes forgotten, meaning they are kept completely separate.

An industry representative remarked that there is a trade-off between the environmental and social considerations. That is now impacting clients. There is innovative thinking about the potential impacts, and consideration should be given to what can be done upfront.

A Central Bank official noted that everyone recognises that governments and business will drive the transition. There are tough choices with social and economic consequences.

7. The transition is also an open door for new opportunities

An industry representative stated that the transition should be seen not only at a risk level but also at an opportunities level. The Chair noted that François Villeroy de Galhau mentioned in his opening remarks the need for financing new projects and venture capital to finance new technologies. It is not only about investing in existing green projects, with all the problems of greenwashing; it is also about financing new endeavours.

An industry representative stated that the matter concerns plans and also concrete projects that need to be financed. An industry representative agreed that the transition should be looked at not only as being about risk, though there is a need to prepare for the risk and have a framework for that, but as also being about opportunities. It is about being on the side of people who are working on new technologies and trying to make sure that can be invested in. There has to be creativity in the way that is done. It is an exciting period because it is a real revolution, and this revolution means many new things will be invented; new technologies and new ways of doing things will emerge. There is a need to be very active with that, not only in managing risk but also in creating some opportunities.

An industry representative added that climate change is a great opportunity to deploy new capital, to be on the side of new clients and to make sure that they can be helped to find great ideas. The right way to finance must be found.

ESG global reporting standards: addressing consistency and greenwashing issues

1. Requirements for reducing existing green confusion and costs, and fostering sustainable investment

1.1 More interoperable non-financial reporting standards globally are necessary

An industry representative remarked that having sustainability reporting plays a central role in the transition. For financial institutions to fulfil their commitments and regulatory requirements, they need relevant, consistent and reliable sustainability reporting. Currently, there are multiple reporting frameworks unlike with financial information. Sustainability reporting also needs to be of equal quality to the financial information.

The current reporting requirements have to reflect both local public policy and regulations, which creates an extra-territorial dependency. For global reporting there should be interoperability between the different standards.

An industry representative stated that standardisation forms a real challenge. Everybody wants robust and reliable standards, but there is a whole host of standards which measure slightly different things.

Proper governance and a proper reporting framework are needed, which means an internal control process. Everything already available in financial information is needed for these new environmental, social and governance (ESG) reporting standards.

However another industry representative suggested that convergence should not follow the route the EU has taken in financial reporting. Indeed while there is US generally accepted accounting principles (GAAP) decided by the US democratic process, there is no EU GAAP. Conversely a European firm follows accounting rules that are not decided in Europe. Although there will be a great deal of discussion, the US will ultimately decide on their standards of conduct for US firms and that will be it. Consequently there is an issue of democratic deficit in Europe.

1.2 Data availability and quality is a precondition to scale sustainability commitments and meet investment requirements

Data availability and quality are very important. Data related to small and medium-sized enterprises (SME) are outside the scope of the reporting.

An industry representative noted the need for reliable and comparable data to make informed investment decisions. There is an estimated $4 trillion per year needed in investment in innovation, clean energy and infrastructure, which is three times more than the current amount. That requires confidence in the data available. Companies and banks need reliable data to scale sustainability commitments and move sectors through the transition.

1.3 The data challenge must be addressed at the global level

An industry representative noted that most reporting obligations arise in developed markets while most of the business is done in emerging markets. SMEs and larger organisations in those markets do not have available data, so there is a real data gap.

There are also consistency, reliability, and repeatability concerns in terms of the quality of the data. Some of that is because the methodologies for considering and measuring carbon emissions are still evolving. That is before even getting into areas where only the surface has been scratched, like biodiversity.

1.4 Opportunity and impact are specifics of non-financial reporting

This matter should be considered not only from a risk perspective but also from an opportunity and impact perspective. Given where the transition financing needs are, the impact on ultimate carbon reduction from funding a solar or wind project in India is much greater than funding for the same in France, because the energy mix is different.

2. Defining interoperable non-financial reporting requires difficult political agreements at the global level

An industry representative suggested there may be a false symmetry between financial reporting and sustainability reporting. It is going to be much harder to agree on what is and is not fine in the way corporations should behave. Within Europe there is not agreement about which of coal and nuclear energy is green. When moving to shale gas or fracking, Europe will disagree with the US. The Japanese will have much to say about nuclear energy. There will be political differences in determining which sources of energy are green.

3. The EU and the International Financial Reporting Standards Foundation (IFRS) Foundation are both addressing the urgent need for non-financial reporting standards

3.1 Corporate Sustainability Reporting Directive (CSRD) and the taxonomy, which go beyond climate-related issues

A policy-maker suggested that the EU is the frontrunner in sustainable finance, and it cannot stop and wait for the rest. It has started to build up a sustainable reporting framework with the CSRD. The taxonomy is also an important element in this. There are equal criteria, and they are all linked together. It is important to have clarity on the standardisation and ESG. It is also very important to adhere to the principle of double materiality. Proportionality is also an issue.

3.2 Striving for convergence and global cooperation

A policy-maker agreed that alignment should be striven for as much possible, but the political agendas have to be considered. Cooperation at the global level is key. The CSRD incorporates the key elements of the Taskforce on climate-related financial disclosures (TCFD) recommendations developed by the Financial Stability Board.

3.3 A dedicated governing body within the European Financial Reporting Advisory Group (EFRAG) will prepare sustainability reporting standards within the EU

An official explained that EFRAG is tasked with the elaboration of sustainability standards for submission to the European Commission, which will adopt them as delegated acts and create a playing field for every business in scope.

EFRAG is currently finalising its new governance with a new pillar dedicated to sustainability reporting standard setting. This will be in place in March. The work has been at the request of and in close dialogue with the European Commission. The project task force will hand over a comprehensive set of exposure drafts to the newly established sustainability reporting pillar of EFRAG in readiness for public consultation before the end of April. A cost/benefit analysis will also be carried out on the initiative.

The Chair noted the importance of the sequencing for the adoption of the directive. A policy-maker explained that EFRAG is carrying out preparatory work, but ultimately the Commission decides whether to make this the law.

An industry representative stated that public policy must play a huge role in making decisions on some of the options that are open, and there has to be transparency about those decisions being taken, as well as the source of the authority and the extent of the authority being given, whether it is with standard-setting boards or regulators. The political process needs to be engaged in this as well to make sure that such decisions are being made democratically.

3.4 The work of the International Sustainability Standards Board (ISSB)

An official confirmed that the ISSB is starting its own journey, but is building on some strong legacies. The technical readiness working group (TRWG) in the ISSB has been working hard on the issues, though its work has been simpler than EFRAG's because it focused on the general requirements prototype and the climate prototype.

The ISSB should only be a few weeks away from its exposure draft. Parallel to the EFRAG work, the ISSB will probably have a 90-day consultation. The ISSB continues to believe that with the ambition mentioned by International Organization of Securities Commissions (IOSCO) at COP26, it is feasible to have these first two standards ready for adoption at the end of this year.

3.5 Double materiality complements single materiality

An official emphasised the importance of double materiality. Double materiality complements single materiality and does not replace it. The remit of the IFRS Foundation is about answering market participants' needs, and in particular investor needs which focus on enterprise value and the assessment of enterprise value.

3.6 ISSB targets the definition of an interoperable principle-based global baseline

An official explained that the goal is to establish a comprehensive, global baseline of reliable, comparable, verifiable standards which any jurisdiction could either decide to apply on their own or build upon to bring more granularity and/or double materiality. What is important is interoperability. Avoiding divergence is going to be critical for the single materiality line on which IFRS will focus. There is a review of what are very ambitious scope and granularity levels for the climate requirements of the IFRS Foundation.

Regarding the taxonomy, as far as the IASB requirements that need to be adopted it is not for the ISSB or anyone in standard setting to say what is good, what is green, what is brown or what is black. The EU could have a position for a period of time, but that might change such that it cannot be accepted that global investors and global companies operate with something that is currently green, but which might become something else.

4. Defining interoperable non-financial reporting requires difficult political agreements at the global level

4.1 Building transparent and interoperable reporting will require policy makers to answer challenging questions

An official explained that the taxonomy will have to be evaluated to ensure that investors and companies are available, with the energy mixes they have. That it is a principles-based exercise. For sustainability, that will often have to be very granular to ensure there is neutrality.

The Chair noted that as the main source of funding for IFRS comes from the European Commission and the European member states it is hoped ISSB will maintain close contact with EFRAG and others to avoid duplication.

4.2 Global interoperable standards will have to address regional specificities

An industry representative emphasised convergence and the concern about having double reporting. Regarding interoperability, the task force of the ISSB just proposed a climate prototype, but this is mainly based on Sustainability Accounting Standards Board (SASB) references, which is very US-centric. The EU taxonomy is EU rules-based. The question is if they are going to work together to make sure that clients, companies and auditors will not have double reporting.

4.3 Avoiding duplication requires pragmatism and accepting reasonable political ambitions

An industry representative highlighted the need to avoid for large international corporates situations where multiple different sustainability reporting frameworks would apply, and remarked that one of the challenges is the complexity of the topic versus the urgency. There will need to be an iterative process, because the urgency requires having something good now rather than something perfect.

An industry representative remarked that something adequate rather than something good should probably be settled for currently. History shows it is very difficult, even in areas that are quite technical, to achieve convergence. It is even difficult with the same sort of words to achieve convergence in practice for how those words are interpreted.

With baselines that give a degree of transparency there will likely still be different reporting approaches, but at least if it is possible to pick and choose from a menu, which some countries will apply and others will not, then that is a starting point for achieving interoperability.

5. Political involvement is uneven for non-financial reporting

5.1 In the EU, democratic accountability prevails

An industry representative stated that ultimately Europe should not become subservient to the global. Solvency II provides a good example of the correct approach. Europe should be just be as sovereign as the US.

A policy-maker stated the legislators are sovereign. If the US legislator decides on things, that is their decision. It is nonetheless always good to talk to each other, which is what happens. There is regulatory dialogue with the US and these issues are put on the table. Each jurisdiction is accountable to its citizens for what it does and the decisions taken, but that does not mean that there is no attempt to find common ground where possible.

5.2 The level of political involvement in non-financial reporting is lower in the US than in the EU

An official stated that the US is a very low-regulation country overall. It may be that in the US market adoption will be even more important for the global baseline. The SASB metrics are being used by thousands of companies in the US. They will need to be internationalised through the ISSB's work when consolidating the value reporting foundation. Europe has a very strong political process driving the work on these metrics, and that is very unlikely to be the case either now or in the short-term future in the US.

5.3 The ISSB anticipates an important role for market participants on standard setting

An official noted that much will rely on market participants and industry associations. Sustainability topics will involve a broad set of co-construction and dialogues. To have the metrics adopted efficiently for all economic actors, repetition has to be avoided.

The constituencies to do this are being built. The equivalent of the Accounting Standards Advisory Forum of the IASB is being set up by the trustees of the foundation. The first working discussions started just a few weeks ago. The intention is to involve Europe, the US and other important jurisdictions, including emerging markets. The dialogue has to be conducted in a formal and transparent way with the jurisdictions to guide the work. The Chair noted that this is both a political issue and something that could be market led.

5.4 Non-financial reporting will provide many co-construction opportunities and reduce inconsistency

An official added that to be pragmatic co-construction means trying to avoid multiple reporting. However, the criteria set down in legislation by the co-legislators on the basis of the proposal made by the CSRD have to be met. In co-construction dialogue, there is discussion and argumentation about the topics and how to approach them, but the conclusions are not necessarily the same. Compatibility is being worked on without surrendering key principles like double materiality.

An official stated that it would be very difficult for the IFRS Foundation to impose anything on any government around the world. Adoption is by jurisdiction.

5.5 Non-financial reporting standards should reduce the implications of regional specificities and foster interoperability

An industry representative suggested that it does not matter if there are multiple standards if they all build on each other. It has to be possible for an entity to choose whether it is going to report on certain things, and it should be recognised that investment in certain countries is not going to be able to comply with everything that might be done when investing into a European company in two years' time. They have to be helped over time to reach the needed position. If Europe, the US or others have excellent ESG standards, while finance has not been enabled and facilitated to get to where it is needed most, all of the problems from a planetary perspective will not be solved.

An industry representative noted that specific and prescriptive standards are needed to avoid too much interpretation. An official stated that the building block approach works. Coordination is needed in the timing. The EU has a broad spectrum of sustainability matters which are to be reported on following the CSRD. There is a need to understand what the agenda of the ISSB will be.

6. One challenge is the heterogeneity of the ISSB's and EFRAG's timetables

The Chair asked how long it will take to implement the directive. An official replied that co-legislators are currently discussing it. The initial implementation date, which was 2024 on the basis of reporting year 2023, is deemed by both co-legislators to be too ambitious.

The Chair remarked that climate change will not wait. An official accepted that, but time is needed to implement. Pragmatism and reliable data are needed.

An official suggested the ISSB's position is simpler as it does not have as broad and deep political responsibilities. The SEC is moving on climate and will also have a consultation. There will be an opportunity to have a very open view, including from market participants and others beyond the market. The ambition is to be able to propose to jurisdictions towards the end of this year the adoption of the global baseline on the general requirements.

A policy-maker stated that there will ultimately be a good co-construction product, both at international and European levels, taking into account all needs and looking into the global objectives that have to be fulfilled.

The Chair remarked that for an issue like climate, both public and private should not be opposed, but it should be light-touch work. The urgency and seriousness of the question of the climate should be appreciated, though it is not only about the climate. Standards should be adopted. The public side is playing its role, which is sometimes to make things mandatory. There are serious challenges ahead, and there has to be a move from a carbonised economy to something else. It is not going to happen if it is left to the market or maybe even if it is just left to politicians.

Corporate Sustainability Reporting: data challenges

1. The Corporate Sustainability Reporting Directive (CSRD): a step forward to a precise and strong legislative framework

A Central Bank official noted that since 2015 French financial institutions, banks and insurers have had to carry out sustainability reporting under article 173 of the French Energy Transition for Green Growth Act.

A regulator described how the CSRD will create a strong legislative level with several key features. First, there is the establishment of a mandatory regime for all large entities, listed or not. In the EU, one definition of 'large entities' is entities with over 250 employees, which illustrates how many businesses will be in scope. Small and medium sized enterprises (SME) will be encouraged to report under a voluntary regime. Secondly, there will be a comprehensive set of standards not only at the legislative level but at the regulatory level as well, which will cover environmental, social and governance (ESG). Thirdly, CSRD contains a clear commitment to fundamental concepts such as double materiality and the principles of information quality from financial reporting: relevance, faithful representation, understandability, verifiability, and comparability. Finally, auditing will be a mandatory element of sustainability reporting. On that basis, level 1 will be quite strong, but it will be important to see the features of the regulatory level.

The regulator explained that this sits under a clear architecture with what the European Financial Reporting Advisory Group (EFRAG) calls the 'rule of three'. The first part of this rule of three is around the three layers of sector agnostic, sector specific and entity specific disclosures. The second element is the reporting areas: strategy, governance, and risk management; implementation, i.e., being pragmatic and realistic about what entities produce; and measurement of performance. Thirdly and finally, there are also three topics: E, S and G. These features provide reasonable assurance that progress is being made in the right direction. There is a good case to be optimistic about this topic. The EU is making progress on the quality of its sustainability reporting. In fact, CSRD will be a game changing step.

An industry representative agreed that the framework coming from the CSRD and the standards under development at EFRAG are moving in the right direction. Another industry speaker agreed that the CSRD is a major step forward. London Stock Exchange Group (LSEG) is very supportive of the disclosure requirements, and the European Union is showing strong leadership here. Hopefully, other countries' financial sectors and private firms will develop similar efforts around alignment. From the investor perspective, the CSRD will help investors meet their new Sustainable Finance Disclosure Regulation (SFDR) and taxonomy requirements.

2. The key role of ESG data providers in sharing and distributing data between companies and financial institutions

An industry representative described the role of ESG data providers, which are institutions that sit between the corporates that disclose information and the investors and financial institutions that need it to make investment, financing, or other decisions. The industry representative noted that there are three types of information that will be required, adding that it would be 'wonderful' if EFRAG could take these issues forward in their work.

First, there is a need for quantitative information, i.e., fundamental information on ESG issues such as gender equality, greenhouse gas emissions and so on. This is the basic information needed from corporates. The industry is moving in the right direction, although there are many different standards. CSRD will help, but it will take time and it is a particular issue for smaller companies. Secondly, there is a need for qualitative information. This is required by ESG research providers and ESG data providers, who analyse what is happening inside a company and who must take a position on the ESG performance of companies. In this sense, 'qualitative information' means information on the policies that a corporate puts in place, such as human rights policies or labour policies in a particular jurisdiction. It is also important for ESG data providers to have access to information and policies such as codes of conduct. These should be made publicly available on firms' websites. The third type of data that is needed is somewhat trickier and quite new for ESG: business information. Increasingly, data providers encounter challenges in learning how a company performs on biodiversity, for example, or what kind of physical risks a company faces from climate change. Data providers need locations data from companies, e.g. data on where factories or sites are based. There is also a need for sector information and data on the type and quantity of products that a company produces. This is an increasingly frequent requirement, which is extremely important for impact analysis.

The industry representative also highlighted the importance of forward looking data. There are two ways to find out what might happen in the future. The first way is to create models based on past performance, but this requires good historical data on how a company has performed, which is not always available. The second is to do qualitative analysis. This looks at how a company is positioned in terms of policies and the kinds of measures it puts in place to ensure those policies are implemented. For ESG data providers, this is a way to look into the future by understanding how prepared a company is to respond to ESG challenges.

An industry speaker emphasised the role of ESG scores or ratings. These tools are being used increasingly in decision making processes. This can be seen in investment decision making, business decision making, capital raising decisions, on the passive and active sides of asset management and in public markets and private markets. These scores are being used everywhere.

3. A new pillar to financial reporting: sustainability and climate related reporting

A regulator noted that EFRAG is modifying its governance by creating a sustainability reporting pillar in addition to its financial reporting pillar.

A Central Bank official explained that financial institutions are familiar with producing financial information and reporting organised information. The Banque de France considers that five ingredients will be required to provide meaningful and usable climate related reporting. First, there is a requirement around data availability. Secondly, definitions and methodologies must use the same vocabulary. Data is not enough; financial institutions should have the same vocabulary and the same understanding of what is reported. A taxonomy could provide this framework; it is vital to get into the detail of this and to share definitions and understanding. Thirdly, there is a need for standardisation and common formats, which will make data comparable and achieve greater transparency. Fourthly, there is a requirement for easy and complete access to data and reporting. Finally, there is a need for reliable information. CSRD will be a substantial benefit because it will require reported information to be audited. Even if this is resource intensive, it is necessary to engender trust in the data that is produced.

An industry speaker suggested that the incorporation of sustainability considerations into financial processes is accelerating incredibly quickly. There is a huge and growing demand for help around incorporating data and understanding how it impacts decision-making and process innovation.

An industry representative considered that auditors have an important role to play not only in terms of supporting pragmatic solutions in the initial years of reporting but also in relation to the connectivity between financial reporting and sustainability reporting. Indeed, it is sensible for the same auditors to assess the financial and sustainability figures and take an integrated view of a company. In the long run, a complete disconnect between the two frameworks does not make sense.

A regulator emphasised the collective nature of the effort on sustainability reporting. If the financial sector is serious about putting sustainability reporting on an equal footing with financial reporting, there will have to be a chain of responsibilities. A chain is only as strong as its weakest link, and the financial sector should not have any weak links.

4. Several challenges remain

4.1 Data availability, consistency and quality need to be improved

A Central Bank official outlined the difficulties around data availability and comparability that emerged during the first climate pilot exercise conducted by the Autorité de Contrôle Prudentiel et de Resolution (ACPR) in 2020. Some of the information received was absent or incomplete, in particular on physical risks and especially at the European level. The ACPR and the Autorité des Marchés Financiers (AMF) also conducted joint work on the commitments made by financial institutions on the greening and decarbonisation of their activities. Again, it was difficult to extract a clear conclusion from this data due to a lack of clarity on definitions. The participants did not use the same vocabulary, which made it difficult to aggregate data or reach conclusions.

An industry speaker highlighted the existence of fragmentation in the data, a lack of high quality data and a lack of transparency in the definitions. These issues are hampering efforts in this space significantly. Individual institutions are solving for small pieces of the puzzle; the sector is not yet solving for the overall puzzle. There should be clear definitions on how data is collected and data points are used. It is 'amazing' to see how complicated sustainability and ESG data is. It has become very important to understand what a specific data point actually measures. Nobody argues about the definition of 'book to market'; many people argue about the definition of 'diversity'. This demonstrates the need for transparency. There is also a broader need for more data across asset classes and markets globally, regionally and in different sectors. This should be tied together by a common language and framework at a global level.

An industry representative suggested that ESG data providers are facing a particular challenge. ESG data is indeed very complex. There are hundreds of single indicators that need to be analysed and that clients ask for. In this regard, it is very challenging to make progress on SMEs who disclose less data and who have less resources to dedicate to ESG reporting. There are two main issues here. First, modelling the data will be extremely important. Many of the players in ESG data are already doing this. However, there should be deeper dives done into some of these models because what the models produce is not necessarily what is expected. There can be a problem with bad data going in and bad data coming out and real-world information on sectors, company size and location should be included. Simply using average scores on an indicator level can lead to false results. Secondly, ESG assessment models (and disclosure obligations) can be simplified for SMEs, using less data points.

A Central Bank official emphasised the importance of transparency and disclosure both from counterparts and corporates. Transition pathways will be an important element of this transparency. It will be necessary to have the right processes and access to use the information, but it will also be important to have visibility on the efforts made by corporates to define pathways and to be able to ascertain whether the vision in those pathways has been implemented.

4.2 The regulatory framework is still under construction and there is a need for a global language

An industry representative considered that the absence of a harmonised regulation and sustainability reporting framework is a key challenge. CSRD is clearly a significant step forward, but it will not come into force for two or three years. This time lag creates a challenge. Financial institutions will have to wait until corporates produce their first reports. As always, there is a one year delay between reporting periods. At the moment, the industry is in an interim stage. This information is available and there are reporting requirements under SFDR, the taxonomy and so on. However, the underlying data are missing to a considerable extent. Nevertheless, this alone will probably be insufficient for financial institutions. For example, Allianz invests customer proceeds globally. There is a need for international alignment on sustainability reporting requirements to foster transparency and comparability globally. This will ensure a level playing field for information preparers, but it is also important for users, because financial institutions need to manage sustainability risk for all investments, not only those in European investees.

A Central Bank official suggested that the CSDR is an important element of the progress that must be made. It will be a very long journey and it is essential to start the journey now.

An industry speaker agreed on the need for the CSDR to be integrated within a common global language. This will enable global portfolios and global investors to look at decision making holistically. It is essential for the industry to provide better clarity on how methodologies work and on the underlying data. The task of the public sector is to set the frameworks and requirements for disclosure, which will create a common language and basis of truth.

An industry representative noted that preparers also do not want a completely fragmented landscape of regulation and metrics. Within the EU there is the taxonomy, the CSRD and several other regulations. These tools and frameworks must be interoperable; this is also true at a global level.

An industry speaker highlighted the challenge for corporates and financial institutions around creating consistent processes to identify data sources and production chains. The CSRD has expanded the scope, depth, quality, and quantity of information on sustainability, but the directive on corporate sustainability due diligence will also soon be announced. The practical implementation of this in data aggregation and compilation, i.e. its transformation into compliant sustainability reporting approved by governance bodies, requires serious work if it is to avoid the quasi duplication of similar information and create standardised processes with multiple purposes. It remains unclear how markets and investors will interpret and use this information. It will take several years before these benchmarks become meaningful reference points. A completely new mindset and skillset is needed here, including for supervisors.

4.3 Finding the right balance: all actors need to define clear strategies to create a roadmap/pathway and provide complete sustainability reporting

An industry representative noted that it is also important for Europe to support global developments. It is impossible to pause things in Europe until a global baseline is established. There is an urgent need for data, but there is also a need to find the right balance between co constructing the global baseline with the International Sustainability Standards Board (ISSB) and the need to make progress in Europe in line with the requirements of European regulation.

An industry speaker outlined two key recommendations. First, it is important to understand that private markets are equally as important as public markets in the transition. Excluding private markets from these efforts, risks missing part of the climate impact. The fact a company is publicly listed or the fact an instrument is public does not determine how relevant it is in the transition. Therefore, greater consideration should be given to the introduction of a strong framework for the private markets. Secondly, transition information should be included in the CSRD requirements. There is a need for information around companies' governance processes and a need for clear targets on greenhouse emissions. Looking forward, targets are a key component that will inform the journey as well as the destination.

An industry speaker noted the challenge around the intertwined nature of financial and sustainability information. To be meaningful, sustainability information and financial information cannot be prepared in two parallel silos. Consistency with financial reporting is a precondition of the added value in sustainability reporting. Such integrated reporting should embrace all aspects of material information, reflecting the commercial, financial, social, and environmental context in which a company operates.

An industry representative emphasised the need for prioritisation on feasibility and proportionality. It is impossible to ask all companies to meet the same level. Prioritisation on scope and timing is also important. The world cannot be saved in a day; progress will be needed over a period of time without delaying the implementation of the CSRD. Another industry speaker agreed on the need for prioritisation. There are many new demands and regulations. Trying to solve everything simultaneously risks a reliance on placeholder solutions that ultimately will not have the required impact.

A Central Bank official suggested that it is important to start with strategy, because the industry needs a forward looking approach. A strategy will facilitate a step by step approach and a roadmap. The most important element here is the transition pathway, and a strategy can be the first step. For example, Banque de France launched a responsible investor strategy. This was a chart which contained the vision and the way to establish the goal. The next objective was to build capacity. Banque de France built capacity and asked for help from service providers. This type of process is also being used for the roadmap for greening monetary policy at the Eurosystem; there was a strong commitment on this from the Governing Council.

4.4 One last challenge: corporates and CEOs should be supported in order to encourage disclosure and involve them seriously in the process

A regulator outlined the key components of the chain of responsibilities around sustainability reporting. First, there is a need for robust standards. This is not something that a CEO can do; it is a task for other people. At the level of the company, there is a need for management processes; the governance must also take this seriously and ensure there is the proper oversight. Then the auditors must also play their role. There is a question around digitisation because it is essential not to lag on this. The process should be digital from the beginning. This implies a need to have the data and the taxonomy in place. Finally, there is a need for an enforcement system that can see that progress is being made in a pragmatic way. These are the six links in the chain; hopefully none of them will be weak.

An official noted that corporates are being asked to provide a substantial amount of data. CEOs might not understand what will be done with this data, but in the end, they understand that their company will be judged, and it will influence the firm's financing. If this is the law, a CEO will do it, but they will want the wider financial industry to help the corporate using reinsurance.

An industry representative conceded that this is a real challenge. Corporates will need a considerable amount of support. All stakeholders involved in sustainability reporting should provide their support, but the public sector has a specific role to play due to the lack of harmonised regulation and the fact that the regulation is evolving. Firstly, prioritisation is important. If a CEO were asked to provide everything in a complete form, very fast and fully assured by external auditors, the disclosure would not happen. Even for larger corporates, which have sometimes been doing sustainability reporting for two decades, the upcoming requirements are a real challenge. There is also a need to have safeguards during the first years of reporting. Companies need to be encouraged to disclose, make progress, and not hold back because they feel uneasy. Public authorities and market participants must work towards pragmatic solutions.

An industry speaker emphasised that helping CEOs would involve action on data and frameworks, but it would also require interpretability. CEOs will need to be provided with the tools to understand what sustainability reporting means for their business and their decision making.

Emerging ESG challenges: biodiversity, circular economy, social...

1. Realistic ambitions: what does it mean?

A Central Bank official noted that the title of the session refers to 'setting realistic ambitions for the financial sector'. However it is difficult to measure what is realistic. Was it realistic to introduce the euro and make it thrive. Ambition should be set at this level. Society, clients and citizens are asking not only for finance but for finance to have responsibilities in society. Furthermore, this can be a way to develop business.

An industry representative stated that realistic ambitions must be set for the non-financial sector, including companies from mining and extractive industries, oil and gas industries, the transportation industry, and the building and construction industry. Then the financial sector can decide whether, as an asset manager, bank or insurer, it wants to lend these companies money, insure them or buy their securities.

2. Emerging ESG Challenges

Strong regulation is needed, but other key instruments and actors are also necessary.

A policy-maker commented that regulation alone is not enough, although it will help. Public funds are also needed, not necessarily in the Keynesian sense. Some public money may be needed, but some ability to give incentives to public funds is certainly important. Incentives may come from regulation or from public funds. In addition, public funds and programmes that also include the private sector will be crucial. In the last few years, there has been an important shift in the way things are done from Brussels. The European Commission implements regulations and programmes but has also increased its ability to provide technical support and advice.

An official commented that regulation is helpful and can sometimes be necessary, but it is certainly not sufficient.

An industry representative commented that, in addition to regulation, there is a general expectation of how organisations run their business in the context of environmental, social and governance (ESG).

An industry representative noted that there are instruments other than regulation, for example use of public funds, programmes and technical advice. The issue of regional versus global standards is also important here. Europe has regional standards on how companies should behave. For companies that behave in a different way abroad, although there could be a carbon tax at the European border, there are also bilateral trade agreements. It is possible to do lot of regulation in the financial sector, but something else will be at play in terms of whether cattle raised on land that comes from deforestation are imported. Trade agreements with other regions will also hinge upon biodiversity and water, which is a very powerful instrument.

2.1 A biodiversity crisis in addition to the climate crisis

An official explained that the Taskforce on Nature-related Financial Disclosures (TNFD) is a private-sector initiative that is funded by the public sector. Through the TNFD, the private sector is trying to understand the complex area of nature, biodiversity and climate, and create standards for understanding, identifying and managing risk, and disclosing and measuring against it. The stress testing that has been happening in the Banque de France, the Dutch bank and the Brazilian bank around nature scenarios is really important. In addition to the climate crisis, there is also a crisis of biodiversity of nature, which is creating material risk for companies and the investors and banks that are financing, lending and creating funds around them. The World Economic Forum has published reports on the biodiversity crisis and the numbers are becoming well-understood. However, how to approach this is not well-understood. Climate and nature should not be approached as separate issues.

A Central Bank official commented that awareness on climate is already increasing. However, climate cannot be separated from other nature-related risks.

An industry representative noted that biodiversity has been rapidly rising on the agenda of investors and is probably the primary focus for 2022. The damage caused by biodiversity loss will be over $10 trillion by 2050. Half of gross domestic product (GDP) is moderately or severely dependent on nature. Climate change is one of the main drivers of biodiversity loss. Action should be taken on both of these in equal measure, given that they are pressing and interconnected.

An industry representative indicated that the research unit at their organisation created a biodiversity index three years previously, recognising that nature is an asset with economic value, calculating everything on the planet in terms of percentage of GDP and making nature a percentage of GDP. This enabled links to be made between biodiversity elements like water, air quality and pollution and economic activities. A map and an index were produced, showing the link between economy activity and nature's inputs to economy activity. This demonstrates how exposed some areas are to challenging biodiversity. 55% of GDP is linked to biodiversity and 20% of countries on the planet are exposed to significant economic consequences if action is not taken on biodiversity.

An official stated that scientists have demonstrated that it will not be possible to decarbonise energy supplies or transport in the necessary timeframe and therefore carbon offsets will be needed. There have been lots of reports about mechanical or artificial carbon offsets that are not very efficient, effective or cheap. The most effective and most-used carbon offsets will be nature-based. The integration between climate and nature must be considered. Initial work was on climate, but a framework must be developed quickly that considers the two together.

An industry representative noted that water is also a very important issue. Oceans and marine ecosystem certification is connected to nature and biodiversity as well as to climate.

3. ESG is a multidimensional challenge and requires an integrated solution

A Central Bank official summarised that a major challenge is whether all aspects of ESG can be addressed together, or whether there is a need to focus. Institutional investors have already done a great deal of work on the G, but perhaps more as an opportunity than as a risk factor. The S is still very underdeveloped. E includes climate and other things. Work on the different elements is moving at different paces. Climate, nature and biodiversity are linked and cannot be separated. If financial institutions and Central Banks, as investors, develop a framework for how to manage these risks and focus only on climate, other aspects may be forgotten. All aspects should be addressed in parallel, acknowledging that the paces can be different. Biodiversity, circular economy and social aspects are considered very similarly. Progress is still in the early stages but it is necessary. There are similarities in the aspects of negative externalities and how they are priced, inclusion in regulation and pressure of expectations of citizens.

An industry representative stated that the challenge of ESG is that there are no strong concepts of how this should be treated.

An official noted that the 2030 agenda has brought about a major paradigm shift in the need to consider sustainable development in a systemic manner and to treat the sustainable development goals (SDGs) as a compact, rather than as a juxtaposition of 17 independent goals. However, there is currently no indisputable conceptual framework for sustainable development. This is what makes the implementation of the agenda so difficult. Sustainable development is very much context-dependent, as each individual or group of people can act in a certain way, depending on their desire for the future. This superposition of visions leads to a permanent debate on sustainability and innovation. This debate is important, but it is sometimes complicated to understand each other. The social, political and institutional process is probably the core of sustainability. It should be supported and reinforced by constantly seeking open spaces, such as the current debate, enabling people and organisations to fully consider the package together. Similar considerations should apply also to ESG.

An official stated that the planet does not care whether the different aspects of ESG are tackled separately or together. Climate and nature are integrated. Climate risk manifests itself in food production. With the increasing temperature of the oceans, the destruction of the reefs and all the reports about land fertility and productivity, climate change is damaging the ecosystems needed to produce food. Therefore, these two things cannot be separated. The different issues are sometimes treated as though it is possible to address one and then the other. These are integrated issues for the planet and an integrated solution is needed.

An official commented that the ESG challenges are not additional to pre-existing ones. They are consequential. It is not very efficient to think that there is some arbitrage between them. Aligning finance with the SDG agenda has become a new theory of change that can be taken into account.

3.1 A common legal framework will lead to a more efficient impact

An official noted that, in most cases, it is not yet illegal to emit carbon dioxide or greenhouse gases like methane. It is illegal to fish without permits, to cut down forests without permission, to destroy species or to pollute, and so the legality framework of nature and biodiversity versus climate is quite different. The financial industry can have an input here. Often the actors involved in illegal deforestation, fishing or human trafficking are connected to money laundering. Many countries, such as France, Singapore and the UK, have started to consider implementing screening measures to ensure that companies are not involved in illegal forestry, fishing, wildlife trafficking and other things that are so damaging.

An official commented that the legal framework for nature and biodiversity can be executed more quickly than the legal framework for climate. Banks and financial investors take anti-money laundering (AML) regimes very seriously. The fact that these are coming is quite encouraging, because it means that legal frameworks can start to be relied upon. There is a great deal of emphasis on trade deals currently. The carbon or nature footprint and nature-positive dynamics of that trade and those imports should be considered. Illegality in those trade deals should be considered. This is a really important part of the regulatory framework. Including the legal framework of illegal forestry, fishing and wildlife trafficking could have an immediate impact.

An industry representative stated that the legal point is very valid. Deforestation takes place outside Europe in Asia, Africa and Latin America, so it may not be illegal everywhere. The issue then is where economic flows are cut. If a company does not carry out deforestation, the question is whether it is acceptable for it to trade with companies that do it legally in their jurisdiction. The measurement issue is very difficult. There are other ways to address that and the legal aspect is a very strong lever.

A Central Bank official commented that pricing does not always work for biodiversity. Using legal norms might work much better. Central Banks are not the ones that are setting the limits or the norms on biodiversity, but they, as well as regulators, can work this through in the right kind of framework, using the right kind of legislation.

3.2 Raising awareness

An industry representative noted that one of the biggest challenges is around companies understanding their dependencies and reporting on these impacts. Engagement is vital, as well as raising awareness and understanding these issues and how they all interconnect. The data may not be available, but there is an awareness that this is important. Even with qualitative information, a lot can be done. This is not only about trade and the legal framework, but also about the role that the industry can play to drive change and ensure that these nature-related risks are understood at the board level.

An industry representative explained that the commitment to sustainable finance is linked to the awareness that the growth model, where negative externalities are not taken into account, will not work. It is not possible to continue to grow in that way for another 300 years, because the planet will not be able to sustain it. This has also been part of the political discussion in the Nordic countries, as well as a part of the expectations on banks and asset managers.

3.3 A focus on brown companies is needed

An industry representative noted that a transition is currently underway. It is one thing to have all the green companies, but the biggest difference is when organisations also engage with brown companies and make them improve. The top 200 emitters in the industry representative's organisation's portfolios typically sit within what are known as Article 6 funds. These are funds that are not seen as ESG funds. Engagement with the Article 6 fund constituents is a priority, because that is where the biggest real world impact can be made.

An industry representative commented that progress starts with the big industries that are using the real assets and natural resources. The question is how to engage with these companies, because there is no way to fly planes without emitting greenhouse gases, but how much capex is expended to have lower emissions needs to be discussed with companies that are insured or invested in by the financial sector.

3.4 Maintaining this ambition is also challenging

An official commented that regulators must be included in the discussion. Private sector mobilisation is also needed. Ambition must be maintained to augment corporate and social responsibility by incentivising financial institutions not only to manage risk and promote sustainable development opportunities, but also to take ESG into account in their general strategy as being something fundamental for them. Access to data is not always easy, but is a potential approach to the identified challenges.

An industry representative noted that comparable data and the ability to see what good looks like is missing. The industry representative's organisation has a team of biodiversity experts, but access to the necessary data to be able to make progress from a regulatory perspective is a challenge.

A Central Bank official stated that collecting data on biodiversity and biodiversity risks is complicated, because there are many facets and the data are not always available. It is important for central banks and financial institutions to work together with experts. The official's Central Bank is investigating whether, by combining data sources in an innovative way, it is possible to gain an understanding of the physical risks of biodiversity. On a standalone basis, data might not provide any insights, but it might be more useful if data-analysis techniques are used.

An industry representative stated that there was a huge mobilisation of the public and private sector to combat commodity-driven deforestation. In order to be able to realise these huge ambitions, better data is needed. The work of the TNFD is needed. The biggest challenge in data is the need to move beyond whether companies have policies in place and to look at the impacts. It should be possible to compare impacts on different species and habitats between companies. Getting more visibility into supply chains is another major challenge. Investors are still far away from where they would need to be in order to be able to track, measure and put pressure on companies through their stewardship activities.

An industry representative noted that Europe is on a path of getting sustainability-related data from almost all economic actors. The industry representative's organisation is a global company with a global footprint and therefore supports dialogue and global convergence on sustainability reporting standards. Convergence is an idealistic scenario, but strong ambitions will ensure that there is some progress and alignment. Internal discussions in the industry representative's organisation focus on the different reporting requirements and developments across the world. A global perspective is needed, because climate change risks have a global coverage and underwriting of (re)insurance risks happen on a global basis as well.

4. ESG also brings new opportunities

An industry representative commented that, in addition to a risk, protecting and restoring nature is also a huge opportunity. The industry representative's organisation is launching a biodiversity fund. Research indicates that, for every dollar invested, up to $30 in benefits can be generated. The Sustainable Markets Initiative and the COP-launched Natural Capital Investment Alliance are seeking to mainstream this as an investment theme. Organisations that are not yet investing in nature are encouraged to join this initiative.

4.1 PDBs could be part of the solution

An official explained that the Finance in Common movement gathers all public development banks (PDBs) and development finance institutions (DFIs) around the world. The PDBs gathered for the first time in 2020 in Paris and formed a global coalition. The objective is to promote cooperation among PDBs in order to tap the full potential of the PDB system to help align finance with SDG-compatible pathways. Policy could help to make sustainability the new norm in finance. The PDBs invest $2.5 trillion each year, which is 12-13% of annual global investment. The remainder comes from government budgets and the private sector. Building the bridge between PDBs' investments with government and the private sector, between domestic and international agendas, between global liquidity and macroeconomic solutions is the current position. PDBs can help to mobilise direct investment, public investment and private finance flows to build back better on a sustainable-development investment track.

An official concluded that governments must reinforce the social development mandate of the PDBs, and regulators and supervisors should provide incentives. This can be by fostering the market transparency of sustainable finance and related disclosure requirements and by elaborating frameworks on asset-based criteria, including a full mobilisation of the whole financial sector to flow capital towards those projects. The financial sector does not just align the supply. It also aligns the demand and builds projects in that mindset. Much work remains to be done on ESG.

Sustainability trends in asset-management and potential ESG confusion

1. ESG confusion is real. Addressing this issue might alleviate greenwashing concerns and engage the green transition

A regulator stated that there is confusion in the asset management industry around how to address environmental, social and governance (ESG) issues and even more confusion on the investors' side around the effective ESG reach of their investments. With its higher ambitions in ESG matters, there is more confusion in the EU than in other jurisdictions. Commitments are numerous but often rather vague and difficult to compare. However, there is no reason to be overly pessimistic. Much progress has been made and it is understandable that, at a time when new standards, datasets, analyses, and methodologies have to be elaborated, and new competencies have to be acquired by the whole financial ecosystem and end investors, there will be some confusion.

An industry representative commented that there are several areas of confusion. The context of profound mutation is important. Investor demand is growing more quickly than the collective capability to adapt the system, even if progress is fast in Europe in particular. The subsequent confusion creates a perception of greenwashing that must be tackled to protect trust in the system.

An industry representative stated that the ESG confusion must be addressed urgently. A climate emergency has been declared and it is not known if a tipping point has been reached from a climate science perspective. A positive tipping point has been reached from a policy perspective. A tipping point is the point after which there is no return and acceleration.

A regulator commented that it is courageous for the title of the panel to be 'ESG confusion'. ESG issues have been discussed for some time and nobody dared called it 'ESG confusion' previously. The constantly evolving framework can indeed be challenging. Investor demand is growing and evolving, while political decisions around regulatory requirements are still being made, with an ambitious agenda in mind. At this moment, there is not yet a comprehensive framework. The policy approach started with disclosure requirements without having framework for corporate reporting. We recognise that there needs to be some practical guidance provided to market participants.

An official stated that greenwashing is a reality. A lot of greenwashing is unintentional, but there are undoubtedly cases where it is less than entirely unintentional, and the full range of supervisory techniques should be used. The International Organization of Securities Commissions (IOSCO) issued a report last year that explained a number of ways in which it can happen and is happening. Because of the scale of ESG-focused investor mandates and enthusiasm in Europe, the scale of greenwashing rises proportionately.

An industry representative commented that sustainability can encourage people to invest and promote engagement with new parts of the market, particularly younger people. However, there is a mismatch between what clients state their appetite for investing is and how they are investing. The broader landscape and how different parts of the value chain interact must be considered. Asset managers sit in the middle of different competing forces, including distributors and other parts of the value chain, such as ESG ratings providers, benchmark providers and corporates. There is a need for common definitions and datapoints when marketing a product. When considering broader disclosures for clients, sustainability should be at the core, not considered as a separate exercise.

2. Several sources of ESG confusion exist and should be addressed for it to be alleviated

2.1 Good quality data on ESG is still lacking

An industry representative stated that there are usually three motivations to invest: investment in sustainable funds or mandates, alignment to values, and seeking sustainable outcomes. In all three cases, data analytics is still missing. Issuer-level data is critical. Limited or poor-quality data leads to confusion. Identifying which activities are aligned with green or transition enables investors, asset managers and the industry to build products based on this alignment at the issuer level. For corporate CEOs or investors investing in the future, the more clarity about the future and the more certainty of investments, the less risk reward and the less data is needed. Greenhouse Gas (GHG) Scope 3 emissions are critical, because, without Scope 3 it is possible to maximise at the micro level, but not at the macro level. Private assets and issuers are important. If only public issuers disclose, there will be more and more public issuers selling what they do not want to sit on their balance sheets to private issuers.

An industry representative stated that data and transparency is a major barrier to sustainable finance. Institutions need to be able to prove that their product does what it claims to. The Sustainable Financial Disclosure Regulation (SFDR) will be great, but it is crucial that the metrics do what they say they will. Upstream data is needed to ensure that data is valuable. It is important to mainstream the impact of sustainable investing and how it interacts with performance and risk. ESG is not an add-on but should instead be integral to the way sustainable investment is discussed with clients. ESG data issues are global. Investments are not just in companies but also in sovereigns, infrastructure, and real estate. A comprehensive system must be built to obtain data across all of these elements. If a very high bar is set for the data needed for ESG products in Europe, that data will never be obtained in emerging markets or for private assets. Building an interoperable system will be a huge challenge.

A public representative commented that how the market for sustainability and data is going to develop and work and what the role of the public sector is, are all concerns. Data could be seen as a public good where the marginal cost is zero. The private market for sustainability data, and what the public good should be, should be considered. Some private parties have taken advantage of this opportunity and are trying to collect the data and sell it for a high price. The European Single Access Point (ESAP) is a splendid opportunity. A joint effort from the financial sector would be wonderful.

An official said there were three elements in any approach to the current situation: i) supervisory action against greenwashing, ii) mandating the structuring data to help investors find good ESG investments and iii) prescribing standards for issuer information. Prescribing standards for issuer information will take time but is underway. Mandating the structuring of data before that is challenging. Europe has approached this through Articles 6, 8 and 9, taxonomies and work on benchmarks. Every single issue around sustainable finance is part of an inverted pyramid, with good quality issuer data at the base. In the meantime, there must be an acceptance that sustainable finance regulation will be in containment mode, relying on supervisory action, until there is good, audited or well assured data from issuers that everybody else can process, distribute, assimilate, and act on. In this regard he noted that the amendments to the Alternative Investment Fund Managers Derivative (AIFMD), Undertakings for the Collective Investment in Transferable Securities (UCITS) and MiFID to create process requirements has helped to put supervisors in a better position to undertake supervisory action.

An industry representative stated that it is not just the amount of data but the quality and comparability of the data from the issuers that ultimately drives investment decisions. However, asset managers cannot wait for perfect data but instead need to decide today where to invest. As such, asset managers need to not only consider the reports from the corporates or the ESAP that become available next year or the rating agencies that sell data, but, through active management, engage with the companies and assess the credibility of the data that they publish.

An industry representative commented that data is a struggle currently, but there is a need to start somewhere and be pragmatic. The next step will be to shift from a world of the actual picture to one of a capacity to forecast. There are different angles of methodology and different outputs, but this is also important when considering some indication of future commitment.

A regulator stated that the European Securities and Markets Authority (ESMA) does not want to standardise methodologies for ESG data and rating providers but is calling for some form of oversight of such activities, so that there is more transparency on the applied methodologies and robust arrangements for prevention of conflicts of interest. In this context, recently ESMA sent a call for evidence on the market's characteristics for ESG rating providers, which is complementary to what the European Commission is expected to do.

2.2 Challenges in reporting, labels and ratings

A regulator stated that the relevance of ESG ratings is difficult to assess.

An industry representative commented that there is confusion between disclosure and definition. Disclosure is the main way to facilitate transparency and avoid greenwashing. The establishment of categories 8 and 9 has led to a perception that there is some sort of qualification in terms of what is and is not ESG. There is a risk of giving the impression that Article 8 could be some sort of qualification. There is currently plenty of disclosure and there will be more. The SFDR does not cover the definition aspect, so those who choose an ESG product will have to assess what is or is not ESG-intensive. They will have information but not a complete grid of analysis. The objectives between full disclosure or some sort of minimum threshold for qualifying what is and is not ESG need to be clarified.

An industry representative stated that the lack of knowledge and confusion around how products are labelled and talked about is a major barrier. The industry often talks about impact, responsibility or sustainability and uses these terms interchangeably. Articles 6, 8 and 9 are a great improvement, but the average retail investor does not understand what they are.

A regulator added that interpretation is a challenge, as there are disclosures available but not labelling or name conventions. In the absence of detailed guidance, it could be said that there is unintentional greenwashing happening. Even with well-intended disclosures, if sustainability or ESG is in the name, it can be confusing for the end investor.

2.3 Consideration of the transition aspect

An industry representative noted that transition is key to achieving the net zero objectives for 2050. The investment industry is looking at ESG data depicting the companies as they are today, while buying the future. Shareholders invest to support and accompany a trajectory. In addition to data on carbon emissions, the commitment that the company has made to be on the right trajectory and whether that has been validated by the Science Based Targets Initiative (SBTi) can be considered. This is already done by about 20% of companies worldwide. The industry must reinforce its ability to engage in order to be at the very beginning of the story and to ask for clear key performance indicators (KPIs) from the invested company, with timelines and escalation processes.

A public representative stated that the transition plans are a crucial concept that have been introduced in the EU Green Bond Standard and will avoid greenwashing. It is possible to have green activities in a very brown company that do not achieve net zero by 2050. These companies should not be invested in, but there should be opportunity for investment in activities that are not sustainable but may become sustainable. Long-run views that are not green or brown are needed. It is the transformation of the companies and the economy that really matters.

An industry representative commented that there is a risk that an ESG solution focused on the transition and investing in solutions that are not aligned but intend to be aligned will not be considered as ESG, because it is not yet exposed to aligned activity. The notion of transition is therefore not really captured. There is a risk that, to shift the capital, this effort by the industry with the existing equipment, in terms of disclosure, is not being recognised.

An industry representative commented that, whether it is called green or light brown, a framework for transition finance is needed to help investors to channel capital to drive the transition.

2.4 Consistency worldwide is an issue

Comparing the ESG approach between EU countries, a regulator noted the difference in regulatory and supervisory approaches, contrary to what should be a Capital Markets Union (CMU), since ESMA does not currently have the tools to implement any real convergence in that field.

An industry representative commented that clients invest across asset classes, geographies and sectors, so global consistency is needed. Regions, companies, and countries can build their own additional frameworks on top of that global consistency framework, but global consistency is critical. There are also sector-specific aspects. Investors consider companies within the same sector and globally, so data must be relevant at the sector level.

A regulator noted the importance of global consistency. The expansion of the ESG market is a global challenge and thus global responses are needed. The EU has been advancing and will need to ensure as much consistency as possible. ESMA will remain committed to encourage compatible, interoperable, and consistent solutions.

An industry representative noted that small and medium-sized enterprises (SME) will not be able to report at the same level as a multinational corporate. The minimum baseline of core data metrics for everyone to report on should be a gold standard to move towards. The issue must be addressed holistically, because investments are not just in single jurisdictions or asset classes.

An official stated that, if there is not a clear distinction between developing local regimes and participating in the development of global standards, there is the threat of fragmentation. There is a difference between developing a local corporate reporting regime and participating in developing an effective global set of standards. Global standards will greatly help with the SFDR and the other obligations that Europeans who hold assets all around the world have to comply with.

2.5 Financial education is an area for progress

An industry representative stated that the lack of support from the industry, particularly from financial advisors, is a major barrier. Clients must be educated on these topics.

An industry representative stated that a consumer mindset tipping point is urgently needed in retail. The necessary level of consumer awareness could be achieved through investor education. Financial literacy must be grown for retail consumers and institutional investors, and sustainability literacy developed, and this must be done quickly. Initiatives aiming to develop this financial and sustainability literacy have already been developed. There will never be a final definition of ESG and there will also be disagreement on some places, for example nuclear and whether it is a sustainable or transition energy. Ultimately, the client will decide if an energy source is sustainable. The most important means of addressing ESG confusion quickly is to empower the consumer to make choices. The consumer must realise that they can make a difference for the planet if they allocate capital in line with their ethical and environmental objectives.

A regulator stated that investor confusion and a lack of investor education is another challenge. There might be a mismatch between the value proposition that a well-intentioned provider is offering and what the investor is seeking.

An official stated that ESG confusion can be addressed with education of investors and intermediaries. The financial competence framework issued by the European Commission, which includes a sustainable finance part, is particularly impressive in this regard, and there are a number of other initiatives, but these will not be enough to address the issue in the short term.

3. The regulatory perspective

A regulator noted that regulation on sustainable finance is unfinished and almost impossible to properly implement at this stage. With the introduction of Article 8 and Article 9 funds by the SFDR, there was a realisation that investors have been investing in green funds all along. The regulatory framework in Europe will be complete in another two or three years.

An industry representative stated that regulation has brought clarification. The package of regulation, as well as SFDR, has been a strong, significant, and positive gamechanger for the industry. It has established the notion of double materiality, which clarifies the previously vague ESG definition. It has also set the standard of disclosure and helps the industry to shape its offering through categories 6, 8 and 9. The evaluation grid written by the second Markets in Financial Instruments Directive (MiFID II) delegated act will provide additional information and is a major improvement. However, the grid is based on percentage of alignment on green activities according to the taxonomy and SFDR definition, and only depicts the current situation.

An industry representative stated that, from a retail investor perspective, SFDR taxonomy and the Corporate Sustainability Reporting Derivative (CSRD) are confusing but are an enormous opportunity. The upcoming MiFID sustainability preferences are of great importance. The reference in the draft guidelines to needing to translate these very technical elements of taxonomy, sustainable investments, and principal adverse impacts (PAIs) into language that an investor can understand is strongly appreciated.

An industry representative commented that the industry does a lot but also acknowledged that only the public sector can truly deliver financial education in a holistic and neutral way. The CMU action plan point number 7 is very much welcomed. That states that there will be a greater role for the European Commission to coordinate this at member state level. The regulatory community is very conscious of the challenges that the industry is facing while it tries to navigate through the evolving framework. Public authorities are fully mobilised to support the implementation of the framework. There is a desire to support the ambitious European approach but also a need to be pragmatic. The framework will not start to function overnight. There are inconsistencies, challenges and a need for clarification.

A regulator noted that sustainability is now an integral part of ESMA's mandate and is very high on the agenda of all national authorities across the EU. Preserving trust in the system is a collective challenge. ESMA aims to provide more guidance, considering the applicable rulebook, and working with the national competent authorities (NCAs) to develop a common view of the expectations, including regarding transparency, and addressing fragmentation. Building capacity is also a big task looking ahead. The framework is evolving, and the ambition level is high, but the retail investor is not sustainability literate yet. This is also true for regulators, providers, and advisors, so a collective effort is needed. Market developments are evolving fast, and the regulatory community wants to ensure it continues to monitor trends and incorporates relevant risks.

A public representative commented that regulation on this issue is a work in progress. Financial institutions are asked to share ideas for improvement with legislators. The framework is being built but pieces of the puzzle are missing. The framework needs to be adjusted because the legislators learn along the way. Financial institutions are asked to combine their efforts and come to the supervisors and the legislators. Sometimes different players in the financial sector all work on the same problems individually.

An official commented that it was also important to have a clear view on how to reconcile the European approach to corporate reporting with a global approach in a way which both allows Europe to adopt its own approach and encourages information to be developed across the world on the ESG characteristics of assets which is capable of being analysed comparatively. Achieving that will be a substantial prize and Europe should think carefully about how it can be a positive agent in promoting good global standards as well as pursuing its own goals.

Banking sustainability risks: prudential implications

1. At the heart of the current 'learning exercise' is a key question for the banking sector: how do climate risks impact prudential frameworks?

A Central Bank official explained that sustainability and environmental risks remain relevant for the financial system, as is evident from the reports of the Intergovernmental Panel on Climate Change (IPCC). In 2015, Mark Carney's speech on the relevance of climate risks for the banking sector was the starting shot for enormous developments by banks, supervisors, regulators, and market participants related to sustainability and climate. As an example, both the European Central Bank (ECB) and the Bank of England now are now conducting stress test for climate risks.

1.1 This 'learning exercise' is focused on assessing banks' progress on incorporating sustainability risks into frameworks and practices.

A Central Bank official suggested that 'learning exercise' is a key phrase in the debate. There is a question about whether the industry should be moving towards something more specific than a 'learning exercise'. The other key part of the debate is data. In this field, data is not easily found or analysed. The data is granular and difficult to understand. The Single Supervisory Mechanism (SSM) wants banks to look at the risks posed by climate change. The SSM's new test was launched last week. In September 2021 the ECB published its economy wide climate stress test and subsequently reported on how banks are adjusting their models and managing climate risk. There will also be a 2022 review on the incorporation of climate and environmental risks into banks' practices. The SSM's new test will be 'gentle' for banks because it looks at qualitative issues and does not include capital requirements. The industry as a whole must think about whether the banking industry should remain in a 'learning exercises' or whether the public authorities can push banks further here. While the pandemic and other global issues have created more awareness of sustainability risks, the banking industry needs to address them more proactively.

1.2 The existence of such 'learning exercises' is due to the many new challenges posed by sustainability risks

An industry representative noted that the banking industry faces a challenge posed by the fact that climate related risks are long term while banks' investment horizon and balance sheet maturity is much more short term. It is difficult to adjust asset structure given the high level of uncertainty about technology, climate, and policy. Additionally, smaller subsidiaries of large financial groups are limited by local resources and capabilities. To a certain extent, these entities must rely on their parent's environmental, social and governance (ESG) initiatives. As an example, if the parent selects the long term stress scenario and the group entities use the scenario, this can mean that local specificities are not properly captured. For groups headquartered outside the EU, there is also a challenge on the timing and deadline. Most banks prioritise short term actions with higher impacts, such as risk identification and governance. There is also a problem around data. It is difficult to assess borrowers or counterparties in terms of performance on climate related risk management when there is no readily available, comprehensive and comparative data.

1.3 Defining and accessing appropriate and quality data is an evolutionary process

A Central Bank official highlighted the importance of starting the ESG journey before 'perfect data' is available. The process of developing good quality data was always likely to be slow. Another industry representative agreed, adding that it is important to avoid greenwashing. If a bank is financing a business which is buying more energy efficient machines, it is essential to understand the carbon footprint of these machines and determine whether the purchase could increase carbon emissions. Indeed, bankers are not climate specialists. Banks need people with the right skills.

1.4 Despite awareness in the banking sector, most notably in the EU, the 'learning exercise' remains partial and uneven, and only the very first steps have been taken

A regulator agreed that there is a sense of urgency around sustainability. In May 2021, the European Banking Authority (EBA) published an assessment of the alignment of banks to the taxonomy and some sensitivity analysis. This report had four key conclusions. First, banks are clearly extremely committed. Banks volunteered to participate in the EBA's exercise. There were 29 banks from 10 countries, which is over 50% of banking assets. Secondly, there is a scarcity of data. Thirdly, while there is meaningful information for portfolios such as large corporates, the data is heterogeneous. Banks have developed their own datasets in their own ways over time. Finally, there is a need to steer expectations. The transition risk in some portfolios can be extremely significant. This must be organised collectively in an orderly manner. These exercises will help to steer banks in the right direction and manage any side effects.

Noting that his comments would focus on S&P's interaction with banks in the rating process, an industry speaker suggested there were two key elements to managing climate risk for banks. While there has been significant progress, this is only the beginning of a long journey. The ECB also recently made clear that, while there has been progress, it has been too little and too slow. The industry accepted the goal to be net zero by 2050, but there is a lack of speed. There is a lack of focus on the intermediary steps to reach this goal. On a positive note, banks are increasingly aware of the correlation between environmental risk and financial risk. The European banks are advanced in this area, though US banks are catching up quickly. This trend is also evident in Asian countries such as Hong Kong or Korea. Sustainability risk is a key priority for many CEOs and board members. The sustainability expertise of board members has been improving steadily. Remuneration is increasingly being indexed or partly related to sustainability achievement, which creates a strong incentive to make progress.

The industry speaker highlighted the fact that exclusion policies have become very common in the industry. The integration of sustainability risk in risk management and strategy is not uniform across banks' business lines. The large banks have made the most progress, because they started earlier, and they have more expertise. They have been able to attract talent because they have the financial means to do so. This will be a challenge for smaller banks. In terms of the debate between exclusion and engagement, there has been less engagement. Exclusion is easier, but it is probably not the only needed strategy as it can result in sustainability risk simply moving to another lender. There are areas for improvement, however. For example, very little attention has been given to issues such as biodiversity or water scarcity and pollution. When banks make commitments, they tend to be relatively general. There is a lack of key performance indicators (KPIs) or key risk indicators (KRIs). Scenario analyses and stress testing are also relatively rare. They are done when regulators ask for them, but the banks themselves struggle to do them. The regulators can play a key role in guiding banks. It is interesting to hear that banks are keen to conduct stress testing. There is also a lack of high level assumptions. The work done by the regulators and the Network for Greening the Financial System (NGFS) can be useful for banks because it marks the beginning of consistency on what these high level assumptions might be.

1.5 Sustainability risk has still not been incorporated into analyses of banks' creditworthiness

A Central Bank official queried whether sustainability risks affect firms' credit ratings. If there are true prudential risks, it would be interesting to understand how these might affect ratings in the financial sector and the non financial sector. An industry speaker suggested that this is a huge challenge for all players in the financial sector, including ratings agencies. Ratings agencies have also had to build expertise. S&P created a sustainable finance team, which has 60 analysts dedicated to ESG. S&P has published ESG criteria, and this has been embedded fully in its criteria. Until now, there has been a greater impact on corporates. For instance, last year S&P downgraded a number of major oil companies due to changes in public policy and investor pressure. The impact of climate risk on banks has been limited so far because banks' business models are diverse and because these risks are long term. For banks, it is difficult to predict how and when the risks will materialise.

1.6 There will be a competitive advantage for 'first mover' institutions that integrate sustainability risks into their business models, governance, and credit risk management

A Central Bank official explained that the UK supervisors are not in a 'learning exercise' on sustainability risks. Policies on climate risk came into force on 1 January 2022 and firms are expected to meet them. The firms that do well on this will gain competitive advantage because the regulators will judge other firms with reference to these firms' practices. A Central Bank official queried whether UK regulators would go into their toolkit and use 'tough' measures. The Central Bank official confirmed this, suggesting that sustainability risk is like any other aspect of supervision. If firms do nothing to address supervisory expectations, there will be consequences. Sustainability risk is no more complex than some of regulators' other tasks, although the capital element is certainly tricky.

1.7 Additionally, there is a need to incorporate stress test results in capital requirements

The scenario exercise or stress test being run across the UK system currently is indeed more of a 'learning exercise', however. The UK authorities have been clear that they will not be setting capital requirements as a result of this exercise, which is relevant to the capital debate.

2. Policy initiatives required to address sustainability risk in the banking sector globally

2.1 Policy actions must preserve banks' soundness and define banks' role in the transition

A Central Bank official queried whether the banking sector has the right mix of government policies and private sector measures, noting that it might be possible for banks to compensate if governments are slow on carbon pricing, the responsibility cannot simply be transferred to the banks. A regulator agreed that the policy discussion should be framed around the distribution of responsibilities. The banking sector has a role to play in facilitating the huge relocation of resources required by an orderly transition.

2.2 Defining a sustainability-related risk profile should be left to the management of financial firms; regulators should focus on banks' risk assessment and management practices

A member of the audience suggested that there could be remuneration for good sustainability performance and queried whether banks should be outspoken on sacrificing returns in order to achieve sustainability objectives. A Central Bank official emphasised the importance of regulators not overstepping their boundaries. There are legitimately different choices for private institutions to make about whether to sacrifice short term earnings for other gains. Regulators should not police that. Regulators should expect firms to 'grip' these issues, however. A regulator suggested that remuneration for good sustainability performance would change the balance of risk and return. Banks could have lower returns if they are noticing and properly addressing the risks related to climate developments.

2.3 The specificities of sustainability risk require supervisors to force banks to adapt their long-term lending, investment, and risk management policies using Pillar 2 measures and stress testing

A regulator explained that physical and transition risk will affect the safety and soundness of financial institutions and could eventually have implications for financial stability more generally. This means there is a clear case for adjusting the regulatory framework, without stretching the mandate of regulation, to ensure that banks have a climate related risk management framework which is consistent with their risk appetite, risk profile and operating environment. Due to the long-time horizons and the uncertainty around the materialisation of climate related risks, standard instruments, particularly Pillar 1 type instruments, are not suitable for addressing these risks. The Pillar 2 framework under the Basel principles allows for capital and non capital instruments; this could be effective in ensuring banks assess and manage climate related financial risks. Certainly, much of what is done on Pillar 2 could be based on a climate stress test. Supervisors could use these tools to increase banks' awareness of deficiencies in the way they manage climate related financial risks, which could be used to produce management actions for banks. If it is necessary to increase loss absorption capacity, it is possible to introduce capital add ons under Pillar 2. The flexibility of Pillar 2 will be helpful in properly addressing these risks, but this could generate level playing field issues. There should be general guidance on the use of Pillar 2 to address climate related financial risks, which could develop the options being considered by the Basel Committee.

Another regulator noted that this is one of the EBA's priorities. The EBA wants to embed these elements in its regulatory risk analysis and risk assessment reports. It is imperative to ensure that regulators have the right information, however. The EBA is also working on risk management. It has clarified its guidelines on including sustainability risks and risk drivers in risk appetites, risk management practices, remediation schemes and stress testing approaches. In terms of international coordination, the European framework is very similar to what was discussed and developed in Basel. The EBA is also working on the prudential treatment and will publish a discussion paper in 2022 with a view to producing a more advanced report in 2023, as requested by the Commission. The EBA is working with the Basel Committee on this, but there is a need for data. Banks and supervisors will need to put considerable effort into this.

2.4 The backbone of sustainability risk management is Pillar 3, which will involve disclosures

A Central Bank official noted that the Basel Committee is working hard on producing global standards. A regulator described how the EBA is working on disclosure, which is Pillar 3, risk management, which may come into Pillar 2, and Pillar 1. Progress must be made on disclosure, which is the backbone of this issue. The EBA has published a package with a number of proposals to help banks to structure information for market participants. The green asset ratio (GAR) is one useful measure, but it is important not to have one single indicator but a combination of things which can help people understand companies' balance sheets.

2.5 Pillar 1 challenges: data, a lack of analytical tools and the long-term nature of sustainability risk

A Central Bank official noted that the EBA's consultation on its Pillar 1 proposals is yet to start. A regulator stated that the EBA will issue something on this in the first half of 2022, adding that not much more could be currently said about the subject. The Commission, however, has high hopes that the consultation will set the stage somewhat more precisely.

A Central Bank official outlined the Bank of England's clear philosophy that it is not a good idea to use the bank capital framework to drive the transition. It will be both bad for the bank capital framework and ineffective. The evidence on the effect of the SME discount factor, for example, strongly supports this. The framework should simply capture the risks from climate change. It is hard to determine whether the risks are in fact captured due to capability gaps and framework gaps. These capability gaps include data, a lack of channels for macro effects to move into bank capital and a lack of analytical tools. Secondly, there are also framework gaps. Much of the Pillar 1 framework happens on a one year look forward basis, which immediately demonstrates why a large amount of climate risk cannot be captured. The Central Bank official asked the other panellists whether the capital requirements for the banking system would be increased if the framework did not capture these risks properly. This is the 'elephant in the room'. Alternatively, and very unfashionably, climate risk might be more of a pay as you go drag on earnings.

2.6 The inclusion of a green supporting factor within the prudential framework raises difficulties, because a green asset is not necessarily a safe asset; additionally, bank solvency regulation is not the only policy tool to addressing transition challenges

A member of the audience considered it interesting that the supervisor and regulator on the panel supported a green supporting or brown penalising factor. In the political arena, this is a difficult issue. A regulator emphasised the importance of being evidence based. Something that is green may also become a high risk over time. There could be incentives down the road, but it is difficult to do something that would distort the pricing of the risk ex ante. Another regulator explained that the green supporting factor would break the link between risk and capital requirements, which can hardly be positive in terms of financial stability. Conceptually speaking, it may well be counterproductive. The first regulator stated that, when stakeholders realise the potential transition risk impact on banks' balance sheets and the economy at large, they might consider incentives of this kind. However, this could easily make the transition more disorderly than orderly.

A Central Bank official asked the panellists to comment on whether there is currently the right balance between government policies and what is expected from banks and whether things are progressing at the right pace. A Central Bank official suggested that this is an awkward topic because it sometimes feels like regulators are trying to fill gaps that other players will eventually need to address. Another Central Bank official agreed on the need to move on a similar path on sustainability risk issues. What central banks can do also depends on the choices of governments.

3. Seeking consistency and regional specificity can smooth corporate financing in the transition

An industry speaker stated that the regulatory and supervisory framework in Europe is more advanced than in any other region. In Japan, the Japanese regulator is designing a new disclosure framework and supervisory framework. The major Japanese banks have already started carbon neutrality initiatives and are aligning with the Paris Agreement by integrating climate risk into their risk management and governance frameworks. They are also making disclosures in accordance with the Task Force on Climate related Financial Disclosures (TCFD) and engaging with clients on the green transformation. From the international bank perspective, the pathway to carbon neutrality differs by region and country, but the initiatives for carbon neutrality by global corporates should be done on a global basis because capital flows globally. There is indeed a lack of consistency. On ESG ratings, for example, many rating agencies are providing ESG ratings to corporates, but the scores given by each ratings agency are completely different. Given these factors, there is a need for international harmonisation of regulation. However, it is important to balance international standards with local standards. In that respect, the Basel Capital Accord is a useful example of an international common standard which also has national discretion.

Additionally, it is essential to avoid creating funding risk in the transition. In order for corporates to transform their businesses, they will need an unprecedented amount of investment in renewable energy. However, they also have to maintain credit quality; they have to continue to access funding. The capital should flow to green, but there is a risk that corporates will not be able to raise funds appropriately due to this short term ism. Ensuring that liquidity is appropriately provided to enable corporates to transform their businesses should be monitored locally as well as globally.

Insurance sustainability risks: prudential frameworks needed at the global and EU levels

1. Global sustainability risk impact on the insurance sector

1.1 The increase in frequency and severity of national hazards and the potential economic and societal may impact asset and insurance companies' liabilities values: the resulting challenge is the availability and the affordability of coverage for consumers

An official stated that the United States is exposed to many climate, catastrophic and sustainability risks which do not recognise borders. Sustainability risk is like other systemic risks insurance faces as an industry, and mostly comes down to physical risks such as the increasing frequency and severity of property loss from national hazards and transition risks, or how economic and societal shifts may impact asset values and the cost of doing business. The most prominent challenge that is faced is increasing property loss, degrading the affordability and the availability of insurance coverage. These extreme loss events often result in immediate market disruptions that extend for several years, and repeat losses only exacerbate this effect.

An official added that it is still not widely known how transition risks will impact investment pricing in the long term, but there appears to be more interest from investors for environmental, social, and corporate governance (ESG) disclosure. There is also potential for insurers to encounter liability issues due to climate-related impacts. These factors could impact the solvency position of insurers, particularly if they are heavily concentrated in certain markets or have a niche in particular industries. A significant challenge for state regulators is balancing the solvency risk to insurers with the availability and the affordability of coverage for consumers. There are also opportunities for insurers to take a proactive role in risk management, as well as offer products and services that support mitigation and adaption, including using innovative technologies.

1.2 Insurance companies and states have to partner to make sustainability risks insurable

The Chair stated that the uncertainty of what is or is not green and the uncertainty in putting the taxonomy into practice are challenges that insurance companies are facing. The sustainability risk case is multifaceted. The measurement of sustainability risk also includes disciplines that are not usual for finance. Assets and liabilities are fully exposed to sustainability risk, but even more because of the role of insurance in driving toward the path of sustainability by using its own professional activity, the release of protections. Special focus should be given to the regulation, as it should not limit the ability of insurers to provide protection.

A market expert observed that the financial sector is essential to the financing of the rising climate risk. Europe has €10 trillion of assets in insurance and is a very important investor. The risks insured by the insurance sector are diverse, both in nature and frequency. The main risk is drought. Marine submersion is a very long-term threat, but where the state and the public authorities are first concerned. The most important sector where insurance has historically intervened is natural catastrophes like floods, hurricanes, and typhoons when a company is multinational. Insurance has a very important role in evaluating and pricing the risk. The knowhow of insurers regarding risk pricing is a tool that authorities should use because it is a way to gradually face the challenges of the emerging and growing risks.

A market expert added that insurance is an educational tool and helps to create a green client. If Europe wants to have a green economy in the future, then corporates and households need to take the sustainability risk into account and understand the positives of the propositions of the insurance companies. Insurance is a commercial activity. Insurers try to attract potential clients by interesting devices, but at the same time they educate the client and help them to understand the preventative need. However, care is needed regarding the balance between public intervention and the insurers.

A market expert explained that the contribution of insurers is also necessary, as they have the possibility through their networks to evaluate the risks on a very local basis. Most of those risks have local or regional dimensions; different locations on earth do not suffer from drought at the same rate, so it is important to take that into account when considering a risk. However, although a sound geological expertise is required, when such an expertise eventually increases the price of the premium then the potential policyholder could refuse to pay it, meaning the insurance company leaves those kinds of markets.

A market expert stated that the yearly cost of climate change for Europe is estimated at €180 billion per year. Studies from the France Assureurs evaluate the enrichment effect to half of the cost, meaning that the client should only accept paying half of the risk. The rest is paid by the taxpayer through various devices and state intervention. Conversely, if only the state intervenes and takes over these risks then it disincentivises clients paying for a premium and increases a protection gap. Insurance has already found a method to mix the intervention of state and insurance through reinsurance approaches. It is a system that France established in 1984, where the insurance costs and risks are partially financed through a tax on the premiums. In the sustainability risk context Europe must systematically manage to have an effective availability of insurance, and to preserve the affordability of insurance.

An industry representative noted that Covéa recently published a study that evaluates the impacts of climate change on natural catastrophe perils and claims based on the worst-case scenario such as the Representative Concentration Pathway (RCP) 8.5 until 2050. The study shows that underwriting based on informed granular elements can accompany new trends. We see no impact of climate change on storms in France for instance, this is an important result. The impacts are to be found on flood and drought. Non-life insurers are best placed to monitor the physical risks implied by climate change and Covéa has developed sophisticated and granular modelling capacities to inform on the actual perils' impacts on our liability exposures linked to our very large policyholder base. Hence also peril intensity will be more severe on drought than flood at global peril level in France, it will translate the other way on our portfolio due the precise location of our exposures. Insurers also need to be mindful of possible second-round effects. Discounting premiums cannot compensate the cost of preventive measures. Preventive measures can be incredibly costly, so discounts can send a signal but will not make up for the cost of prevention measures. Insurers need to be mindful of not becoming socially unfair. Mutualisation needs to be maintained, and in cases where the risk is too intense, or hazard disappears then insurers might have to resort to private/public partnerships.

An industry representative observed that adaptation is a manageable challenge. Non life insurers are well placed for that with the prevention measures. Insurers can help prevent damage and help limit the damage once it has occurred. The less manageable aspect is the mitigation of climate change, which is deemed beyond reach of the connection with real risk drivers. Underwriting must remain risk based, and there might be a risk in reducing the availability of insurance covers for traditional activities.

2. Sustainability risk is a key risk that has been monitored for a while in the EU, and many areas for further investigation are identified

The Chair noted that the challenges outlined in North America are also very common in Europe. The Chair asked a regulator for his assessment of the extent and the way in which EU insurers manage sustainability risk, based on the monitoring activity of EIOPA.

A regulator stated that sustainability risk is a key risk that has been monitored for a while. EIOPA has already included ESG risk in its 2021 risk dashboard because it is becoming more and more relevant. The 2018 stress test already included natural catastrophe scenarios. The outcome of that stress test was that the sector can manage the risk, and there was a strategy to absorb losses as envisaged in the scenario that EIOPA put forward.

A regulator added that EIOPA has also performed some vulnerability analyses, detecting the holding of equity and corporate bonds that can be affected by climate risk such as fossil fuel, which is another industry that is sensitive to this risk. The scenario that was being tested is still manageable. Losses may be significant but there is diversification of the portfolio of investment in the insurance sector. The tendency to increase the investment in more sustainable topical assets can counterbalance the negative impact of this kind of scenario. The risk must be monitored continuously, and this year will see further investigation. Data analysis will take place going forward. EIOPA will detect more in the case of enhancing the frequency and severity of natural catastrophes, and what the impact on the underwriting risk can be.

3. Sustainability risks have systemic relevance, and analytical tools need to be developed to translate these issues into financial risks

The Chair noted that Europe is at the beginning of a long journey and asked an official to give her assessment on the systemic relevance of sustainability risk.

An official stated that in 2021 the IAIS published an analysis that assesses the consequences of climate change for investment exposures of the insurance sector under the three NGFS-based scenarios: an orderly transition, a disorderly transition, and a too little, too late scenario. The IAIS collected data from more than 30 members and concluded that 35% of investments could be exposed to climate risk. In the orderly transition scenario, the risks are manageable. In the disorderly scenario the insurance sector loses more than 14% of its solvency ratio, and in the too little, too late scenario it can lose up to 50%, but even in that scenario the insurance sector in aggregate remains financially sound, given the good pre-stress solvency levels. The IAIS is not complacent. Much of the analytical toolkit needs to be further developed to translate these issues into financial risks. Also, the 2021 analysis was only concentrated on the asset side. There are also risks on the liability side, which will be further examined through the IAIS' annual Global Monitoring Exercise in 2022.

4. Double materiality and risk assessment challenges

4.1 Addressing incurred risk and the risk that is generated by companies points to data and financial metrics challenges, and measuring sustainability risk of sovereigns is challenging

An industry representative stated that investor's view climate risk from two perspectives: the incurred risk and the risk that is generated. The concept of double materiality is relevant and represents the compass insurers should adopt. The first main challenge is data availability and standardisation. The second is how to integrate it with pricing and the financial metrics, because companies have a fiduciary duty towards their policyholders and need to generate sufficient return for shareholders and life clients. It is important to ensure the ESG angle is fully integrated with the traditional financial metrics. More than 85% of insurers' portfolios are comprised of fixed income securities bonds while ESG scores are at issuer level, and there is relatively little research on the difference between ESG metrics in valuing bonds vs equities.

4.2 The way to combine the time horizons of insurers' assets and liabilities and sustainability risk is not yet defined, and more is to be done in the S&G part of the ESG

An industry representative noted that the second question pertained on how to deal with sovereign bond exposure. In continental Europe around 50% of insurer assets are invested into government bonds. Regarding carbon footprint, as an example, there is still no consensus on how to measure the risk if looking at consumption based metrics, production based metrics, or if it is weighed on gross domestic product (GDP) or population. When looking at climate risk investors need to make projections over 20 or 30 years. However, in 20 or 30 years most of the bonds in the portfolio will have already matured.

An industry representative added that the S&G part of the ESG equation is also important, where there is even more to be done in terms of standardisation data and metrics. Engagement with issuers is critical. Certain topics like diversity and inclusion are very relevant when looking at companies in which investors invest.

An industry representative noted that the challenge regarding the release of protection in property and casualty (P&C) insurance is also applicable to risk management and supervision. The main challenge is to remain pragmatic, operational, and mindful of second-round effects. Companies cannot factor all the world's issues in an insurance underwriting process or business model, as the number of drivers and interactions are infinite.

An industry representative stated that climate is a very complex thing to model, particularly when associated with additional elements such as technology, science, geopolitics, and socioeconomic inputs. Insurers need to be prepared for the unforeseen and should refrain from single, dogmatic focuses and approaches. Insurers need to be reactive, adaptable, and resilient, and make use of their adequate management actions. Insurers are well placed to foster resilience and are best placed to assess climate risks, hazards, perils and trends when being a P&C insurer.

5. The journey toward embedding sustainability risk specificities in insurance companies is complex and lengthy

An industry representative stated that the sustainability risk journey posed three main challenges: a conceptual challenge, an execution challenge, and a leadership challenge. For the conceptual challenge the question was how to map and measure the risk in words that can be understood by stakeholders. Three dimensions were chosen: insurance activity, investment activity and internal operations. Three different forms were chosen: physical risk, transition risk, and responsibility risk.

An industry representative added that the conceptual challenge was in place because the risk had to be measured. Different metrics were chosen: the Solvency II balance sheet, income statements, and the valuation of the investment portfolio. The main impact is through the assets of the investment portfolio. CNP then made the decision to focus on financial risk related to its investment activity, which was the execution challenge.

An industry representative explained that the first part of the execution challenge was to choose the methodology to expose the facts and the reasoning. CNP chose the Task Force on Climate Related Financial Disclosures (TCFD) reporting, which is used by more than 3,000 companies over the world in more than 90 countries. The TCFD is a very good framework and worked extremely well. CNP also had a technical challenge, which was mostly a lack of data disclosed by companies in which it invested regarding climate-related exposures, a lack of harmonisation and a lack of audit.

An industry representative noted that the third challenge was the leadership challenge. It was important to look at the topic through many different eyes. CNP set up a committee comprising risks, investments, actuary, corporate social responsibility (CSR) and legal. Once started, continuous improvement is needed on the methodology, quality of data, perimeter, and key performance indicators (KPIs). CNP also decided to include biodiversity in its 2022 perimeter, as if it is not examined then some aspects are missing. When that happens the company's reputational risk is at stake, because if they are inconsistent their reputation can be destroyed.

6. Expected improvements in the prudential framework in the EU and globally

The Chair observed that disclosing specific risks is potentially even as complex as managing them, and asked industry representatives what they want to see in an ideally improved prudential framework.

6.1 Fully leveraging appropriate stress testing requires further refining related methodologies

An industry representative stated that stress testing is very important. It is essential to create a standardisation, but also to increase the awareness of both industry players and regulators. What is important is also to be mindful of potential and unintended consequences. When looking at climate, insurers should avoid cutting-off certain economic activities in sectors or countries embracing a credible energy transition. It is also important to avoid incentivizing 'brown spinning', where companies divest from certain brown activities towards investors with weak or absent ESG policies, but those activities are still there and generate negative impact on climate or society. Engagement with issuers is key in this respect. It is also important to look forward rather than backward, and to reward those who are best in class.

The Chair noted that the reward question could be posed to EIOPA.

6.2 Existing risk sensitive EU framework is mostly adequate

An industry representative noted that the framework is a good framework to welcome any new risk. Solvency II and the Insurance Capital Standards (ICS) are also very sensible. It can embed risk on the asset side and on the liability side. All the natural catastrophe perils have been identified. Within this framework, if focus remains on risks being risk based then insurers have a good chance to factor these issues.

6.3 The frameworks should encourage the diversity of business models, which is an essential tool for reducing systemic risk

An industry representative added that it is important to allow and foster the diversity of models, because they can be very sensitive to parameters and to their own intrinsic methodologies. It is important for the regulation to foster the diversity of models so that they do not have systemic failure in them. The diversity of the business models is a very good idea to enhance resilience. It is important not to impose a one-size-fits-all standard, as well as not to mix communication and risk awareness exercises with operational processes like the own risk and solvency assessment (ORSA) that insurers need to inform their business and governance decisions.

The Chair agreed that cooperation between supervisors is key and asked a regulator to outline what EIOPA is going to do, particularly regarding the request of the commission on the review of Solvency II.

A regulator noted that it is too early to see the outcome. EIOPA will work on the risk differential to understand if there is a need for a dedicated prudential treatment on the asset side, but also on the underwriting side, as that is part of the difference between the insurance sector and the others. The approach will be risk based. If the industry is not on the same page as EIOPA it is at least on an equivalent page. The difference between ORSA and the stress test is clear, and EIOPA welcomes the requirement to consider it in the ORSA.

6.4 A cautious, consistent, and holistic implementation of the Corporate Sustainability Reporting Directive will be an essential contribution to risk assessment

An industry representative stated that CNP supports the Corporate Sustainability Reporting Directive (CSRD) and the European Financial Reporting Advisory Group (EFRAG) standards project. The main features of a framework should be harmonisation of the definition of the KPIs, mandatory disclosure and mandatory external audit. Beyond those technical considerations it is important not to go too fast. Climate change is an area where Europe is in a hurry, but it is useful to take time to involve stakeholders and the actors of the industry.

An industry representative added that an integrated approach is preferred. It is better to have fewer KPIs covering all the scopes of climate, social, and biodiversity than a lot of KPIs dedicated to climate. If climate risk is managed without having the social impact of going too fast in the decarbonated investment portfolio in mind, then it could put a lot of people out of their jobs. It is better to think in a coherent way rather than going very deep in one direction because that way was calculated as the most important.

6.5 The NAIC has many initiatives underway, notably on risk disclosures, addressing additional perils within its risk-based capital framework, climate risk stress tests and scenario analysis

The Chair observed that this is the approach of regulators and asked an official to outline the top priorities for improving the framework in the US, if necessary.

An official stated that one of the NAIC's regulatory priorities in 2022 is the work of the Climate Resiliency Task Force (CRTF). The task force will focus on five topics, two of which are solvency and climate risk disclosure. Regarding solvency, the task force is looking at enhancements to its current existing regulatory solvency tools, as well as including a risk framework for addressing additional perils within its risk-based capital framework. The NAIC already has hurricane risk and earthquake risk captured in these capital models but is looking to add a risk of wildfire.

An official added that the NAIC is looking for modifications to its ORSA process, its financial analysis handbooks and its financial condition examiners handbooks. The NAIC is also looking to develop climate risk stress tests and scenario analysis of climate risk, including examining scenarios, assumptions, and parameters for the stress testing exercise. The NAIC is progressing on work to determine a methodology for quantifying insurers' exposure to climate-related investments.

An official explained that the Insurance Climate Risk Disclosure Survey has been collected by state insurance regulators for over a decade. It currently captures about 80% of the market by direct premiums in the US. The disclosure survey contains eight questions covering topics that include climate risk governance, management, modelling and analytics, stakeholder engagements and greenhouse gas management. Last year the NAIC undertook a review of this disclosure survey and in mid February it released a revised version of the survey which is more aligned with the TCFD framework.

6.6 Sustainability risk is material and should be disclosed through the TCFD framework, though IAIS is closely watching what the International Sustainability Standard Board (ISSB) is going to be doing

The Chair stated that an issue where both the industry and the supervisor have the same objective should be exploited, as it does not happen that frequently. The Chair asked an official for her thoughts on the global cooperation of a supervisor and the top priority of IAIS in the framework.

An official stated that, as highlighted in the IAIS' recent application paper, climate risk needs to be included in the ORSA if it is a material risk. The IAIS Insurance Core Principles (ICPs) also require that material risks should be disclosed and the IAIS has stated that that should be done through the TCFD framework because it is the only global framework available. The IAIS is closely monitoring the ISSB's development of standards and has publicly stated its support for this work, starting first with climate and then potentially broadening them to other priorities. This is going to be a global standard for disclosure across the corporate sector.

The IAIS is also working on three more workstreams on climate risk. The first is scenario analysis. The IAIS has just completed a stock take of the practices of its membership, with a view of potentially incorporating it into an application paper or other guidance in terms of possible best practice. The IAIS is also reviewing its standards (ICPs) whether there are any gaps. Lastly, it is looking at whether it can incorporate data collection on climate risk more systematically in its financial stability analysis. On other sustainability topics, the area that the IAIS is currently exploring is diversity, equity, and inclusion, and how that is reflected in strengthening decision making and governance by reducing groupthink in insurers.

The Chair summarised that there is a lot of work to do, but it is better to work together to mitigate the sustainability risk and make the insurance sector play its role in this context.

Sessions Summaries

V

CMU IMPLEMENTATION

CMU: state of play and way forward

1. Update on the implementation of CMU

1.1 Progress made and proposals underway

Panellists agreed that the Capital Markets Union (CMU) project is progressing. A policy-maker noted that the first two action plans published in 2015 and 2017 have been implemented and the focus is now on the implementation of the third action plan of 2020, which encompasses 14 additional measures. In November 2021, a first package of initiatives was proposed for implementing this action plan with four important initiatives currently under discussion.

First, the European Single Access Point (ESAP) project aims to provide investors with all necessary information at one point at no cost, making investing easier and cheaper. Second, adjustments to the MiFID II / MiFIR[1] frameworks are under discussion, including the proposed implementation of a consolidated tape, which will introduce post-trade transparency. Pre-trade transparency can be considered at a later stage. Third, the European Long-Term Investment Fund (ELTIF) fund framework will be modernised. Uptake has been very limited so far and it is hoped that changes to the regulation will make it more attractive and will allow the collection of money that can contribute to long-term sustainability objectives. Fourth, the rules of the Alternative Investment Fund Managers Directive (AIFMD) will also be enhanced to ensure its continued success. Other initiatives in the pipeline include a framework on open finance to facilitate the reuse of data by financial institutions and the circulation of investor and client information, a review of the Central Securities Depositories Regulation (CSDR), the publication of a retail investment strategy and a reconsideration of insolvency rules and withholding tax. This latter area is very challenging and has been discussed for many years, but the time is now right to address it with some targeted adjustments.

Some additional comments were made by the panellists on the ESAP proposal. An official stated that the ESAP project will address the lack of adequate investor information and the fragmentation of accounting standards used by small and medium-sized enterprises (SMEs) which results in differing presentations of financial accounts across EU countries. The International Financial Reporting Standards (IFRS) that exist for public companies are not used for non-listed companies, which is a major obstacle for auditors and investors in a cross-border context.

Another official clarified that the general IFRS can be used by SMEs that do not invest in derivatives and are not a part of mergers, but this is not the case at present. The official added that the revision of the Capital Requirements Directive (CRD)[2] concerning SMEs is also welcome, as well as the referral rule proposing that if a bank declines a loan to an SME, the SME requesting the loan should be directed to alternative funding providers.

1.2 Speed of implementation of the CMU

A policy-maker stated that the pace of progress on the CMU has been steady. It was clear from the beginning that the CMU project could not be delivered overnight. It is hoped that political support will be maintained for the upcoming proposals and that, ultimately, all the objectives agreed at the outset of the initiative will be reached.

An official agreed with the characterisation of 'steady progress'. While many actions are in the pipeline, it will take many decades to build a true European capital market and there will always be room for improvement. Realism and pragmatism is needed in this respect.

A regulator agreed that building the CMU is a long journey, but warned that the credibility of the whole CMU project could be at stake if some progress is not made sufficiently fast from now on. The proposals already on the table must be delivered rapidly, with some compromises if necessary, otherwise discouragement may gain. The recent European Court of Auditors report on the performance of the EU single market for investment funds, which is thought to be the most integrated part of the EU capital market, concludes that, although a single market for investment funds has been established with passporting, true cross-border activities and related benefits for EU investors remain limited. In addition fund supervision and investor protection are considered to be insufficiently effective at the cross-border level. This illustrates the scope of progress still required to achieve a true CMU.

An industry representative had mixed feelings about the progress on CMU. Nobody challenges the need for CMU and for a more integrated capital market to support the post-Covid recovery and there is an alignment on the sense of urgency of this project, which is positive. There has also been tremendous growth over the past few years in capital market volumes in the EU and also significant progress in the market structure, with important developments such as TARGET2 Securities (T2S) and related harmonisation efforts, the implementation of the CSDR, extensive efforts on shareholder transparency and settlement efficiency and delays, as well as an increase in

1. Markets in Financial Instruments Directive (MiFID)/Markets in Financial Instruments Regulation (MiFIR).
2. Aiming to avoid undue impacts from the implementation of Basel III on long-term SME equity investments by banks and on banks' and investment firms' market-making activity.

resilience and risk management requirements. However, despite calls for a step change, there is a feeling in the industry that the impact so far of the CMU initiative on securities markets, beyond these actions which were already in the pipeline mostly, is too limited and that the pace of change is too slow.

The industry representative moreover suggested that the international competitiveness of European financial institutions and market infrastructures is an objective that should be more prominently put forward in the CMU. There are some achievements in this area. More than one third of euro denominated corporate bonds issued are from companies outside of the EU 27 countries, showing the attractiveness of the euro and related bond markets. Half of the holdings in euro-denominated debt in the books of Euroclear for example, a major European CSD, are held by non-EU investors. The Next Generation EU (NGEU) programme has also attracted significant interest from international investors. However international competitiveness is a permanent challenge and it is important to monitor closely the potential impacts in terms of competitiveness of the implementation and recurring costs of the capital market regulations proposed.

An industry representative also welcomed the general direction of progress on CMU. The ESAP, the consolidated tape and ELTIF are all very important topics. However, there is execution risk. As mentioned by a previous speaker, proposals on the table must be implemented as soon as possible to maintain the overall confidence in the project, because there is a risk that changes in the market will outpace regulation and may make part of the project irrelevant by the time it is implemented. Three examples were given to illustrate this. First, inflation may have significant impacts for investors. The entire regulatory framework has been built around cash being the safest asset, which no longer applies in a context where households may be losing 5 to 8% per year from their purchasing power if money is held in cash deposits. This should be considered in further regulatory initiatives. Secondly, there is a very strong demand for more sustainable investments, but EU regulation lags behind with no common thread for the time being. There is still a lack of clarity around some of the measures and categorisations of sustainable investments in the Corporate Sustainability Reporting Directive (CSRD). Consequently, investors still do not have the relevant corporate data and are forced to make decisions based on very poor information. The Markets in Crypto-assets (MiCA) proposal on digital assets is a third example. The proposal is welcome, but it focuses on stablecoins and tokenisation, and is silent about decentralised finance (DeFi), the fastest-growing segment in digital assets at present.

A regulator agreed that DeFi is not explicitly covered in MiCA, but it can be addressed indirectly with the regulation of stablecoins, which are key for the functioning of DeFi platforms, and with rules imposed on digital asset service providers. Fine-tuning the Level 2 requirements of MiCA will be essential. The pragmatic approach would be to finalise MiCA and then address DeFi in a second step, because otherwise that may delay MiCA significantly.

2. Further steps concerning retail investors and SMEs

An industry representative considered that there is insufficient ambition in the CMU on retail investment and SME funding, which are key areas for the growth of the EU economy. SMEs that are eventually listed on a public market create three to four times more jobs than other similar companies. Getting access to capital allows them to expand beyond their home country into the rest of Europe and in some cases globally. In addition capital can be raised in several stages to support their growth. The planned Retail Investment Strategy and Listing Act are relevant objectives, but more needs to be done to support these two areas and a stronger priority should be put on these actions. While proposals for a consolidated tape for example are welcome, they will not be decisive for developing EU capital markets.

Rather than waiting for the EU to make progress with its policies, market stakeholders should take action themselves, the industry speaker suggested. Sweden, where the whole financial industry joined forces to promote equity financing for SMEs, is a convincing example in this respect. An SME market, Nasdaq First North, was built in Sweden 10 years ago, where 219 companies are now listed and 174 new IPOs were recorded last year, among which more than 100 were SMEs. Listing procedures were simplified and the prospectus was replaced for certain types of companies by a shorter company description, cheaper and faster to produce. More than 100 of the SMEs listed on the First North market have been lifted to the main stock market, growing from being small SMEs to mid or large-cap companies, which is a significant achievement.

A policy-maker indicated that proposals for a Listing Act and Retail Investment Strategy are upcoming. The Retail Investment Strategy proposal will include elements on disclosure and reporting, investor protection and also financial literacy. The objective is to offer every investor the opportunity to be better informed. While education is outside the remit of the European institutions, there is scope for supporting the Member States in putting in place actions for improving financial literacy.

The industry representative agreed that initiatives to develop retail investment are important. Time spent by the financial industry educating retail investors in the Nordics has led to high levels of retail participation. As a result, Sweden probably has the most sophisticated retail market in Europe and a high level of retail participation in SME equity markets. 40% of the capital in the First North SME market comes from retail. Retail investors are also a significant part of liquidity and price formation in SME markets now, with trading in SME stocks gaining in popularity, which enhances the level of confidence of investors in the market. Another factor is that transactions are conducted in a very transparent way, with retail investors putting their orders in through their bank's broker, who then sends them directly to the exchange.

An official considered that building confidence is essential for achieving the objectives of the CMU. There are important institutional investors such as pension funds and insurance companies, but they hold the money of retail clients who make the decision to invest in capital market instruments and need to be confident in the market. With the pan European pension product (PEPP), this will be even more the case. The confidence of retail investors diminished following the 2008 financial crisis, but Covid has led to a rise in retail investment. With the current low interest rates, retail investors are looking for yields and this will continue with inflation. The capital market however has to compete with cryptocurrencies and demonstrate that there is an advantage in investing in a regulated market. The MiCA regulation is also essential in this regard for tokens which are not securities.

The official stated that enhancing financial literacy is also important for entrepreneurs, meaning the CFOs or CEOs of SMEs, who need to be educated about the capital market and its possibilities, whereas the CFOs of larger companies usually have sufficient knowledge about this. Together with the European Commission, the Czech Republic Ministry of Finance for example has created a website outlining how SMEs can be financed in the capital markets. SME go through different stages: personal funding and crowdfunding, then venture capital and private equity; and finally public markets. The funding can be made in equity or bonds, but it is usually easier for SMEs to issue bonds in the first place, because it is psychologically the same as taking out a loan. Equity is different from a governance perspective, which is a potential obstacle to the development of equity financing that needs to be overcome.

3. Main pending issues and remaining challenges

The panellists mentioned a number of topics related to legal and fiscal barriers and EU-level supervision where further focus would be needed in the CMU initiative. The Chair suggested that increased attention must also be paid to securitisation and pensions. The situation in EU securitisation markets is worse than it was 15 years ago, despite the implementation of a new EU regime of simple, transparent and standardised (STS) securitisation. On pensions, which are one of the great strengths underlying the US capital market, further consideration is needed on how to build a deep pool of savings for long-term investments. At present it is uncertain whether the Pan-European Personal Pension Product (PEPP) will work.

3.1 Legal and fiscal barriers

An official noted that there are many language, cultural and legal barriers to achieving the CMU. Deeply entrenched legal cultures in member states concerning for instance financial reporting standards or the management of insolvency procedures, must be addressed. Some of these issues are outside the responsibility of finance ministries and are covered e.g. by ministers of justice, who tend to have different priorities than finance ministers in relation to capital markets. Reconsideration by the Commission of the possibility to enhance the consistency of insolvency rules is key, because there is a clear link between creditors' rights and capital provision and in domestic laws there are very different ideas about the appropriate balance between the rights of creditors and debtors across the EU. Reform on this point is difficult, because some of the ideas are very deeply entrenched, however real progress on the CMU cannot be made without tackling this issue. Tax harmonisation is an even more difficult area on which there are few initiatives. Even harmonising the procedures (rather than the level of taxes) such as the withholding tax procedure is hugely controversial. A policy-maker indeed explained that unanimity is required to address the issues around taxes at a European level.

An official commented that the Czech Republic is keen to open discussions on the long-standing issues of the harmonisation of securities law, in addition to insolvency rules and taxation. This should not be a major challenge, the official felt, because it could be achieved by implementing the Hague Securities Convention and the Geneva Securities Convention as EU regulation. The Giovannini report also provides useful guidance in this regard. The harmonisation of corporate taxation and a consolidated basis for corporate tax would be useful as well. As for language barriers mentioned by a previous speaker, they are disappearing online with the use of translation apps.

A regulator reiterated that, before addressing such challenging issues as insolvency laws and taxation, which are essential, it is important to realise that the credibility of CMU relies on timing and on delivering first and rapidly what is already on the table.

3.2 EU-level supervision

A regulator stated that the digitalisation of financial services means that there will be more cross-border services and investment in the future, but the framework for supervising cross-border retail markets and addressing investor protection concerns in this context does not yet exist in the EU. At present, investor protection relies entirely on the home supervisor and is fragmented across 27 jurisdictions. Supervisors have different levels of competence depending on the size and activities of the financial sector in their jurisdiction. With increasing digitalisation, firms might locate in countries with a lower level of sophistication in terms of capital market supervision and distribute their products throughout the EU. Moreover large jurisdictions will increasingly be host supervisors with a difficulty to appropriately address customer protection issues in their jurisdiction posed by firms and products based in other EU countries.

The regulator suggested that after having delivered the proposals of the current CMU action plan, a review of the supervisory framework is needed to support the development of cross-border investment, which is one of the objectives of CMU. An option, considering the way the Single Supervisory Mechanism (SSM) for banking activities is structured, could be to have a different supervisory approach for entities that are above a certain size and are truly cross-border.

4. Way forward

The Chair suggested that a timeframe is needed, together with a political agreement to deliver the planned initiatives of the CMU sufficiently fast i.e. in this European cycle and before the next parliamentary elections.

A policy-maker summarised that the comments made by the panellists essentially go in two directions: the need to deliver quickly and the suggestion to do more on CMU. These two objectives are valid but contradictory to a certain extent because the more that is done and the more ambitious is the action plan, the harder it is to deliver quickly. Best efforts are being made by the Commission to find the right balance between these two conflicting objectives. Reacting to some suggestions made by the panellists, the policy maker agreed that further work on securitisation could be beneficial, but there is resistance of some stakeholders towards this. Concerning SMEs, a Listing Act is in progress, however, the more that is put in that, the harder it will be to deliver quickly. The priority is first to deliver the initiatives that are on the table as fast as possible. Strong political support is essential for moving the CMU forward, but it must go beyond commitments in principle and materialize in compromises on the legislative texts proposed.

An official agreed that there is a trade-off between ambition and speed and that many good proposals have been made. The difficulty in making progress is that there are many divisions not only within the Council but also among market players. The Council is split on securitisation for example between those who want a more competitive banking market and those who favour customer protection and regulatory stability. It is the same for market participants about the importance of the consolidated tape and how to implement it. There are also different views about reinforcing EU level supervision through ESMA. This latter issue is further complicated by the fact that within the EU some countries have developed capital markets that require sophisticated supervision and others have practically no capital markets and limited supervision functions in this area. In any case, creating a true, functional European supervisor raises many challenges in terms of resources and budget, which are difficult to tackle in the short term.

An industry representative stated that they would encourage the Commission to take a 'minimum viable product approach'[3] to the CMU next steps in order to put sufficient conditions in place to move as fast as possible. The digital space must not be forgotten in the CMU debate. Otherwise, the 27 countries will impose their own rules, and this will result in a new layer of dis-harmonisation on top of the existing one. In order to create more support for the CMU among political decision makers and the wider public, the industry speaker suggested that consideration could be given to renaming CMU with a view to putting savers and the financing of the economy, notably SMEs, at the centre of it.

A second industry representative stated that regulators face a difficult task. However, the contrast between either working on a large scope of proposals slowly or a smaller scope quickly is too restrictive. Another option is adopting a more iterative approach to regulation, rather than the current sequential approach. MiCA for example includes asset reference tokens in the definitions of crypto-assets, derived from the Libra concept, which is now dead. If legislation was developed iteratively, starting with a broad framework and then adjusting and refining the detail, a great deal of speed could be gained.

A third industry representative reiterated that there are two priorities for the CMU, SMEs and retail, where focus at the EU level should be increased. If retail investors get used to investing in SMEs, SMEs will see the benefit of accessing capital at the stock exchanges and will know that they can rely on this source of funding. Investors will get better returns than on their savings accounts and play an active role in developing economic growth and job creation. Achieving this combination should be the main priority of the CMU.

The Chair concluded that while CMU has to be democratically negotiated, the CMU project cannot be delayed indefinitely while agreement is found on all topics. At some point there must be a priority given to achieving progress on the building up of a European capital market over the detail of the substance.

3. The MVP approach is based on the premise that sufficient customer value can be provided by delivering minimal features that early adopters will use. Feedback can then be collected and used to build a better product that will resonate with future users.

Retail investment strategy: what priorities?

1. Overview of retail investment trends in the EU

An investor representative gave an overview of retail financial investments in the EU. Firstly, financial savings in the EU are not only in bank accounts, which represent 33% of retail financial assets. They are also – and more - in life insurance and pension products, which comprise 38% of financial assets. This means that 71% of financial assets are mostly in fixed rate or fixed income related underlying assets. Third are listed stocks and bonds, representing 9% of assets. Lastly, investment funds represent about 9%. Retail investors only have a limited direct exposure to funds, but they are also exposed to them economically via unit linked products within life insurance and pension products. In terms of regulation, this means that retail investors are currently affected by a range of different rules; this is a consequence of the silo approach adopted by European law in which rules differ across product categories. The Retail Investment Strategy will hopefully mark an attempt to develop a consistent approach to investor protection rules throughout these different product categories.

A regulator highlighted the similar evolutions in every country since the beginning of the Covid pandemic. There has been a huge inflow of retail investors into the market. The fall in stock prices was seen as a buying opportunity. People also had more time on their hands, had saved money with restricted spending opportunities and had easier access to financial markets thanks to digital apps. Surveys conducted in the Netherlands have shown that these newcomers to the capital markets are younger than the average investors, are relatively confident about their capacity to make appropriate investment decisions and use execution only services, relying mostly on social media and 'finfluencers' for stock market advice. However, surveys have also concluded that roughly one third of these new investors had suboptimal investment strategies. They traded in and out too frequently and did not spread their investments sufficiently across assets and time, making them vulnerable to potential market fluctuations.

An industry speaker emphasised that saving rates hugely increased in 2020 and 2021 with the Covid crisis. There were some newcomers to the capital markets, but most European households saved in bank accounts and savings products. The normal rate of savings for a European family is around 12%. During the last two years, it was closer to 20%.

2. Opportunities and challenges associated with retail investment

2.1 Opportunities related to the development of retail investment

The Chair observed that the current macroeconomic environment of low interest rates provides an opportunity to encourage more household investment in capital market instruments, however also potentially generating new risks.

A regulator emphasised that the main policy objectives concerning retail saving should be to address the pension gap, build more pension adequacy in old age and enhance the long term funding capacity of the European economy. This long term perspective should underly the objective of developing retail investment. In Portugal and Spain, the average replacement ratio of pensions will be 40% of the salary in 40 years' time if nothing is done, compared to around 70 to 75% at present. When considering the macroeconomic environment and the risk of inflation, a push of the value for money offered to retail investors is also necessary. It is therefore necessary to propose simple, cost effective products for people to complete their savings for retirement. The regulator described digitalisation as a major opportunity in this regard, because it will facilitate the provision of simpler, more cost effective and more comparable products and services. Many of the costs supported by retail investors are due to the complexity of products. This should also lead to a simplification of regulatory requirements. Building a truly single market for capital is a further opportunity to support retail investment.

An industry speaker agreed that the objective of increasing retail participation in the capital markets should focus on achieving better outcomes for investors in terms of pension adequacy and long term saving. It is possible to generate much better value for investors by providing products corresponding to their long-term savings needs and adequate advice for facilitating their investment decisions.

An industry speaker emphasised that the development of retail investment also provides the opportunity to massively support a transition towards a more sustainable and digital economy. Asset managers in particular have a key role to play in channelling retail savings towards these investments.

2.2 Challenges faced by retail investors

Considering the challenges associated with the objective of developing retail investment, an investor representative stated that this is one of the worst times for retail investors because 'financial repression' is at an all time high. The current combination of monetary and prudential policies is resulting in investors obtaining a negative return in real terms on their investments and this will worsen with the upsurge of inflation since 2021. This is not a temporary issue and retail investors will be hit hard because 71% of their financial savings are in savings accounts and mostly fixed income related products. For example, in France, where capital guaranteed life insurance is the main saving product with €1.6 trillion of assets in 2021 alone, savers lost €43 billion in real terms in purchasing power in 2021 with an inflation of 3.4%. In addition, savers are taxed in most cases on nominal income, which is partly a fictitious income, and they are also being encouraged to move their assets to unit linked products, which are riskier, more expensive and more complex, at a time when stock markets are at an all time high. In the same way, the biggest saving pot in Belgium, which is bank saving accounts, lost €22 billion in purchasing power in 2021 alone.

An industry speaker agreed that inflation is a game changer that is due to last and increase. There could even be a stagflation situation because the price of energy is going to rise quite dramatically, especially due to events in Ukraine. The consequences of inflation for retail savers are quite significant. Statistics show that €10,000 left in a bank account over the last 10 years has lost at least 10% in value in real terms. The same amount invested in an average diversified portfolio fund would have generated around 60% in real terms and net performance during the same period. This shows that savers need to invest in more diversified assets, which is an objective that investment funds can contribute to achieving. However, only 10% of retail savings are invested in funds at present, which needs improving.

A regulator stated that, while many savers are showing a new interest in investing in capital markets, it is important not to lose them as investors in the future due to foreseeable disappointments. Cost and trust are important in this respect. 'Cost' means that people should be offered products at fair prices. These products should make sense for retail investors and work under various economic circumstances. There should also be no inherent conflicts of interest that work to the detriment of investors in the system. Retail investors should also be protected from fraudulent or excessively risky propositions. In this new world of digitalisation, it is still very difficult for supervisors to go after foreign firms. Therefore, it is necessary to address investor protection from a cross border perspective. A further issue is that the strong interest in meaningful environmental, social and governance (ESG) investments means that way too much money is currently chasing too few ESG assets, leading to risks of greenwashing and a green asset price bubble.

The Chair stressed that ensuring investor protection for cross border investment is a significant challenge. A specific area of concern raised notably by the International Monetary Fund (IMF) concerns the way supervision is organised in the cross border context with the growing digitalisation of financial services.

A regulator added that the current geopolitical challenges will induce more volatility in a system that was already heated due to liquidity and risks that were probably inadequately measured. This will also impact retail investors.

3. Objectives of the Retail Investment Strategy

A policy maker explained that the Commission is considering putting forward a Retail Investment Strategy centred on the retail investor. This is the first time that the objective has been presented in this way at the EU level. Moving in this direction is a significant priority for the Commission.

The Commission's key objective is to develop retail investors' access to capital markets to better cater for their long term saving needs. The Commission's assessment of the present situation is in line with the comments made by the panellists. Capital markets represent opportunities and risks for retail investors. Changes in the profile of investors have been observed since the Covid crisis. Challenges include the limited level of financial literacy and the way the regulatory framework is currently structured, which may need some streamlining.

No decision has been taken yet, and consultations are ongoing. A first area that the Commission is considering is enhancing financial literacy. There is no legal basis in the treaty for interventions at the EU level in the field of education, but support can be provided by the Commission to member states. A second area is the streamlining of disclosure rules on which a study has been commissioned. Advice has also been asked from the three European Supervisory Authorities (ESAs) on possible improvements to these rules. Inducements are being assessed to determine whether they contribute to creating a conflict of interest that may hinder the provision of unbiased advice. This is a very divisive subject on which there are different views.

More generally, the Commission is assessing whether a more investor centred perspective can be developed in the regulatory framework, the policy-maker explained, because rules are mostly product based at present. The intention is to evolve towards a perspective of individual portfolio creation in the advice provided; this involves reconsidering whether the current product suitability and appropriateness regimes are still fit for purpose and how information that is currently provided for each product in great quantities should be presented to better suit the needs of investors. All these issues also need to be considered together with the opportunities and risks stemming from digitalisation. Finding the right balance between innovation and investor protection is not easy, but this is the objective that the Commission is endeavouring to achieve with the input to the ongoing consultation.

An investor representative stated that the Retail Investment Strategy is a once in a lifetime opportunity to improve the issues affecting individual investors in Europe that should not be missed.

The Chair emphasised that encouraging the participation of retail investors in EU capital markets is a priority in the context of the Capital Markets Union (CMU). The Retail Investment Strategy is a welcome initiative, as it should allow for breaking barriers to cross border investment, providing long term investment options to European households and ensuring that they have access to strong investor protection. This objective is particularly relevant in a context where households have accumulated significant savings during the pandemic and are facing low returns on their savings account due to the low interest rates.

An industry speaker considered that the Retail Investment Strategy, is a great opportunity to reflect on what is needed to strengthen the current pension environment and foster longer term saving in Europe. The objective to assess every step of the investor journey is the right approach as there is no silver bullet for achieving better outcomes for investors. Investment funds can provide an instrumental contribution to this objective, supporting wealth creation rather than just wealth management.

Another industry speaker was looking forward to the recommendations of the Retail Investment Strategy. Targeted changes to existing rules are needed rather than an overhaul of current frameworks and additional requirements and a more holistic and streamlined approach should be favoured rather than the current work in product silos.

A regulator added that simpler products and investor information would probably necessitate less regulation but more effective supervision. It is necessary to have stronger conduct supervision in Europe, and this needs to be much more centralised in European institutions.

4. Key areas of the Retail Investment Strategy

4.1 Financial education

An industry speaker believed that improving investor education is essential, which requires developing access to qualified advice. Retail investors should not rely on tips from social media or YouTube and should be able to make their own investment decisions. The level of financial literacy is very variable across EU Member States at present. Not much can be done at the European level in the area of education, which is under the remit of domestic authorities. The strong presence of pension funds in certain countries such as the NL has contributed to a higher level of financial literacy, but this is not widespread across the EU.

An industry speaker stressed that while financial education and literacy are very important pillars for the development of retail investment, they are also a long term goal. There is a role for mechanisms that can help individuals to think about financial planning and how to plan for retirement at different periods of their life, creating the right incentives along their wealth creation journey.

A regulator agreed that nudging people towards a periodic financial health check, as suggested by the previous speaker, that would examine whether their financial situation is still fit for purpose, given possible changes in their lives or projects or evolutions of the economy would be a good idea. There are questions about how recommendations can be made, the form that they may take, whether some may be compulsory, who is going to do the health check and who is going to take the necessary follow up actions, but this is worth thinking about in the context of the preparation of the Retail Investment Strategy.

The regulator added that empowering retail investors to be able to make their investment decisions should be the objective rather than educating them about finance. This does not mean them receiving more information, but rather better information. Indeed, it is not certain that better trained investors would make better financial decisions, because there are many behavioural factors at play: individuals are prone to biases, can be over-confident, excessively short-term oriented… Therefore, individuals will still need to be provided with an appropriate level of protection.

An investor representative stated that improving financial literacy is at best a quite long term solution that is often mentioned but cannot realistically be implemented at the EU level because there is no legal basis for the EU to intervene in the area of education. In addition, adults are not interested in being trained in this area, therefore a first critical step is should be to better inform them and advise them at the point of sale. The second objective should be to facilitate the engagement of investors. Developing responsible investment, especially for environmental reasons is a way to involve the younger generation. Facilitating the exercise of shareholder rights, particularly cross-border within the EU should be another objective. The new Shareholder Rights Directive (SRD II) was introduced in 2021 but it is not working and it is still extremely difficult and costly for small shareholders to exercise their voting rights within the EU. This would nevertheless be the best way to encourage companies to apply ESG criteria and invest in a responsible way, as shown by many studies including assessments conducted by Better Finance.

4.2 Product distribution and advice provision

An industry speaker welcomed the reassessment of the inducements regime in the context of the Retail Investment Strategy and suggested that this should be done from the perspective of improving the advice provided to retail investors in terms of quality and access. There is already significant evidence from the Netherlands and the UK showing that the suppression of inducements has not led to a shortfall in the provision of advice; in fact, it has led to more competition and higher levels of quality in the services and products provided. The objective to enhance the level playing field between investment funds or insurance products is also relevant.

Another industry speaker emphasized that in the continental Europe distribution model, banks play a key role in terms of advice and distribution of investment products and that suppressing inducements would accomplish exactly the reverse of the objective in this context. A range of advice from face to face to simple digital advice can be provided, but it has to be paid for. In addition there is a huge challenge in terms of advising customers about sustainable investments and assessing their preferences in terms of ESG. If people are asked to pay for something that is currently free, most of them will choose the cheapest option with very limited or no advice as is the case for low-cost flights. Assessments conducted in the UK show that the average customer benefitting from advice has investments amounting to around £150,000, but the median amount held in securities in Europe is around €10,000. With the current bank centric distribution model in Europe, a full inducements ban would really risk excluding most investors from suitability tests and advice. There could be further unintended consequences from the suppression of inducements such as limitations to the development of open architecture distribution, as mentioned in an ESMA technical advice in 2021.

A regulator acknowledged the wide range of views that exist on the impacts of inducements. In the Netherlands, there has been a full ban on inducements since 2014 because of a major mis selling scandal. Eight years later, the authorities are satisfied because the costs for investors are the lowest in the EU. The advice industry was forced to become more innovative developing a range of advisory packages with different price tags, because there was no longer easy money to be made with inducements. Those who were not able to react left the industry and the others managed to innovate. It is true this change raises some challenges, but these are more of a short term nature and can be overcome, the regulator believed.

An investor representative emphasized that advice must be 'bias-free' (a main objective of the EC's retail investor strategy), because there is massive evidence of the damage caused by biased advice. Taking the example of France, two-thirds of the retail equity fund market is constituted by unit linked products promoted by insurance companies and banks, that returned on average 4% per year over the last five years, whereas cheaper exchange traded funds (ETFs) on the French stock market returned close to 8% over the same period. This is wealth destruction that shows the damage caused by the advice provided by biased financial advisors. An industry speaker agreed, stressing however that the number of retail investors finding their way to lower cost products that are easier for them to access, such as ETFs, is increasing.

The regulator stated that cost and trust are essential for retail investors. In particular, this requires rigorous product governance on the part of the financial industry and appropriate supervision. Products that are sold to retail customers should be cost effective and should work not only in good times, but also in bad ones. They should be marketed to the right people, and firms should be encouraged to guide customers towards products that make sense for them instead of the seller. This is part of product governance.

4.3 Digitalisation

An industry speaker emphasised that cost and value-for-money are a critical element for the growth of retail investment. One trend that should support this objective is an increased use of digital tools for executing transactions and also accessing different types of advice and guidance services. Providing a sliding scale of advice that includes digital options such as digital enabled advice or simpler digital guidance models is an effective way to attract a wider range of customers to financial advice. This reduces the barriers to entry and people of all ages may prefer digital interaction. Technology and its use in an open finance environment can also create efficiency and add value in other related areas such as the onboarding of clients, product comparison or the analysis of market data. All of that potentially paves the way for a far more scalable investment industry that reaches more people of all ages, incomes and stages.

A regulator stated that a huge part of the initial cost of advice lies with the product suitability and appropriateness tests. New technologies and open finance mechanisms can be used to streamline and standardise these tests, potentially reducing their cost significantly. This could work for a vast majority of customers.

4.4 Product disclosure and labelling

An industry speaker stressed that further standardising and streamlining investor disclosures should be a key objective, starting with an assessment of the present degree of divergence of disclosure across financial products. The amount of available information is overwhelming for retail investors and current key investor documents (KIDs) or prospectuses do not help much, as they are not easy to use and do not allow an easy comparison.

A regulator confirmed that KIDs are not often used by retail investors and that a new paradigm should be proposed for disclosures. This is a long-standing issue that needs to be tackled rather than repeating the same mistakes. The principles stated in the EU directives are correct, requiring to provide easy to read, comparable and understandable information. The problem is that this objective is then translated into a long list of items that need to be part of a KID, contradicting the initial objective. A way of providing radically simpler information needs to be found. The starting point should be the client to whom the product is going to be sold and the client's objectives and not the product itself. A way of doing this is layering the information. If some people want more detail they should be able to access it, but the first level of information should remain simple.

The regulator added that in some areas, labelling should also be part of the solution. This is the case for example of ESG investment. This is an area where a great deal of information is going to be provided to customers to inform them and understand their preferences. Retail investors should also get an upside from ESG investments, which means fighting against greenwashing and favouring the emergence of long term, ESG compatible investments, that may also be adequate for preparing retirement. Labelling could be of great help in this perspective.

Improving SME equity financing

1. Overview of the financing of SMEs in Europe

The Chair introduced the discussion by emphasizing that the issue of small and medium-sized enterprise (SME) equity financing is a longstanding one. The new needs around the digital and green transitions will require more equity financing and at the same time, the Covid crisis has added more debt to SME balance sheets, which will necessitate a rebalancing of financing sources. The growth of retail participation in public equity markets observed since March 2020 is a trend that may be leveraged in this perspective. These objectives are at the heart of the new Capital Markets Union (CMU) action plan published in November 2021.

An official explained that SMEs are the most numerous and fragile enterprises in the EU economy. They represent two-thirds of gross domestic product (GDP) and in some countries almost 99% of enterprises are SMEs. Prior to the Covid crisis, SMEs were already quite indebted. The additional financing provided during the crisis to support SMEs was mostly in the form of debt, leading to higher SME indebtedness. The result was a 5 10 percentage point increase in indebtedness as a proportion of GDP and in terms of the debt to equity ratio. These figures are now reverting to their pre crisis levels, but there is still a substantial need to further diversify the financing of SMEs in the EU, notably with more equity investment.

Thanks to the interventions of central banks and public institutions, the European economy was kept afloat during the Covid crisis and is expected to return to a pre crisis level in 2022, the official added. While this evolution is positive, macro reports produced last year for example by the International Monetary Fund (IMF) and the European Capital Markets Institute (ECMI), estimate that Europe has an equity deficit of €600 billion, which is significant compared to other jurisdictions, notably the US. This gap is particularly acute for certain segments of enterprises such as start ups. The number of start ups in Europe has increased over recent years, but still lags behind the US. As a percentage of GDP, there is 10 times less investment in venture capital in Europe than in the US. Improving the financing of European scale-ups is also essential, because many of these companies end up being financed by US and Asian investment funds as a first step to listing on the NASDAQ or other non-EU exchanges. In Europe today, up to 75% of these fast growing companies are refinanced at a later stage by US or Asian funds. An industry speaker confirmed that at present many innovative SMEs in Europe turn to other countries to be listed, because there are less obstacles and more liquidity available.

A policy-maker noted that the European economy has emerged from the crisis with more debt on the private and public sides and agreed that it is important to ensure that enterprises access new sources of finance in order to finance their development.

A second official emphasised the heterogeneity of the EU capital markets landscape. In Western Europe, there are countries with large and buoyant capital markets such as France, Germany or Luxembourg, but in Central Eastern Europe (CEE) bank financing remains prevalent and capital markets are under-developed. There are similar contrasts between the North and South of Europe. In this regard, it is worth considering concrete examples from the Baltic countries. All three Baltic countries have a stock exchange and an increasing capital market turnover, but the market capitalisation in these countries remains low, ranging between 3 and 10% of GDP[1] compared to 120% in Finland and even more in Sweden. Retail participation, crowd funding and investment funds are growing, but figures are limited compared to the EU countries with highly developed capital markets[2]. There are also very few initial public offerings (IPOs) happening in these countries. Many of the IPOs concern enterprises that were previously state-owned and these IPOs generally happen in the local market.

The official also stressed the importance of enhancing SME financing in the CEE region. Lithuania's economy for example is composed mainly of SMEs with 90% of enterprises having fewer than 10 employees. According to a survey carried out by the Bank of Lithuania, bank loans are the third most popular source of SME financing after internal savings of the owners and their relatives and state aid, which is mainly European assistance provided notably by the Cohesion Fund.

2. Obstacles to the further development of SME equity financing in the EU

2.1. Demand-side issues

An industry speaker observed that retail clients are interested in buying SME shares, but there are some

1. Lithuania's market capitalisation is 9% of GDP and Estonia's is 10% of GDP, but Latvia's is only 3% of GDP. The annual turnover In the Lithuanian stock market was between €70 million and €90 million, but it has now increased to €100 million. The overwhelming majority of this is shares; bonds are non existent.
2. In terms of retail participation, only 16,000 of Lithuania's population of 3 million participate in the stock market. 40,000 mainly younger people participate in crowdfunding, which is an important channel for SME financing. Crowdfunding has grown by €53 million to €650 million. While the investment fund market in Lithuania is substantial, Lithuania only has 14 domestic UCITS funds out of 64,000 in Europe, according to data from the European Court of Auditors (ECA). There are also 100 Alternative Investment Funds (AIF) in Lithuania, but 64 of these are purely real estate. Financial market instruments are almost non existent.

practical obstacles that need to be considered. First, there is a lack of research on SMEs, which is being addressed by the MiFID II Quick Fix with amendments proposed to the current research and execution cost unbundling rules with respect to small and mid-cap issuers. Secondly, transaction costs in the EU are too high due to market fragmentation, particularly in the post-trading space, which increases the costs of intra-EU cross-border transactions. Fiscal fragmentation is another key issue here. As a result, French investors for example mainly purchase shares on their domestic market and if they purchase foreign shares, they tend to invest in US stocks rather than EU ones. Purchasing SME stocks also tends to be more expensive than blue chip ones, even on a domestic basis, due to the cost of clearing and settlement. The limited liquidity of SME markets is a third challenge, which has a particular impact when markets are volatile. If investors who need the money are trapped with SME shares, they may not re enter the market in the future.

These different issues show that SME markets remain fragile, the industry speaker stressed. Investors must be able to have trust in SME markets, otherwise they will purchase blue chip stocks or investment products such as exchange traded funds (ETFs), which are not appropriate for financing SMEs. More generally, there is a challenge around building investor trust and developing their level of autonomy. Digitalisation can help and some e brokers are making considerable efforts to train clients interested in trading on equity markets, but these investors often want to meet an advisor in person before initiating transactions. Additionally, the implementation of environmental, social and governance (ESG) standards by SMEs could create a real appetite for these shares. However, with the standards proposed, companies are considered to be either green or brown, which does not encourage investment. Savers want to see progress and invest in companies transitioning to higher ESG standards or contributing to the transition.

Another industry representative highlighted the challenges around financial literacy and investor incentives. It is encouraging to see that more young people are investing in stock markets, but there are major differences in the financial culture across European countries and across generations. The CMU action plan has proposed some actions to improve the engagement of retail investors such as the Retail Investment Strategy, but investors will not buy equity products if they do not consider them to be profitable. This is where tax becomes relevant. Tax incentives should be developed to encourage people to invest in equities. The Chair agreed that tax incentives could have an important effect on retail investment behaviours, although this is an area mostly outside the remit of European institutions.

An official emphasized the challenges that exist in the cultural landscapes of many CEE countries, where there is a heritage of reliance on state paid pensions. Previously, people did not have investments; they had a salary or a pension and just a few savings. Therefore, the older generation does not trust shares and considers bank deposits and liquid savings to be more reliable. CEE citizens need to be educated about investment, business initiative and entrepreneurship. There are often heated debates in domestic parliaments of the CEE region about the need to protect citizens from the risks of financial investment. There is also a generational split: the younger generation is tech savvy and ready to invest in crowd funding and foreign stock markets, but they do not have the money to invest.

2.2. Supply side issues

An industry representative described several key issues that SMEs are facing when seeking to raise equity funding on the public markets and which make European markets less attractive and less advanced than those in the US or Asia. First, are the costs of going public and maintaining a listing, mainly due to disproportionate regulatory requirements, which lead many SMEs to seek other financing options, such as private equity. Investor protection is often put forward as the underlying reason for these requirements. While this is an essential aspect, a better balance should be found between the objectives of risk mitigation and economic growth with more proportionate listing requirements, allowing these companies, which are fundamental for the EU economy, to obtain the financing that is needed for their scaling up. This will in turn support the growth of the EU economy and provide investors with higher returns. Secondly, the lack of research on EU SMEs, which the MiFID II Quick Fix is attempting to solve, also has implications for SME issuers in terms of visibility in the market, access to funding and liquidity. Private initiatives have been set up in certain countries to alleviate this issue. For example in Spain, the stock exchange and the Spanish Institute of Financial Analysts (IEAF) have launched an initiative, which aims to increase the research coverage by providing free information on listed Spanish stocks. Thirdly, there is a need for a consistent definition of SMEs across the EU, which varies at present across regulations and member states. A homogenous definition would enable initiatives to be implemented more consistently with a stronger impact at EU level. Fourthly, many innovative companies do not have a regular cashflow, which means they have limited access to bank funding and due to their limited size they do not have sufficient visibility in the markets. Specific measures are also needed for these companies.

A regulator emphasised that tax also plays an important role on the supply side. The fiscal bias towards debt has huge consequences for the decisions made by SMEs about their financing structure.

3. Policy initiatives to support SME financing in the EU

3.1. Actions related to the Capital Markets Union (CMU) initiative

A policy-maker described the actions being taken by the European Commission to support and diversify the financing of SMEs and to develop investor demand in the context of the CMU. Progress is being made and now actions need to be implemented on the ground. The latest CMU action plan published in 2020 proposed actions in three main areas: supporting the twin green and digital transitions and a resilient economic recovery; making the EU an even safer place to invest; and integrating national capital markets into a genuine capital market. This action plan includes measures aiming to remove some of the obstacles to the supply of financing for SMEs. For example, there is a proposal to redirect SMEs that have not obtained financing from banks to alternative providers of funding. There is also a proposal to implement a dedicated platform at EU level, the European Single Access Point (ESAP) to facilitate the access to financial and non-financial information on EU enterprises, including SMEs. A Listing Act review aiming to simplify rules for companies, particularly SMEs, wanting to raise funds on public markets is also due to be published in the coming months.

On the demand side of capital markets, the European Commission is also seeking to empower citizens through initiatives to improve financial literacy, the policy-maker added. The objective is to make them more aware of the risks and opportunities of investing and to help them to make their own investment decisions, rather than relying solely on investor protection rules which may hinder investment. The European Commission is working with the OECD on actions to improve financial literacy in a number of Member States. In Italy, for example, with the Financial Education Committee, a Netflix-type series has been created on investment in an attempt to reach a wide audience. Actions are also conducted in France and Portugal to make younger retail investors more aware of the benefits over time of regularly investing small sums of money. Banks across the EU are also doing a substantial amount of work on youth education regarding financial matters.

An industry representative stated that the CMU action plan is a very welcome initiative. The four legislative proposals published in November 2021 should indeed contribute to developing SME financing[3]. The ELTIF review is a step in the right direction, but the framework should not be limited to companies involved in the green and digital transitions and should also include scale-ups, which have important investment needs. The ESAP initiative could also increase the visibility of SMEs and should be linked to actions to increase the research available on these companies.

Some of the other actions in the CMU action plan should help develop equity investment in EU SMEs, the industry speaker believed. The Listing Act review proposed by the European Commission is an opportunity to improve the conditions under which SMEs can list their shares on public markets. This is happening alongside national initiatives. This review should address the direct cost of listing, help to simplify prospectuses and also make it easier for companies to move from growth markets to regulated ones. The simplified recovery prospectus[4] facilitating secondary issuance was an adequate initiative in this perspective, although it has not been widely used. More generally, there should be more proportionality in the rules applying to SMEs (e.g. around sanctions and governance) and a harmonization of definitions across EU regulations (e.g. concerning the definition of SMEs and semi-professional clients). There are also some important issues to fine tune on the investor side. The actions to improve financial literacy and the information available to investors are highly relevant, because they will contribute to building investor trust. The dual voting structure is an interesting idea for encouraging more long term investment. Lastly, suitability tests for retail clients should be entirely reviewed and should be harmonised between the different regulations concerning retail investors or savers.

3.2. Regional initiatives

An official suggested that the heterogeneity of capital markets in the EU means it is necessary to develop smaller capital markets in parallel with their integration into a single EU capital market. The European Commission should help Member States achieve this through its Technical Support Instrument[5], in particular in smaller markets which do not benefit from economies of scale and lack investor interest. There could be several benefits to including a regional approach in the building of the CMU. The three Baltic countries provide a relevant example of this. Specific legislation on covered bonds and securitisation has been drafted in the three Baltic States with the support of the European Commission and the European Bank for Reconstruction and Development (EBRD). There have also been initiatives to harmonise corporate law in some Baltic and Nordic countries which have similar legal systems. Another idea that has been suggested is the indexation of the Baltic countries into a single region in the MSCI index, which would create a larger market and increase their attractiveness for foreign investors. There could also be a benefit in consolidations of market infrastructures at the regional level, such as merging the Baltic stock markets. A further initiative could be an enforcement of European structural reforms through country specific recommendations. The intention of these proposals is not to create additional barriers between this region and the rest of the Europe, but to support the development of capital markets in Europe by creating stronger and more effective regional building blocks, the official explained. This approach was suggested in the recent report of the European Court of Auditors (ECA) on the CMU[6].

A policy-maker agreed that the work conducted jointly by the European Commission and the EBRD was very

3. In November 2021, the European Commission put forward four legislative proposals for implementing the September 2020 CMU action plan: (i) set up a European Single Access Point to provide financial and sustainability related information on EU companies and financial products in a digitally useable format; (ii) improve the ELTIF (European Long-Term Investment Fund Regulation) framework in order to make ELTIFs more attractive for investors and easier for asset managers to operate and market; (iii) enhance the Alternative Investment Fund Managers Directive (AIFMD) to better integrate the EU AIF market, improve investor protection and better monitor the risks to financial stability posed by AIFs; (iv) review the Markets in Financial Instruments Regulation (MiFIR) in order to tackle the transparency and level playing field issues posed by current rules and enhance the international competitiveness of EU capital markets.

4. The recovery prospectus is a temporary regime that simplifies the procedure for raising capital for issuers during the COVID 19 pandemic. This prospectus focuses on essential information and is only available for the secondary issuances of shares.

5. Regulation (EU) 2021/240 of the European Parliament and of the Council of 10 February 2021 establishing a Technical Support Instrument, *https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0240&qid=1650611651118&from=en*.

6. Capital Markets Union – Slow start towards an ambitious goal ECA report November 2020.

relevant and has helped to create a regional market for certain financial instruments. While there should be an endogenous will within member states to reform their markets and ask for assistance from the European authorities, the European institutions should also be able to propose reforms to member states.

3.3. The potential role of digitalisation

A policy-maker emphasized that digitalisation should also help to drive further investment in SMEs. Banks need to further digitalise their processes and regulators also need to adapt regulation and supervision to the increasing use of technology through the use of tools such as regulatory sandboxes. To this end, an EU Supervisory Digital Finance Academy is currently being launched with the participation of 26 European supervisors. However, digitalisation will also require an improvement of financial literacy, which is essential for customers to make the most of digitalisation.

An industry speaker confirmed that retail investors are increasingly interested in the opportunities offered by digitalisation such as tokenised assets. Digitalisation can also contribute to reducing post trading costs, which will benefit cost sensitive clients and issuers. Ultimately, this could create more liquidity for SME stocks. Digitalisation should also facilitate cross-border investment and enable market making on a cross border level.

3.4. The role of public support and investment programmes

An official agreed that the actions proposed in the context of the CMU action plan are going in the right direction. Improving regulation will benefit scale ups and growth markets and contribute to attracting more private sector money into equity investment. However, these market gaps can also be addressed through other kinds of public action. Public investment programmes can bring more liquidity to certain markets and also attract more private investors, thus creating more financing and more support for European companies. Public programmes can also facilitate the provision of additional data, which can make the market more transparent, more liquid and attract private sector money. The Scale-Up Europe initiative[7] conducted under the aegis of French Presidency of the EU is an example of a programme supported by the public authorities aiming at making proposals for increasing investment in start-ups and fast-growing companies.

SMEs were also at the core of the response of the European institutions to the Covid crisis, the official noted. Massive support was provided to the economy by the European Union in coordination with member states. Equity, particularly for SMEs and start-ups, was a key component of this. The volume deployed in the context of these programmes was three times the volume that has been deployed in recent years.

7. Launched by President Macron in March 2021, with the support of the European Commission and other Member States, the Scale-Up Europe initiative brings together a cohort of over 300 start-up and scale-up founders, investors, researchers and corporations, all sharing the same bold objective: for the continent to become home to 10 tech giants each valued at more than €100bn by 2030. https://presidence-francaise.consilium.europa.eu/en/news/press-release-scale-up-europe-spurs-collective-action-to-accelerate-european-tech/.

AIFMD / ELTIF reviews: are the proposals up to the challenges of the CMU?

1. European long-term investment funds (ELTIF) regulation review

1.1 Current level of development of the ELTIF market and improvement objectives

The success of the ELTIF framework aiming to channel long-term financing to small and medium-sized enterprises (SMEs) and infrastructure projects has so far been limited. A regulator highlighted ESMA's June 2020 survey which indicated that almost five years after the implementation of the ELTIF regulation there are only 17 ELTIFs actively marketed in the EU. The majority of those are based in only four countries: France, Luxembourg, Spain and Italy. There has been a slight uptick over the last couple of years, particularly due to some local fiscal incentives, especially in Italy, but the market remains limited.

The regulator emphasised the need to look at what can be changed in the framework to make ELTIFs a more significant instrument for the financing in the European economy and a more attractive investment for retail and professional investors. Retail clients going into these instruments need to be adequately protected against potential liquidity and maturity issues. However, sufficient flexibility should also be provided in the framework to ensure that ELTIFs can invest in a wide enough range of assets consistent with the long-term investment aim. An industry representative fully supported the strategic importance of a vehicle facilitating infrastructure investment in particular and benefitting from a European passport, given the importance of infrastructures for the European economy.

An industry representative was favourable to developing ELTIF funds in the retail space, which is one key objective of the ELTIF review. This will support the financing of SMEs and infrastructure projects and also engage European citizens more in the development of the European economy. In France some domestic alternative investment funds (AIFs) investing in infrastructure or SMEs launched in 2021 have been quite successful in the retail market. More than 80% of the investments were made by mass retail investors with tickets below €10,000, showing the potential of such funds. But currently, such AIFs do not benefit from a European passport, which limits their development potential.

An official stated that ELTIFs are an important part of the Capital Markets Union (CMU). The objectives of fostering longer-term investment and providing capital to the real economy should not be forgotten in the technical discussions about the legislative proposal. However, there is much work to do, when considering the present level of development of the ELTIF market. Bringing retail savers into this framework will provide such investors with new investment opportunities while at the same time providing the EU economy with additional sources of capital. That said, involving retail investors will require a focus on investor protection and this may require trade-offs. Building trust and confidence among retail investors will be needed, in addition to improving financial literacy. These are part of the key objectives of the Capital Markets Union (CMU).

A public representative agreed about the importance of improving financial education in Europe. For capital markets to function appropriately, it is necessary to provide investors with the right information, but they also need to have the capacity to understand and use that information in their investment decisions.

1.2 Regulatory changes proposed

The Chair noted that ESMA had sent a letter to the Commission at the beginning of 2021 with recommendations on how to review the ELTIF regime covering areas such as eligible assets, the authorisation process, portfolio composition, redemptions and disclosures. A regulator stated that ESMA is in favour of the proposals made for reviewing the ELTIF framework. It has to be ensured however that more retail investor participation is accompanied by the right level of protection.

An official considered that the provisions proposed by the Commission for developing retail investment in ELTIFs, such as the lowering of the entry threshold, as well as the proposals for facilitating the administrative management of these funds and reducing compliance costs are heading in the right direction. However their impact will need to be evaluated and it should be ensured that they do not undermine investor protection. There is a fine line to walk there.

An industry representative agreed that many tricky issues with ELTIFs are being tackled in the review proposal, including the possible opening of these funds to retail investors and related liquidity issues, and also how the burden and costs of managing these funds can be alleviated for asset managers. Another industry representative added that the ELTIF review proposal is addressing many issues that were obstacles to the launch of ELTIFs in the initial framework. These include the widening of the eligible assets on the real estate and infrastructure side and the reduction of the minimum investment threshold for retail investors.

The Chair noted that finding the right balance in terms of liquidity rules is an important issue, because retail investors must not have the impression that ELTIFs can be redeemed at any moment. A regulator agreed that liquidity provisions are instrumental in defining the way that these funds can be used by retail investors. Level 2 empowerment on the matching mechanism will allow a fine-tuning of these rules.

2. Alternative Investment Fund Managers Directive (AIFMD) and UCITS Review

2.1 Overall objectives of the AIFMD review and challenges to overcome

The Chair pointed out that, in fact, this reform was much more than an AIFMD reform, since it touched also on a number of important UCITS provisions. The panellists were generally supportive of the proposal made by the Commission to amend the AIFMD directive. An industry representative remarked that the existing AIFMD and UCITS frameworks have largely contributed to creating two major investment fund markets, which are among the most successful ones in the world. This success is due to the frameworks striking the right balance between investor protection and innovation, allowing the development of products corresponding to the main needs of investors. The AIFMD framework also proved its solidity during the 2008 financial crisis and the Covid crisis. It is important in this review exercise to not try to rebuild what has proven to be solid. Adjustments should be focused on areas that have evidenced problematic weaknesses or gaps.

An official noted that AIFMD has developed into a global brand and agreed that a major overhaul of the directive is not desirable. It is founded on a very successful passporting regime balancing financial innovation and expertise with the safeguards of investor protection and financial stability. What is being considered in the AIFMD review is evolution rather than revolution, which is the right way forward. Though there are points of concern which have to be addressed to ensure there are no vectors of instability, it should not be forgotten that the guard rails of AIFMD have worked so far including during the Covid crisis, which was an unforeseen extreme period of stress for the overall economy.

A public representative emphasized that AIFMD is a key element of the wider CMU strategy aiming to facilitate investment in EU businesses as well as provide attractive investment opportunities. The European Parliament is in the process of listening to different stakeholders in order to identify what changes are potentially needed in the AIFMD to enhance the legislation. A calendar has now been approved for the review with an objective to schedule the final plenary vote on the AIFMD review report in the first or second session of October in order to finalize the revision as soon as possible.

Agreeing with the previous panellists, the public representative suggested that while a revision is needed, the benefits and strong points of the current legislation must be preserved. The aim is to have the right balance between enhancing the competitiveness of the EU fund market and investor protection. The proposal for the review of AIFMD is moving in the right direction in this regard. The ambition is for the EU to become the first market for funds at the global level over time. Supervision is a further issue to be tackled for supporting the development of the EU fund market and more broadly the CMU, because at present it works in a fragmented way across jurisdictions and financial sectors in Europe. There is a need for a real European supervisory authority equipped with appropriate tools to conduct supervision across the EU in connection with the national competent authorities (NCAs).

A regulator noted that supervisory convergence actions such as peer reviews are already conducted on a regular basis in order to achieve common supervisory outcomes. There have been suggestions that the frequency of peer reviews should be increased and more clearly mandated in Level 1, but the intensity of supervisory convergence and the convergence tool used should primarily depend on the potential risks and the desired outcome.

2.2 Delegation arrangements

An industry representative noted that delegation is an important aspect of the AIFMD directive and has proven its added value, allowing an optimisation of portfolio management activities in particular. The aim is to give investors the best possible product. The current delegation framework also proved its resilience during the recent market turmoil and is a solid basis. There should not be a distinctive treatment between delegations inside the EU and delegations outside of the EU, because the responsibility in the two cases remains with the management company based in the EU. In addition one idea, which could be preferable, could be to task ESMA with carrying out a common supervisory activity on delegation to determine if all the delegation arrangements put in place by a given management company are working adequately.

A regulator noted that delegation remains a controversial topic. Rules were put in place in the Brexit context to avoid empty shells and clarify responsibilities, but there is no intention of forbidding delegation. The new proposals made in this area are important for achieving further supervisory convergence and collecting the data and information needed for ensuring a more effective oversight of market practices and risks. It may be helpful also to have a common view on the breakdown of activities included in the portfolio management function in order to facilitate the assessment of delegation arrangements by the NCAs.

A public representative stated that the proposals made on delegation are on the right path. Funds need to be profitable, which includes allowing delegation so that portfolio management activities can be organised in an optimal way. However, access to information and investor protection must be preserved in a context of delegation. An official suggested that improved financial literacy and investor trust and confidence would facilitate the tackling of issues such as delegation and the location of asset management activities, along with the use of liquidity management tools (LMT).

2.3 Liquidity management tools (LMTs)

An industry representative considered that the proposal to provide a minimum set of LMTs at the Level 1 of AIFMD is an improvement. There is too much diversity across member states at present and some of them do not allow a sufficient use of LMTs. However, caution is needed regarding the mandates given to ESMA in this context. In the current drafting, the proposed Level 1 indicates that

ESMA should define the conditions for using LMTs. While the intention of defining ex ante the way that LMTs may be activated, is understandable, the risk is that there ends up being very specific conditions for using LMTs. Flexibility is needed in this regard. The use of LMTs should remain in the hands of the asset managers. In the most exceptional circumstances regulators may also have the power to activate some tools such as suspensions and gates, but for swing pricing, for instance, it would not make sense.

A second industry representative agreed on the need for flexibility and approved of the starting point regarding LMTs in the AIFMD review proposal, notably the fact that LMTs will be available in all EU member states in the future. Ultimately, the decision to trigger the LMTs should be with the management company, under the close supervision of the NCAs, one of the main reasons being that the appropriate tools to use may vary from one fund to another.

An official was also supportive of the proposals concerning LMTs. A number of member states would agree with the responsibility for the deployment of LMTs being with the fund manager and limiting the powers of NCAs to very exceptional circumstances. However, some member states have no experience of these tools and need to gain some understanding of their functioning.

A regulator agreed about the importance of clarifying the use of LMTs further and appreciated the sensitivity and possible concerns around NCAs being involved in the activation or deactivation of those tools. ESMA is indeed tasked with establishing the conditions under which NCAs could request managers to use these tools. The first-line obligation needs to be on the managers. The question is whether an NCA should have a 'stick', which hopefully it will never use, to be able to ultimately force the use of these tools and if so in which circumstances.

The Chair noted that CNMV, the Spanish supervisor, published recently a new set of technical guidelines on LMTs that are broadly consistent with the comments made by the panellists. The responsibility for activating LMTs lies with the manager but there are procedures defining how the fund should react to certain stress situations and the 'stick' will remain in the hands of the NCA in extreme cases where the fund manager would not take appropriate action.

2.4 Reporting requirements

An industry representative suggested that reporting requirements could be streamlined. For UCITS, fund inventories are reported in a very granular way (i.e. line by line, asset by asset, for each fund) to the national central banks of the jurisdictions where the funds are domiciled, particularly for France and Luxembourg. However, this data is not shared by central banks with their local securities regulators, leading to potential duplications. The sharing of reporting data provided among the authorities should be requested in Level 1. An official agreed that reporting should be conducted in a way that does not over-burden the fund industry with duplication or inconsistencies. There is a need to be smart and streamlined in this regard and ensure that the data flows across the different authorities.

A regulator was thankful for the closing of the reporting gap on UCITS. There has been AIFMD reporting for a long time, but this was not the case for the UCITS market. ESMA is very supportive of achieving integrated reporting and aligning reporting requirements. The most needs to be made out collectively of the reporting, which means that it needs to be properly channelled to the authorities who need to work on the data and shared among them, rather than setting up separate reporting requirements. One area where information to supervisors remains insufficient is transaction reporting for market abuse monitoring purposes.

A public representative noted that the Parliament is generally in favour of increasing transparency, improving the access of supervisors to information and data sharing. The key is to find the right balance and to propose the right procedure for providing the information and sharing it in an effective way and also to define what type of information needs to be constantly available. This is currently being assessed and is likely to be one of the most controversial topics in the negotiation on the AIFMD review.

The Chair mentioned that Spain has had monthly reporting of line-by-line ISIN level positions since 1990, which is a primary source of information for CNMV's supervision. For instance, on 14 March 2020 with the Covid crisis and the biggest plunge in the stock markets in recent history for Spain, it would not have been possible to identify quickly enough which management companies were experiencing problems without these end-of-month reports. This detailed monthly reporting will also allow a review on the ESG features of funds compared to what they actually invest in for instance.

2.5 Loan origination funds

An industry representative stated that concerning loan-origination funds some aspects need considering in the fine-tuning of the Level 1 of AIFMD. For example, there is a 5% retention obligation in the current proposal. The underlying aim is to ensure that managers have some 'skin in the game' and do not put all the risk on investors, but this rule should be softened, the speaker felt, either with exemptions in some specific cases or being applicable only during a limited holding period.

An official agreed that common guidance and participation should be sought on loan origination funds. ESMA could be turned to for enhancing supervisory convergence in this area and identifying best practices.

MiFID II / MiFIR review priorities

1. Overall objectives of the MiFIR review and key issues at stake

The Chair noted that the Markets in Financial Instruments Regulation (MiFIR) review is underway. The UK proposal on the same issues is expected in the coming weeks as a follow-up to the consultation on the Wholesale Market Review (WMR). Enhancing transparency and price formation are at the core of both of these initiatives. For the EU, a number of important issues are covered by the MiFIR review including: the definition of a consistent approach to waivers and deferrals, the role of systematic internalisers (SI), the implementation of consolidated tapes, the acceptability of payment for order flow (PFOF) and ultimately how best execution and efficient price formation may be achieved.

An industry representative emphasized the importance of contextualising the MiFIR review debate in the EU macroeconomic environment. Currently there is a risk of durable high inflation and very weak economic growth in Europe, together with unprecedented levels of public debt and constrained public finances. In this context, developing capital markets is essential to advance on the ESG and digital transformations, and also to solve key societal questions for EU citizens such as the future of pension systems. However the development and integration of capital markets in Europe are at a standstill. Of the 1,800 initial public offerings (IPO) globally last year, only 10% took place in the EU. In terms of market cap of listed companies compared to GDP, the US is roughly at 150% while the EU is at around 52%. Fragmentation is also prevalent in the EU with about 500 trading and execution venues compared to about 100 in the US, which is a larger market. The MiFIR review is critically important for improving the structure and functioning of EU capital markets, the industry speaker stated and the legislative proposals from the European Commission on the MiFIR review are a good starting point in this regard, also bringing in some broader thinking on the financial autonomy and competitiveness of the EU and the importance of capital markets for the EU economy.

A regulator observed that the work on the MiFIR review is part of the broader context of the Capital Markets Union (CMU) initiative aiming to develop, enhance and further integrate EU capital markets, which is essential for the growth and resilience of the EU economy.

2. Level playing field among trading venues

A regulator considered that a key objective of the MiFIR review should be to achieve a level playing field among the different types of execution venues that are really 'multilateral' and to do so with a future-proof approach. Indeed, after the first years of implementation of MiFID II it was identified that a significant number of equity transactions are still not executed on lit markets, which needs to be addressed. In addition, some systems that allow the pre-arranging of buying and selling orders represent a threat to the level playing field and to transparency.

The regulator also stressed that Systematic Internalisers (SIs) should not be subject to exactly all the same MiFIR rules as multilateral venues. SIs that deal on own account are intrinsically different from other trading venues, because they face different underlying risks, although their activity appears to be quite similar. Although there are nuances across instruments, for many transactions executed by SIs the underlying products are not that much standardised or liquid. Notably for derivatives, the tailor-made trades executed by SIs serve the purpose of specific needs, are out of scope of the derivative trading obligation, and are of limited interest for the price discovery process. Imposing full transparency to SIs may expose them to liquidity and trading risk in connection with possible herding or opportunistic behaviour by other market operators. This could in turn hamper the function of sustaining liquidity that SIs normally perform. The Chair noted that the proposal had previously been made to limit the scope of SIs to large-in-scale trades, which would simplify transparency issues, solve the problems posed by Payment For Order Flow (PFOF), and ultimately enhance price formation. Simplification regarding double volume caps, that are too complex, would also be welcome. In any case, equity and non-equity must be distinguished in addressing these questions, the Chair underlined.

An industry representative emphasised that preserving a sufficient diversity of trading mechanisms is essential. Level playing field measures may impact the competitiveness of EU capital markets, if they restrict too much the choice of execution venues or how they may be used. Investors indeed optimize their choice of venue depending on the size and type of transaction, which means appropriately calibrating the requirements imposed on venues so that users are not penalized. Sufficient choice in terms of execution venues also contributes to fostering competition and decreasing execution costs for end investors.

Another industry representative confirmed that for equities the proportion of transactions executed on lit venues is limited in the EU, where it amounts to 35 to 50% of volumes compared to 60 to 65% in the US and about 80% in Japan. The EU trading landscape is also very fragmented with a significant share of internalisation of flows, which also has impacts on post-trading, with a high proportion of settlement fails.

The industry speaker moreover considered that the MiFIR review measures to enhance the level playing field among trading venues will not limit competition or investor choice. The different types of trading venues established by regulation should correspond to different investor needs and be subject to tailored rules. Concerning SIs for example, it is important to bear in mind that the initial objective of these venues was to handle large institutional orders in order to avoid market impact. However assessments conducted by the French Autorité des Marchés Financiers (AMF) have established that the median order size on SIs is lower than €6,000, which is quite far from the original intention of SIs. Changing the definitions in the directive regarding multilateral trading is therefore welcome, although proper enforcement will be key. Care should be taken also to capture the market holistically and not allow for new loopholes to develop. For example frequent batch auction-based systems could create new loopholes and their development should be closely monitored.

3. Transparency requirements

3.1 Opportunities and challenges associated with the enhancement of transparency

A regulator stated that there is a need to increase transparency particularly in the non-equity market and for post-trade data. Opaque markets are indeed a threat to financial stability as demonstrated during the 2008 financial crisis. Although measures to improve transparency were taken, a report issued in 2019 highlighted that a complicated deferral regime under MiFIR, along with the fragmented publication of transaction information, decreased transparency in the bond markets in Sweden. In March 2020, Sweden experienced a fund run, due to the malfunctioning of the underlying corporate bond market, which was basically opaque. A large number of investors tried to take their money out of corporate bond funds, which were trying to sell their assets in the market and subsequently 40 mutual funds had to be temporarily closed. Since then, Sweden has started a reform agenda for the corporate bond market. The Swedish authorities have initiated measures to improve post trade transparency by working with the industry to adopt an industry agreement where they voluntarily publish aggregated information about transactions end of the day. Transparency should be a guiding principle in the review of MiFIR, the regulator emphasized because otherwise the effectiveness of the EU capital markets will be reduced and some players will exit the market at a time when EU capital markets need to develop post-Brexit.

An industry representative agreed that there needs to be more transparency for fixed income and derivative transactions in the EU. Another industry representative was also in favour of enhancing transparency in EU capital markets, but observed that transparency measures could have a negative impact in certain areas of the market, such as a reduction of market liquidity and an increase of costs for end investors if they are not implemented in a balanced way in terms of speed and scope. The mistakes of the initial implementation of MiFID II which had very ambitious objectives in terms of pre- and post-trade transparency, but ultimately failed to deliver meaningful transparency, should not be reproduced. Although the information on transactions is published, it is fragmented across multiple venues and provided in different formats so it cannot be consolidated and is not usable.

A regulator noted that banks usually claim that there is a trade-off between liquidity and transparency but, for the most part, increasing transparency will lead to more liquidity as it will make the markets more credible and foster consumer protection, attracting new investors. Another regulator however observed that this trade-off may exist for certain types of venues such as SIs, as illustrated by the previous comments made.

3.2 EU consolidated tape (CT) proposal

A regulator considered that the CT proposal of the MiFIR review is a step in the right direction, but may not be sufficient to provide an appropriate level of transparency in the market. One issue is that there is still some uncertainty as to how the CT will function and whether a private sector solution will emerge or if ESMA will need to step in.

An industry representative stated that the CT will provide a consolidated and real-time view of transactions, which will help to make a better use of the available information. This will benefit investors, including retail investors, who should be a focus of this initiative, and also regulators for designing data-led policies.

Another industry representative emphasized that a CT has the potential to support further investment in the EU, provided certain conditions are respected. Data quality and availability is a first condition and will not be solved solely by a review of deferrals and waivers and by the implementation process of a CT. The main issue concerns SIs, dark pools and other non-lit parts of the market for which data is not readily available. Secondly, an adequate use case needs to be defined for the CT. The rationale and approach for a CT has to be defined for each type of instrument, depending on the market structure. A CT for OTC derivatives makes sense because in the EU 92% of derivatives trading is OTC with insufficient transparency. However, the situation is different for equities, where data quality issues are mainly focused in certain areas of the market, such as SIs and dark pools, which need to be tackled first, as previously mentioned. In addition the publication delay in the CT needs to be carefully considered because a close to real-time tape for example could potentially favour robots over human investors. The Chair agreed that greater data quality is key for the usefulness of the CT, because this will ensure that a greater amount of relevant information is embedded in it.

A third industry representative considered that, generally speaking, the more real-time the CT is, the more valuable it will be. For retail investors the ability to actually see the post-trade execution data in close to real-time would be incredibly helpful, because this information is not available at present for them, which undermines best execution. A real-time post-trade CT would also help to even the playing field between exchanges and SIs and probably encourage more on-venue trading. The CT can moreover contribute to the resilience of capital markets. Having a post-trade CT during exchange outages is indeed very helpful for the market to figure out where the price is for example. However, 'real-time' can be interpreted in different ways for different asset classes,. For equities it would be seconds but for fixed income about 15 minutes is likely to be the right measure.

The industry speaker added that the EU CT proposal, as it is currently framed, should be relatively uncontroversial because it is limited to post-trade reporting. This should not impact exchanges that much, because the vast majority of market-maker fees paid to exchanges are for pre-trade data and smaller exchanges may actually benefit from the CT because it will increase their visibility. In terms of business case, potential CT providers (CTP) will be interested in setting up a CT provided the reporting to the CT is mandatory and free.

3.3 Deferral regime

A regulator stated that the post-trade deferral regime should be simplified because the current system, based on different criteria such as sizes and ratings, is too complicated. The US TRACE (Trade Reporting and Compliance Engine) system, which publishes prices of bond transactions with a 15-minute deferral, could be a source of inspiration. European market players often consider that reducing deferrals would make market-making impossible, but such transparency would on the contrary help to increase the liquidity and the credibility of the market.

An industry representative considered that the current proposal to reduce post-trade deferrals is too inflexible. For certain pockets of the market where instruments are quite illiquid and where transactions are large, a two weeks' deferral for volume and end of day for price publications will not be sufficient. TRACE is not a real reference for the EU because it has a narrower scope than MiFID; it is mainly focused on US-denominated corporate bonds and does not introduce any real-time transparency for US Treasuries. It is moreover surprising that the Commission's proposal includes a harmonisation of deferrals for corporate bonds but not for sovereign bonds.

An industry representative explained that Treasuries are reported to TRACE in the US but transactions are not made publicly available. This situation should not be reproduced in Europe. Given that Treasuries are one of the world's most important markets, there should be greater transparency and the Federal Reserve and the US SEC are taking steps at present to address this issue. There are legitimate reasons to have some delay in reporting in certain cases, particularly to afford hedging, and price and volume should be treated differently in terms of deferrals. There can be a 15-minute delay for price reporting and a longer deferral for volume reporting e.g. 48 hours or some reasonable amount of time. The proposals of the Commission seem quite adequate in this regard.

A regulator considered that deferrals should be limited in liquid markets, so the argument for deferrals holds more for corporate bonds than for government bonds. The deferral regime should also change for government bonds to make it more transparent. Another regulator noted that while being more liquid, sovereign bonds are less amenable to fast monetisation in the view of the European Commission. The deterioration of liquidity is also probably a bigger threat for sovereign bonds than for corporate bonds, because they are more exposed to different destabilising factors (e.g. credit ratings, credit default swaps, … as the past experience demonstrates).

3.4 Fine-tuning of the MiFIR transparency regime

A regulator acknowledged at large the need to further fine-tune the current MiFIR transparency framework beyond reconsideration of waivers and deferrals, for instance to improve transparency of quotes made available by SIs. However, the new requirement for SIs to publish firm quotes for equities relating to a minimum of twice the standard market size seems to go too far, as moving the threshold from 10% to 200% seems excessive[1]. Following a specific question by the Chair, the regulator also replied that the proposed simplification of the double volume cap system is welcome.

An industry representative added that the accumulation of changes proposed in the MiFIR review needs to be carefully thought through, bearing in mind the balance between liquidity and transparency. There are proposals to increase real-time post-trade transparency while also increasing pre-trade transparency by removing the size specific to the instrument (SSTI) exemption and at the same time the phased-in approach for both derivatives and bonds is being removed.

Another industry representative was favourable to moving to a single volume cap, maintaining only the EU-wide threshold, is adequate since the double volume cap is not functioning properly. The increase for SIs of the pre-trade quotation size to two times standard market size for publication requirements is welcome, as are the changes to the reference price waiver to avoid the matching of smaller trades at midpoint. Moreover, a ban of payment for order flow (PFOF) is needed. A work by the French AMF based on real transaction data has indeed identified execution services which involve a part of retail flows being diverted from lit markets to the benefit of the handful of institutional investors that are members of the various programmes targeting retail investors, with strong evidence that end-customers are often disadvantaged.

4. Competitiveness of EU capital markets

4.1 Share and derivative trading obligations and open access measures

A regulator stated that concerning derivatives the objective put forward by the Commission to strengthen EU central clearing is valid from a competitiveness standpoint, as well as the proposal to align the scope of the clearing obligation under EMIR and of the derivatives trading

1. At present SIs are required to make public, on a regular and continuous basis during normal trading hours, firm quotes for equity and 'equity-like' instruments when there is a liquid market. Where there is no liquid market, SIs must disclose quotes to their clients upon request. The requirements apply only when dealing in sizes up to standard market size. SIs are able to decide sizes at which they will quote, provided they are at least 10 per cent of standard market size.

obligation (DTO) in MiFIR. This objective is justifiable on technical grounds, as the contribution to the price discovery process and the benefits of the straight-through processing for transactions that occur on exchanges do materialise for derivatives with marked features of standardisation and liquidity, which are the ones already subject to the clearing obligation. From a more strategic perspective, keeping these transactions in the EU market could also contribute to building up the EU clearing capacity.

The regulator was moreover in favour of keeping some flexibility in the process of activating a possible suspension of the derivative and share trading obligations (DTO and STO) in order to be able to cope with market disruptions. The flexibility available for suspending the STO proved very useful for tackling the challenges connected to Brexit for example. However, while the exemption foreseen for non-systematic, ad-hoc, irregular and infrequent transactions should not necessarily be maintained as it is, given it could prove very general and difficult to enforce, a certain degree of flexibility in the suspension of both the DTO and the STO would be beneficial. In particular, the possibility of suspension of the STO could be modelled along the lines already proposed by the European Commission for the DTO. Such suspensions could be activated by a single national competent authority (NCA), possibly in coordination with other NCAs and also ESMA, to ensure convergence of approaches. Maintaining this power to suspend the DTO and STO on an ad hoc basis is also important because the EU authorities do not have the possibility to adopt no action letters in the same way as authorities in some other jurisdictions.

An industry representative agreed about the proposal to align the scope of the DTO with that of the clearing obligation. The industry speaker also stressed the importance of deleting the open access framework. No other jurisdiction has such a framework in place and its elimination is currently being considered in the UK. Open access may indeed hinder market competitiveness because if all of the trading venues and CCPs are linked up, then there is access to all of the other services and products, which reduces incentives to compete on the basis of better services and products and cheaper prices. In addition, on the clearing side, it is important for financial stability that clearing should be as centralized as possible rather than interconnected. Open access rules also need to be considered in the context of future market developments, as they may make it more difficult for certain market infrastructures to move to a Distributed Ledger Technology (DLT) environment, which may have further implications for the competitiveness of EU markets.

The Chair observed that the topic of the competitiveness of EU capital markets is potentially more sensitive for bonds, for which there is no trading obligation, than for derivatives which is a truly global, international market.

4.2 Impact of MiFIR review transparency proposals on the competitiveness of EU capital markets

Answering a question from the Chair about the possible impact in terms of competitiveness of the MiFIR review transparency measures for bonds in particular, an industry representative considered that the current deferrals are too limited to cater for the very wide scope of instruments that come under MiFID II with different liquidity characteristics. For sovereign bonds, MiFID II covers any sovereign bond that is traded or needs to trade in Europe. This regime does not currently cater for all of the different liquidity profiles that will be seen in those instruments. There is a real risk that the EU could be at a disadvantage as a result of the measures proposed.

An industry representative stated that generally speaking more transparency will lead to more competitive and resilient markets. The US grappled with the same questions about post-trade transparency and whether to implement a close to real time reporting system about 8 years ago and academic studies have since shown that spreads tightened for institutional investors by about 10%, more entrants came into the markets with smaller dealers enhancing competition and the overall market volume did not decrease. This shows the positive impacts of transparency measures in the US market, which is however only one reference point.

4.3 Comparison with the UK Wholesale Market Review (WMR)

An industry representative noted that although the end result of the WMR is not yet known, the direction of travel is different than in the EU. The UK is taking a more liberal approach, proposing to eliminate certain requirements that do not provide end investors with appropriate outcomes such as the shares trading obligation and the double volume cap. There is also a different approach to dark trading, which the UK perceives as potentially playing a positive role in certain pockets of the market. Concerning pre-trade and post-trade transparency, the UK Treasury considered in a recent consultation paper, that the specificities of equities and non-equities and how liquidity is created in those markets are not sufficiently well taken into account in MiFID II. They are notably looking to potentially restrict pre-trade transparency obligation in the UK in the fixed income and derivatives markets to only automated order books. The UK Treasury is also proposing to provide regulators with more power and a secondary objective around economic growth and competitiveness, which Europe should also consider.

Another industry representative added that the UK Treasury indicated that they would start with a post-trade CT in fixed income and in OTC derivatives as that would have the biggest potential benefit. While there should be consideration of what the UK is doing, if it takes a step back from transparency then Europe should not follow it.

Consolidated Tape: prospects for delivery

1. Objectives of the EU consolidated tape (CT) project and related opportunities

An industry representative was in favour of the MiFIR[1] review proposal to set up an EU consolidated tape (CT). The aim is to make European securities markets more attractive for investors and to increase liquidity, which should support the financing of the EU economy and make European markets more resilient. The CT should provide investors with the data they need to make investment decisions with a consolidated view of all EU markets. The objective should also be to make this data available as widely and as cheaply as possible, in order to attract more investors to the market.

Another industry representative agreed on the benefit of setting up a CT providing a view across transactions executed on- and off-venue in the EU, including systematic internalisers (SI) and over-the-counter (OTC).

An investor representative also supported the CT initiative, which should help to enhance costs and competition in the market by providing institutional and retail investors with a consolidated view on the pricing of transactions. This should also facilitate the access of companies to capital market financing and support the green transition. European markets indeed remain fragmented despite the implementation of the MiFID[2] and MiFIR legislations. Transaction data also continues to be relatively opaque and best execution is not delivered, with retail investors in particular paying the price for this market dysfunction in terms of spreads being unnecessarily wide. Systemic internalisation is widespread and loopholes from best execution are not serving the market well.

A regulator emphasised that beyond serving the interests of investors by addressing the present fragmentation, cost and difficulty of accessing adequate transaction data, the tape will also support the activities of regulators and supervisors analysing the market and working on the improvement of regulation. Another regulator stressed the potential contribution of the CT to building a single European capital market and addressing the current fragmentation, by making data available to investors across the Union.

2. Main characteristics and content of the CT

2.1. Type of data available on the CT

An industry representative stated that the CT project, which proposes the setting up of a unique CT providing close to real time data for equity shares and bonds is moving in the right direction. Some aspects however need to be reconsidered from an investor perspective. Only post trade data will be available in the first phase of implementation, but this should be extended to pre-trade data for equities because equity markets work with an order book, the visibility on which is necessary to make investment decisions. While a phased implementation starting with post-trade data is understandable, it should not be limited to this for equities because the use case of the CT will be insufficient.

A second industry representative was on the contrary in favour of a post trade delayed tape and not a pre-trade tape. A pre-trade tape is not feasible due to the latency issues that will be seen across the geography of Europe. In addition, it may lead to the creation of a two-tier market with some financial firms able to afford low latency services and others only using the CT where part of the liquidity will no longer be available, thus creating a false reference point. A phased approach is therefore needed, starting with a delayed 15 minute tape. Since data provided by the exchanges is free after 15 minutes, this would also solve remuneration issues. Once this has been done, an impact assessment of introducing a real-time post-trade CT can be conducted to plan possible further steps of the CT.

An investor representative agreed that the post-trade CT should be the primary objective, as it is timestamped, traceable and includes information on the market venue on which the transaction was executed. It would allow the tackling of the main data fragmentation issues. Although a real-time CT would normally be the ultimate goal, this might lead to a potential increase in trading costs due to the investments required for collecting, consolidating and distributing the data in real-time, which does not seem worthwhile at present. In addition, retail investors who are not able to engage in price arbitrage between a variety of markets, unlike high frequency traders, will probably not benefit that much from a real-time CT. In the initial implementation a 15 second delay could be an acceptable compromise for the equity CT, since this would still allow the validation of best execution without disrupting current market practices.

A third industry representative explained that for fixed income the focus should be on post-trade data because of the nature of the product. Post-trade data will have more value than pre-trade data in this case. The majority of bonds are trading via the RFQ (Request for Quote) negotiation protocol, which means that the pre-trade price and the post-trade price actually print very close to each other. Someone would rather wait for the certainty

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of the post-trade price than bank on pre-trade prices, which may not have actually executed.

A regulator stated that a staggered approach leaving the possibility to adjust the project if needed is the best way forward, because such a project is difficult to plan upfront entirely. The MiFIR review proposal is right to start with a post-trade CT for bonds and equities, before considering going to pre-trade data. The implications of a pre-trade CT for equities, i.e. the delays, its purpose, and the cost and complexity of implementation, need to be further clarified, because views vary on these issues.

The first industry representative observed that a further element that needs to be considered is the phasing in of deferrals. At the moment the Commission wants to reduce deferrals significantly and build the CT at the same time, however waiting for the CT to be built and fine-tuned before addressing data deferrals would seem more appropriate. This would allow a better definition of transparency needs based on an assessment of the market structure, the liquidity in the market and current transaction flows, before deferrals are adjusted. The regulator suggested that regarding deferrals, there should be one single regime in Europe, because harmonising the existing patchwork of national specificities will be very complicated.

2.2. Priorities in terms of coverage of instruments

An industry representative pointed out the breadth of the range of asset classes due to be included in the CT according to the current proposal and the need to establish priorities. Implementing 4 CTs in 12 months in a big bang type approach seems very ambitious. Previously the introduction of MiFID transparency requirements in January 2018 for example faced major data quality issues resulting in significant delays. The priority should be given to equities and bonds, as they are simple instruments for which clear use cases have been established, which is less the case for ETFs and derivatives. The CT for other asset classes could come later if clear use cases are defined.

An investor representative agreed that priorities should be established. It would be costly to go for the full 4 CTs at once, as it would mean imposing many requirements concerning the provision and analysis of the data in order to ensure best execution. Bond markets should be a priority, because of the lack of data. Only a quarter of bond transactions take place on lit markets. It is necessary to ensure that the different trading venues including SIs and the approved publication arrangements (APA) are required to provide the trading data to the consolidated tape provider (CTP) free of charge, and in highly harmonised, high-quality formats to have the most cost-efficient way of distributing the data.

A regulator suggested that a staggered approach should also be used for rolling out the different CTs. It is possible to start with one asset class, learn from that, and then move to a more complex one. This would give enough time to ESMA to stop and correct things if needed. The CT should first be implemented in the markets where fragmentation is highest and where the data is the most difficult to gather. That is both bonds and equities, for different reasons, in the first case because of the market structure and the way fixed income markets function, and in the other case because of the proliferation of equity trading venues.

A regulator stressed that it is important to keep the momentum. Four years were given to see whether a CTP would emerge, and it has not. It is important to be ambitious but at the same time pragmatic and thus a staged approach would be beneficial.

The Chair observed that a challenge with the staged approach is that while it allows progressive learning and adjustments to the CT in terms of functioning and business model, it will make it more difficult to establish clear rules up front and therefore market players may not know what point they are moving towards. One idea would be to provide ESMA with more discretionary powers so that rules can be tweaked at a later stage if needed.

3. Data quality and availability issues

The Chair emphasized the importance of data quality for the CT and the related challenges to be considered including deferrals, waivers, and data publication delays.

An industry representative considered that data quality issues should be fixed before the CT is put in place. While good quality transaction data is easily available from the exchanges, this is not the case for SIs and OTC transactions, which should be first required to meet their publication obligations in the right format.

A second industry representative stated that data quality depends on the asset class, and is simpler to accomplish for equity and bonds than for derivatives. Achieving sufficient data quality requires constant work on the part of financial institutions and also of the APAs, who check the transactions reported in their systems, identify potential outlier trades and correct errors. Solving certain issues also requires a collective effort of the whole ecosystem. SIs have an obligation of post-trade transparency and already publish on APAs. There are only a few APAs on equity, and one of those is preponderant. That data is available and it is as real time as possible, since SIs have the obligation to send it in less than one minute. It is up to the APAs to make it more accessible.

A third industry representative considered that data quality is a slight misnomer when it comes to fixed income. There is not a data quality issue as such in these markets, but an issue around the clarity of existing regulatory standards and the way they are interpreted, which ESMA could contribute to fix.

A regulator noted that for data quality there is a need to have appropriate preparation and definitions ex ante in the Level 1 and 2 texts and in the regulatory standards before the process of data collection is started, otherwise the risk of failure is high. The Commission has done excellent work with its proposals on data quality and data standards, but there is some confusion with the multiplicity of consultative committees currently working on data. These assessments should be coordinated by ESMA, which would then be able to advise the Commission on these issues or propose changes in the delegated acts.

Another regulator highlighted the importance of collective work on the improvement of data quality. It is essential that this work takes place across all the asset classes and venues, not just regulated markets, and that all trades are reflected on the CT. ESMA is reviewing the relevant Regulatory Technical Standards (RTS), and also working on a day-to-day basis with the national competent authorities (NCAs) and financial firms on the improvement of data completeness and quality, considering however that perfect quality is difficult to achieve. The CT will be an incentive to further improve data. It makes sense to keep data quality requirements as technical standards and not change them into a delegated act.

4. Implementation challenges

A regulator stated that one of the first challenges in terms of implementation of the CT is in having a process with realistic timings. The selection procedure of the CTPs is due to be run by ESMA for the four different CTs. It is important to define high level criteria on which decisions will be based in order to ensure that the process is transparent and clear for all candidates that come forward. There is an issue of timing however, because the criteria will need to take into account the data that the CTPs will be providing and that will be specified in Level 2 measures. Those Level 2 measures will therefore be needed before ESMA can decide the criteria on which it will judge who will be selected. The three months that is currently envisaged for managing the selection and the authorisation process would be problematic both for ESMA who will be running the process and also for the candidates who will be applying. An industry representative agreed that it is vital to be careful with the selection criteria, as shown by the first iteration of the US tapes which was a failure.

A second issue, the regulator felt, is the current combination of the selection and authorisation process. The selection process is about assessing who best meets the selection criteria, and the authorisation process is about making sure that the entity retained actually complies with the requirements to run the tape. By merging the two there is a risk that applicants will have to make significant investments which could be lost if they are not selected, or that ESMA may have to make a decision without all the elements of information needed. Splitting the selection and authorisation processes would therefore be beneficial, as well as separating and phasing the selection procedures for the four CTs.

An industry representative sympathised with the challenges faced by ESMA in the implementation of the CTP. The current timelines are incredibly tight and may lead to a bad outcome if they are maintained. Any potential applicant to be a CTP would likely need to make significant investment and run the risk of not actually winning the tender itself, leading to sunk costs. Another issue concerns APAs. Incumbent APAs are the main players in the market who could provide a CT in a relatively short timeframe, as their technology stack performs very similar tasks to a CTP and their commercial model is up and running. In addition APAs are already regulated by ESMA. However in the explanatory notes of the MiFIR review it is clearly stated that ESMA should consider independent providers, potentially outside the incumbent providers such as APAs, which reduces their probability of being selected. There is nevertheless a good chance of getting a CTP due to the fallback option, whereby the Commission would request ESMA to interject and create a CTP. But to allow a commercial solution to emerge the observations made previously concerning non-equity instruments need to be addressed, requiring a different approach for equities and fixed income in particular.

A regulator was concerned about the fallback option mentioned by the previous speaker. If no commercial provider with all the necessary experience emerges then it will not be easy for ESMA to take on the responsibility of developing the CT. More time is needed before declaring that no commercial CTP solution is viable. Another regulator stressed the importance of appropriately planning the development of the CT, taking into account the time needed to move from the Level 1 text to data standards and detailed specifications.

The Chair agreed that sufficient time and effort needs to be spent in the market to see whether there is a possibility to make the CT commercially viable in a reasonable timeframe before there is any discussion of a fallback.

5. Governance and business model issues

An industry representative stated that further clarity is needed regarding the governance and commercial viability of the CT. In terms of governance, a precise definition of who conducts the oversight of the CT is needed, as well as who is in charge of data quality and ensuring that SIs and firms executing OTC transactions are meeting their publication requirements in the proper format.

The business case and the conditions for ensuring the commercial viability of the CT also need to be more precisely specified, the industry speaker suggested. Making a CT function correctly for the market cannot be done cheaply and requires a significant amount of work. It is important to have more detail on remuneration and how it will be ensured that data providers are rightly compensated and that small exchanges do not lose a vital revenue stream. A business case where exchanges are mandated to furnish their data and users have no obligation to use it would not work. Moreover, a badly designed tape could harm the smaller exchanges and the capital markets in which they operate. For example, the three exchanges in the Baltics heavily rely on their revenue from data because their activities are not very diversified and data revenues finance their other listing and trading operations. Removing data revenue would reduce the contribution of those exchanges to the development of the capital markets in which they operate. The impacts however depend on the choices made for the tape. A post-trade delayed tape would not significantly affect the main exchanges that have diversified revenue sources, but will impact the smaller exchanges like the Baltics, whereas a real-time post-trade tape would also affect the revenues of the larger exchanges. This depends also on the position that exchanges have on different instruments.

A second industry representative considered that the revenue redistribution aspects of the CT proposal need to be reconsidered, because at this stage it adopts a mechanism that maximises profits from market data instead of focusing on getting the data available as cheaply as possible for investors. The speaker also noted that professional investors and market makers will continue to pay direct fees to every single exchange in every market, because quick access is needed when trading electronically. The tape will therefore probably result in a loss of revenue for exchanges and an increase of the direct fees paid by professional investors and market makers. A participant in the audience confirmed that fees paid by market-makers keep rising. There is hope that volumes will increase in European markets when pre and post-trade transparency reach the desired level, but it is uncertain.

A third industry representative emphasized the potential impacts of the CTP proposal on APAs. A CTP will consolidate data from APAs and trading venues into a publishable format and then publish it for consumption. Suggestions have been made that APAs should give their data to the CTP for free, but if this is the case their revenue will likely be cut in half, which could lead some of them to exiting the market. The industry speaker moreover emphasized some commercial challenges associated with the CTP for APAs. Operating a CTP is not a technical challenge since nine major APAs already exist in the EU conducting similar activities, but a commercial challenge, which is impacted by the regulatory requirements applying to the CTP. One issue that CTPs could be facing is the responsibility for the appropriate implementation of waivers and deferrals. Bringing that upstream to the CTPs, rather than leaving it with trading venues will result in a duplication of effort and another commercial burden for the CTPs.

The industry speaker was also concerned by the viability of the bond and derivative CTs. Many of the regulatory requirements applying to fixed income CTs were initially defined for the equity CT and do not fit the fixed income market. This explains why no CT has emerged for fixed income for the time being. The current proposal corrects some of the challenges that existed in the incumbent legislation for equities, but this is less the case for fixed income. As for derivatives, the industry representative considered that a CTP is not viable until the International Securities Identification Number (ISIN) challenge is solved. For example, if someone wants to use a derivative CT for comparing a 10-year swap over 250 business days of the year that will require dealing with 250 ISINs, which is impossible. Until this issue is solved, there is no use case for a derivative CTP. A regulator agreed that this ISIN problem has to be fixed for derivatives. A derivative CT can make sense, but these feasibility issues need to be addressed first.

An investor representative was also worried by potential impact of the cost of implementing the CTs on retail investors. The anticipated annual revenues for equity and bond CTPs are about €100-$150 million per annum; it should be ensured that this does not translate into price increases for investors. This should be taken into account in the assessments conducted by ESMA.

The Chair summarised that there is broad support for the CT, which is a concrete project which can drive EU capital markets and the CMU forward. It is important to keep momentum, but a sensible way forward needs to be defined, according to the panellists, which could possibly be a staggered approach, allowing learning over time. It is also important to delve into the details and make sure that the CTP is viable, because it is a highly technical subject. In particular, unnecessarily wrecking existing business models which have positive externalities in smaller exchanges should be avoided.

Clearing: priorities for enhancing financial stability and the EU clearing ecosystem

1. Approach concerning UK-based CCPs

1.1 Update on risk assessments and temporary recognition decisions

A regulator noted that ESMA has issued the outcome of its comprehensive assessment of the issues around systemically important third country central counterparties CCPs (TC CCPs). Three clearing services were identified as being of substantial systemic importance for the EU: SwapClear in LCH Ltd in relation to euro and Polish zloty, the credit default swap (CDS) and short term interest rate segments in euro within ICE Clear Europe. After a comprehensive cost-benefit analysis, ESMA concluded that the costs of derecognising these services would outweigh the benefits in the current situation, but identified a range of important risks and vulnerabilities associated with these clearing services which need to be addressed.

A policy-maker explained that clearing is an essential part of the Capital Markets Union (CMU). The Commission decided to extend the temporary equivalence decision covering the UK framework for CCPs by 3 years in order to avoid a cliff-edge, which would pave the way for ESMA to extend its recognition of UK CCPs under EMIR for the same period (i.e. until 30 June 2025). This delay will also give the Commission time to put in place a strategy for increasing the EU clearing capacity and ensuring greater financial stability. Initial ideas have been proposed through a public consultation.

1.2 Potential financial stability issues posed by the dependency of the EU on UK CCPs

A policy-maker stated that the Commission is paying considerable attention to clearing, because UK CCPs offer services that are critical to many EU players, but are now outside the EU regulatory and supervisory perimeter. This raises questions about how to manage potential financial stability risks posed by these CCPs. There have been some moves from European market participants over the last few months to open accounts at EU CCPs and engage with these CCPs for clearing but, according to the assessments conducted by ESMA, there continues to be an over-reliance on systemic third-country CCPs which could threaten financial stability, particularly in periods of stress.

A Central Bank official agreed that UK CCPs continue to pose financial stability risks to the EU, given the high volume of clearing occurring at UK CCPs. While clearing volumes for over the counter (OTC) interest rate derivatives have grown at EU CCPs, the current market share amounting to around 21% is insufficient and shifts to the EU have remained marginal. London also controls around 90% of euro swaps cleared and has a 90% global market share in interest rate derivatives. The exposure of EU market participants to UK CCPs therefore continues to be very high, which is not sustainable because of the dependency it creates and the exposure to possible disruptions in the operations of UK CCPs this may lead to, even though this is a tail risk.

An industry speaker disagreed with the remarks of the previous panellists about the financial stability risks posed by UK CCPs to the EU, emphasising that LCH Ltd for example is directly supervised by ESMA and subject to the EU EMIR law, and this will not change. LCH also has a deposit account with the European Central Bank (ECB), which is important for financial stability because collateral in Europe is held in cash at the ECB.

A Central Bank official agreed on the importance of ensuring financial stability in the clearing space, suggesting that the G20 decision that CCPs should be part of the solution to the financial crisis and problems in derivatives markets was made in full awareness that CCPs had to be cross-border and multi-currency. As a result of this deliberate G20 policy, clearing has grown. Regulators have to ensure that CCPs do not pose a risk to their financial markets. But this can be done without sacrificing the benefits of cross-border clearing, by developing tools to make sure that home supervisors, through cooperation, can provide safety and by moving in a direction to be able to give those assurances and avoid fragmentation.

1.3 The importance of EU-UK supervisory cooperation

A Central Bank official considered that major UK CCPs will remain systematically important for the EU in the foreseeable future, which means that close and constructive cooperation between the EU and UK authorities will be needed in the coming years. EMIR 2.2 already grants enhanced powers to ESMA to supervise and oversee Tier 2 systemically important CCPs, and ESMA has made several suggestions about how to improve its supervisory capacity in this regard. Legislative action to support this evolution will also be needed and in this respect the Commission's ongoing consultation is welcome.

An industry speaker emphasised that the solution for ensuring financial stability is to strengthen supervisory responsibilities and powers and also supervisory cooperation. Derivative markets are global by nature and any action to fragment them may create risks which cannot be foreseen. LCH is comfortable working with different countries; it has 11 different licences. With the adequate supervision, market forces will allow the market to evolve towards a structure that is relevant for the marketplace. For example five years ago the share of euro CDSs, single names and euro indices, cleared at LCH SA the Paris-based sister entity of LCH Ltd was 5%. Now it has grown to nearly 50%. Regulation did not push this to happen; it was achieved through efforts made by the CCP to provide products and services relevant for the marketplace.

A Central Bank official described how the Bank of England, as it implements its own version of EMIR 2.2, will ensure that there are very high standards of cooperation and transparency between regulators, especially where CCPs have a significant market share in a domestic market. Communication between the Bank of England, ESMA and other relevant authorities is frequent and the Bank of England believes it has the necessary tools and information to make sure that financial stability aims can be achieved with regard to CCPs.

In the UK, the Bank of England has consulted on an approach called 'informed reliance', the Central Bank official explained, whereby the UK authorities would not need to regulate a foreign CCP directly if there is a high level of information and cooperation. The level necessary will depend on the risks posed by a CCP to financial stability in the UK. The objective is to ensure financial stability without undermining the global clearing market. This system will only work if there is mutual trust however, which is why cooperation is important. UK regulators are also taking steps to make very clear that, even in times of crisis, they do not discriminate clearing members on the basis of nationality, because there is a need to consider financial stability from a global perspective. The path forward is to build more trust and comfort about cross-border activities and more visibility and reassurances about what may happen in the event of a crisis. This will make it possible to preserve the financial stability benefits of global CCPs. Moving in the other direction would be a mistake.

A regulator observed that cooperation is the underlying principle of both the UK and EU approaches. EMIR reflects this. For Tier 1 non-systemic CCPs, there is a principle of mutual reliance. For systemic CCPs, however, there must be consideration of the specific issues that these CCPs raise in terms of elevated exposures and supervisory approach needed for tackling crisis situations, in order to define appropriate further steps. The regulator added that the goal of supervision is both the safety and efficiency of infrastructure. This can be a difficult balance to strike, but it is an objective that is shared between supervisors across the world.

A policy-maker stressed that supervisory cooperation between the EU and the UK will remain crucial, but not all issues can be tackled that way. Reducing the over-reliance of the EU on foreign CCPs and the related risks also requires assessing options to further strengthen the EU clearing ecosystem.

2. Issues raised by the recognition of non-UK third-country CCPs

An industry representative suggested that there is a growing point of tension for EU clearing members and counterparties concerning the equivalence and recognition process of non-UK third country CCPs. The 'qualified CCP' status that is applicable to many foreign clearing houses that operate under a framework that has not yet been recognised as equivalent by the EU will no longer be available after June 2022. This status currently allows EU stakeholders to treat these CCPs in terms of capital requirements as if they were recognized as equivalent. If nothing is done to address this, the risk weighted assets (RWAs) allocated to transactions involving these third country CCPs will need to be multiplied by roughly 50 times, which will make it difficult for EU clearing members to continue providing services to their clients for these CCPs at a reasonable cost.

While the 3 year equivalence granted to the UK CCPs allow sufficient time to review and implement relevant solutions, the June 2022 deadline applicable to these other Third Country CCPs will come fast and the issues raised will need to be addressed shortly, the industry speaker emphasized. The CCPs affected by this problem fall into three categories. First, there are the US CCPs which are very important for EU stakeholders; the US framework is recognised as equivalent by the European Commission, but the process of formal recognition is still underway at ESMA and it is uncertain whether it will be achieved before the deadline. Secondly, there are local market CCPs based in China, Turkey or Latin America, which currently have neither equivalence nor recognition. Finally, there are authorised CCPs recognized by ESMA e.g. in India that are undergoing reviews in respect of EMIR 2.2, which will require agreement on a new memorandum of understanding (MOU). The range of market activities covered by these different CCPs is very wide, making this a significant issue for EU banks. The problem concerns mainly the second group of CCPs in local markets, because for the US and Indian ones there are recognition processes underway. Specific proposals have been made by the financial institutions concerned for addressing this issue on a case-by-case basis, for example solutions are being implemented in the US and UK to allow the non EU peers of EU banks to continue clearing with these CCPs, at least the Chinese ones.

A regulator agreed that this issue, which shows that clearing markets are global should not be obscured by the focus on Tier 2 CCPs. ESMA is currently reviewing another 33 existing recognitions under the new EMIR regime and renegotiating MOUs with around 17 jurisdictions. This will help to foster a common understanding among authorities about cross-border cooperation needs in a non-systemic context. All efforts are being made by the EU authorities to resolve the outstanding issues within the timeline.

3. Strengthening the EU clearing ecosystem

3.1 On-going consultation on the competitiveness of EU CCPs

A policy-maker emphasised that the Commission's consultation on how to improve the competitiveness of EU CCPs and clearing activities as well as ensure that their risks are appropriately managed and supervised is very open. It aims to create the conditions to make the EU a more attractive place to clear. Market participants are invited to put forward their ideas for improving the current situation. The consultation considers both the supply and demand sides. On the supply side, an important question is how to make it easier and quicker for EU CCPs to offer new products. At present, EU CCPs do not offer the full range of products needed by clients. On the demand side, various issues are being considered. One is the role that capital requirements could play, another one is the idea that market participants could open active accounts at EU CCPs. Another question is whether to broaden the clearing obligation itself. A third question is about the supervision of EU CCPs and whether it should remain local or be more centralised at EU level.

3.2 Current dynamics of the euro clearing market

An industry speaker considered that Europe is already an attractive place to clear and is already globally competitive in the clearing and market infrastructure space. There are more than 70 CCPs in the world at present, but only four are globally relevant: CME and ICE in the US, LCH in the UK and Eurex in Frankfurt. Eurex clears a wide range of products including benchmarks for European equity markets and exchange-traded derivatives. In risk management terms, a strong portfolio based margining approach is in place. The EU has also shown thought leadership on many CCP risk management issues, such as anti procyclicality, margin models, and how to manage recovery and resolution.

The industry speaker stated that the EU could have a greater level of sovereignty in euro clearing. The market was previously concentrated in London for many instruments, but now about 20% of the clearing volume has shifted to the EU through a market-led approach, although it is only 10% on the trading side (which is consistent with the figure previously mentioned of 90% of cleared euro swaps handled in London). This is not a question of technology or risk management standards, but of incentives. EU CCPs have the infrastructure and technology needed to handle significant volumes of transactions. On risk management, EU CCPs have all the necessary tools in place and this is not an area where CCPs compete. What needs to be recognized is that while London has developed as a hub where supply and demand for euro instruments meet, this situation may not last forever because this is not where the supply and demand originate. Inherently, the principal issuers of euro instruments are EU countries, followed by banks and corporates. London is not where euro exposures are ultimately housed either. These exposures are located in pension funds, the European insurance sector, banks and such. The EU has the ingredients to create a healthy and balanced alternative market for the euro, in competition with the UK CCPs. A market led proposal has been put in place by Eurex for example for initiating progress towards this objective with the incentivisation of 10 EU and non-EU banks and institutions to set up a liquidity alternative within Eurex, which also involves adjustments in the governance of the CCP.

Another industry speaker stressed that the euro is not only a European instrument but an international currency. It is a testament to the success of Europe as an economic zone and of European regulations, which have allowed the euro to become so internationally important. 73% of new trade registrations in LCH Ltd originate from non EU entities. This shows that there is a desire, with the discussion about the clearing of euro instruments, to create something local from a currency which is intrinsically global.

3.3 Possible measures to strengthen the EU clearing ecosystem

A Central Bank official considered it necessary to shift more clearing activities towards the EU over time in order to strengthen the EU financial market, but this will only happen if there are effective incentives. This can be achieved via three measures: improving clearing services in the EU, bringing additional market volume to central clearing in the EU and ensuring that EU market participants concerned build up their clearing capacities in the EU. Achieving these objectives will require the industry to develop a robust long-term strategy and make concrete improvement proposals.

An industry speaker was convinced that attracting additional clearing volumes to the EU could be done, agreeing with previous comments that the EU has some way to go to achieve higher market shares. The question here is around the supporting measures, which can be determined hopefully with the output of the Commission's consultation. A first measure could be to broaden the scope of application of clearing requirements. Many EU institutions, sovereigns and quasi sovereigns exempted from the central clearing obligations are or have become large issuers of euro instruments. Some exemptions, such as the one for pension funds should be reviewed, as proposed by ESMA, in order to get more institutions that hold euro exposures into the clearing ecosystem. Additionally, there are some obstacles that need to be lifted. For instance there are still outstanding issues in the area of hedge accounting. Banks must be able to switch their portfolios in a tax neutral way, if they move from a UK to an EU CCP. Finally, the idea of increasing the number of active accounts is a good one, because it will be possible to avoid cliff edge risks in 2025 if most clients have properly prepared for the transition by opening an account with an EU CCP and test-driven this alternative. At present, out of 600 potential counterparties, only 300 have active accounts at Eurex for example.

A Central Bank official suggested that there is an opportunity to improve the clearing landscape in Europe following the consultation process, with some time in hand to make changes. There is the scope for a fair rebalancing of risks between the EU and UK, because there is no point in having a global monopoly in derivatives. This will require a collective effort from the industry and from the regulators, but it should mainly be an industrial project. Regulators can help in their role as catalysts, but it is essential that they target the most efficient measures. Enhancing the offer for clearing will be essential. A number of proposals made by the Commission in its consultation paper are worth exploring, such as extending the clearing obligation for certain products or extending the scope of participants, if the risks can be properly managed. Another avenue could be to ensure that CCPs systematically offer the use of EU-based CCPs to clients.

The Central Bank official was also favourable to the objective of increasing the number of active accounts. However this action will only be efficient if it is accompanied by regulatory measures to ensure there is a sufficient flow of transactions going through these accounts, and it will not be a success if the measures can only be used if there is a problem. Quantitative aspects are also important, because volume will be required to build up the EU clearing offer. This effort should be supported by incentives and also targets to provide market participants with sufficient visibility. Thresholds for systemic CCPs or systemic clearing segments are already enshrined in EMIR. It would make sense for regulators to show the path for EU clearing by defining quantitative objectives that can be reached with a reasonable and gradual approach. In terms of supervision, the actions proposed should be pragmatic. There is no need for a major overhaul of the EU supervisory structure for clearing which seems quite efficient. It is essential to continue the current collegial approach, especially for CCPs, which have important liquidity needs and for which it is important that the central bank of issue is very much present in the discussion.

An industry speaker highlighted the need to be aware of the directionality of risk in clearing, when speaking about having more clearing activity in Europe. If a European CCP has a concentrated direction of risk, this may actually weaken EU financial stability rather than enhance it. In addition, it would not be surprising if LCH SA were to become systemically relevant for the UK, given the number of participants in the service which are based in the UK. Despite the fact that LCH SA is a euro CCP in terms of the underlying currency, it is very international because many of its participants emanate from the UK and not the EU. This shows again that it is challenging to tamper with markets that are intrinsically global. Every time there is fragmentation in the approach, it creates new and unforeseen risks for regulators.

As a concluding remark, a regulator agreed that tampering with the market could cause issues, but the European public authorities have a responsibility for financial stability and also preserving monetary policy when there are issues that concern the usage of the euro. It will be important to consider carefully the adequacy of the EU's existing supervisory structures in the context of increasing EU clearing volumes. There is also a global dimension to this and it will also be necessary to take a global perspective on how to address globally relevant financial market infrastructures.

How can banks contribute more to the CMU?

1. The complementarities between bank financing and capital market financing

1.1 The roles of banks and capital markets and areas of synergy in financing

An official outlined the synergies between banks and capital markets. Banks can be enablers of more liquid and deeper capital markets by acting as issuers of securities, as intermediaries for issuance, as intermediaries for institutional and retail investors and in some cases as investors. Banks are well positioned to help companies diversify their sources of financing and to contribute to channelling the unprecedented levels of savings created by the pandemic. These synergies should be taken advantage of particularly for the financing of start-ups and scale-ups, which lack equity financing. 2021 has been a record year for initial public offerings (IPO) in Europe and many new unicorns have emerged, but capital market financing needs to be more widely promoted from a public policy perspective. In addition to the role as intermediaries previously mentioned, banks can also play a more direct role in the financing of scale-ups, as investors or as promoters of venture capital funds investing in such companies.

An official explained that banks contribute to efficient capital allocation and risk diversification. In terms of capital allocation, banks help to connect investors and issuers. On the investor side, they can play a key role in particular in terms of encouraging savers to invest in capital market instruments in Europe, which does not have the same broker dealer and financial advisor ecosystem as the US. On the issuer side, banks can provide support notably through advisory work for small and medium sized enterprises (SMEs); market making; direct investment, which the new Capital Requirements Regulation (CRR) proposal facilitates using lower risk weights; and creating growth funds.

The official agreed that supporting the growth of scale ups is a particular challenge in Europe, because at a certain stage of their development, many of these companies turn to funding provided by non-EU investors and then get listed in the US, which may have consequences in terms of management control and growth potential for Europe further down the line. Countries such as Canada or the UK have created common bank funds to support scale-ups, which is an option that should be further considered in the EU. The development of a broader range of issuers in the EU, with more start-ups and scale-ups to invest in, would also provide investors with greater diversification. Moreover, a further integration of the EU banking sector with the implementation of the Banking Union could help to support issuers and investors across borders, contributing to a better allocation of capital across the Union.

An industry speaker added that banks raise their own funds both from deposits and the capital markets, issuing their own securities. They tend to raise funds in their own domestic market but should endeavour to attract more funding from other EU countries, although managing 27 different sets of legal rules is challenging.

1.2 Leveraging the complementarities between banks and capital markets to relaunch growth post-Covid

A Central Bank official noted that complementarities have developed between bank based and market based financing in Europe. In the wake of the 2008 financial crisis, the growth of capital market funding has reduced the EU's over reliance on bank funding, which was procyclical. Conversely, during the COVID 19 crisis, the banking sector countercyclically substituted the thinner market funding provided by capital markets and provided additional liquidity to the corporate and sovereign bond market. Going forward there are major opportunities for banks to further contribute to the growth of capital markets in the EU.

An official agreed that the response to the Covid crisis was different to the response to the financial crisis. The banking sector contributed in a significant way to all three stages of the response to the Covid crisis. Taking the example of Spain, banks in the first stage of the Covid crisis, granted more than €135 billion in publicly guaranteed loans to meet firms' liquidity needs. This helped SMEs in particular to cushion the fall in revenue that they experienced at the outset of the crisis. In the second and current stage of the crisis, the banking sector is a key tool used by the public authorities to ensure that credit flows correctly and that financing conditions are stable. In the third stage towards which the European economy is evolving, with public stimulus moving towards more targeted actions, it will be essential to drive excess savings from the pandemic into completing the twin green and digital transitions. Banks can play a key role in this perspective as intermediaries and also with their capacity to conduct risk and viability assessments. They can also encourage retail investors to engage in capital markets by familiarising them with these instruments.

Another official stressed the importance of capital market financing going forward and of the Capital Markets Union (CMU). The Russia Ukraine conflict will increase expectations of inflation, and decrease expectations of growth in Europe, potentially creating further economic damage and increasing the leverage of the corporate sector.

An industry speaker emphasised that Europe is in a novel historical moment: Covid has led to record saving rates among the retail population, even though interest rates are at zero. Economies being switched off also meant that the revenues, turnover and profits of most enterprises went down, which resulted in an erosion of equity. Alongside this, awareness of the need to fight the consequences of climate change rose significantly. As a consequence, banks are sitting on a huge pool of liquidity which needs to be put at work to support the economic transformation that is needed in Europe. Banks will need to create products and platforms, as intermediaries rather than direct investors, to make this cash available to the economy. Deepening the integration of the European financial sector and capital markets with a consistent implementation of regulations such as MiFID II should be a key objective in this perspective in order to facilitate the distribution of capital market products across the EU.

1.3 The role and potential of securitisation

An industry representative suggested that securitisation is an example of how banks can contribute to the development of capital markets and how the transition from relying entirely on bank lending to introducing more direct institutional investment in the market can be facilitated. The Simple, Transparent, and Standardised (STS) securitisation legislation was one of the first actions implemented in the CMU initiative, establishing standardised issuance rules and features that enable investors to compare one transaction to another. STS securitisations, which have become the benchmark across Europe, allow banks to alleviate their balance sheets in order to raise their lending capacity and may also contribute to the development of capital markets, by transforming lending portfolios into securities that can be issued to institutional investors. SME loan securitisation programmes which are put in place in Spain and Portugal on a yearly basis for example allow institutional investors to get exposure to the lending portfolios of banks. As they become more familiar with SME risk, these investors may consider taking direct exposure to SME investment. The same mechanisms are used in a variety of loan markets such as residential mortgage, auto-loans and consumer credit.

An official agreed that securitisation could work on both sides by ensuring that risk is unloaded from banks and developing a bigger capital market. This type of cross fertilisation between banks and capital markets should be further encouraged.

Another official considered that securitisation has very promising potential in creating space on banks' balance sheets, which is necessary in a competitive banking market. There might be too much emphasis however being placed on securitisation as a way to develop capital markets. The official queried the potential of SME securitisation in particular, because it can be quite hard to bundle SME loans. While STS provides securitisation standards, the underlying SME loans are not easy to standardise. Where banks could help SMEs to go to the market would be handling the issuance part.

The industry representative acknowledged that SMEs are not the largest asset class, although regular programmes exist in countries like Spain and Portugal and projects are being put together in other countries. One key challenge is the fact that SMEs are heterogenous. This is where securitisation can pave the way to further capital market financing, because banks can assemble a diverse pool of different types of SMEs, rather than having investors make bets on individual SMEs.

2. Obstacles to the CMU and to the role of banks in capital markets

An official considered that the Commission's CMU action plan covers many important issues for the development of capital markets in the EU, but it also faces two key challenges. First, its implementation is taking a long time, because underlying issues such as Banking Union and the fragmentation of securities rules are genuinely difficult to tackle, even though the CMU action plan is not addressing in depth the most difficult issues in terms of harmonisation (i.e. related to insolvency, taxation and withholding tax regimes). Because Europe is bank based, a considerable proportion of intermediation takes place through banks, both conventional intermediation such as loans and also capital market intermediation supported by banks. Without Banking Union, there will be no integrated CMU. In addition, capital market rules such as MiFID are not sufficiently consistent across the EU, because they have been implemented differently. Achieving CMU will be impossible if these issues are not addressed properly.

The official explained that the second issue is around the importance of cross-border banking activities for the CMU action plan. If Banking Union remains unfinished and cross border banking flows continue to be limited, banks will be unable to catalyse sufficiently the development of the CMU. This is not about issues such as the European Deposit Insurance Scheme (EDIS), which are very difficult to tackle. Even for simpler topics such as home host issues, the ring fencing of liquidity or resolution, progress is insufficient, which means that Europe is still not treated as a single jurisdiction by the Basel Committee. If banks cannot seamlessly perform the issuance and distribution of securities on a pan European scale, it will be impossible to overcome the national barriers to capital and achieve the single market aims of the CMU. Taking the securitisation example previously mentioned, it is very difficult at present to bundle securitized loans from different EU countries together because of their underlying nature. It would be easier to achieve this if there was a sufficient level of cross border banking. This would allow the creation of larger pools of assets with similar characteristics and could appeal to more institutional investors.

A second official agreed that tackling the obstacles to a more integrated banking market in Europe, such as ring-fencing issues, is needed for fostering greater cross border activity. However this cannot and will not happen single handedly, because countries in Europe have understandable risk considerations and want protection. This is why these issues have to be addressed in the context of a wider package including subjects such as EDIS, taking into consideration the interests of the different stakeholders concerned, in order to make progress on the Banking Union. A third official agreed that a holistic and pragmatic approach is needed on Banking Union to get everybody on board and make the project sustainable.

A Central Bank official agreed that the main issues on which progress is needed have been identified in the CMU, but there are challenges around implementation. An industry representative concurred with the previous point on securitisation. It is indeed difficult to pool securitised portfolios across borders, because there are different regimes for the underlying loans, different regulators, and different sets of practices. The CMU plan is the right way forward, but there is now a need for execution. For example the promise of the STS securitisation legislation has not been fulfilled. There has been moderate progress in terms of issuance, but not the step change that was envisioned.

The industry representative highlighted several obstacles that need to be tackled regarding securitisation. First, legislative activities are too siloed. In the attempt to harmonise securitisation legislation, it was forgotten that using a best in class benchmark type securitisation should be recognised in the liquidity ratio, because a separate working group was handling this aspect of the legislation. There is a similar issue on the capital requirement side which makes it very difficult to incentivise this type of activity within banks The speaker was however hopeful that the 'silo mentality' could be addressed in the same that it has been possible to produce a common and well accepted legislation on securitisation. Secondly, improving transparency remains a challenging task. Some efforts have been made in the market, for example with the European DataWarehouse securitisation repository, established by a certain number of banks, where loan level detail is made available to all investors. ESMA also included in the new legislation a template aiming to harmonise information related to securitisations, which is a good idea, but the template does not work at present in several areas. Changes should be made for transparency to become a reality in the European securitisation market.

3. Possible actions to further develop EU capital markets and related role of banks

3.1 Better managing the supply and demand for capital

An industry speaker agreed with previous speakers that the CMU proposals contain most actions that are needed for developing capital market financing in the EU. However, to define the appropriate course of action it is essential first to define the problem and then, without any preconceived ideology, discuss the solution. The problem that needs to be addressed most urgently in Europe is unlocking the potential of retail investors to contribute to the growth of an economy that is lagging behind other competing jurisdictions. The scattered regulatory environment around MiFID and some consumer protection rules are unnecessarily impeding the demand of retail investors. There are also issues on the supply side and the power of the combination of supply and demand also needs considering in the CMU initiative. On the supply side, there are issues with the European Long term Investment Fund Regulation (ELTIF) for example, such as the minimum investment threshold for retail investors and a lack of flexibility in the rules applying to portfolio composition. Removing these different barriers will be a long-term project, but should help to unlock the growth potential there is in the European economy. If retail clients are put in the right position, they will take informed decisions.

The industry speaker emphasised the importance of improving financial literacy in particular, noting that there are several ways to drive this. This topic is moving slowly in national financial education curricula, but it can be addressed via private public partnerships or private initiatives. In Slovakia for example, curricula are being developed by the speaker's bank in partnership with schools, in which financial literacy is not a particular discipline but features in many subjects covered e.g. languages, mathematics, history or geography. As a second example, a digital museum for financial literacy has been created in Vienna, which is visited by more than 35,000 pupils per year who learn how money works, how a budget works, how the global economy works and about the role of central banks.

An official was very supportive of initiatives on financial literacy, observing however that this is not sufficient to create a vibrant capital market such as the US. In the US individual savers invest in different ways through banks, brokers or pension funds; however, this does not mean they fully comprehend what underlies the assets in their savings pool.

Another official agreed that turning retail savers into investors is a major objective. This notably means having attractive companies in Europe to invest in, but there is also a challenge for banks here, which continue to sell loan products to those companies in great quantities, when there should also be an objective to move towards more diversified financing and less leverage.

A third official stressed that digital literacy also contributes to financial literacy in today's world and although it is important to set up financial and digital literacy programmes in schools for the future, it is also essential to ensure that the less digitally literate customers and SME owners are not left behind in the rapid drive to digitisation.

An industry representative also suggested that securitisation could play a role in transitioning investors to the capital markets, by making them more familiar with taking risk.

3.2 Supporting the financing of SMEs

An official considered that the main objective that the CMU project is seeking to achieve is providing companies with a more even cost of capital across the EU, especially for SMEs. At present, SMEs are penalized and banks could do more to improve the situation. Banks should endeavour to graduate SMEs to market finance, whether it is traded equity or debt finance. One of the CMU proposals suggests that banks should support the companies which they cannot finance in finding alternative sources of finance, but this seems odd because it is harder to take a firm to the market if a bank is not willing to lend to it.

Another official described how the Spanish authorities were supporting the development of capital market financing through changes in the Spanish regulatory framework. Recently, new regulations were introduced on promoting the constitution and growth of companies and on removing barriers for start ups. This includes measures to promote crowd funding services, to adapt the Spanish legal framework to European legislation, to improve the venture capital and private equity legal framework, and to improve the requirements for the marketing of those products to retail investors in line with ELTIF.

EU securitisation relaunch: critical political decisions and timing

A public representative stated that securitisation regulation was introduced five years ago, establishing the Simple, Transparent, and Standardised (STS) framework. It now has to be reviewed. It should have been reviewed in the previous January by the Commission, but it was not.

1. Despite the improvements brought about by regulatory improvements, the securitisation market in the EU is not equal to the challenge faced by the banking sector of the €650 billion digital and sustainability transformations investment need

1.1 The EU STS reform reduced the stigma and today securitisation in Europe is perceived as sound

An industry representative stated that the earlier STS reform did not help to develop the market, but it at least helped to smooth out and reduce the stigma to create a safer environment. The regulation has achieved a great deal, with the retention rules, the supervision of ratings agencies and the systematic assessment of the Significant Risk Transfer (SRT) by the competent authority. Psychologically, a change in mindset is about to happen: today securitisation in Europe is sound and has been useful as a tool to transfer risk from banks to educated investors.

An official commented that a very productive framework in Europe has been developed over the past decade to address specific risks stemming from securitisation. Re-securitisation has been prohibited. Risk retention rules have been established to ensure the originator remains exposed to possible losses on the loans being securitised. Disclosure requirements have also been introduced to ensure investors have the information they need to understand the risks they are taking. These safeguards will remain in order to build up trust in securitisation in Europe and to alleviate risks to financial stability. The view of securitisation should be changed. This tool could be used to address the financial needs of the economy, including the green and digital transitions. Securitisation can help free up capital from already very constrained banks' balance sheets and enhance their competitiveness.

1.2 The wall of investment faced by the EU means that the take-off of the EU securitisation market must be accelerated

An official commented that it is urgent that the necessary steps are taken to allow the market to grow to address the wall of investments that is faced. The European Commission has suggested that the additional investments in relation to the green transformation and digital transition will reach around 650 billion per year until 2030, which is not within the capacities of the banking system in Europe or within the supervisors' appetites for banks' balance sheet growth.

1.3 What banks are missing is sufficient regulatory capital, not funding

An industry representative stated that funding is available. However, it is very clear that the banks have ever rising capital constraints and cannot raise all the capital that corresponds to the 650 billion. The only solution is securitisation. The name of securitisation is misleading because it is about risk sharing. Banks need to be able to originate. Banks have the reach, know the companies, and can accommodate the needs of each of their clients. Banks have then to find a way to transfer part of the risk to investors that are eager to take those risks. The current regulation does not allow that kind of bridge.

An expert noted that it is often stated that we [banks] do not issue residential mortgage-backed securities (RMBS) because they have a lot of funding for targeted longer-term refinancing operations (TLTRO) and all the other systems. This is not true. The banks issued €120 billion benchmark covered bonds, which are based on mortgages, while the total issuance of covered bonds in 2020 was €570 billion. This is three times more than the placed and retained issuance of securitisation in Europe, suggesting that there are other factors involved.

A public representative commented that it is correct that risk sharing and raising capital is critical. The banks had a need for that, so it was not that Europeans did not need the capital. Capital was needed in the past years, but covered bonds were chosen.

An expert noted that covered bonds are cheap and easy to issue. The whole system favours the covered bond market. It is often stated that RMBS creates systemic risk with 0.5% of gross domestic product (GDP), where covered bonds have 50% of the European mortgage market.

An industry representative stated that covered bonds do not address the capital issue. In covered bonds, the investor is protected by the mortgage, but the bank keeps all the risk. Standard securitisation is about risk sharing. Covered bonds are not helping banks reduce their risk-weighted assets (RWA). Covered bonds address liquidity, not the capital as needed.

A regulator stated that the securitisation market in Europe is underdeveloped. This is a problem because capital is scarce within the banking sector, and it is becoming even scarcer, because there are more things requiring financing while bank prudential requirements will be tightened in the future. An instrument is required to enable the banking sector to efficiently use available capital in front of the risk that needs to be retained. The absence of this has been possible up until now for a variety of reasons, including the presence of other refinancing tools, such as covered bonds. Covered bonds only address the very specific issue of refinancing and do not allow the freeing up of capital.

1.4 As a risk sharing tool, securitisation should make an important contribution to deepening the banking union

A regulator commented that banking union progress has stalled due to the choice to make progress as far as possible in terms of risk reduction. Reviving securitisation could adjust the degree of exposure the banking sector has to the risks that stem from the real economy by using private risk-sharing agreements rather than public risk-sharing agreements with the banking sector.

2. Policy makers must answer the question of why, despite the benefits of the STS regulation, the EU securitisation market is a fraction of the size of similar markets in other parts of the world

An expert stated that, in 2008, the European securitisation issuance was 75% of US securitisation issuance. It is currently 6%. There has been a collapse of the European securitisation market. In the US, Australia and China, securitisation issuance is 2-4% of GDP. In Europe, it is 0.5%. Last year, Europe issued €90 billion of securitisation, versus €750-800 billion in the US. A common belief is that this is because the US has agency, but this is incorrect as the figures completely exclude the US agency market. Australia does not have an agency market and still issues significantly more securitisation as a percentage of GDP relative to Europe. STS was needed, but what it contributes is questionable. Of the €90 billion issued last year, non-STS was €60-65 billion. STS is more relevant to political recognition of securitisation than market stimulation. Only €7 billion of the €25-26 billion STS issuance last year was RMBS.

2.1 The cost of securitisation impedes swift development of the market

An expert stated that there are many reasons why banks did not resort to securitisation when capital was needed. First, there was massive support from the monetary system. Secondly, there was a very long period of implementation of the output floor. Securitisation is difficult to do and expensive. It takes one to two hours to syndicate a covered bond. A repeat issue of 20 experience of RMBS will take at least a week. There is very little disclosure for covered bonds. Securitisation disclosure is loan by loan and there is the prospect of having two parallel disclosures under the European Securities and Markets Authority (ESMA) and the European Central Bank (ECB).

2.2 The investors regulatory framework does not help

An expert noted that securitisation holdings in European insurance dropped from 10% in 2010 to 2% in 2020. This is partly because the regulatory capital is incredibly high for insurers. For a deal in the US[?], the aim is for 10-30% participation of insurance companies. In Europe, 2-4% is considered a success. All the issues outlined make securitisation very expensive, which prevents the bank moving the assets to share the risk and reduce the capital. In addition, the velocity of the balance sheet of the European banks and their competitiveness relative to US banks are reduced.

2.3 Fragmented EU financing needs also explain the limited success of securitisation

A regulator commented that regulators should be humble because there are fundamental reasons why the securitisation market in Europe is not as successful as that in the US. These reasons are not always easy for regulation to circumvent. An example in relation to RMBS was provided. In securitisation, the law of large numbers is used to predict the credit risk on a pool of assets. The pool of assets must be homogenous, but mortgages are not homogenous in Europe. These difficulties do not mean that financial regulators should not try to do something.

3. Investors in the EU are eager to invest in securitisation and the multiple tools to share risk with banks

3.1 The various forms of securitisations make it possible to address a wide range of risk appetite specificities of the investors

A public representative noted that there has been a change in the regulation, where synthetic regulation was used.

An industry representative commented that it is helpful to distinguish between true sales securitisation, which has been a flourishing big market and should re-flourish, and balance sheet synthetic securitisation, where the loans stay with the bank. Institutional investors and banks teaming up will be a win-win, because banks have an excellent network, know their clients well and have long-term relationships that we [investors] could never mimic. We [PGGM] is looking to diversify its credit risk as an institutional investor. Securitisation is vital for the European economy to prosper and flourish. Expansion by investors will be possible if good investments are available.

A better term for 'synthetic' is credit risk-sharing transactions. STS rules are very helpful in creating a solid and sustainable market. A significant part of the true sale securitisation is there to also attract the senior funding of a bank. It is a different kind of market. Very often, banks hold the first losses themselves. It is an efficient way to attract liquidity into a bank. The current risk sharing transactions are focused on providing the capital that banks need. Synthetic securitisation and true sale securitisation are both very important markets. Investments are needed for the transition to help fight climate change. There is technological risk inherent in this. It will be important to spread risks across the banking sector and institutional investors.

3.2 Tailoring securitisation transactions to both the bank's and the investors' needs is necessary, though it makes securitisation a more complex financing tool

An industry representative stated that it is incorrect to believe that securitisation is about taking a loan, putting it into the form of a bond and selling the whole thing. Loans are tailor made for specific clients. When a bank wants to offset or share the risk with investors, it has to consider the needs of the investors. It is not exactly what the borrowers require, so the risk must be changed and cut in another way. It is not possible to take a loan and sell it to somebody else. The originate to distribute (OTD) is not like a bond. Securitisation implies some work on the pool of loans in order to propose tranches with the relevant level of risk, which can be bought by investors, with the rest remaining in the bank, so not everything will be sold. This is more complex. Securitisation will never be simple.

3.3 The stability of the investors regulatory framework regarding securitisation is a prerequisite for investors

An industry representative stated that, for a long-term strategy, a good, solid, and sustainable market is needed. Rules that change all the time discourage banks and investors. Clear rules must be set for these investments, because they are new to many investors. New investors joining the market is a very positive development for credit risk-sharing transactions, but new investors should be supported to interact with the market in the correct way. The last few years have been benign in terms of credit risk, so the risk is that people's standards become looser.

4. Main reasons for the current poor performance of the EU securitisation market and ways forward

4.1 General reasons

An official stated that there are three main reasons for the weak performance of this market in the EU compared to the US. First, there are more attractive sources of financing, for example covered bonds. Second, the prudential framework discourages holding securitisation positions, which is why the investor base has not broadened in the last decade. In particular, insurance companies remain marginal in the European securitisation market. Third, there is a degree of legal uncertainty to be tackled, particularly regarding the SRT test, which creates uncertainty around the ability to obtain prudential deconsolidation. It may be too early to judge the STS regime because the label was extended to synthetic securitisations in 2020 as part of the recovery package.

4.2 A remaining stigma among policy makers, which is driving unnecessarily restrictive regulations, is the possible overarching problem, according to the High-level Expert Group

An industry representative noted that the high-level working group identified five gamechangers. One of these is the overarching problem that there is still a stigma within the authorities. Tone from the top is needed on securitisation in order to smoothen the old restrictions in the regulation and in terms of the way the regulation is implemented by the supervisors. The regulation should be reviewed and implemented with an open mind. Banks are supposed to practice OTD. Banks lend money and then have to distribute. The supervisor does not approve each lending transaction. Similarly, there is no need for constraints and limits when banks are selling part of the risk. It is the normal day-to-day job of banks to originate and distribute. It is a problem if supervision is such that in practice banks can only originate and not distribute.

4.3 Fixing regulation excesses is essential to bring issuers and investors back to the market but also to levelling the playing field among the various bank financing tools

An expert stated that the investors must be brought back in, so the insurers are needed. The opportunity to fix Solvency II is being missed. As there is the synthetic risk transfer and many banks are systemically importing sophisticated banks, the securitisation internal ratings-based approach (SEC-IRBA) and securitisation standardised approach (SEC-SA) must be fixed. The P factor must be fixed. The P factor is a constant input in a formula that increases the capital for securitisation because of a number of issues like agency risk and so on, which do not exist.

An industry representative outlined that bank loans have an associated RWA, because there is a certain level of risk. When the loan is securitised, suddenly the regulatory capital associated with that loan becomes P times the previous figure. The P factor is the multiplier of capital requirements required just because a loan is securitised. Up to a certain level this is acceptable because there is a little more operational risk with securitisation, but it should be 1.2 or 1.3, not two to three times as it is now.

An industry representative commented that STS provides good, standard rules, robust structures and a benefit to the bank. In the original rules, there is a lot of slack in how much capital must be allocated after having securitised. STS already corrects this a bit. It has a lower risk weight for the senior tranche that is kept by the bank, which improves the metrics. This could be further improved. If all the tranches are compared to the original portfolio, it is ridiculous that the amount of additional risk weighting is much higher. That reduces the economic basis for the transaction.

An expert added that the playing field among capital market instruments should be levelled. It is not possible to have 2.7 trillion of mortgages out of 5 trillion into covered bonds, state that this is not systemic risk, and, at the same time, try to revive the RMBS market.

A regulator stated that there is no level playing field between securitisation and covered bonds because covered bonds are very different instruments. Covered bonds are claims on a bank that are secured by the asset, so there is no direct exposure to the underlying assets. Considering whether securitisation, RMBS and covered bonds are treated equally is not necessary. There are legitimate reasons why they are treated differently.

An industry representative commented that the STS rules intended to make the collateral rules clear for investors. Unfortunately, the result is that a straightforward cash deposit with a bank, without collateral, is what STS requires. That is a risk to the investors. To ensure the market is good and stable, it should be collateralised and opened up to repos money market funds (MMF). The money is there and safe in escrow, but not with the bank. Otherwise, in a dire situation, the hedge is lost and the capital is lost because it was on a cash deposit, which is in the bank. This is not logical.

An official stated that the prudential treatment has been dealt with already and there is a great deal to be done. Discussions are ongoing on Solvency II and Basel III. It is obvious that there is an issue. The requirements for private securitisations are too burdensome and redundant. Streamlining these would be welcomed. The EU Commission would need to ask ESMA for an assessment of this.

4.4 One key added value of the STS regime is the mandatory portion of risk retained by the bank, which is intended to reduce moral hazard and ground investors' confidence, particularly regarding less transparent securitisations

An industry representative stated that it is welcomed that STS has a clear rule on risk alignment. The big lesson from the global financial crisis is that the originator, even if it does some OTD, should take ownership and keep risk. There is a 5% risk retention rule generically in the market for securitisation, specifically for credit risk-sharing transactions. True sale transactions is a different market. On credit risk-sharing transactions, we [PGGM] puts money in to cover the bank's losses, but the bank is fully independent. Banks should continue to have responsibility and for a bigger percentage. 20% is in our [PGGM's] mandate and this should be retained as a market to protect the stability of the market. If this project is successful, it will be a structural way for banks to capitalise their lending books in a very cost efficient way. More progress has been made in the EU than the US up to now. Very clear and high-risk alignment measures must be retained, to avoid market players originating to get rid of the risk.

An expert commented that it is necessary to differentiate between black box transactions and transparent transactions.

4.5 The predictability for banks of the effectiveness of the credit risk transfer is an essential area for progress

A regulator acknowledged that the prudential debate is not within the market regulators' remit. There are issues with the parametric treatment of securitisation exposures on the asset side of the banks, but the main issue is the credit risk transfer, meaning the proof that the supervisor requires that the risk of the assets has been transferred to a third party outside the banking group. This frees up capital. However, this credit risk transfer is completely unpredictable. Greater clarity on the expectations of supervisors regarding risk transfers is needed. However, is not possible to have a point beyond which supervisors cannot question risk transfers.

4.6 Further clarity is required regarding EU/Third Country securitisation transactions

A regulator stated that the territorial scope of the regulation in terms of disclosure and transparency requirements should be clarified. This would be a significant help to EU investors in securitisation. Currently, the most likely reading of the regulation is that EU rules should be applied, including for third-country investors and in countries that have their own regime for transparency and disclosure, which does not make any sense.

Sessions Summaries

VI

DIGITALISATION AND PAYMENTS

Tech in finance: opportunities, challenges and policy approach

1. Ongoing digitalisation trends in the financial services sector

1.1. Opportunities from digital transformation in the financial sector

A public representative highlighted the significant acceleration of digital transformation and technological developments that has happened over the last two years, with the Covid crisis, in particular in the financial sector.

At the most macro level, an industry representative explained that the financing of the $100 trillion world economy is facilitated by a $6 trillion group of capital markets intermediaries and infrastructures, which are undergoing fundamental change. Particularly in Europe, but also at the global level, building deeper, more integrated and vaster capital markets is a major objective in which digitalisation has a key role to play. One of the tenets of this evolution is to build more democratic markets engaging a greater number of stakeholders and individuals. Digitalisation also involves multiple technological solutions implemented by financial services firms and market infrastructures, which have been investing in core digital systems for decades, and also third-party service providers such as cloud service providers (CSPs) which are playing an increasing role. This is why digitalisation needs to be implemented with an open architecture and in an interoperable way, with partnerships becoming a cornerstone of this evolution.

Another industry representative emphasized that the best way to drive opportunity and growth around data-led innovation is to bring data that is held in different siloed parts of organisations together, harmonise it and use it to benefit the end customer. The industry speaker stressed two key opportunities associated with digitalisation in the financial services sector. First is the creation of new products and services which can be supported by the 'mining' of the data held by financial institutions to gain insights on customer preferences and needs and their potential evolution in the future e.g. in respect of issues such as ESG, which is a key strategic area for many financial services companies. This effort can also be supported by connections with other data sources such as the Google Earth Engine and the related Climate Engine. Embedded finance, with financial services such as credit included in the purchase processes of digital platforms, is another area of growth leveraging digitalisation on the retail side. This provides customers with greater convenience, but it also generates data on customer spending habits and preferences which can be used to drive further business development and new products answering customer needs. This integration of financial services in purchasing processes however needs to be provided in a safe and compliant way, for which rules around digital identity for example can play an important role.

The industry speaker added that secondly, technology also provides many opportunities for improving risk management to the benefit of consumers. A first example is the use of high-performance computing in the cloud, enabling complex models to be assimilated at high speed, for conducting risk simulations in capital market activities such as trading and asset management. A second example is liquidity reporting. The financial crisis in 2008 showed the importance for central banks of having quick access to liquidity reporting in order to evaluate the liquidity positions of banks. That data can be moved into the cloud, allowing reporting to be performed in hours rather than days.

A policy-maker agreed that there are multiple benefits associated with using digitalisation to its full potential in finance. Digitalisation offers many opportunities in terms of development of new financial products for consumers, including for those who cannot currently access financial services, and also of new forms of funding for businesses, in particular for SMEs, thus contributing to the economic recovery and the building up of Europe's open strategic autonomy. Digitalisation can moreover contribute to enhancing financial stability and market integrity by supporting regulatory and supervisory activities and also help to overcome the fragmentation of capital and banking markets across the Union.

1.2. Challenges associated with digitalisation

An industry representative emphasized two key challenges from increasing digitalisation. First, cybersecurity, which is an increasing concern for individuals, institutions and governments and which cloud usage can contribute to tackling thanks to the state-of-the-art security systems and processes used by CSPs for e.g. blocking spams, scanning webpages and testing security protocols. Secondly, data sovereignty is an important issue for European customers that can be addressed through partnerships at a regional or domestic level between CSPs and European tech companies for example, and which may also contribute to enhancing operational risk mitigation.

Another industry speaker concurred that managing data ownership rights and data privacy, so that people are able to have trust in the security of the financial system, and also cybersecurity, are key challenges that need addressing in the perspective of growing digitalisation.

A policy-maker stated that digitalisation should be conducted in a safe and compliant way, with an appropriate mitigation of risks and based on European values. The potential disruptive effect that digital finance may have on business models needs considering in particular. Formally integrated value chains are breaking up with digitalisation and the increasing role of third-party providers and new companies, such as fintechs, are entering the financial sphere.

2. Issues to consider in the policy approach to digitalisation

2.1. Finding an appropriate balance between supporting innovation and mitigating risks

An industry representative stated that with rapid digital transformation, the right balance needs to be found between supporting data-led innovation and growth on the one hand and preserving financial stability and customer protection on the other.

A public representative regretted that the industry and regulators often have different views concerning digital and technological evolutions. Regulators tend to be behind the curve, especially with the recent acceleration of digital developments. The challenge for regulators is balancing regulations in order to promote the progress of digitalisation, while ensuring consumer protection in a context where customers are exposed to a new range of risks. There is also the objective to maintain a fair competitive environment among the different players operating in the market i.e. regulated financial firms, tech companies…. This requires notably, preserving data ownership and data protection, preventing fraudulent behaviour and other cyber-risks and ensuring sufficient transparency e.g. in the way data is handled.

A policy-maker suggested that digitalisation requires a new way of looking at regulation because innovation is constant. The current MiCA (Markets in Cryptoassets) proposal, for example, does not explicitly cover decentralised finance (DeFi), which has developed since the initial drafting of the proposal, illustrating the challenge that legislators are facing in terms of adapting legislation to innovation. Building on the principle of 'same risk, same activity, same rules', it is important to carefully consider Europe's system of regulation going forward to ensure that digital finance remains a well-regulated space.

2.2. Supporting a democratisation of finance in coherence with European values

Answering a question from the Chair about the implications of democratisation and respecting European values for the financial industry in the context of increasing digitalisation, an industry speaker explained that people in most societies, including Europe, increasingly want to have access to and be involved in wealth creation opportunities. For that to happen, current mindsets and approaches need to evolve in a number of areas. A first area concerns transparency on the way customers' money is handled and used. An increasing number of customers want to make sure that their money is appropriately used e.g. to fight climate change. This involves greater transparency and also the provision of adequate and reliable information about the companies in which savers' money is invested and the actions they are undertaking. Secondly, democratisation also means that customer data itself has become an asset and has value. Solutions need to be found so that some of the benefit that companies have obtained in using customer data can be given back to these customers. Given the work underway in the areas of ESG and data usage and sharing, Europe has the potential to be at the forefront of these developments.

A policy-maker stated that while the European model aims to achieve better outcomes for citizens on the whole, this is not a reason to overlook or hinder disruptive innovation. Many questions have been raised about how data is collected, handled and shared and who owns it, but in a platform economy it is important for regulators to focus on key issues such as market power and the risks around the use of algorithms in AI based processes.

A public representative agreed that a change is needed in terms of mindset around financial services and markets in Europe and believed that financial regulators and the industry are on the right track for supporting this evolution. First, citizens must be encouraged to put their savings regularly in appropriate investments with a long term perspective in order to avoid losing money on their savings in the current macroeconomic environment. In order to achieve this objective, it is essential to ensure that information is provided in a transparent way and that trust is created, so that more people are inclined to look into the opportunities offered by long-term investment and understand the potential benefit of this for their own wealth, as well as for Europe's economic growth. Secondly, financial institutions must be encouraged by the public authorities to innovate, which is happening with the current focus put on digital developments in European policy proposals. The public representative also noted that a digital euro is now under discussion. This could encourage the start-up industry and SMEs in Europe to start developing solutions for how to implement that in the market. Digital currencies are also an opportunity to attract the younger generations, who are more familiar with these developments, to financial markets.

2.3. Allowing a 'test and learn' approach to digitalisation and a right to fail

Answering a question from the Chair about what kind of regulation is needed to support these evolutions, an industry representative explained that the outcome of regulation is best when it fosters innovation, noting that one key element here is the degree to which waste and error are allowed. The global economy is in transition, some new technologies will succeed and some others will fail. In terms of innovation there is therefore a question around the degree of risk-taking that is allowed. Allowing failures is the most effective way to make the European market more competitive, as long as it does not harm individuals beyond an acceptable level. The role of regulators should be to increase the level of participation in financial markets by creating adequate 'rules of the road' that will allow risk-taking without severe damage for customers. In addition it is essential to understand that regulation is not fixed, but must evolve with the market and the understanding of the implications of innovations for customers.

Another industry representative observed that the regulatory regime is evolving and that some tools that enable the process of testing and failing exist. The public authorities in the EU have created sandbox environments which allow the testing of new digital solutions such as distributed ledger technology (DLT) and crypto ledgers for instance. In this environment, it is possible for supervisors to oversee what is being tested and learn alongside market participants, without waiting for the technology to be fully mature. This approach fosters a shared understanding between the industry and the authorities of the opportunities and challenges associated with these technologies in a transparent and trustful way. The very fast pace of digitalisation across almost every sector since the beginning of the pandemic has produced a huge amount of information that market players together with the regulators need to understand and assimilate, in order to provide regulation that delivers trust and transparency, as well as growth and innovation.

A policy-maker was favourable to allowing a right to fail and setting up sandbox environments where innovations can be safely tested. The MiCA legislation is a good example of this. Provided certain requirements are respected and that the risks are appropriately explained to the customers, anyone can develop and offer a crypto-currency in the market and can fail in doing so. For a stablecoin claiming to be linked to the euro, stricter guarantees will be needed for customers. These developments including also central bank digital currencies (CBDC) will potentially lead to a great deal of innovation when they are connected to digital platforms and new mechanisms such as smart contracts and should be encouraged. There are however some cases in which it is not possible to grant the right to fail, for example when there is a breach of personal data privacy or if the output of an Artificial Intelligence (AI) system may threaten people's lives. This is why the EU approach to AI is risk-based and the OECD is moving in the same direction. Concerning AI, data manipulations with algorithms should be allowed above a certain level of caution. For example, using AI for marketing purposes is allowed, because customers make the final decision, so long as this concerns consenting adults and not kids, but some other applications that are more intrusive in people's lives may be forbidden.

3. EU legislative proposals underway

Comments were made by the panellists on the main EU legislative proposals underway concerning digitalisation in finance.

A policy-maker explained that the Commission published in September 2020 a Digital Finance Package including a digital finance strategy and legislative proposals on crypto-assets and digital resilience, aiming to support digitalisation in the financial services sector. This is part of the broader digital and data strategy being developed by the Commission (which includes the Data Act, the AI Act etc…) and complements it with a more specific focus on finance i.e. sector-specific provisions based on the broader principles of the European horizontal digital policies and cross-references to these horizontal policies. The Commission is seeking to regulate digital finance with the appropriate mindset, in an innovation-friendly way. An important objective is to clarify the rules for consumers, businesses, service providers and the financial industry in this evolving context, because regulatory certainty and stability are essential for supporting innovation.

This is the approach that was used for example for cryptoassets with the MiCA proposal, where the EU was a first-mover, the policy-maker stressed. There was a deliberate choice to regulate this market so that it could develop quickly within a clear set of rules. Progress is being made on the different proposals of the Digital Finance Package. The trialogues on MiCA will be able to start shortly and hopefully conclude quickly. The trialogues have also started on the DORA (Digital Operational Resilience Act) proposal, with the objective of concluding the legislative process in the next few months, adding an important dimension to the EU regulatory framework on cybersecurity in the financial space. Moving forward, work will also be initiated on open data and what it could mean in the financial sector, in conjunction with the review of Payment Services Directive 2 (PSD2). Open finance opportunities are also being considered for capital markets in the context of the Capital Markets Union (CMU) initiative.

A second policy-maker noted that European regulation is progressing in a number of areas that are important for the digitalisation of the financial sector and will further support innovation in the financial sector. In the same way as the Digital Finance Package, the overall objective of these legislations is to mitigate risks while facilitating innovation and the realisation of the opportunities offered by digitalisation. These initiatives include the proposed Data Act and the previously approved Data Governance Act, which address key issues around data ownership and sharing; the European Digital Identity framework, which will notably facilitate the access of European citizens to online financial services throughout the Union; the AI Act (for financial services, requirements will concern mainly loan provision, for which AI use is considered as potentially 'high-risk' for EU citizens); and cyber-resilience frameworks.

A public representative considered that the legislative process in Europe regarding digitalisation in finance is on the right track. In the Digital Finance Package, the Commission has established the groundwork for supporting on-going digital developments in the financial sector with rules addressing cryptoassets, DLT and digital operational resilience in particular. The fast pace of evolution of technology and digital solutions is however a challenges that will require effective cooperation between the industry and the public authorities.

An industry representative concluded that Europe is leading the way in defining regulation that supports digitalisation while preserving financial stability and benefiting end customers. DORA is a great example of this, particularly in the process that was used to build this legislation, with interaction with and input from the key stakeholders concerned.

Decentralized finance (DeFi): prospects and policy challenges

1. Decentralised Finance (DeFi) characteristics and market trends

1.1 Objectives and characteristics of DeFi[1]

An industry representative explained that the promise of decentralised finance (DeFi) is to disintermediate financial services as much as possible with a high degree of automation and an easier access for customers. Customers should be able to execute transactions directly for example on a decentralised stock exchange operating on a blockchain or obtain a loan directly on a DeFi app without any intermediary or bank. DeFi proposes many attractive features, but there are issues to address and changes to make for fulfilling this promise.

Another industry representative explained that the main features of DeFi are clearly articulated in the 2013 Ethereum white paper. First DeFi applications run on a permissionless blockchain, which means that individuals using DeFi applications can transact directly on the blockchain and join as validators and that there is no central entity controlling the blockchain. This also means that transactions on a DeFi platform are peer-to-peer. A second characteristic of DeFi is that it uses smart contracts (i.e. self-executing programmes) to automate the execution of transactions and the implementation of business or product rules when predetermined conditions are met, without the need for intermediaries. A third characteristic is the decentralised governance of DeFi platforms, normally based on voting schemes, for making decisions concerning the protocols and the operation of the platform and also the services or products offered on the platform, replacing in effect traditional product or infrastructure governance rules. A final important feature is the importance of stablecoins, which are used as collateral or for the payment of interest in DeFi protocols and are therefore essential to the functioning of DeFi markets facilitating fund transfers between users and across platforms.

1.2 State of development and market trends

An industry representative stated that the growth of DeFi was outstanding in 2021 with a total value locked in DeFi platforms reaching $250 billion and an increase of almost 2,000% in a single year. Trading on decentralised exchanges (DEXs) has also grown significantly in particular, with around $300 billion per month now being traded on DEXs.

A second industry representative agreed that DeFi has been growing dramatically in recent months. A large part of the value is locked in crypto-asset trading on DEXs, but crypto-asset based lending platforms and to a lesser extent other services such as decentralised crypto-asset management, payment services or derivative products are starting to get into the DeFi space. DeFi is developing mainly through retail participation, but it is expected that the applications of DeFi in the institutional and business-to-business space will also pick up when a proper regulatory and legal framework is in place.

A third industry representative emphasized the growing importance of stablecoin lending, which is one of the most significant DeFi activities at present. This can be explained by the fact that an individual can currently earn abnormal returns (up to 10% interest) by borrowing and lending stablecoins. The issuance and purchase of NFTs (non-fungible tokens) is also an important activity on DeFi with around $20 billion of the 250 billion of value of DeFi locked in NFTs. Traditional players such as custodians, are observing these developments, even though they are not currently actively facilitating these services, because their clients are expressing an interest in DeFi. For example asset managers are currently assessing how they could integrate DeFi into their portfolio management and investment activities. Exchange traded funds and products (ETFs and ETPs) investing in crypto-assets are also expected to extend their investments to DeFi products in the near future. At present, however, DeFi is still very much linked to speculation on crypto-assets.

Other industry representatives on the panel confirmed that stock exchanges are also active in this space, creating digital exchanges, investing in blockchain solution providers or in tokenisation solutions and handling ETPs investing in crypto-assets.

1.3 Limited level of decentralisation of most DeFi platforms

An industry representative stated that DeFi is not as decentralised as is claimed. The code is created by a foundational organisation and a pre-determined governance process is used in most cases to make changes to that code. Data oracles[2] are also used to connect DeFi platforms to external sources of data or applications, providing a bridge between the DeFi blockchain and the real world. These are points that could be potentially regulated in the future.

1. Decentralised finance (DeFi) refers to financial applications which are run on a permissionless blockchain and use smart contracts automating the provision of financial services without the need for intermediaries.
For further detail on the characteristics and related opportunities and challenges of DeFi see: OECD report “Why DeFi matters and the policy implications” January 2022 https://www.oecd.org/daf/fin/financial-markets/Why-Decentralised-Finance-DeFi-Matters-and-the-Policy-Implications.pdf
and Eurofi note on DeFi: opportunities, challenges and policy implications (Eurofi Regulatory Update February 2022) https://www.eurofi.net/wp-content/uploads/2022/02/regulatory-update_paris_february-2022.pdf

2. So-called oracle services allow data and content external to the blockchain (e.g. asset prices needed to execute transactions or to price derivatives), to be incorporated into the DeFi transaction flow, enabling the execution of smart contracts. Connections can also be established with external wallets, allowing users to store, transfer and manage their digital assets.

Another industry representative considered that the decentralisation of DeFi is somewhat of a "paradox". Everything is presented in a decentralised way in DeFi, but the main activities of DeFi such as crypto exchanges are actually quite centralised. Most of the liquidity and settlement is managed in a centralised way[3] and only certain activities are conducted on decentralised blockchains. Although these platforms have many features of third parties intermediating transactions, they are not regulated. In addition, accessibility to DeFi platforms for ordinary customers is not that easy, therefore they will probably have to use some form of intermediation to access them in the future.

An official observed that while some features of centralisation in DeFi are related to the newness of the market and to the current level of maturity of platforms, there are other structural and more durable factors that may limit decentralisation. For example, the principle of completeness in contracts shows that there are limits to the way that contractual outcomes can be predetermined with smart contracts. in a multivariable environment, meaning that human decisions (made in a centralised way) will probably be needed at some point.

The Chair added that the BIS has reached similar conclusions in a paper written about the "illusion" of decentralisation in DeFi[4] and how the functioning of these platforms can result in them being much more centralised than they look.

2. Opportunities, challenges and risks associated with DeFi

2.1 Opportunities

An industry representative stated that the possible opportunities offered by DeFi include a higher level of automation and a higher level of direct interaction with the end customer. DeFi can allow financial services providers to operate 24/7 across the globe, extending also their reach to "unbanked" areas. If regulations are updated to take DeFi into account then opportunities could be further opened up and this would encourage more companies and institutional players to move into the DeFi space.

Another industry representative noted that the main potential benefit of DeFi in their view is to create more efficiency. DeFi could help to deal with general inefficiencies of transaction settlement, such as delays, uncertainties, failures, by reducing the level of intermediation in the system, and could also help to address the illiquidity of some assets, such as mid caps. In the future, the characteristics and underlying technologies of DeFi may also help to handle some new use cases that the current financial system is not addressing.

2.2 Challenges

An industry representative stated that there are challenges in the development of DeFi, particularly in the institutional and business-to-business spaces because of a lack of regulation. The development of DeFi across borders and sectors may also be limited by the current fragmentation of legal systems and regulatory frameworks across national and sector-specific lines. A first objective is therefore to adapt regulation to the cross-border and cross-sector nature of DeFi. Moving transactions to a DeFi environment is a second challenge, as it is still unclear how the liquidity, latency, speed and volatility issues handled at present by stock exchanges can be managed in a decentralised environment. A third challenge concerns the scalability of DeFi platforms, which would need to be improved in order to compete with stock exchanges and payment infrastructures that handle large volumes of transactions and are available at all times.

A second industry representative added that a significant problem with DeFi is that on paper it can provide a great deal of efficiencies and very palatable use cases, but for market players to achieve them, significant investments are needed. These investments are difficult to justify with the current volumes and development prospects of DeFi, creating a situation of lock-in.

An official observed that there are also network congestion issues at an operational level. These problems of scalability combined with high fees that are impeding the participation of retail investors with a small size of transactions mean that retail access is difficult, which is the opposite of what DeFi is claiming to promote.

Another official emphasized that it is important to take a dynamic approach to considerations of opportunities and challenges associated with DeFi. A major issue with DeFi at present is that there are differences between aspiration and reality. DeFi promises changes in the way that financial services are delivered, but currently there are few real economy use cases. DeFi is still mostly a way of facilitating activity across different digital asset markets. In addition, while DeFi promises decentralisation, many features of DeFi platforms are actually quite centralized, as previously mentioned. It is therefore important to understand aspirations, realities, and the underlying factors to evaluate the real potential of DeFi.

2.3 Risks

An industry representative stated that the most significant risk in the DeFi space are currently cybercriminal hacking and theft from DeFi platforms. Lending platforms have been particularly vulnerable, with criminals exploiting bugs or flaws in certain open-source software protocols to steal funds from these platforms. Around $10.5 billion in losses were suffered from cybercriminal hacking of DeFi platforms in 2021. A week before the Eurofi conference, $325 million was stolen in a single instance from a DeFi platform. That

3. While some DEXs match orders through order books which are on-chain and therefore totally decentralised, order books are more frequently off-chain and managed by centralised third-parties which provide participants with the information they need to select an order they would like to match.

4. DeFi risks and the decentralisation illusion – BIS Quarterly Review, December 2021 https://www.bis.org/publ/qtrpdf/r_qt2112b.pdf.

type of criminal activity will continue as long as the space remains outside proactive regulatory oversight. Money laundering activity is also occurring through parts of the DeFi ecosystem, particularly through DEXs. Nation state actors like North Korea are exploiting some of those platforms and using them to try to launder funds.

The industry representative stated that while a great deal of DeFi activity is currently sitting outside the regulatory perimeter, a large part of it is quite transparent. Transactions and activities are recorded on smart contracts and on the blockchain in a very open fashion, making the tracking of fund flows actually more transparent than in many centralised institutions. A regulator agreed that distributed ledger technology (DLT) allows a tracking of funds and in some cases it is easier to track flows in a DLT environment than in some more traditional ones. How this tracking is performed is the first element that domestic regulators check when authorizing a crypto-asset service provider.

An official stated that criminal activity with DeFi is mainly linked to the anonymity of users on the platforms. Many DeFi apps also involve the provision in a noncompliant manner of financial services that are normally regulated. For example, the governance tokens that DeFi protocols issue to their community have characteristics of securities or investment contracts, but their issuance, trading or promotion is unregulated in many jurisdictions. In addition, DeFi platforms do not provide their users with basic safeguards that exist in regulated environments, such as investor protection, recourse possibilities, market integrity rules or due diligence audits. Moreover, the governance of most DeFi platforms is weak and there is no accountability. As a result there is evidence of significant fraudulent activity on DeFi platforms, including 'pump and dump' schemes that artificially inflate or manipulate cryptoasset prices, making trading more costly than on centralized exchanges.

The official added that there are systemic risks associated with DeFi related to uncontrolled leverage, which is currently one of the main drivers of investor participation in the space. Channels of risk transmission in DeFi from highly volatile crypto-asset markets to traditional financial services also create new vulnerabilities. Stablecoins are the bridge between the decentralised space and the traditional financial markets, and are one of the greatest vulnerability points for DeFi. There is a lack of transparency in some issuers of stablecoins around reserves and a lack of clarity around redemption rights, which could bring DeFi protocols down and also disrupt some parts of the traditional financial markets such as short term commercial paper markets.

3. The regulatory approach to DeFi

3.1 Stablecoin and crypto-asset service provider regulation

The Chair emphasised that there are different time horizons to consider regarding the regulation of DeFi. A first step underway is the regulation of crypto-assets. New crypto-asset regulations are being implemented in Europe with the Markets in Crypto Assets (MiCA) regulation. Central banks are working on central bank digital coins (CBDC) but with an extended time horizon. An issue to consider regarding DeFi however is how to undertake an appropriate regulation at a time when it is unclear what the ecosystem will look like in five years' time.

An official stated that the key issue that policy-makers and supervisors have to resolve regarding truly decentralised protocols is the absence of a single regulatory access point.

A regulator considered that Europe is behind the curve on DeFi. The EU is in the process of delivering the MiCA regulation but it does not cover DeFi protocols per se. One reason for this is that some stakeholders prefer not to provide DeFi with an official recognition in regulation at this stage. The regulation of DeFi is not a pressing concern because the size of the market remains limited, but the issue needs to be addressed. There should be a focus on stablecoins in MiCA applying both to private and public coins, because outside stablecoins, the use case for DeFi is quite weak and this will therefore provide part of the answer. The level two of MiCA will be key in this regard. Another part of the answer is the regulation of digital asset service providers, such as custodians and platforms. It is important not to approach that regulation at the domestic level, because most of these players operate on a cross-border basis. International standard setters have a role to play in that field in order to deliver rules which are consistent and which can support deep cooperation between supervisors. There are also issues of consistency to address at the EU and international levels regarding securities investment services, which are regulated services, but with a definition that varies across countries. An issue however is that there are different views on the need to regulate coins and service providers at the international level. The idea to address crypto-asset intermediaries and platforms has been pushed by some European regulators in FSB forums and in discussions with US regulators, but at present the focus internationally is mainly on coins. Once these two elements are in place a further step for Europe would be to deliver a full DeFi framework based on the principle of 'same service, same risk, same rules'.

An official agreed that it is vital to get the requirements for stablecoins right in the first instance. In the US, stablecoins that are intended to be used as means of payment were the subject of a report of the President's Working Group on financial markets that came out at the end of 2021. The report asks the Financial Stability Oversight Council (FSOC), which has authorities to designate certain activities that are deemed systemic, to consider the steps it has available to address risks from stablecoins. U.S. banking agencies and market regulators are also utilizing their existing regulatory powers to address the payment chain run risks and concentration risks associated with stablecoins that were identified in the report. There is also a recommendation to Congress to pass legislation that would address some of the fundamental gaps that the report identifies in the regulation and supervision of stablecoins in the United States. That would include requiring issuers of stablecoins to be depositary institutions, falling within the banking regulation umbrella.

At the international level, the discussion focused first mostly on the use of stablecoins for retail payments, the official explained, but it is now moving towards a more holistic assessment of the broader digital asset ecosystem including DeFi and other types of market intermediaries. This follows the recognition that analysing stablecoins in isolation is not sufficient and that it is necessary to understand how the whole ecosystem is working. In this perspective, the FSB is conducting a holistic mapping of the current regulatory treatment of the broader digital asset market, to be published in October 2022. The second workstream is a deep dive on DeFi, with an emphasis on challenges that policy-makers face in understanding risks and opportunities in the DeFi ecosystem. There is a considerable data challenge that needs to be addressed for analysing financial stability issues, such as the extent of leverage in the system, which is a significant impediment for policymakers.

An industry representative noted that if security tokens used in DeFi were to be regulated then a large part of the permissionless nature of the platforms would no longer work. The industry representative also emphasized that there are a number of specific technical questions to solve in terms of regulation to allow regulated financial institutions to operate in the DeFi space. For example, if investments are made by an asset manager via a DeFi platform, a question for the custodian is how to provide ownership verification under the AIFMD and UCITS directives. A regulator observed that the EU DLT pilot project would help to answer such questions, and this is also why there is an on-going review of existing legal frameworks in the context of the EU Digital Finance Strategy.

Another industry representative was hopeful that regulation of the DeFi space will eventually deter theft and crime, trigger institutional money and enhance financial stability. A regulation of DeFi is also necessary to ensure a level playing field and reduce regulatory arbitrage. A balance however needs to be found so that crypto-asset service providers that are playing by the rules can continue to innovate.

An official stated that it is crucial to promote greater international regulatory cooperation due to the ease and speed at which players in the DeFi space can change geographical locations. Europe may need to also consider bringing in non traditional parties to the conversation such as software or protocol developers which are also active in the DeFi space.

3.2 AML/CFT rules

An industry representative noted that there is an increasing emphasis on how regulatory compliance principles can be carried out in the DeFi space, with market players seeking ways to embed aspects of anti money laundering (AML) and countering the financing of terrorism (CFT) compliance into their platforms.

In terms of regulation, an official stated that the Financial Action Task Force (FATF) has clarified that the existing AML and CFT recommendations apply across the board to all activities involving crypto assets. Another official added that the FATF published an updated risk-based guidance in October 2021, with details on how AML/CFT rules should apply to crypto-assets including in a DeFi environment, but implementation is not yet there. In addition, a number of the large DeFi protocols are coming out with institutional versions of their protocols, including white listed pools of investors, in order to be able to comply with AML/CFT rules.

A regulator explained that the two main historical concerns for regulators with crypto-assets were AML and mis selling. How authorized digital asset service providers handle AML/CFT requirements is the main issue that national competent authorities are checking at present. It is now clear that the AML rules will apply to crypto-assets including in the DeFi environment, which is a step forward. An industry representative agreed, noting that any ransomware attack in the world asks for cryptocurrencies, which shows that the area is not yet covered properly. The issue of AML/CFT should be addressed at international level, because illegal activities happen at a cross-border level.

An industry representative stated that the fundamental principles that have been laid out in the FATF guidance are sound. The FATF is assuming that someone can be held accountable for the implementation of AML/CFT rules in DeFi platforms, which is feasible at present since many platforms are not as decentralised as they appear, as previously mentioned, with significant points of centralisation in those ecosystems. The situation may evolve however in the coming years and the issue of how to address a truly decentralised ecosystem and who to hold accountable for the proper implementation of AML/CFT rules may become more relevant. There is also a potential problem of inconsistent implementation of rules across jurisdictions, due to the speed at which the DeFi space is evolving, leading to possible regulatory arbitrage across jurisdictions if they do not move at the same speed in terms of implementation of AML/CFT rules.

The Chair concluded that there has to be a learning process with DeFi. The FATF has learned in the past about other issues such as un-hosted wallets and how to address them, and the same kind of learning process might be expected regarding peer-to-peer transactions in DeFi.

Leveraging the benefits of DLT in securities markets

1. Opportunities and challenges associated with the use of DLT in securities markets

1.1 Use cases of DLT in securities markets and lessons learned

An industry representative explained that considerable effort is being made by the financial industry and the public authorities to implement distributed ledger technology (DLT) in the securities market, particularly in post-trading. €30 billion was spent worldwide on DLT projects in 2021 and investments are also significant in Europe. There is a strong belief that DLT can help the post-trade market address many of the remaining inefficiencies in securities markets. DLT can also help the EU securities industry to propose new services. Finally, these technologies could lead to a complete reshaping of the structure and functioning of financial markets that needs to be anticipated. The industry representative described an experiment that was recently conducted by the Banque de France around issuing French sovereign debt on a single permissioned blockchain, which involved the French Treasury, Euroclear, primary and secondary dealers and custodians. This was a way for market players to evaluate the impact of DLT in securities markets in terms of efficiency and safety and to test how this technology could help to manage certain processes such as corporate actions. This experiment also allowed an evaluation of the extent to which the existing market ecosystem would need to be reorganised to make use of DLT and whether this could lead to simplification in the relationship between players, since they were all accessing the same blockchain.

An industry speaker agreed that DLT has the potential to reshape financial markets. Projects should focus on what is most valuable for investors rather than on what is technically feasible. While discussions on cryptocurrencies and the tokenisation of real assets are worthwhile, the main application of DLT will be in the securities markets, because the main needs of investors have not evolved that much. The European Central Bank (ECB) estimates that there are €20 trillion of euro denominated securities that are not shares. If some of these were transformed into digital securities tradable on a blockchain, this could be much more significant than the tokenisation of real assets such as real estate.

An industry representative emphasized that in the US considerable efforts are also being made to further evaluate the potential impacts of DLT and to build expertise and skills around DLT. Beyond this, a key objective of DTCC in particular, over the last 5 years has been to start operationalising DLT. This started with the work to re-platform the Trade Information Warehouse for credit derivatives on Axoni's blockchain. More recently, two proven and industry-validated innovation proofs-of-concept have been promoted to minimum viable product (MVP[1]) status. The first of these is Project Ion, which is built on R3's Corda, a private permissioned DLT platform. This solution will run alongside DTCC's traditional clearing and settlement processes for a subset of clients and cash equities and is a way for the industry to start experimenting in a live production environment with the clearing and settlement of securities on DLT, including the use of different settlement cycles, tokenised assets and application programming interfaces (APIs). This will allow the assessment of client confidence in DLT-based infrastructure and of the added value provided.

The second initiative is the Digital Securities Management Platform, which is an industry-wide regulation-compliant solution focused on the private market space. These markets are hampered by many inefficiencies including manual processes, market fragmentation, a lack of reference-data standards and insufficient compliance enforcement. Some initiatives led in this area by fintechs such as initial coin offerings (ICOs) and security token offerings have faced many regulatory and adoption challenges. After assessing these issues DTCC sought to experiment how blockchain might deliver a solution that would better support US private-market assets from issuance through to secondary trading. This prototype showed that a common infrastructure and further standardisation could bring efficiencies in this market and that a centralised stock record database could bring value to the broker-dealer community, allowing them to hold securities on an investor's behalf in traditional or tokenised form.

The industry representative concluded that the objective of these use cases is not to promote DLT but to create client value. DLT will not solve every problem in the securities market, but it can enable more efficiency. In addition, DLT-based solutions can help the tokenisation ecosystem to take off and provide clients with a regulatory-compliant solution for these assets.

A regulator agreed that the most compelling use cases for DLT are in the securities space, and this is where most projects are happening. However, there is a wide heterogeneity of business models at present and strong uncertainty around which models will succeed. Different technological choices co-exist, leading potentially to

1. A proof of concept is a test of the real-world potential of an incomplete idea. It is not about delivering the idea but demonstrating its feasibility. An MVP aims to accelerate learning about a possible solution with real users, whilst testing only the essential core of the concept, rather than the full solution, in order to use a minimum amount of resources. The objective is to learn early on whether there is an actual need or demand for the solution, to understand what is working and what is not and to make adjustments accordingly.

quite different outcomes: for instance, some blockchains are permissioned, others are non permissioned and involve a recourse to trusted third parties to different degrees. There are also differences in the extent of activities conducted on the blockchain: in some cases all activities are conducted on the blockchain with the objective of eliminating traditional intermediation and maximise productivity gains, in other cases there is only a partial use of DLT and recourse to more traditional players for part of the activities. Regulators should not choose between these different models and should adopt a technology-neutral approach, because there is currently too much uncertainty around the right technological choices. The market should be left to converge towards the best solutions and outcomes.

1.2 Main benefits and efficiencies associated with the use of DLT in securities markets

An industry representative suggested that the implementation of DLT in securities post trading could have a positive impact in four main areas: a reduction or even a removal of reconciliations; easier investor identification; improved cross border settlement; and a reduction in transaction settlement time. The latter impact is often presented as a key benefit of DLT, but the speaker believed that some of the former aspects are more significant. There are also five key benefits for customers and securities markets more generally from the use of DLT. First, the blockchain could create benefits around anti-money laundering (AML) and know your customer (KYC) verifications, particularly for investment funds. Secondly, DLT could facilitate real time and cross-border corporate actions. Thirdly, there could be a benefit for small and medium-sized enterprise (SME) financing from DLT providing easier access to listing and public markets. Fourthly, smart contracts operating on DLT could allow the implementation of conditional sales or purchases e.g. according to predefined ESG criteria. Fifthly, there could be a benefit in terms of tax management, by using DLT to create a system for real-time and automated reporting to fiscal authorities.

Another industry speaker explained that DLT is not about having a digital rather than a physical ownership certificate of securities, but about issuing, trading and settling digital securities on a blockchain. It is also important to understand the benefits of DLT for investors. First, a DLT may allow a significant reduction of transaction costs with settlement costs decreasing by more than 50%. Secondly, DLT may also allow investors to visualise the holdings in their portfolio immediately after the transaction, which could increase market efficiency. Thirdly, DLT may facilitate a further integration of market infrastructure in Europe, which is currently fragmented along national lines. A DLT network with a common standard for modelling financial instruments could be used to exchange digital assets and simplify cross-border transactions, which would be handled on the chain in the same way as domestic trades. This is an important objective, because if European securities markets were unified, the European market could play a much greater role in the global capital markets landscape than today.

A regulator agreed that there is an opportunity with DLT to increase the efficiency of financial market infrastructures (FMI) in addition to the AML and KYC testing benefits previously mentioned. As a shared data record, DLT can modernise, streamline and automate FMI trading and settlement processes. Additionally, DLT can increase settlement efficiency for securities and reduce settlement times and failures. Lastly, the use of smart contracts, which are an important component of DLT systems, can be very beneficial for the efficiency of securities markets, for example supporting the automation of outdated middle and back office settlement processes.

1.3 Challenges and risks posed by the use of DLT in securities markets

While the use of DLT could significantly facilitate the issuance and settlement of traditional securities, an industry representative considered that managing this transition will be difficult and expensive. It is not yet clear at which stage the benefits of DLT may outweigh the challenges and justify an implementation of DLT at scale in securities post-trading activities.

A regulator highlighted several key risks posed by the use of DLT. First, the implementation of DLT could lead to significant changes in the organisation, structure and functioning of FMI arrangements, which could cause, at least in the short term, further market and liquidity fragmentation or reductions in liquidity and settlement efficiency. There are also questions about the ability to scale up DLT systems sufficiently to be able to use them in an efficient way in core securities markets. Additionally, DLT could lead to disintermediation if investors are able to directly participate in FMI arrangements without having to use firms. While this could increase efficiency, it could remove some of the existing investor protections in the market. It is therefore important to understand what investor protections will be provided under these new arrangements.

An industry speaker emphasized that there will be no opportunities for customers and the financial industry with the use of DLT if the risks are not appropriately mitigated, because there needs to be trust in the functioning of the market and the new securities issued on blockchains. In addition to questions about how investor protection will be handled on DLT platforms, one key area of concern is around the custody of digital financial instruments, which is where most fraud and IT security issues happen. Establishing proper standards on custody in terms of knowledge, system requirements and the ability to handle losses from operational risks is essential to build trust in these systems.

2. Regulatory and supervisory challenges raised by the use of DLT in securities markets

A regulator emphasized the challenges of supervising certain DLT-based systems. An important issue is being able to identify which entity to supervise. DLT was invented with decentralisation in mind, but most of the platforms implemented so far function in a centralised way. However decentralised finance platforms (DeFi) are starting to appear and are gaining traction in the market. In some cases, it can be difficult to evaluate the level of decentralisation of a DLT platform, but a truly decentralised platform, if regulated, would be a 'game-changer', because it would be an upheaval for existing supervisory processes.

A second regulator concurred that securities market regulators and supervisors will be facing new challenges with the development of DLT. Some challenges such as cyber-risk are already well identified, but there are also new areas of concern. One is decentralised finance (DeFi) mentioned by the previous speaker. At present most business models are not really decentralized but in the longer term this may evolve, potentially necessitating a rethink of the architecture of European supervision. Another issue is that EU policy-making is perhaps not agile enough to address growing technological change, as shown by the time that was needed to agree on the DLT pilot regime proposal. An obvious solution would be to empower the European supervisory institutions with more direct supervision powers, in order to be able to adapt their approach more easily to changes in the market. In the long term, other topics such as securities law will need to be reopened, probably at level 1, because DLT raises new questions in terms of security ownership. Finally, the regulator noted that in March 2020 the International Monetary Fund (IMF) had produced a paper which listed the regulations that could create an impediment to experimenting with DLT for securities and which concluded that most of the impediments were in the trading space. The first regulator noted that the securities used in a tokenised form on DLT systems are still securities, i.e. financial instruments regulated under the MiFID II Directive.

An industry speaker reiterated the importance of not being technology specific in the policy approach. For example, IT security issues or KYC issues can happen in a central infrastructure or a DLT environment. The extent of those issues might be different, but the type of risk is not different. In the same way a digital security is still a security or a financial instrument for KYC purposes or for the application of MiFID rules.

A second industry representative emphasised the importance of the challenge around securities law. There are still many discussions happening domestically about what form a security token should take in a blockchain and the outcome of this debate is uncertain. Secondly, there is indeed an issue around the supervision of blockchains, whether they are centralised or decentralised. The distributed nature of platforms will complicate supervision in any case, with a key question about who is accountable e.g. in case of an incident. Additionally, there is a question around Central Bank Digital Currencies (CBDC) and how they may be used in the context of DLT. The speaker felt that a safe settlement coin regulated as a CBDC would be useful for post-trading activities, waiting for a decision to be taken more broadly about the provision of CBDCs.

A third industry representative agreed with previous speakers that it is activities that need to be regulated rather than specific technologies and that it is essential to have adequate governance and accountability in place in DLT platforms for managing the network and the code, dealing with potential problems and ensuring data standardisation and quality. This should include DeFi platforms, which also have centralised players running the network, at the current stage of their development at least. The speaker also agreed that the rules around the ownership of digital securities remain to be clarified. Finally concerning CBDC and settlement coins, this is an area where experiments are being conducted by Central Banks and also private companies and where there are many opportunities. The speaker did not want to advocate for any particular solution but supported the underlying goal of speeding up payment rails and moving towards real-time settlement.

3. Regulatory approaches to DLT in securities markets

3.1 EU DLT pilot regime

The Chair invited the panellists to consider the extent to which the existing regulatory framework is fit for purpose and can accommodate the innovation created by DLT. It is important to determine whether the proposals made in the context of the EU Digital Finance Package, which include the innovative DLT pilot regime proposal, will support the uptake of DLT in the securities market. While the text of the DLT pilot regime is not yet finalised, a political agreement between the Parliament and the Council was reached on 24 November 2021 and the regime is likely to apply from 2023.

A regulator considered the DLT pilot regime a positive proposal. As the name indicates, this pilot will help market participants and supervisors to gain experience with DLT. ESMA issued a call for evidence in January 2022 on the proposed DLT pilot regime, which will help to fine-tune rules applying to DLT. The DLT pilot regime indeed requires ESMA to assess, based on feedback from stakeholders, whether the regulatory technical standards (RTS) developed under MiFIR relative to certain pre and post-trade transparency and data reporting requirements need to be amended in order to be effectively applied to securities issued, traded and recorded on DLT.

The regulator mentioned five additional issues that need addressing with regard to DLT. First, because entities participating in the pilot regime will be exempted from some requirements of MiFIR and CSDR, regulators across the EU must grant these exemptions in a consistent manner to avoid divergence and regulatory arbitrage. Secondly, the approach to transaction reporting may need to be adapted in order to allow regulators to retrieve the records that exist on blockchains. Thirdly, while the call for evidence concerning the DLT pilot regime concentrates on venue trading, it is important to also tackle over-the-counter (OTC) transactions and to assess interoperability. Fourthly, investor protection implications need to be clarified. While retail participation is envisaged by the DLT pilot regime, further safeguards need to be implemented, as retail orders will not be executed via intermediaries. Finally, the DLT pilot regime is a project, which means it should have an end, but what comes after it needs to be defined. One aspect that will need to be evaluated at the end of the pilot regime is whether any changes are needed in MiFIR and CSDR for allowing the use of DLT-based systems. The success of the DLT pilot regime will ultimately be measured by the number of applications that national competent authorities (NCAs) receive, the types of projects that emerge and whether they bring sufficient value to customers.

A second regulator considered that the DLT pilot regime will help to create an appropriate regulatory and supervisory environment for DLT. A number of amendments are needed, however. In particular, the definition of a financial instrument requires further harmonisation at the EU level. This is a concern, because it is hard to know what 'universe' some real-life projects are in. From a supervisory perspective, it is also important to observe that the EU DLT pilot regime is not a sandbox, but a regime, which provides the entities concerned with an EU passport.

An industry speaker was supportive of the DLT pilot regime which would allow market stakeholders to learn from experience, and considered that it should be extended at the end of the experimentation and become a full regime, taking out the notion of a 'pilot'. In this context rules around the custody of digital assets should be an area of focus. Another industry representative agreed that the DLT pilot regime, together with the Regulation on Markets in Crypto Assets (MiCA), offer many useful possibilities to test and innovate with DLT.

3.2 The UK regulatory sandbox approach

A regulator outlined the ongoing initiatives being conducted by UK regulators concerning DLT. One of the most prominent ways the FCA supports innovation is through its regulatory sandbox, which allows firms to experiment and test innovative solutions in the market with retail consumers in a safe environment. In total, more than 700 firms have used the sandbox so far in terms of regulatory guidance. Last year alone, the FCA supported 43 firms with crypto-asset or DLT-based innovations in its sandbox. The FCA is also considering a Financial Market Infrastructure (FMI) Sandbox, jointly with HM Treasury and the Bank of England. The aim would be to promote innovation in FMI and experiment with changes to legislative requirements that could facilitate the use of DLT in this area, while remaining technology neutral. The FMI sandbox will focus on enabling multilateral trading facilities (MTFs) to develop and test DLT settlement arrangements against temporary changes to legislative requirements that they identify as obstacles preventing them from using DLT for settlement. This will also allow the verification of how different objectives such as the appropriate segregation and protection of client assets can be ensured in this new environment. Possible changes needed to the regulatory framework[2] will then be addressed by the UK authorities, however MTFs in the sandbox are requested to continue to meet all existing requirements that are not obstacles to DLT arrangements.

Regulators will also need to consider the risks arising from activities performed through DLT, the regulator stressed, in particular those related to automated smart contracts and to the safekeeping of client assets using private keys and wallets. Moreover, cyber resilience is also a highly relevant risk in this context, with considerable challenges in terms of ensuring the integrity, security and confidentiality of data, the resilience of DLT platforms, and protection against cybercrime in the future. International cooperation will also be essential for sharing experience and expertise on DLT with the counterparties of other jurisdictions.

2. Such as updating technical definitions, outsourcing requirements, communication protocols, reconciliation requirements and arrangements for recording and segregating participant and client assets

Cyber and digital operational resilience policy proposals

1. ICT Risk Management

1.1 Objectives of DORA in terms of ICT risk management and related opportunities

Introducing the discussion on the ICT[1] risk management measures of the EU DORA[2] proposal, the Chair described how, internationally and at a European level, the current financial regulatory framework for cyber and digital operational resilience is fragmented, extending across multiple binding and non binding standards which themselves vary between different sectors and jurisdictions. With DORA there is an objective to make these fragmented elements work together at the European level and create a reference point for tackling these issues. The trilogue process on DORA between the Commission, Parliament and the European Council have started. There are challenges around the proportionality of rules for different types of market players. There are questions also around whether or not DORA is future proof, i.e. whether it will be able to mitigate new and evolving ICT risks including cyber-risks. Having the necessary resources and competences for supervising these rules is also a challenge for supervisors.

A regulator considered ICT risk management to be a priority. 88% of respondents to a survey carried out by the European Banking Authority (EBA) among EU banks highlighted cyber risk as most prominent driver of increased operational risks in their organisations. In 2019 the EBA, with the other European Supervisory Agencies (ESAs), issued a recommendation to the Commission suggesting that this was an area where regulation should be enhanced, which is why progress on DORA is very much welcome.

Agreeing that one key goal of DORA is to establish a common framework for the management of ICT risks, a Central Bank official highlighted other main goals that DORA is pursuing: enhancing ICT risk management systems and frameworks within financial institutions, establishing the sound testing of ICT systems, increasing awareness about ICT risks within firms and public authorities, and also creating a consistent incident reporting mechanism.

A regulator agreed that DORA is an important step towards a more resilient European financial sector and a harmonisation of rules in this area. DORA is building on a solid but fragmented regulatory basis. The regulator was confident that DORA would allow significant progress, because it builds on the fundamental elements developed by the G7 on cybersecurity and the FSB work on response and recovery. These are the current best practices, however the question of their future-proofness remains relevant.

An industry speaker emphasised the opportunities represented by digitalisation in the financial sector. The EU is still in the early stages of its digital transformation, but the pandemic triggered a considerable acceleration of this transition, with five years' worth changes being achieved in a few weeks. While technology creates new opportunities for consumers, the bar needs to be raised in terms of security and resilience. Another industry representative agreed that DORA presents an opportunity to increase consistency across the EU by aligning rules and guidance in the area of cybersecurity and resilience and also creating a supervisory framework for assessing technology risks within and outside financial institutions.

1.2 Issues and challenges to further consider regarding DORA ICT risk management measures

1.2.1 Interaction and consistency with other regulations

A regulator noted the importance of better defining how DORA will interact with other parts of the regulatory framework at domestic and EU level, because there is significant complexity around this interaction. Almost all competent authorities are interacting with supervised entities on the improvement of their cyber risk capabilities. 11 EU member states have already adopted or are in the process of adopting the TIBER-EU framework (threat intelligence-based ethical red-teaming) for threat led penetration testing. There is moreover considerable work underway on the enhancement of sharing and collaboration between different authorities involved in ICT risk management i.e. financial sector and cross-sectoral authorities, domestic and cross border ones.

An industry representative stressed the importance of also considering in the trilogues, the interactions between DORA and ongoing regulatory activities at the international level, such as the BCBS principles for operational resilience (which include cybersecurity requirements) and also the FSB initiatives on third party and ICT risk management. The industry representative stated that there may be a few challenges that may exist with the current versions of the DORA text. The first issue is around impact tolerances. An impact tolerance is a measure which determines the point at which a disruption will impact financial stability or the viability of a firm. DORA and the BCBS use different approaches to this measure: while the BCBS views impact tolerance from a business operations perspective, DORA considers it in terms of technology. This may require the establishment of two different impact tolerance measures - one for business operations and one for the underlying technology – which could

1. ICT: information and communications technology
2. DORA: Digital Operational Resilience Act

create serious confusion. Secondly, cyber incident reporting requirements under DORA raise potential consistency issues with international rules. These include the conflation of definitions, such as 'cyber incident' and 'cyber event', which might create confusion when DORA is integrated into the larger global cyber incident reporting frameworks being developed.

A regulator observed that DORA should also be consistent with existing EU regulatory frameworks, such as the guidelines and regulations of the ESAs. In areas such as IT project management and application development, the ESA guidelines should complement and reinforce DORA requirements.

A Central Bank official suggested that it is necessary to make sure that the provisions in DORA will, in combination with existing regulatory measures, make European firms sufficiently resilient to continue delivering their critical functions during disruptions. This will have to be assessed during the implementation of these measures through collaboration between the authorities and firms.

1.2.2 Implementation challenges

A Central Bank official noted that the differences across banks in terms of maturity on ICT risk management will make the implementation of DORA quite challenging for firms and authorities. These differences in maturity stem from the complexity of the organisations, their IT systems or the way pre-existing EBA guidelines on ICT security risk and outsourcing have been implemented. Implementing DORA will require some firms to make a significant effort. This will also be challenging for the authorities due to a potential lack of skills and resources, particularly for supervising the more sophisticated financial institutions in this area.

An industry representative explained that DORA is seen positively in terms of harmonisation by many financial institutions. Nevertheless, firms want more clarity on the precise and detailed implementation steps which they are expected to make. Another industry speaker suggested that firms would need time to prepare for DORA, because they will need to develop the necessary skills and will also have to build applications to address cybersecurity and resiliency issues with proper architectures.

1.2.3 Proportionality issues

A Central Bank official emphasised the importance of ensuring an appropriate level of proportionality in DORA for each type of institution depending on its complexity. Firms and supervisors will need to discuss this in greater detail. There is a desire to raise the bar here, because digital operational resilience is crucial for the resilience of the EU financial sector, but it is important to find the right balance.

A regulator agreed on the importance of ensuring the bar is raised on digital operational resilience and kept high. When applying the principle of proportionality, especially in the context of cyber-resilience, it is important not to reduce the ambition too much, but ensure that a minimum level of cyber hygiene is implemented by all market players.

1.2.4 Information sharing

A Central Bank official considered information sharing to be another important objective. DORA will mandate the authorities to share information between each other. This is a challenge, because this sharing will occur not only between financial supervisory authorities but also with cross-sectoral supervisory authorities. But enhancing cross sector cooperation and building up EU cyber intelligence is essential for enhancing resilience since cyber-incidents can propagate very rapidly across entities of different sectors.

A regulator agreed that there are significant challenges around information sharing and collaboration. It is of tremendous importance that in times of crisis or stress in particular, there is secure and timely information and that best use is made of European resources and knowledge in the field of cyber-resilience. Information sharing and collaboration is of utmost importance in this regard and needs to be enhanced. The supervisory landscape drawn by DORA and existing initiatives contains a large number of components that need to be coordinated in an appropriate way. These include threat led penetration testing; Threat Intelligence based Ethical Red Teaming (TIBER) and the dedicated TIBER community; the oversight architecture, with dedicated joint oversight teams working on incidents reported to supervisors and more traditional teams carrying out on site inspections at financial institutions; the Network Information Systems Directive (NIS) ecosystem; and the Cyber Security Incident Response Teams (CSIRTs).

1.2.5 Future proofing

The Chair asked panellists whether DORA would be able to create sufficient resilience in the future, given the progress and innovation happening on digitalisation, cyber risk and service provision. A question is whether there is the appropriate balance in DORA between a principles-based and a rules-based approach to tackle present risks and those that may emerge in the future. Another is what should be the process for updating DORA to reflect new challenges and progress made on digital operational resilience.

An industry representative noted that the same principles have been used to address cyber risk for decades, but the detail of the framework may have to change to reflect evolutions in the underlying technology and security architecture standards and how they are used. That should drive what is done at a more granular level. In terms of future-proofing, DORA must be sufficiently high level to allow the overall framework to be still valid when activities progress, which is unavoidable with new and emerging technologies, the evolution of which is impossible to predict.

Another industry speaker added that giving players sufficient time to implement and having adequate dialogue and coordination across the industry will be essential for futureproofing DORA, because it will give firms flexibility as the needs of the industry continue to change. Cybersecurity is not static, and neither are the industry's needs around resiliency.

2. Third-party provider ICT risks

2.1 The challenges of third-party vulnerabilities

An industry representative described how a survey conducted in 2021 among financial institutions in the UK indicated that third party vulnerabilities are seen as the most challenging aspect of operational resilience. Addressing the issues raised by dependency on third party providers (TPPs) is also a key priority for the management of these institutions. Based on the information available to date, it is however clear that many financial services firms have not yet ascertained how to address these vulnerabilities. DORA will likely have a 24 month implementation period, but the Level 2 regulatory technical standards will take much longer to finalise. Firms should not wait for the conclusion of this legislative process to address these new challenges, because timing is essential in this area. A certain number of 'no-regret' actions can be taken now by firms to start tackling third-party vulnerabilities. First, a gap analysis of the existing ICT risk framework can be conducted especially focusing on TPPs. Secondly, a holistic view of TPP connections can be developed in order to document and review the vulnerabilities arising from the use of TPPs. This can support the structuring or updating of a risk containment strategy. There are also questions in terms of international and group-level consistency. Cross border firms should start by implementing a standardised approach at a group wide level and then adjust to local regulation or specificity if needed. The Chair agreed that the financial sector is generally not well aware of all the risks concerning TPPs, which shows that there is a need for DORA to be implemented quickly to tackle these issues.

2.2 DORA objectives regarding the supervision of critical third-party ICT providers (CTPPs)

The Chair noted that third party ICT risks present many challenges, including the management of third party/fourth party risk and concentration risk. Handling these issues is one of the key objectives of DORA, which contains notably a new proposal concerning the oversight of critical third party service providers (CTPPs), including those based in third countries. However, it is essential to define precisely these terms, because oversight is different from supervision[3]. In addition, the DORA proposals concerning TPPs must be reconciled with the work of the FSB and IOSCO in this area, and also take into account the need to develop adequate supervisory capabilities.

A regulator explained that a basic principle driving DORA is the assumption that supervised financial entities are responsible for the risks that are created by their activities throughout the whole value chain, including TPPs. This can be difficult to manage for financial institutions, especially when some TPPs are major global players providing services to a large number of entities in the financial sector and potentially raising systemic issues, which is the underlying reason for the oversight of CTPPs mandated by DORA. The way in which TPP services are provided may evolve, as well as the TPP industry structure, but at this stage it is important to address potential concentration risk adequately. It is however important to understand what DORA does and does not do. DORA mandates an oversight and not a supervision of CTPPs. Additionally, this is an oversight of the provision of ICT services exclusively to the financial sector, not an oversight of the services provided by CTPPs across all industries. Thirdly, DORA will address the provision of ICT services by CTPPs across all financial activities such as banking, insurance services, securities markets and so on. A lead overseer will be identified for a given CTPP in charge of overseeing the provision of services by this CTPP across all financial activities.

Ensuring an appropriate interaction between the supervisor of the financial entity, the lead overseers of the relevant CTPPs and the other competent authorities concerned will be quite challenging, the regulator felt, and needs to be defined in the context of the implementation of DORA. In addition, there is a question of enforcement of supervisory measures concerning TPPs. At present, supervisory decisions concerning TPPs (e.g. the request to change providers or to modify the way the services are delivered) are imposed on the supervised financial entities, but that is quite an indirect process. With DORA, these requests could be addressed to the supervised financial entity or to the CTPP. It would be probably more effective to go directly from the lead overseer to the CTPP, rather than through the supervisor of the financial entity, but this needs to be clarified. It is also important to understand which supervisory entity will be in charge of requesting changes. This could be the supervisor of the supervised financial entity or the lead overseer of the CTPP.

A second regulator supported the implementation of a European level oversight for CTPPs, which will allow having a counterweight against large global service providers that have developed a strong footprint at the European level. The success of DORA in this regard will however depend on the criteria established for identifying CTPPs and defining how they should be overseen.

The Chair agreed that there are many issues remaining to be tackled regarding the implementation of DORA. Supervised financial entities cannot be made responsible for their TPPs in all circumstances, particularly when TPPs are much larger than the supervised entity, which in that case has little real power to request changes. A Central Bank official agreed that this is a question of power as well as proportionality. A global TPP has a power that is very significant and this needs to be taken into account. A first key step is the designation of the CTPPs to be supervised, which will also be crucial for preparing the implementation of DORA, because it will help to determine the skills and resources that the authorities and also the TPPs will need for implementing the legislation in a context where these are in limited supply.

An industry representative noted that, as a result of DORA, cloud service providers (CSP) in particular will

3. Oversight is considered less intrusive than supervision. Oversight might be viewed more as surveillance, i.e. conducted at a distance, while supervision involves close first-hand observation and analysis and direct interaction with concerned entities on a regular basis.

most likely be placed under the direct oversight of the European Supervisory Authorities for their activities in the financial sector. This will bring new third parties and non financial services firms into the scope covered by financial services supervisors. However, this will require the building up of new skills within the supervisory authorities to address cybersecurity issues and risks related to cloud usage, which is quite challenging given that resources are scarce in these areas. This will require preparation and anticipation.

Another industry speaker acknowledged that while CSPs are not sources of risk per se, there is a need to ensure adequate cybersecurity and resiliency across the different actors operating in the financial value chain, including CSPs. The most encouraging element of the debate on DORA is the objective to increase the harmonisation of rules, because the policy approach to outsourcing is quite fragmented at present. If DORA can harmonise the approach to TPPs, it will allow participants, providers and regulatory organisations to have common understanding and expectations, which will facilitate the implementation of requirements and lead to higher resiliency and security. Implementing fragmented requirements can be challenging for international financial institutions, because it requires them to create their own holistic framework incorporating the different existing rules. DORA therefore represents an opportunity to create the harmonisation that will facilitate this approach.

2.3 International consistency questions related to TPP DORA measures

An industry representative emphasised the importance of ensuring consistency between DORA and the BCBS principles for operational resilience concerning TPPs. First, regarding intra group ICT providers, more proportionate rules would be needed, because DORA considers them in the same way as external TPPs. This does not seem appropriate, since there are differences in terms of risk profile, e.g. there can be more confidence in the management of risks by a sister entity if similar processes and tools are in place. In addition, exit strategies (i.e. the strategy used by the financial institution to offboard a TPP) also have different implications for intra-group TPPs and external ones. The impact of a change concerning an intra group ICT provider will indeed be much more significant for the organisation, because it might not only affect ICT services, but also the intra-group management of Compliance, Risk (including cyber risk) or HR. Additionally in many cases an exit strategy for an intra group provider will not be implemented in practice, because it is not feasible to implement it in a way that does not 'kill off' an affiliate whose financial health is largely based on that of its parent. There are also potential issues around contractual terms, such as the obligation for a parent organisation to provide assistance to affiliate entities for ICT incidents, given the reputational or safety implications.

A second issue around TPPs in terms of consistency with BCBS requirements, the industry speaker noted, is the level of granularity required in DORA around the mapping of interconnections. The main concepts and tools used by DORA and the BCBS are similar such as process mapping, impact tolerances and an understanding of third party dependencies. However, the scope of the mapping in DORA is more extensive. The aim of the BCBS principles around the mapping of interconnections is to ensure that financial entities understand how their functions and business operations fit together with TPPs and to enable them to define how they will respond in case of problem based on different scenarios. DORA, extends that mapping into system configurations, which means that it may need to be updated each time a system is patched or upgraded, potentially mobilising significant time and resources.

Referring to the comments about intra-group providers, a regulator added that the ability of a supervisor to enforce supervisory measures is different for an intra-group entity of a regulated financial entity and for an external provider. A large amount of ICT services that were previously sub-contracted to intra-group or specialized entities of financial groups have however been shifted to external players, some of which are now very large players at the international level. This is where the proportionality argument has emerged mainly in the DORA discussions.

AI Act: is the EU approach the right one?

1. Market trends, opportunities and challenges related to the use of AI in the financial sector

1.1 Progress made in the implementation of AI systems in the financial sector

The Chair stated that artificial intelligence (AI) is one of the key technologies driving the digital transformation of the financial sector. In a recent survey conducted by the French supervisor of banks and insurance companies (ACPR), the vast majority of banks and insurers mentioned AI as the first key technology driving digital transformation in the financial sector.

A regulator emphasized that insurers have been working with and analysing data for decades. It is therefore natural that AI is developing in this sector. In a 2020 EIOPA survey, 35% of insurers declared they were already using AI and 25% were in the proof of concept phase. With the acceleration of digitalisation it is probable that those proportions will have significantly increased. AI is used throughout the insurance value chain. In product development insurers use data coming from underwriting and claims, chatbots are used for client interaction and AI is already an important part of the claims handling process for many insurers. It is expected that these applications of AI will increase in the future. The speaker saw a significant potential for AI use particularly in claims handling, e.g. for checking the validity of invoices before they are paid or for assessing damages to a car based on images sent by customers, leading to improved efficiency and fraud detection.

An industry speaker stated that it is really important to differentiate between the hype around AI and practical applications in the financial industry. Robots are not going to totally replace humans in finance any time soon, but there will be an increasing use of natural language processing and machine learning (ML) in particular over time. When people are talking about AI, they are really talking about extreme automation in most cases. Regtech companies for example are leveraging AI as a way to turn regulatory requirements into code. Using and leveraging AI is really about making people's jobs more interesting by automating certain activities and about gaining new insights with a better usage of data. This also coincides with the way that aspirations are evolving following the Covid crisis. Many people want their jobs to be more interesting and offer better prospects, which can be facilitated by AI-supported automation. It is however essential to keep having a 'human in the loop' to ensure that technology and data are being used in an appropriate way.

Another industry speaker agreed that AI and ML are at the heart of innovation and the digitalisation of the financial sector. Financial institutions are using AI and ML to solve complex problems and create new opportunities in a number of different areas including product personalisation, automation, fraud detection and market surveillance. For example banks are using AI to tailor customer experience and product recommendations based on spending patterns and customer profiles; asset managers are optimising portfolio management with the analysis of alternative data sets. AI and ML adoption has accelerated in recent years and this trend is expected to continue, supported by the access to practically unlimited computer power and data storage offered by cloud services in particular.

An official stated that many potential applications of AI could help financial service consumers. AI and ML software can for instance be used to facilitate consumer protection with AI based systems performing verifications of online contract details[1], provided the data is available in a machine readable way.

1.2 Potential obstacles and challenges to a greater adoption of AI

A regulator stressed that insurers will have to adapt in order to leverage the potential of AI. Companies wanting to make full use of AI and ML for risk management purposes will need to keep their internal risk governance and risk management processes up to date with a regular testing and validation of feedback loops. This process can be partly automated, but human intervention will always be necessary to validate the internal and external data that goes into the ML or AI systems. Secondly, companies wanting to use ML throughout their entire business will probably need a more agile IT infrastructure, moving to new servers and potentially to the cloud in order to have access to greater capacity and state-of-the art technology. Thirdly, it is necessary to develop the adequate competences in companies for using AI technology in a proper way, as well as an awareness of the ethical issues at stake.

An industry speaker agreed that upskilling the workforce is essential for intensifying the use of AI and that clients also need to be made aware of the implications of these changes, i.e. of the potential benefits of AI, the related risks and the measures put in place to mitigate these risks. Change management is also important, because while AI and related automation can help to reduce manual operations and operational risk dramatically, people can be resistant to these changes if they have

1. This is already happening through a project conducted by the European University Institute in Florence called CLAUDETTE that uses an AI-based system to review contracts and look for GDPR compliance, highlighting clauses that may go against EU regulations or that are not in the favour of customers.

not been adequately trained and involved in the implementation of these new technologies. Data standardisation is another essential condition for fostering the uptake of AI in finance, the industry speaker emphasized, because AI algorithms need to be trained, which requires access to vast pools of good quality data. This requires improving in particular the way that data sources function and the way that databases collect data

An official agreed that data quality and availability are essential for developing AI applications in the financial sector. A key element is also that the data should be available in a machine readable way.

1.3 Main risks associated with the use of AI

An official stated that while there is enormous potential in the use of AI for the economy and financial markets, there are also some risks. The first risks stem from the innovative nature of AI. Secondly, AI use may amplify some existing risks in financial markets, given the ability of AI related techniques to dynamically adjust models based on the conditions, in a fully autonomous way without human intervention. One of the biggest challenges with AI is explainability i.e. the potential difficulty of understanding how and why a model generates results. This possible 'black box' nature of AI may create risks and also practical obstacles to its use. For example if the underlying reasons of recommendations made with an AI-based investment advice system or with an AI-supported credit attribution system cannot be easily explained, this can be an issue for customers and advisors using the system and may also breach regulatory requirements. Indeed, in certain jurisdictions, borrowers who have been denied lending have the right to know the reasons for this.

The official added that AI also raises issues in terms of governance, because it is very difficult to assign accountability when models are fully autonomous. This becomes even more complex when third party players such as cloud service providers (CSPs) or data providers are involved. There are also potential systemic risks associated with the use of AI which may encourage one way markets e.g. in trading activities, if many counterparties use the same types of models, leading to a convergence of outcomes and potential volatility or illiquidity spikes. A final risk is related to the use of inadequate data which may lead to bias or discrimination in the outputs of AI-based models.

An industry representative agreed that explainability is a potential issue, but stressed that it has been a regulatory requirement for years now and that related concepts and best practices are now clearly identified.

2. Objectives of the EU policy approach to AI

A policy maker stated that the European Commission has issued several policies that support AI and it is addressing the risks mentioned above with the proposed AI Act. No other economy in the world has such a comprehensive framework for AI on the table. The Commission is aiming with this initiative to give more certainty to companies regarding the use of AI, first with an identification of the techniques that fall under the AI Act framework (mainly ML approaches and expert systems) and secondly with a harmonization across the EU of the rules applying to AI. The second main objective of the AI Act is to create more trust for users in a context where AI systems have been demonised to a certain extent. The AI Act is a horizontal framework, with the same principles of e.g. explainability applying to all sectors, because risks of AI usage are the same. However, the specificities of the financial sector have been taken into account in the drafting of the legislation, as well as the existing financial regulations, to ensure that the AI Act does not overlap or contradict them, but rather completes existing regulation. A third aspect is that the AI Act is risk-based, which means that only applications that really present a high risk e.g. for the fundamental rights or safety of customers will be regulated. In the financial sector, only AI-based credit scoring and creditworthiness assessment systems are concerned; companies using these systems will be required to undertake tests before they are put in place to ensure that they are reliable and not biased.

The European Commission is also supporting the development of AI through its research programmes, the policy maker stressed. Dedicated testing and experimentation facilities have been put in place, as well as policies supporting the development of AI-related skills. Companies using AI should indeed have the necessary skills to implement an adequate risk management framework and should be able to use AI in an appropriate way.

The panellists were generally supportive of the risk based approach proposed in the AI Act. An industry speaker concurred with the objective of a human centric approach to AI respecting civil liberties and the fundamental rights of citizens and emphasized the need for a risk-based regulation of AI, because the risk of AI lies in its application, not in the technology itself.

A regulator stated that the AI Act is a positive development because a large part of existing financial regulation was drafted before AI existed, which might have created regulatory loopholes or inconsistencies that the Act will contribute to addressing.

3. Interaction between the AI Act and existing requirements

3.1 Existing EU guidance on AI

A regulator stated that insurers have been assessing how to price and evaluate risks on the basis of large data sets for decades. The EU insurance industry is adequately regulated, and governance principles regarding AI have already been published by EIOPA in this perspective; the principles in there are similar to those in the AI Act and include fairness, non discrimination, transparency and explainability. Providing explainability requires human oversight (including by actuaries in the case of insurance), appropriate data management and recordkeeping, and also developing the capacity to explain the outcome of an AI based system and ensuring its continuous robustness and accuracy.

The regulator therefore felt that supervisors in the EU have adequate powers at present to supervise AI applications in the insurance sector through sectoral legislation and governance principles, although it cannot be excluded that new applications of AI may lead to an inclusion of insurers in the scope of the AI Act at a future stage.

3.2 OECD AI principles

An official stated that the AI Act proposal is aligned with the OECD AI principles. The OECD indeed considers that regulatory and supervisory requirements concerning AI should be examined in a proportional and contextual manner, depending on the criticality of the application, similarly to the risk-based approach of the AI Act. Lending was also identified by the OECD as an area of AI application that could potentially represent a high risk, given the possible material impacts on consumers.

One element of the OECD principles to highlight in relation to the objective previously mentioned of developing further awareness about AI use, are the transparency and responsible disclosure principles around the use of AI systems. Customers should be made aware that an AI mechanism was involved in the delivery of their service and they should be able to challenge any decisions supported by an AI based system if needed.

The official also emphasised the importance of 'human primacy' in decision-making or having a 'human in the loop', particularly in the case of high risk applications. For the sake of proportionality, human intervention is not necessary at every iteration of an AI or ML model, but it is necessary to ensure that governance and accountability mechanisms are in place and that models are appropriately validated and tested. There should also be 'kill switches' in place that allow the switching off of AI or ML models, particularly when they do not behave in the expected manner, as well as back-up plans with business continuity procedures in case an AI application is switched off.

3.3 EU data strategy and GDPR

Answering a question from the Chair about the rules needed in terms of data access and sharing to support AI uptake, an official stated that the EU Data Act should allow more data to be used in a structured and interoperable manner, which would contribute to the development of AI systems. The cross-border dimension of data access also needs to be considered. Questions might arise for example about data that is processed and held in other jurisdictions. It is important to have OECD guidelines in this perspective because they are a common international basis that could be built on. The applicability of the rules of the EU Data Act concerning data access and sharing will also need to be examined in an international perspective, as was previously done with GDPR.

An industry speaker added that the interactions between the AI Act and GDPR might need further examination. There could be some clauses in the AI Act that contradict some items of GDPR or other EU data regulations.

4. Issues that may require further clarification or emphasis in the AI Act proposal

4.1 Definition of high-risk AI applications

An industry speaker stated that further clarity around the definitions of what exactly is high risk and around the scope of implementation of the AI Act is necessary i.e. whether it should apply to generic use cases or case-by-case to certain components of a given application. The latter seems preferable in order to strike a proper balance between risk mitigation and supporting innovation. For example in the case of an AI-based system for granting loans, the regulation should apply to the AI model that makes decisions about the creditworthiness of customers and not to the components that contribute to the automation of the process. Technology will continue to evolve and having that type of flexibility or specificity in the approach to use cases will support a further development of the technology.

A regulator agreed with the suggestion that high risk applications should be addressed specifically and on a case by case basis and gave further illustrations. Using AI for an individual assessment of creditworthiness is indeed riskier than using it for the evaluation of an average risk posed by a large group of people based on the analysis of their data. And chatbots that may be used in the context of a credit application process should not usually be considered as presenting a high-risk.

A policy maker explained that the approach of the AI Act is meant to be flexible since the list of use cases and techniques covered by the legislation is detailed in an annex and can therefore be modified through a delegated act, without changing the Level 1 text. The objective is to make the legislation more futureproof because these rules concern technology that changes over time.

4.2 Supporting innovation in AI

An industry speaker stated that although the AI Act and its risk based approach are ground-breaking in many ways, Europe is behind the curve in terms of innovation in the area of AI. More emphasis needs to be put in Europe on the objective of ensuring the best leveraging of AI in a way that is good for citizens. There is an opportunity for Europe in this regard because it has a strong track record in setting rules and guidance for protecting the welfare of its citizens, and Europe might be able to impose these rules for AI internationally in the same way as was done for GDPR.

The futureproofing of the AI Act also needs more work, the industry speaker felt. For example, the focus is very much on the initial development of models in the present proposal, but the reality is that AI models will keep learning from themselves. Therefore, a question is how to regulate AI in an agile manner to preserve the agile innovation model of AI, which is a technology that continues to evolve as it is used. This issue is not really tackled in the AI Act.

A policy maker observed that this issue has been addressed in the AI Act proposal. It is foreseen that if an AI system continues to learn once it is implemented and if that learning significantly modifies the behaviour of the AI system, then the user will be considered as a deployer of the AI system and will be subject to the same obligations as the initial deployer. That way, the feedback loop will be in place.

4.3 Accountability

A regulator stated that roles and responsibilities (e.g. concerning the respective roles of the prudential supervisor and the company management) need to be more clearly defined in the AI Act regulation in order to prevent confusion and overlaps.

An industry speaker suggested that the accountability part of the conversation on AI regulation needs to be developed further. Financial companies need to be accountable for the AI systems and the credit scores they use, but supervisors should also be accountable for the regulatory framework that is put in place. There are some requirements around the number of employees that should be involved in supervision, but specifying the skills that are needed for supervising appropriately AI systems and similar technologies would seem more relevant. More guidance is also needed around the tools that supervisors should use for supervising AI algorithms. A great deal of upskilling will also be necessary for supervisors and regulators to be able to really regulate AI, and this dimension is not currently sufficiently emphasised in Europe. More broadly, educating citizens about the potential benefits and risks of AI models should be a major political objective.

A policy maker stated that the AI Act identifies accountability quite precisely, notably for cases where something goes wrong. In the first place the deployer is accountable, but the user can also be made accountable in certain circumstances. A system for market surveillance has also been proposed that combines the domestic authorities of member states with surveillance authorities in charge of the different sectors covered by the AI Act that will be responsible for reacting if incidents happen. These authorities will also have the power to go through the documentation from the conformity assessment established by the AI's deployer in order to identify who is responsible for a given incident. More guidance regarding the roles and responsibilities of these different actors is needed, the speaker acknowledged; the Commission will ensure that this is clarified. In terms of awareness about the use of AI systems, the Commission also wants customers to know that they are dealing with an automated or AI-based system such as a chatbot for the sake of transparency.

Open finance: what prospects and policy needs?

1. Open finance: what does it mean?

A regulator stated that open finance is an opening of the access to banking and financial data, beyond information and data on payments, which already exist.

An industry speaker stated that open finance is not new. Thanks to PSD2, it might have boomed over recent years. Open finance is a no brainer from a client perspective. Clients clearly ask for the provider to build a customised solution based on open finance principles; this is becoming business as usual, at least in the business-to-business (B2B) business.

2. Open finance brings several benefits

2.1 A greater diversity in products and players

An official started with the motto of the EU, 'united in diversity'. 'Diversity' does not mean the fragmentation of the internal market, but rather the intervention potential that new players, fintechs, start ups or small and medium-sized enterprises (SMEs) can bring to consumers or users in general. Member states have seen that new products and players have entered the market when the payment market has been opened by Payment Services Directive 2 (PSD2).

This diversity has brought more choice for consumers or businesses that are able to deal with information about payments more effectively. This innovation is not only brought by established financial institutions, but also by newcomers in the market like IT companies that are able to provide services to customers in new ways. They already focus fairly specifically on the needs that customers have, and they are expected to be able to deliver interesting products that were not seen before in the market.

An official suggested saying, 'more diversity in our products that will be provided or offered to consumers'. The Digital Finance Strategy (DFS) could bring this. More players are expected to enter the financial market in the EU, and they could be newcomers with fresh ideas. These newcomers could not only be big technical companies like big techs; local companies' focus, or specific needs could also enter the market and evolve to provide cross border services. This has been seen due to open banking in the payments field in central Europe and other parts of the EU.

An industry speaker stated that a wide range of offerings are coming from fintechs, banks and IT providers. The different statutes of the provider already constitute a question in themselves. It is even possible to find solutions that are still looking for their problems.

A public representative stated that the consumer perspective of potentially having broader access to a much broader range of products and services is where the value added of a European approach can also be seen. This enables enhancing cross border access to products and services. In Europe, that possibility is still lacking.

2.2 A door to innovations, not only in finance

An industry speaker explained that he sees this as open data and not just open finance. It is necessary to see genuine, horizontal access to data. The insurance industry is deeply embedded into all industries in some respects and affects all individuals. Restricting it to finance restricts consumers' access to the benefits that they might otherwise see from open data. The focus is on reduction of friction, which is where the real innovation will be seen.

An industry speaker stated that she is very excited about all the solutions that could come out of this, including the ability to enter into a mortgage without needing to have several pieces of paper and being able to set controls on how someone spends or saves. Businesses can also manage their business better because they can begin to upload transactions onto their accounting software through open banking. Institutions will continue to see innovation and opportunities by making the systems more resilient and secure, setting clear expectations for consumers around what consent is going to look like, and being held accountable for the principles and the ways that they operate.

A public representative stated that value could be added by looking from this cross border perspective and creating more opportunities for businesses, including those that are already active in the financial services and others entering the scene using open access. This could also be an important part of ensuring that they are able to go beyond their national markets, scale up if possible, and use the full benefits of the single market, which is very often one of the shortcomings seen in practice.

A public representative stated that this deal shows that it is possible for a third party to allow access to clients' data. It is not just possible to access their data; it is possible to perform actions and initiate payment. When looking forward, it is really important not to self limit in terms of what should be opened.

A public representative stated that an inherent part of a successful digital strategy in financial services for Europe is the digital euro. The ECB is well advanced in this regard. At the beginning of 2023, the European Parliament also expects a proposal from the European Commission on the digital euro. This can enhance innovation in this regard, enrich the entire landscape and help Europe lead when it comes to an implementation and the practical deliverables when it comes to the provision of digital financial services. This important aspect should not be forgotten when speaking about the digital strategy, its potential benefits, or its future success.

2.3 A better control over financial decisions

An industry speaker stated that it is exciting that open banking is going to give consumers or businesses the ability to be in better control of their financial lives for the first time. Instead of several little pots that they cannot quite remember the location of, they are finally able to aggregate their financial information and have the power to pay, save, make the bigger financial decisions in their lives and be in greater control. That is incredibly important in an environment in which the cost of living is rising, and the plethora of services and solutions is increasing. The heart of this is putting consumers, and then businesses, at the centre of that decision making and those solutions.

An industry speaker stated that she is delighted that real conversations regarding resilience, fraud prevention and cybersecurity, have started because that is the basis of any kind of trust. Significant trade offs will need to be made between items like data localisation and fraud prevention. Access to global data better protects European citizens from fraud and cyber risk.

2.4 A way to reinforce European strategic autonomy?

The Chair stated that one of the benefits of the move towards open banking is strengthening and reinforcing European strategic autonomy.

A public representative stated that open strategic autonomy is currently spoken about more often, perhaps in order to align it with open finance, but the proposal on the Data Act that the Commission published on 23 February is also a part of the puzzle. If it is possible to ensure that the data provided by Europeans are stored and used in Europe, it is also one part of tapping more into the potential and benefits of such a strategy. This is somewhat beyond a pure financial service; it is more of a discussion of the vertical and horizontal access to data. However, it is definitely part of discussions, or it should be in future.

An industry speaker stated that the developments on digital identity are very positive in terms of where the EU is going. The combination of digital identity and the potential consumers can leverage through use of open banking data can be really powerful when making a more seamless and accessible environment. It is necessary to go beyond General Data Protection Regulation (GDPR) as corporations and in terms of government policies. This will allow people to think through what a great permission based system is going to be, what consent is going to look like in the future and how to properly inform it.

3. Open finance is still facing challenges

3.1 The need for a clear framework to ensure a smooth transition

A regulator stated that a number of areas will be crucial to clearly define in order to maintain the level playing field and ensure that there is an adequate transition into this new scenario. The specific scope of data that can and should be accessed is one such area. Second, the data is probably owned by the customer, so it is advisable to be clear on how that customer can provide their consent for the use and access to that data. For the PSD, this has been an ongoing, intense discussion. Third, it is also important to clarify the security measures to comply with and the obligations for how the market incumbents and new market players can grant access to the use of that data.

A regulator added that clarity is needed on how to empower supervisory authorities to enforce the security requirements for that area. It is also important to provide guarantees on how this progress towards open finance is consistent with the European GDPR because most of the discussion about open finance reads 'open data', so it means giving open access to data on financial information from EU customers.

A public representative highlighted standards that he used to access payment accounts. Different standards are still used. When an organisation is thinking about standards, it always sees that as a kind of contained innovation, but it is indispensable because it lives in the market of network effects. Therefore, it is necessary to take some mainstream innovation and introduce standards outside technical ones for business processes and practices.

The next item to draw attention to is consistent regulation. It is very important for integration, and there is an interplay with GDPR here. It is very important to solve many issues before implementation because reducing everything is costly for the market and detrimental to users.

3.2 A standardisation supported by a cooperative role for the public and private sectors

The Chair stated that one of the issues, which might also be a lesson from PSD2, is that there is a role for the public and private sectors. He asked what is required from these sectors. An important theme is cooperation between the private and public sectors to develop the necessary building blocks, particularly on the issue of standards.

An industry speaker stated that the real questions are who to work with and what their responsibilities will be in the whole value chain. Several players along the value chain will act. CACEIS develops new products or offerings immediately while defining user experience and customer journey. In terms of regulation, this is a significant change of mindset, but it is advisable to try to move from a product and services approach to a customer journey one in terms of regulation. It will be much easier to cover everything and eliminate this problem of responsibility. In the end, the client is the client of a bank who will benefit from the services from other providers. However, the bank is still managing the client facing, so the important question is who is responsible if something goes wrong.

Standardisation is at the heart of the topic when discussing technical subjects. It is definitely necessary to rely on the standard format and protocol, which will help the whole ecosystem to build on them. 'Standard format' does not mean a standardised offering of services; it virtually means the opposite. There will be some standard format and protocol, but there will also be some evolution and innovations.

An industry speaker stated that the principle called 'same activity, same room' is fundamental. He fully agrees that the sandbox approach has been very important; it has helped creativity and helped new services to go on the market. However, 'same activity, same rule' is fundamental. All panellists will have to rely on the same set of regulations. If they do not, it will be a mess.

A public representative stated that, with this type of EU wide strategy, it is always advisable to consider how to implement it, how to enforce it, how to supervise and how to ensure that the approach from regulators and supervisors is harmonised because that is also one part of the equation. If this is not the case, then it undermines the potential benefits of such a strategy on the EU level and ends up in national markets again.

An industry speaker stated that customers are going to be exposed to new products, services, and ideas as part of the integration. Within that integration is a strong role of ensuring that customers understand what they have access to. Many people will have experienced the benefits of PSD2 without even seeing or understanding it.

A public representative stated that the public and private sector interests here are not opposed. There might even be much more urgency for cooperation than before. The public sector can create conditions that are clear, principle based and predictable into which the businesses can fit while also being strict on the key priorities from the public policy and public interest points of view. For the private sector, it is also advisable to make use of the technology to show that there are solutions that can meet the requirements of the public sector while still empowering consumers and bringing benefits to them.

There are still some gaps in the supervisors and regulators. If the digital strategy is to be taken seriously, it will be necessary to ensure that there is enough uptake of digital technologies on the side of the supervision and regulators so that they keep pace and are able to make use of those technologies to make their work more efficient with fewer frictions. This should be done together with the private sector.

An official highlighted the European Digital Identity (EDI) framework. Cooperation between private and public sectors should be very intense here because a completely new ecosystem is being built and will be built for decades.

3.3 Trust challenge: how to cope with data and cyber risks

An industry speaker stated that there is a question of how data can be shared under GDPR. The Data Act will help to get closer to determining what data can be shared and when.

It is important to empower the consumer and the customer with the ability to decide who they share data with and why. As part of this, innovation will happen when industries and players allow access from a broad and diverse array of markets, countries, and backgrounds. Zurich Insurance Company Ltd sees an opportunity for the EU to show leadership here. GDPR established principles for data security that have been paralleled in many markets around the world, and the same could be seen with open data.

An industry speaker highlighted the risks associated with making it too easy or convenient for external parties to encourage customers to share data they were not aware that they had access to or that they did not need to share. There is a chain of consent. It is advisable to allow external companies from outside the EU to participate, but there needs to be a chain of consent wherein a European organisation is told that consent has been given. The question of how to demonstrate and prove these matters then needs to be asked. It is also necessary to see a regulatory level playing field based on reciprocal data, open access and the principle that the intention is to remove friction for consumers.

A public representative stated that the key factors are data and access to services. The European Parliament is discussing initiatives such as electronic identification that are also part of this. It can make use of the open finance strategy. Cyber resilience is a very important issue if gaining trust is really desirable. It is also linked to the issue of data privacy. It is not only a case of fear of data compromised by cyber risks, but also one of reassurance for those who are providing the personal data that they will be dealt with in full compliance with existing norms.

An industry speaker stated that it is necessary to split data between the producer, the entity that will disseminate the data and the entity that will use it. However, it is very complicated. There could be an open finance world in which there is one producer, one entity that will disseminate and another that will use. Some can do everything. The regulators' guidance will definitely be necessary.

An industry speaker stated that it is going to be an important time to agree on what level of availability is desirable and how to create trust in a world in which the cyber environment is worsening.

3.4 The legislative elements are still under construction and there are some challenges with technical standards

A public representative stated that some parts of the digital finance package that the Commission put forward in September 2020 are not fully in place through the legislation process. However, some individual pieces of legislation should fit into the puzzle. The Distributed Ledger Technology (DLT) Pilot regime has already been agreed between the co legislators and can be implemented. The Digital Operational Resilience Act (DORA) is very advanced and is very much linked to the cybersecurity aspect. The European Parliament is also finalising work on Markets in Crypto-Assets (MiCA).

This regulation should fill the gaps when it comes to the regulatory framework, but many important points also need to be presented. The European Parliament is the electronic identification part of the puzzle. The legislative proposal on open finance and the initiative on the Data Governance Act (DGA) are also important.

A regulator stated that, when confronted with PSD2, there are challenges around whether it is advisable to write the technical specifications. The European Banking Authority (EBA) chose not to do so, but probably for the wrong reason that it only had a 12 month period to deliver on its mandate. However, it turned out that it was better not to do it.

The outcome of this choice was that the EBA during months received questions, complaints and concerns from customers and third party providers about whether they have the right access or not, or whether their financial institution is providing it to them. Customers also have concerns about claims from the credit institutions that they are providing the access, but then putting some 'sand in the wheels' or preventing the access in other ways.

A regulator stated that there is no straightforward answer. The public sector should facilitate the implementation of technologies. On network approaches, it is very important that common standards are being built. There might be a process of dynamic creation of those standards.

An industry speaker stated that Visa Europe believes that EU regulators should promote a more outcome-based approach in the next iterations of PSD2. In Strong Customer Authentication (SCA), consumers are seeing a fair abandonment rate and are not having positive experiences at point of sale. That is not positive for the businesses around Europe that are trying to sell goods digitally at a very difficult time. Visa Europe increasingly wants outcomes in terms of fraud and consumer experiences, rather than inadvertently creating friction that was never intended. Visa Europe can align and debate on standards and outcomes, but it needs to draw back from too much technical implementation.

CBDC: short- and medium-term opportunities and challenges

1. The concept of CBDC and the current status: between the ideal and reality

The Chair noted that central bank digital currency (CBDC) is a fundamental change in the way central bank money is made available to the public, so it touches upon many issues for legislators. Central bankers have also been clear that they do not want to substitute banks' functions. An industry representative noted that around the world there are over 250 different payment systems. This is an opportunity to write the future of how financial services work together.

1.1 A project that is built in stages – Riksbank Case Study

A Central Bank official confirmed that the Riksbank started working on an e-krona, which is a retail CBDC, in 2016. For two years it has been working on a pilot project. There are three phases. The first phase was to set up the distributed ledger technology (DLT). A digital wallet that can be used as a card, as an app or even like a watch is being tried. The second phase was to involve the private sector. The Riksbank is working with two commercial actors who are integrating the digital wallet into their IT systems. The Riksbank is entering the third phase, which is to gather everything learned during these years. It has 19 work streams, with everything from data protection to cyber security to issues related to sustainability and energy usage.

1.2 A process that takes time

A Central Bank official stated that following the Bank of England's consultation paper at the end of the year, if the decision is to proceed the next step would be to issue a technical blueprint, which would probably be within six months, though it would not be the detailed blueprint. The Bank of England has publicly said it does not think a CBDC could be introduced before the second half of this decade, though that is still rather close given what needs to be put in place. It would be a major, national critical infrastructure project not to be undertaken lightly. The timescales are long. However, the worry is that by the time people see the case for this it is too late. It is unclear how to marry up the timescales and the public case for innovation with a project of this size, because breaking things cannot happen as credibility would be lost.

1.3 CBDC does not mean the end of cash

A Central Bank official was surprised by the vision of substituting digital for cash. At least in the medium term, cash remains an important payment instrument. A Central Bank official stated that the financial stability concerns and monetary policy implications of even retail CBDCs can be worked out. Though it would be good to move towards a digital currency, it would be in addition to cash.

2. Use and purpose of CBDC

2.1 CBDC at the service of retail

A Central Bank official noted that there are a number of complicated issues to address. The important foundation of the anchoring of central bank money may be at stake, and issuing a digital form of central bank money for retail payments may be an appropriate and effective tool and instrument for addressing this issue.

A Central Bank official remarked that the Bank of England published a model for discussion in the beginning of 2020 for a retail payment CBDC. It was a platform model in which the central bank would run the infrastructure and ledger, but all of the interaction with the consumer would be by the private sector, and the private sector would be allowed to use the CBDC and innovate around it.

The use case is a retail payments CBDC. It is better to start with the public policy objectives from a central bank point of view; this is about ensuring the integrity and robustness of money that circulates. Currently, all money in the United Kingdom that is circulated at a systemic scale is tied to central bank money, is substitutable on demand for central bank money and is regulated, but the provision of cash in the hands of the public also acts as an anchor that holds the whole system together and probably anchors the concept of money in the minds of citizens.

What is being faced is the disappearance of cash into the existing commercial bank system as the means of transaction, as money needs to be more digital, but it is also the entrance of new players into the provision of money for transaction purposes. The question is whether the integrity and robustness of money can be ensured solely by regulation, or if provision of a public sector alternative is needed as an anchor.

A Central Bank official remarked that there is a very good report from the Committee on Payments and Market Infrastructures (CPMI) work stream on how CBDCs could be interoperable, highlighting different models. There could be separate rails in different countries but common standards, a rail that links the public infrastructure in one country to the public infrastructure in another or one global rail with different CBDCs moving along it.

2.2 CBDC to ease wholesale transactions

An industry representative stated that wholesale is where the use case is more obvious, at least in the short term.

There is the possibility of setting up securities in various configurations for many asset classes. Completing cross-border and cross-currency transactions is good for the market and eventually for retail users.

An industry representative noted that interoperability and the ability to not just keep CBDC for retail is vital. By creating new standards and enabling retail and wholesale to come together there is an opportunity to write a future which takes away much of the existing fragmentation and friction.

2.3 Other fields for CBDC use

A policy-maker noted that peer-to-peer (P2P) and platform-to-business (P2B) are the bulk of the payments market, and here cash is still predominant in the eurozone and beyond. However, this is changing rapidly as payments are digitalising. It makes sense to at least initially work on these use cases. The impact on private payment solutions should be taken into account and carefully analysed. There is the possibility of creating synergies between private payment solutions and a digital euro. When it comes to the use of terminal infrastructure or standards, there are a number of areas where there could be synergies.

A policy-maker highlighted the importance of looking at instances where a digital currency could create value added compared to private solutions. There is potential, for instance, in the area of offline payments, which could help with financial inclusion, but also in the area of micropayments where the fee structure of private solutions does not allow for use of the full potential. Programmable payments are also an area that should be closely monitored and considered for future developments.

3. CBDC faces several challenges and threats

3.1 The legal challenge

3.1.1 Clear legislation is needed

A Central Bank official stated that the Riksbank is approaching the stage of having to make a decision about whether it will actually introduce an e-krona, and because of that an increasingly important and more complicated matter is the legal side. The Riksbank was granted the monopoly right to issue sovereign money in 1904. When that happened it was clearly specified that this monopoly right was related to the physical representation of money. Internal and external lawyers were very clear that if the Riksbank wants to introduce an e-krona it should be as similar to cash as possible.

Some amendments to current law or some new legislation will be needed to make the decision to issue an e-krona. However, the desire is for any changes to law to be minimal, and that is why the discussion on cash-like retail CBDC is being raised. There are openings because certain words are used. Lawyers care greatly about the definitions of certain words. Talking of interest rates is not acceptable, but 'fees' might be acceptable. There will likely be solutions.

A Central Bank official suggested that whatever the letter of the law, a CBDC cannot be introduced without the support of the political authorities, and there would need to be a political debate. That is one of the reasons why it is important that governments and parliaments are involved.

A policy-maker noted that the Commission will come forward with a legislative proposal in the early part of 2023. This will be prepared fully respecting the different prerogatives of the institutions and working closely with the ECB. The digital euro can only be a success if the work of the ECB and the legislator fit hand in glove. Following the legislative proposal, it is hoped that the EU legislator, the Council and the European Parliament will be able to agree a piece of legislation before the end of the following year, because it is clear that the digital euro cannot be launched without the legislative framework in place.

An industry representative noted that there is an urgent need for a rulebook, so it is great to see fast movement with Markets in Crypto-Assets (MiCA) and other initiatives. The CPMI is working hard on this.

3.1.2 The protection of privacy

A policy-maker stated that privacy and the protection of personal data are fundamental rights in the European Union. The EU General Data Protection Regulation (GDPR) is a benchmark legislative framework. This is not only the expectation of citizens. There will be a legal requirement that the same standards apply to the digital euro and this is also a matter of public trust in the digital euro. The protection of personal data does not equal anonymity, about which there has to be clarity.

3.2 Choosing the optimal model is difficult

A Central Bank official remarked that the retail space is complicated because of the criteria for defining the market segments there are to address. A number may not go in exactly the same direction and may even be in conflict. The first that is important is the desire to address the market segments where the anchoring to central bank money is the most threatened, but at the same time the desire is to address market segments where it is not too complicated to deliver a payment scheme with a settlement asset in central bank money. An additional consideration is the importance of network effects in the payments industry.

A Central Bank official noted that a Bank of England Treasury task force is examining what sort of CBDC would be optimal to meet a number of public policy objectives, what the risks are and how they could be mitigated. It is essentially an assessment of what the optimal model would be in terms of public policy, and how the risk could be mitigated. The aim is to produce a consultation paper by the end of the current year.

3.3 Implementing CBDC is not only a technological exercise and requires all parts to work together

A Central Bank official noted that the introduction of a CBDC is more than a technological or technocratic exercise. Money and the way in which money is expressed in society has always been a political issue. Innovation, robustness and financial inclusion are vital. Those are primarily for the political authorities, but central banks need to work with them, which is why it is so important to bring the political and technocratic sides together.

A policy-maker emphasised that no one can do this by themselves. Different institutions have to work together while respecting their different missions and prerogatives which, politically, is quite a sensitive exercise. This cooperation has to cover the entire process. There is technical work going on but there is also a discussion ongoing at the political level of different institutions.

3.4 Higher costs are involved

A Central Bank official stated there is an eventual need for heavy investment on the proof of concept as a whole, rather than of little parts, with testing in a simulated environment, pilot testing in a real environment and finally introduction. Once at that stage the investment becomes very significant, so that is not pursued unless there is a very clear presumption that, if it can be made to work, this is where it is desired to go.

An industry representative stated that an answer was needed for the viability of the business model, because there is an increase of costs while new revenue cannot be seen in the model.

3.5 Will it be enough?

A Central Bank official noted that one argument that is made is that a CBDC is not needed as people are well served by the money that exists. In fact, the issue is whether they will be well served when technology enables money to be used in very different ways and builds in additional functionality that can no more be imagined now than how smartphones are now used could have been imagined 15 years ago. Central banks have to consider what will need to be provided for future use cases rather than whether something is needed at present.

This is why the interaction with the private sector is important. Any CBDC has to allow the private sector to use it to innovate and to build services that people will want in their digital lives. Without that, central banks will not be able to spot the user needs of the future.

3.6 Is CBDC a priority?

A Central Bank official stated that CBDC will not solve all problems and certainly not overnight. Value for money accepted in one jurisdiction still has to be exchanged for money that is accepted in another. Without a common global currency there will always be that problem of foreign exchange.

There are other parts of the payment system, the correspondent banking system and the linking up of faster payment services which also offer possibilities here, so the position should not be to leave everything as it is while waiting for an international CBDC to come along.

A Central Bank official emphasised that retail CBDC is not the only or the most urgent tool to make available and use to address the threat faced on the anchoring of central bank money on the payment system. Banque de France regards regulation as a top priority, and there are important initiatives from the Commission which are very welcome.

An industry representative stressed that Europe has a very well-functioning payment system currently. There is no urgency to issue CBDC for retail payments. Time needs to be taken to analyse this very closely. One concern is that it is sometimes said that there is a need to provide a safe form of public digital money to consumers and this is the safe form of digital cash. That can have the unintended consequence of making people feel that the digital forms of private money are not as safe as the digital forms of public money.

A Central Bank official noted that the Silicon Valley mantra for technical innovation of moving fast and breaking things cannot apply to central banks as they do not break things. This is a once-in-a-century change in terms of technical innovation. Though there is a need to move fast, it has to be done in a way that does not undermine credibility.

An industry representative stated that a digital euro is not optional; Europe has to move fast on this. Competitors like China and the US are coming onto the market.

3.7 Cyber threats

A Central Bank official noted that the cyber side is equally important to financial inclusion. The Riksbank is testing a retail CBDC that would function even without electricity or the internet. That would be a good complement to the whole payment system facing the new threats there are.

A policy-maker stated the right to the protection of personal data has to be balanced with other public policy objectives. It has to be ensured that the digital euro does not facilitate the illicit use of money in a digital world, so the AML/CFT framework, for example, has to be fully applied with regards to the digital euro.

An industry representative added that while privacy does not mean anonymity, intermediaries should be able to use data in a responsible way respecting citizens' privacy. If all data in day-to-day payment transactions is lost sight of then that would stifle growth and innovation in the private sector.

4. CBDC opening new opportunities and future progress in the financial sector

A Central Bank official remarked that the available models need to be assessed against an agreed set of principles, to evaluate the risks and some of the projects that are out there. There are some very exciting projects by the BIS on multiple CBDC (mCBDC) and how to link these things, to give jurisdictions thinking about CBDCs a view on the multilateral interlinking side so that they can build that into their considerations. There is a need to think internationally about how some of the risks in interlinking CBDCs could be managed.

4.1 Innovative ways to use digital currency

An industry representative suggested three innovative ways of using a retail digital euro. The first is that it is a replacement for cash, and that means a new way for customers to pay with a digital cash-like payment. It is a way of greening the payments, depending on the choice of infrastructure and technology used. The second use case is for cross-border payments, including a reduction in the number of intermediaries. It is also a way to extend the euro's influence cross-border. The third use of a digital euro still has to be invented. If there is a digital euro, many start-up fintechs and other innovators will create new payment features that currently do not exist.

4.2 Requirements for success

An industry representative stated that Europe will have to move fast and ensure three major requirements. The first is about privacy and know your customer (KYC). Cash is a question of privacy and KYC for customers but also for financial institutions. The second requirement is to ensure the financial stability of banks will still be there. If a digital euro starts to replace traditional deposits then balance sheets will suffer, which has to be addressed. The third is that it has to be seamless. That means it being widely adopted and simple for customers, where 'simple' means all of the different ways of paying. The digital euro has to be inside wallets. The infrastructures have to be the same in terms of all digital wallets. For customers, the digital euro has to be as easy as any other payment.

A Central Bank official stated that the financial stability concerns and monetary policy implications of even retail CBDCs can be worked out. While not easy, they will be resolved.

An industry representative emphasised 'thinking beyond'. A digital euro should not just stay with the CBDC. It could become digital e-money and digital commercial bank money. With thinking beyond, there can continue to be joint work.

Cross-border payments: success factors and remaining challenges

1. An ambitious 19 building block programme led by the CPMI and supported by an unprecedented political will at the global level

The Chair explained that the topic of cross border payments received new momentum starting in 2019 when it was noted that the cost of cross border payment was not really going down, and the global average cost of sending remittances was still estimated at around 6%. The topic was moved to the top of the G20 agenda under the Saudi Arabian presidency, and the Financial Stability Board (FSB) then took the lead to organise the work. There are 19 building blocks.

The Chair asked about the CPMI work, what has been achieved and what has still to be achieved. An official stated that we consider the 19 building blocks the necessary elements to improve cross border payments. From a small standard setting body perspective, the initiative is a large load, but we have made some great progress. We are working together with the FSB, the IMF, the World Bank and the Financial Action Task Force (FATF) on taking forward all these different elements.

The 19 building blocks can be split in several ways. There are high focus groups, but there are some very technical and standards oriented building blocks such as ISO 20022 or application programme interface (API). There are some very fundamental policy issues harmonising regulatory frameworks and more; the CPMI is mainly leading the more technical sides of those: ISO, API, payments versus payments (PVP) and liquidity bridges. Those technical issues are related to improving existing payment systems, but there is also a set of building blocks about building new systems. This would be related to multilateral platforms, central bank digital currencies (CBDCs) and stablecoin arrangements. Importantly, the political will really exists for this programme. G20 leaders are strongly behind it.

1.1 After a ground-clearing phase, it is time to implement projected changes

An official stated that we monitored our progress in October 2021, and it was published. This will be done again in 2022. We will start in August and September in order to assess our progress to be wrapped into the FSB report on that to be published in October or November 2022. We have published several reports and done considerable ground clearing. We is starting to implement the changes.

An official stated that she is very excited about two reports that we is bringing out on building blocks 10 and 12. The building block 10 report is about expanding access to payment systems and the building block 12 report is on extending and aligning opening hours. The first report is a framework for best practices to consider expanding access to payment systems to non bank payment service providers. The other report looks at the benefits of three scenarios for extending and aligning the operating hours of payment systems. Both reports should be out in May, and it is going to be exciting to see how we can implement some of these changes.

1.2 One essential challenge is to systematically factor in the current of forthcoming payment arrangements, a multilateral and international dimension, which requires standardisation efforts

The Chair asked which building block is the top one, what the most important ones are, and which ones particularly matter within the EU.

A Central Bank official stated that the building blocks directly affecting central bank operations are the most important ones. Notably, building blocks 10 to 12 concern access to and operations of central banks' payment infrastructures.

Major improvements in cross border payments might only be possible with further and more improvements and involvements of the public sector. For example, central banks might be required to broaden their scope. That could mean that we facilitate setting up a multilateral platform, as already envisioned in building block 17, and factors international dimensions into the CBDC designs. That is also very important for all central banks in the euro system.

Standards are key. The migration of TARGET2 to ISO 20022 will enable banks to send and receive more information, resulting in better straight through processing and automated payments. Furthermore, harmonising ISO 20022 messages might be able to transmit harmonised know your client (KYC) information across borders with a global Society for Worldwide Interbank Financial Telecommunication (SWIFT) migration to ISO 20022. TARGET2 will be interoperable with other real time gross settlement (RTGS) systems in Europe and very important around the globe.

1.3 Improving cross-border payments will also benefit the EU

A Central Bank official stated that the payment market in the EU is already deeply integrated, but there could still be a profit for the intra EU cross border payments from the current developments. There is still room to improve payments between euro and non euro countries. For example, sharing the TARGET Instant Payment Settlement (TIPS) infrastructure and enabling the settlement of non euro payments in TIPS will help to further integrate the European payment landscape. Cross currency payments could further deepen the integration as the next step. TIPS could position itself as a pan European hub for interoperability.

1.4 Adopting improved settlement processes is also essential to reducing risk given the ever-growing volumes and political sensitivity of certain currencies

The Chair stated that CLS has been a great success, so ever bigger volumes are being settled securely. Nevertheless, the unsettled part has also been growing. The Chair asked why and what solutions are proposed. An industry speaker stated that CLS is celebrating its 20th anniversary in September 2022. We are settling 18 currencies. For those 18 currencies, we are covering 90% of the addressable transactions within them. On average, over $6 trillion USD equivalents of transactions are settled every day with liquidity needs of only less than 1%. It works very smoothly. We have just released a new technology on it, so it is addressing issues.

Three dimensions are important. The biggest one is that we settle only 18 currencies, so there are currencies that we do not settle that are becoming more and more systemically important. Setting up an appropriate mechanism to provide PvP settlement in line with building block 9 from the CPMI work is challenging. It is more complex than a pure technical issue and will require some efforts on the regulatory and legal fronts and calls for public-private partnership.

There is also a growing part of the market that is coming from what we call 'same day activities'. It is not real time activity because we are in the field of FX. We cannot really speak of real time, contrary to the RTGS context, where there are money market transactions that are settling through delivery versus payment (DVP) mechanisms in which collateral is being delivered through payments primarily in the same currency as their local currency. In our case it requires different processes because it is necessary to have the ability to pay in different currencies than the banks home currency. This creates different processes and challenges that needs to be answered. We have developed a trusted market solution relying on usage of capacities to generate liquidity in other currencies at time of settlement, and we are looking for further adapting it to meet future market needs.

The third element to bringing in new currencies into this very efficient settlement mechanism is to require them to comply, legally and regulatorily, to the high level of standard that we are providing through our system. This is compatible in particular with the Bank for International Settlements (BIS) regulation and principles for financial market infrastructures (PFMI), to which we have to comply.

1.5 Enhancing the accessibility of CLS to certain non-banks is also necessary

An industry speaker stated that the last element is certain non bank entities that cannot access our services today. Such entities are not banks, and therefore cannot access our services as prescribed within the CLS Rule Book (based on rules of law for finality of settlement) under which we operate. These non-bank entities include counterparty clearing houses (CCPs) or more exotic firms that are not eligible to participate in CLS. We are considering possibilities of removing those potential barriers.

1.6 Enabling effective Straight Through Processing (STP) and early information on payments are essential targets that require sustained efforts and stress the size of the data challenge ahead

The Chair stated that SWIFT addresses networks and messaging standards for international payments. The other G20 countries have also worked on message standardisation. The Chair asked if the content of messages is sufficiently rich for allowing cross border STP. He also asked what SWIFT has been doing in the last five years and what is expected in the next five years.

An industry speaker stated that there are hopefully no borders in the world of cross border payments. We started our journey in 2017 with the Global Payments Innovation (GPI) programme. At present, 44% of the payments process is hopefully completed within about five minutes.

In the past, a payment was sent, and we did not know when it arrived. That is no longer the case, and 90% of the payments are confirmed to credited accounts, so we know exactly when they are confirmed. We has the information on the fees, so we know exactly how much a payment cost. We believe that transparency is a big component of further developing and improving payments.

Challenges remain. The current transparency is post fact. We believe that we need to bring that transparency before the payment is even sent. The questions are what we believe is going to happen and where we should invest in the next five years.

The first place to invest is the data layer. There will not be instant payments if there is friction in the chain, and a very good report from the BIS and the CPMI explains the friction points and the data behind it very well. The data is the first prerequisite to develop and improve.

There is a question around the data issue. We are going to invest into richer data, but it needs to follow end to end from any ecosystems. We hear a great deal about new developments and digital currencies or interlinking of MI. This will not work if the data that flows between these ecosystems is not complete. We is investing in that data layer considerably.

The second issue is removing the friction with our projects such as pre validating a payment. We learned a great deal from other companies about how important the customer experience is. Together with the banks, they are investing a great deal in their front end. That experience is going to make the difference in the next five years.

Europe is in a unique position because of this early migration on rich data format. Whether it is in a high value payment system or low value in automated clearing house (ACH) or an instant payment system, it is going to be the same standard. This is fairly unique. Even in CBDCs, everybody is talking about the same standard of data.

1.7 Cost, speed and transparency are key progress areas for improving customer experience that should impose effective regulatory harmonisation and leveraging innovation

The Chair stated that Western Union is one of the leaders on the retail payment side. He asked what the key building block regarding this segment of payments is, and what needs to happen to make the business more efficient in the interests of the people. An industry speaker stated that focus on the consumer is definitely a key driver in the retail space and digital spaces. From a consumer perspective, the three key concepts are cost, speed and transparency.

On cost, we have several compliance laws in place that are not harmonised. When there is a new money laundering (ML) directive, the colleagues of an industry speaker at his US company ask what is different, what they have to implement and what the new European rules and set of standards are. They also ask for the standard so they can start to work together. However, they need to wait because there is not one standard for Europe. It is necessary to multiply for each member state because everyone has a certain degree of flexibility around when they are going to implement the ML legislation. The standards are critical because we will help consumers. We will help companies to work more efficiently and help to build the best in class of compliance in order to help companies invest back into the system.

The second point is on speed. These are real time payments. We need to remember that the last mile integration is absolutely critical if it is connected to real-time or partner banks, as is the time to the market. Several innovations can be implemented. We also need to be mindful of requiring a certain ability to implement all these changes in a timely manner, and also in terms of interoperability. We have a lot of changes that can allow us to leverage technology. Electronic ID and KYC are much more advanced and secure, but work happens at different speeds.

An industry speaker stated that the central bank of Sweden has the ability to KYC customers practically in real time in every country. Italy still has processes designed around retail. We even need to send documentation by post in 2022. This is really not acceptable. It could help to invest back into the financial services sector, announce the payment infrastructure and guarantee much better quality in terms of control, customer experience and wealth for the entire system.

A level playing field was also expected. All actors and non bank providers would have access to intra bank payments, clearing, settlement infrastructure and sometimes more transparency of the regulation in place.

There are opportunities with Covid because interoperability and the capacity to implement faster new use cases is possible in Europe. A Covid pass contains a simple QR code that can be used and scanned across every single European country, but it seems impossible to do that in terms of financial systems.

1.8 PSD2 illustrates that delivering harmonised rules and practices and futureproof legislation is challenging, even within the EU

The Chair explained that Amex is a truly global company, and the G20 work is also truly global. National laws are also relevant. The Chair asked which EU legislation also matters from the cross border perspective and what is most important there.

An industry speaker highlighted the Payment Services Directive (PSD). Some lessons can be learned from it. There are some very sound objectives, and great progress has been made.

Some lessons can be learned from challenges at the rulemaking level on implementation details. As PSD2 was implemented, there was variation across markets. Some markets prohibited surcharging. Others allowed it, but only in certain circumstances like the use of a consumer card. For a business or corporate card, surcharging was allowable. In other instances, there were even markets where surcharging was subject to contracts. This variability creates confusion for the merchant and the consumer that could play out in cross border travel and online transactions.

The second example of sound objective implementation that could have been somewhat smoother is around strong customer authentication. The goal was reducing fraud in the areas of 'card not present' transactions. This is more of a case of designing a regulation that might not be futureproof and is specifically related to requirements about dual authentication. Some ways that can reduce fraud do not rely upon it. If the legislative goal had been to reach a certain fraud level, flexibility from payment institutions and issuers of cards in achieving that would have been a better way to implement the provision.

Third, open banking is a great success story for PSD2. However, we came out of PSD2 with multiple forms of API for banks or institutions to connect to in order to transmit data. A focus area would be harmonising that. It is advisable to bring industry players together to drive towards greater standardisation of a single API to achieve the scale effect across the EU and beyond. This holds great promise.

2. The optimal mix of improvements of existing tools and adoption of innovative arrangements

The Chair advised remembering that card payments are still the key instrument in cross border retail payments. He asked for the most important building blocks in which the most energy should be put into.

2.1 Close public and private sectors cooperation and the current effort for improving existing tools are innovation enablers

An official stated that the building blocks of PVP, ISO, APIs and multilateral platforms are closely related to the improvement of existing platforms. All of these are foundational, which means allowing us to build something that we can build upon.

We donot only have political support to progress; there has also been clear commitment by public sector and private sector individuals. Nobody can improve cross border payments alone. We have been having several conversations with different entities and has committed to working with the private sector.

A Central Bank official stated that a number of building blocks in the G20 roadmap address the need to harmonise anti money laundering (AML) and KYC standards. Those issues must be solved independently.

An industry speaker stated that it will first be necessary to solve 'real-world problems'. The question is what is to be improved. Sometimes, the shortcomings of a new technology are the same: the AML, checks and consistency. The new technologies have the same problems that can be improved, and that is what is very likeable about the work by the BIS and CPMI. It is very pragmatic.

2.2 Choosing between improving existing infrastructure and innovation requires a better perception of actual anticipated benefits and an effective adoption

An industry speaker stated that the question of how to flip between improving existing systems and new ones is the big one because central banks and private firms will have to make the decision on where to invest. This is a good question that is going to have to be decided by central banks and firms, but we are going to need to make investments in both of those areas. The question will then be how much, where and when.

The second point is ensuring that this is not about just a new system, but also the adoption. When there is new data to adopt, SWIFT takes a great deal of time. It is about 7,000 banks. The banks have a great deal to deal with and they need to absorb all this new technology. It is necessary to find a way because SWIFT cannot do anything alone. It does this with its member banks, the PSPs and everybody connected on SWIFT. We have to try to make sure that this adoption problem is resolved, and that comes with reuse.

When considering new solutions, it is advisable to consider them as modular. If the problems are made too great, there will be an adoption challenge. If SWIFT thinks about pre validation, we have to look at domestic initiatives that are already pre validating. The question is how to ensure that the banks do the job so that the bank account becomes the 'best digital wallet'. If the data is right, it is possible to get there. It is advisable to think about that modularity and global solutions. It is not advisable to consider this beyond one jurisdiction. These are going in the right direction.

SWIFT is building the new rails. They are based on rich data, so we want to reuse that. It should be ensured that those rails are instant. They will be API based, but they should also be able to settle on correspondent banking accounts, MI accounts or new wallets.

2.3 Strengths and limitations of CBDCs in improving cross-border payments

2.3.1 To improve cross-border payments, CBDCs should leverage the fact that they start from a clean slate, although most related projects are of domestic reach

The Chair asked about CBDCs in Central Banks in the coming years. He also asked about the potential of stablecoins against CBDC.

A Central Bank official stated that CBDC projects are advancing all around the globe and there is great potential for improving cross border payments if cross border interoperability is considered from the start when designing a CBDC. Transaction chains should be shortened. Payment messages could definitely be further standardised, and the overlap between opening hours could also be maximised. There is a chance to start from a clean slate. It could be possible to create global standards for cross border CBDC use before the majority of countries have finished their own projects.

2.3.2 Any international dimension for CBDCs comes with a host of additional challenges

A Central Bank official stated that most CBDC projects currently have a more domestic scope, whereas cross border use is more of an afterthought. Furthermore, an international dimension for CBDCs comes with a host of new challenges depending on the level of adoption. Countries could become more interconnected, increasing the risk of transmitting shocks. The currency substitution could also be an issue. Measures would have to be taken to prevent this, which may elongate CBDC projects.

Besides the big picture, there is also an element of how to make retail CBDCs interoperable. Several promising prototypes are trying to offer real time DVP settlement via wholesale CBDC.

2.3.3 Global stablecoins are projected but are not for tomorrow, and their closed-loop nature reduces their added value to the cross-border payment challenge

A Central Bank official stated that timing will be a huge challenge. Following Meta's withdrawal from its Diem project, no global stablecoin solutions will seemingly arise in the near future. Nevertheless, this is not to be taken for granted because there is still considerable noise around stablecoins. Other big players have started new stablecoin projects. Meta is also continuing its Novi digital wallet project.

CBDCs will probably try to be as open as possible, whereas stablecoin providers might try to develop closed loop solutions to ensure as many users as possible on their platform. That would not be an efficient structure for the global payment landscape.

2.4 Finally, the likely outcome would be many different cross-border payment models

The Chair asked if there is a risk of fragmentation among new players, CBDCs and private solutions for correspondent banking. An industry speaker stated that a world with many different payment models is foreseen. We is preparing for that world. We should keep correspondent banking improvements and discussions on the interlinking of market infrastructure on track. We see explorations moving onto many stages on CBDCs as well.

2.5 The main priority would be to anticipate undue fragmentation, notably by improving connectivity, accessibility and regulatory consistency (in particular within the EU) and preserving the data conveyed

An industry speaker clarified that fragmentation is already a reality. The question is how to ensure movement in the right direction. The work of the BIS and the CPMI and global attention on cross border payments banking are helping because these discussions will converge on many elements.

The issue is sometimes not the length of the processing chain. Data from the BIS report showed that 85% of cross border payments have one intermediary and 98% of the payments just have two intermediaries. For the majority of the time and the friction, 80% of the delay is at the receiving bank. Operating hours, currency control or batch processing might be able to solve it. However, it is advisable to look at the data.

An industry speaker would like a world in which we could make the chain longer and connect together. A transaction can originate in one system and another one. If the data and the processes are the same, the chain can be even longer. It will be possible to achieve the same goals that we set for ourselves if we design that with no data truncation and the same transparency and compliance processes. An industry speaker is fairly positive about what we are going to achieve together. It is advisable to be realistic because adoption takes time, so it is advisable to do it in blocks and in the same direction.

The Chair asked an industry speaker what is on top of his to do list for EU policymakers and legislators. An industry speaker stated that he sees a great deal ongoing in a positive way. Especially at a central level with the European Central Bank (ECB), the European Banking Authority (EBA) and the European Commission (EC), there is a consensus that it is necessary to elevate the payment industry with more standards that will help everyone.

Going a step further would probably mean moving some of this legislation and making it directly applicable across Europe by moving that to regulation. At that point, it will be much easier to implement a standard. We will be sure that, when we take something, it can be moved across countries and sectors, creating a frictionless experience. CBDCs are another critical point.

There was some discussion about PSD3 or PSD revision. It is desirable to see it guarantee access to banking services to all known banking operators. At the moment, it is a recommendation in PSD2. Some of those critical services are being removed from some of the operators, especially for those that deal with some so called 'risky business'[1]. There is a complete risking of an entire industry, and this should not be acceptable. This should become much more enforceable with real tools that are not present in the legislation because it is more of a general recommendation.

2.6 Innovation should introduce both opportunities and further competition

The Chair stated that instant payment is an emerging topic, and CBDCs might be a little more remote. The Chair asked if these two are competitors or an opportunity. An industry speaker stated that instant payment and CBDCs are both. They are 'frenemies'. We are a global card scheme operating in more than 130 countries. There are instant payments opportunities for us, but all the same themes have been touched upon throughout the conversation: harmonisation, interoperability standards and common standards. To get the scale out of instant payment systems, it will be necessary to lure new competitors and create new products.

We have created new products since the adoption of PSD2 in Europe. Payment initiation creates competition and choice for the consumer to the extent that the scale and ability to do this in a cross border context exist. Because the instant payment systems are connected and interoperable, it is only going to provide the necessary scale to grow those types of innovations again. The time lag for CBDCs to be really disruptive in payments will probably be a little longer.

3. Defining the right tools and approaches requires clarifying the market's needs and making clear political choices

3.1 Effective innovation in retail payment services requires refining many components, which will eventually define the actual service

An industry speaker stated that the challenges are not only those of harmonisation, interoperability, and standard setting in order to create frictionless, fast, cross border, inexpensive movement of funds. Many other questions need to be answered around the balance between privacy and AML banking secrecy act (BSA) requirements, the impacts on the banking system and the capability of the central banks to manage accounts. There is a question around what that would do to the deposit base of banks.

There are several other questions to resolve, including whether this will become a direct competitor to debit oriented products as opposed to credit products with greater protection. The ability to borrow funding for some time means there are liquidity benefits, but there are also chargebacks and more. There are some complicated issues, and whether this is simply a replacement for cash is to be determined.

3.2 On the wholesale space, policy makers must consider wholesale specificities and provide the necessary impetus

An industry speaker stated that he does not see beyond the building blocks because the first part of the building block policy is regulatory driven. The solutions that are positive for retail are not the same for wholesale. The problem of liquidity management requires different answers.

It is necessary to understand market needs and how to define what is needed. From there, it is possible to build solutions and choose a technology at the end. However, it should not be done the wrong way around.

The need for the wholesale market FX is to accommodate the larger currencies not currently settled in CLS. Those currencies are presumably members of the FSB so it should be possible to create a mechanism that allows for exchanging existing exposures, trades and swaps in a safe environment with a PVP mechanism, even during geopolitical tension. Institutions would be protected

1. Some high risks associated with debit and credit cards and other forms of electronic payments specific to certain types of merchants

from the Herstatt Bank risk[2] on those transactions. There is a responsibility on the public side and from a private sector side who cannot resolve it alone.

CLS is ready to build a safe harbour or Switzerland type global financial market infrastructure (FMI) channels that can safely help it to deliver those and put those systems in place. Only public private sector partnerships will be successful in this endeavour, so we need the public sector on that. We really need a strong message from the authorities and central banks to say yes to the market and tell the other side to find a solution. The authorities should mandate banks to use PVP market solutions, which are providing safety and taking away the remaining systemic risk deriving from FX trades.

2. Herstatt risk' occurs when one party may not be able to receive another party's currency after delivering its own due to the delivery lag between the two currencies traded in the foreign exchange market. This risk can be approached by assuming that it is an increasing function of the delivery lag and transaction value.

Instant payments and EPI: what is being achieved and challenges ahead

1. There are many opportunities linked to the development of instant payments

An industry representative asserted that the use of instant payments could create huge opportunities. ING is rolling out instant payments and they are already the new normal in the Netherlands for payments under the high value threshold. However, there is a need for a scheme on top of this, which is why it is essential to consider every opportunity, including the European Payments Initiative (EPI), and determine how to develop scale and acceptance across Europe.

1.1 Instant payments: a solution for cross-border payments?

A Central Bank official suggested that using instant payments to solve cross border payments could drive adoption. Using a fast payment system to solve cross border payment problems could retrofit the usefulness of instant payments within the euro area. Around the world, cross border payments are in 'very bad shape'. The Financial Stability Board (FSB) recently released a paper which established targets for improving cross border payments in terms of cost, access, transparency and speed. An instant payment system would clearly address the requirement for speed and could do this on a cross border basis. The system could improve transparency, because people would know in real time whether a transaction has completed. There is a genuine business case here. There are also many issues with the proposal to connect the world's fast payment systems. There are around 60 fast payment systems across the world. If they could be joined together, the problem of cross-border payments would be solved.

1.2 Instant payments can solve problems that are currently not being addressed

A Central Bank official stated that the most interesting use case for instant payments is something that is not easily achieved with batch based SEPA (Single Euro Payments Area) payments: retail payments and point of sale payments. These are often overlooked in the discussion of SEPA payments, because it is illogical to use a credit transfer at a point of sale. With instant payments, that use case becomes feasible. This could enable the creation of a new payment rail for retail payments at point of sale. This cannot be done using the batch based credit transfer system, although the system itself is not bad.

An industry speaker considered that instant payments have the potential to solve problems which are not currently being addressed, such as the emerging needs of unattended commerce and scan-to-go. These activities are described as omnichannel, but they are often like e commerce in a shop environment. This trend corresponds to the behaviour of the digital age of Europe's population. Instant payments can cater to this demand. As the EPI is proving, instant payments can cater for all the same situations as cards. There is huge potential here, because instant payment can enable these different flows to be unified and harmonised.

A Central Bank official suggested that SEPA Instant Credit Transfer represents an opportunity for the European payments industry to jump into the digital age and support individuals and firms in meeting their daily payment needs. For payment services providers, instant payments can foster customer relationships by focusing on direct account to account transactions. If instant payments are to become the new normal, it is worth considering measures similar to those implemented for the first SEPA instruments.

The Central Bank official described how the European Commission is planning a regulatory initiative later this year or at the beginning of next year which will seek to abolish the hurdles to broader uptake. Nevertheless, it is important to listen to users and the providers of payment services. Only then will instant payments be able to compete effectively. In any case, the uptake of instant payments must not lead to fragmentation. Only a pan European solution will be able to reap the benefits of SEPA and the internal market. EPI could be the right platform to deliver such a pan European solution.

2. What has been achieved thus far?

A Central Bank official described how SEPA has transformed the European payments landscape over the last two decades. Plain vanilla euro payments have become faster, cheaper and more efficient. This transformation was made possible by a broadly coordinated effort on the part of both private and public players. While this has worked well for credit transfers and direct debits, national card schemes have not become cross border. Only in combination with an international card scheme are buyers able to pay with these cards outside their home country. Moreover, some countries' national card schemes have been substituted by international schemes. A similar pattern emerged for payment solutions designed for different situations, such as mobile e commerce or push-to-business (P2B) payments. While the harmonisation of credit transfers and direct debits within SEPA was an important step forward for Europe, adoption and usage remain below expectation as a result of the perceived lack of adjacent schemes and supporting arrangements such as request-to-pay or point-of-interaction (POI) payments.

2.1 There is a large amount of progress still to make

A Central Bank official described how the public authorities have done what could be done around infrastructure. A system has been created which could form the backbone of instant payments throughout Europe; it is up to the private sector to develop the business case. Today, instant payments, particularly through TARGET Instant Payment Settlement (TIPS), is not a big success. Only 60% of European payment services providers (PSPs) have joined SEPA Instant Payment; instant payments are only 11% of overall STG payments. There is considerable room for improvement.

The Central Bank official stated that the public authorities have to determine what to do, but the market players have to move. This is why this issue is so difficult. There are two dimensions to what central banks or public decision making bodies can do: infrastructure and regulation. On infrastructure, central banks are ensuring that accounts can be connected. Last year, the Eurosystem took two decisions to foster pan European reachability by mandating that SCT Inst compliant PSPs must be reachable in TIPS and Automated Clearing Houses (ACHs) must move their accounts from TARGET to TIPS. The authorities are doing their part, but more can be done.

3. The challenges ahead: creating the new normal

3.1 Searching for the optimal model for instant payments

A Central Bank official noted that there are three possible models for cross border payments. One is a 'spaghetti' model, in which all participants connect with each other. This would require a huge number of connections and is not a viable model. The second model is one with regional fast payment systems. This is becoming an interesting reality. The Bank of Italy recently conducted an experiment in which TIPS was connected to Buna. With one link, 19 countries in Europe were joined to 16 countries in Buna. This is an interesting model, because it is manageable and does not require huge agreement. Thirdly, there is a very ambitious project run by the BIS Innovation Hub Centre in Singapore called Project Nexus, which aims to develop a platform which can connect to the rest of the world. The Bank of Italy is joining this project with the Monetary Authority of Singapore and the Central Bank of Malaysia to understand how this could work. A system that uses one rail for domestic and international payments would create a real business case and would be a boost to the business case for instant payments within Europe.

Additionally, the Market Infrastructure Board (MIB) of the Eurosystem is currently defining a plan for how to remove the stumbling blocks in this area. The Central Bank official noted that PSPs have made instant payments a premium product rather than the new normal. As payments are instant, the checks for fraud, for example, may be more expensive. There is no data on this, which means it is important to talk to firms about this. The public authorities must talk to the private sector and understand what is happening, if instant payments are indeed going to become the new normal.

An industry representative highlighted three key priorities for the creation of a pan European solution. First, it is important to address the current issues in instant payments. At present, instant payments work smoothly on a domestic basis, but a large proportion of cross border transactions are not executed in real time. This is due to the requirement to conduct pre transaction screening. This leads to false positives, because there is a very small timeframe to check each transaction. If there is any doubt, the transaction does not complete. Currently, 11% or 12% of transactions do not happen, which for a commerce solution is unacceptable. This compares badly to cards, where post transaction screening is possible. This is clearly one area where it is vital to level the playing field.

3.2 Defining roles: the public sector must set the regulations and maintain fair competition while the private sector has also a key role to play

A Central Bank official explained that the public sector could play a role. For example, in Europe it is not common for governments to make transfers using instant payments. This could be a huge boost to the sector. The Commission is also considering some action at a normative level to boost instant payments. More must be done in order to expand instant payments. This will be essential to prevent European citizens becoming trapped in the 'walled gardens' being built around the world. It is important to ensure there is interoperability and that people can choose their means of payment. There is no magic bullet, however. There must be continuous dialogue between the public authorities and the private sector to determine the appropriate solution. It is very important to address peer to peer e commerce, which is an area where there is a large reliance on non European solutions. Ultimately, the most important priority is to ensure there is dialogue with the private sector. It is imperative to design a system which is compatible with the needs, costs and business models of the private sector. Banks and PSPs are the organisations that will deal with customers. If there is no business case, there will be no possibility to foster this business.

An industry speaker noted that many banks have already implemented instant payments internally, but these systems are not commerce ready. The next step is to develop rules and functionality which are ready to be implemented in commerce. This will require rulebooks which can cater for all the situations a merchant wants to address, which means not only having the functionality but also liability rules, special situations, refunds, returns, fragmented payments and all of the other issues that arise in commerce. The industry speaker acknowledged that the EPI received a considerable amount of support from the central banks of various countries, the European Central Bank (ECB) and the Commission, but more must be done than warm words of support. Instant payments are a challenger. If the system is going to work, the ECB and the Commission will have to offer more support and get more markets involved.

An industry representative described how the governments in ING's home countries have opted to implement fixed fees per transaction at a low level. ING had discussed the possibility of joining the EPI. The EPI's scheme would have the same transaction cost wherever the transaction is, because that is the logical thing to do. It will benchmark relative to the European average and be competitive versus other solutions. However, the envisaged transaction fee under an EPI scheme could still easily be higher than what ING earns on a given transaction. From the perspective of competition law, this would mean selling transactions below cost, which, with ING's market share, would mean that ING was engaging in dumping, which is forbidden. This is why levelling the playing field on interchange is a key concern.

A Central Bank official conceded that there are limits to what the public sector can do. The public sector is not the best at innovating or providing customer facing solutions. Those need to come from the private side. In a nutshell, the public sector can provide the regulatory framework and certain foundational infrastructures, but, beyond that, it is the responsibility of the commercial entities, including banks, to provide the services that citizens will ultimately use.

3.3 Any fragmentation of the European payments landscape will slow down the process

A Central Bank official stated that the fragmented payment landscape is limiting the possibility of having a competitive EU digital market in the global context.

Another Central Bank official suggested that there is a need for pan European instant payments due to the challenge around fragmentation. This is the most significant challenge in the European payments landscape. There have already been many national and regional instant payment solutions across Europe, but it is not possible to achieve a truly single market in this way. The systems could even be interoperable, but this would be a 'half baked' solution, because the market would still remain fragmented. It is not only the payment market that will remain fragmented, however; the European market as a whole will remain fragmented unless the payment landscape is fixed. SEPA has been very successful, but it only addresses a subset of use cases. It is essential to create another success story like SEPA to address the remaining use cases, which are currently somewhat underserved.

An industry speaker outlined the problems caused by fragmentation. First of all, successful payment solutions are global, unified and they have one function rather than multiple local adaptations. This is not because it is more beautiful to have a single system; it is because it is essential to create synergies, to enable volume pooling and to achieve economies of scale. If the system is composed of different solutions in an interoperable model, this level will never be reached, and therefore the system will never reach the critical mass and volumes necessary.

The industry speaker described how this fragmentation could have significant impacts. First, a fragmented system would prevent commerce from having a single integration. Commerce wants to have a single integration, especially in Europe where there are specific standards and protocols functioning in every market. If public authorities and market participants do not pay attention, that is exactly what will be reproduced in instant payments. If these systems are implemented with small but nevertheless important differences, it will be cumbersome for merchants. Secondly, there is an even more important impact on innovation. If there is not a single solution, there will never be the innovation pooling, budget and financing that is necessary to remain competitive with the big players. This impact on innovation is massive, because none of the national or fragmented solutions can support the kind of innovation need that exists in today's digital age.

A Central Bank official emphasised that the intentions of all the actors involved are aligned. Everybody understands what is needed; the difficulty is in getting all of the actors around the same table and getting the project moving. The European landscape is multi currency, multi instrument, multi language and multi standard, and it is a private public partnership. It is a very complex landscape.

3.4 The need for a European scale

A Central Bank official highlighted the clear commitment by Commissioner McGuinness on this issue. There is reason for optimism that the European Commission will continue to work in this direction and acknowledge that until now not enough has been done or achieved.

An industry representative observed that, despite the fact that iDEAL in the Netherlands now has a 70% market share in e commerce and m commerce, the system is only or largely used in the Netherlands. This year, iDEAL is aiming to process around 1.2 billion transactions. This is a significant number, but it will never produce the economies of scale of global schemes. Ultimately, the system will always be at a cost disadvantage. The same amount of money will have to be invested regardless of the number of transactions. This demonstrates why scale matters. Secondly, while consumers like the system, they cannot always use it abroad. Dutch web shops, which use iDEAL for what it brings, cannot use iDEAL to service international customers who want to buy from the Netherlands. This means they must accept other payment methods. This also means that banks have to supply extra payment methods to their consumers to enable them to pay everywhere, which is inefficient. Lastly, as a pan European bank, ING is not able to leverage its scale, because it must also service the domestic solutions in each of its countries. For ING, it would be an excellent idea to look at fast payments from a much bigger and at least pan European scale.

Another industry speaker highlighted the importance of creating a platform for all institutions to connect to, because this is about exchange. There must be direct connectivity, which requires a huge platform.

A Central Bank official considered that retail payments has been one of the key challenges in integrating the single market generally. SEPA Instant Payments is an example here, though this is not the same as retail payments. SEPA Instant Payments has been implemented for five years, but there is still not complete coverage. Even in countries which are nominally covered or reachable, some banks have not implemented both incoming and outgoing instant payments. The goal here will only be reached if both of those aspects function and there is complete coverage on a pan European basis. What is perhaps missing is the motivation for commercial entities to think about payments on a pan-European level. Not every business does business in every European country. It is important to have standards, regulatory initiatives and shared infrastructures through which alignment can be achieved, even if a business focuses only on a certain part of the market.

3.5 The need for a new fraud prevention model

An industry speaker emphasised the need for any platform to be able to handle fraud prevention. Fraud prevention is crucial. If it is not addressed, fraud will become an issue for instant payments in the future. The fraud prevention model must be reinvented for instant payments, ideally combining data from cards and instant payments, because that will be a much more efficient system.

An industry representative explained the issue around data. Previous speakers mentioned the need to integrate data more deeply in commerce and networks. These solutions should also be able to supply instant credit for buyers. This could be things like buy now, pay later. If all of the European and international responsible lending rules are applied, banks will be unable to offer the same seamless experience as the newcomers that deliberately sidestep these regulations. As long as no interest is charged, it is suddenly not a loan. That means there is no requirement to register with a credit bureau or check whether people are able to repay. This is a second key challenge around the level playing field.

Speeches

François Villeroy de Galhau

Governor, Banque de France

Looking up to achieve a Financing Union

Ladies and Gentlemen,

It is a great pleasure for me to open this edition of Eurofi today in Paris, and I extend my warmest thanks to Didier Cahen and David Wright for their tireless efforts that allow us to gather in this beautiful Hôtel du Collectionneur. Today I will indeed be speaking about a collection – not of fine arts, but rather of national banking and financial systems. Unfortunately, such a collection is nothing to rejoice about, it is rather an Achilles heel.

But let me start with a few words about Ukraine. We are obviously monitoring closely the geopolitical developments, and their possible economic and financial implications. Let me already stress that the direct exposure of French financial institutions to Russia remains limited, but the SSM called all European banks to enhanced vigilance on cyber risks. We will assess in our Governing Council in March the more indirect consequences on inflation and growth, and we will be facts driven: more than ever, optionality – about the right monetary stance – and flexibility – to guarantee the right monetary transmission – are the two names of the game for our policy.

A few days ago, on 7 February, we celebrated the thirtieth birthday of the European Union and of the Maastricht Treaty. I was personally present during the signature of this Treaty, which promoted "the strengthening of economic and monetary union, ultimately including a single currency". We have successfully established a monetary Eurosystem, however a real financial Eurosystem must now develop. Let me therefore share some proposals on the Banking Union and the Capital Markets Union (CMU), which are the two cornerstones for such a financial Eurosystem. We are all aware the Banking Union is for 19 countries, and tomorrow 21, while the CMU is for 27. But allow me to mix them today with a common core – the euro area –and a common purpose – the right funding of our economies.

I will quote two thriller books today. You may rightly think of The postman always rings twice: Andrea Enria and myself already conveyed this message quite plainly regarding the Banking Union during the last Eurofi session in September. You may also think that these projects are more or less stuck. It is true that there has been deadlock and I will list the bad reasons for this. But there are also good reasons why we can break this deadlock now and give the projects of Banking Union and CMU new momentum (I). I will then describe the new possible steps for the Banking Union (II) and the CMU (III).

I. Three reasons for delay, and four reasons for hope

So why have these two major European projects struggled to get off the ground fully six years after they were launched? After a strong initial impulse which quickly gave birth to an effective first pillar – supervision –, the Banking Union has been on hold for several years due to lengthy and not very productive discussions, in particular on the third pillar (deposit insurance scheme). When it comes to the CMU, its first action plan back in September 2015 had already identified a number of improvements that are still valid today; its main weakness was not in its content but in the lack of implementation.

Let me start with three bad reasons for that. A first explanation would be that Europe only moves forward in times of crisis. This is partly true: the Banking Union and the CMU are two examples of initiatives taken in the aftermath of the financial and sovereign debt crises. Yet we should not wait complacently until the next crisis to act; it is precisely because we are not in an acute crisis situation that we should move forward now. Second, both initiatives can be described as arid and technical. This is not an issue in itself; we are accustomed to complex topics. But here we may have created a maze of technical and interconnected sub-topics, and lost sight of their original political purpose.

Third and not least, national reflexes are still present, with countries reasoning vis-à-vis "their" banks and "their" financial centre. The result is that each European country, and the EU as a whole, are losing to the benefit of London and the United States – or to the benefit of foreign Bigtechs tomorrow. All in all we have to accept the idea that instead of a single European financial centre, we will have a polycentric network of financial centres – all the more since the digital era encourages it. And accept that there will be no winner-takes-all country, but several pan-European cross-border financial players.

In this early 2022 nevertheless, there are at least four reasons to believe that we can breathe new life into Banking Union and CMU:

- There is growing awareness that European strategic autonomy matters and that financial sovereignty is part of it. This shift started with the Covid crisis but it is being underlined even more starkly now by geopolitics.
- The two "great transformations" ahead of us, digital and ecological, will require massive investments. This calls for common financing from not only public but also private sector. We should rebrand the CMU in a way that better reveals its goals: financing our two major transformations. I proposed some time ago to rebrand it "Financing Union for Investment and Innovation", or "Financing Union for Sustainable Investment" – Christine Lagarde suggested a "Green Capital Markets Union". At the inception of the single market in 1986, the genius of Jacques Delors and the Commission was to hoist over a collection of 300 technical texts the banner of the four freedoms of movement – goods, services, persons and capital. This banner gave a meaning and a purpose to the single market. I am convinced that the success of CMU, in particular, will not depend on an ever-improving technical agenda, but on a much stronger political ownership and impetus, from all European authorities.
- We need an enhanced "private float" to stabilise the Economic and Monetary Union. Fiscal and monetary policies have done a lot to support the economy since 2020, and can no longer be the only tools used to tackle these challenges.
- Recent openings in the position of several countries – especially along the Rhine, but also across the Alps – could hopefully offer the possibility to reach agreements.

II. Finalising the Banking Union to strengthen our banks

The following figures will illustrate our failure so far to offer the right conditions for pan-European banking groups to emerge. In 2020, the domestic market share of the top five US banks stood slightly below 50%, compared with around 25% for the top five in Europe. In 2021, amid a dynamic volume of mergers and acquisitions in Europe, domestic transactions accounted for circa 80% of completed deals from January to November; symmetrically, the share of cross-border deals remains almost negligible. Meanwhile the largest investment bank from euro area ranks only ninth worldwide, far behind the top five ones – which are all American. More worrying still, EU banks are losing ground on their own soil: the market share of the six major US investment banks in Europe increased from 44% to 58% between 2013 and 2020.

This question of size reaches far beyond the question of G-SIBs indicators and methodology, which should of course duly take into account the achievements of the Banking Union so far. More than anything else, our banks need economies of scale to have the means to invest properly – including in their digital transformation. Digital is mainly about IT investment, hence fixed costs, hence size. It is high time to start thinking European, instead of national. Let us not fool ourselves: preventing our banks from growing will only make them less profitable and easier prey. We have to avoid a scenario where European G-SIBs would disappear or remain too few, because then we would have partly surrendered our strategic autonomy.

Regarding the method, we obviously need to switch from a disappointing sequential approach to a more agile process. Raymond Chandler, author of The Big Sleep, once said: "There is no trap so deadly as the trap you set for yourself." I therefore very much welcome Eurogroup President Paschal Donohoe's recent statements. Without prejudging future proposals and discussions, I will briefly lay out what a realistic and pragmatic approach might look like.

In my view, we have to renounce a fully-fledged EDIS as a prerequisite – which is the main deadlock – and opt for an alternative set-up where national guarantee schemes would bring one another liquidity support, and where subsidiaries across the EU could be affiliated to the home deposit guarantee scheme. Other pragmatic steps are possible in a parallel approach. Resolution tools could be used for small and medium banks too, without increasing the size of the Single Resolution Fund. We could significantly improve the coordination between Supervision and Resolution, and better incorporate the cross-border dimension in our requirements for MREL (which are still significantly higher than the TLAC international rule). Having found workable solutions for worst-case scenarios, we will be able to focus on further moving beyond home/host issues in normal times. Banks should be able to make broader use of cross-border liquidity waivers, as currently allowed by the regulation. New waivers for capital requirements should be envisaged as well.

On the prudential topic, I take the opportunity to underline that the Commission's draft transposition of Basel 3 fully takes into account the specificities of European banks and provides sufficient time to adapt to the new features of the supervisory framework. The proposed exemptions will help maintain financing capacities but they have to remain temporary; otherwise, our international credibility and Basel 3 compliance would be harmed. Let me stress it for French and European bankers who are gathered here: accepting good compromises is often a sign of intelligence; maintaining for ever excessive demands is not, and can be a road to failure.

III. Maintaining the momentum to implement the Capital Markets Union

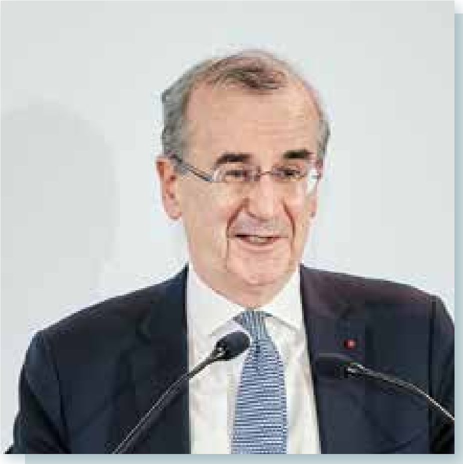
Let me now turn to CMU, which is the natural complement to the Banking Union. Capital markets and banks together provide diversified sources of financing, offering both safety and flexibility to economic agents. From a central bank point of view, a deeper and more integrated financial system is desirable to improve the transmission of our single monetary policy to all parts of the euro area and help absorb asymmetric shocks. In the United States around 60% of the impact of state-level shocks is alleviated through private capital flows, against a poor 20% in the euro area where, financial flows even tend to worsen imbalances and fragmentation in times of crisis.

We need to reverse this trend, and in particular to foster equity financing which is the most appropriate tool for innovative projects. Insofar as innovation will be the key factor of success in the two major transformations ahead of us – digital and ecological –, we ought to pay special attention to the take-off of venture capital in the EU, which is still fivefold less developed than in North America. The EU has the world's greatest pool of savings at its disposal: the surplus of domestic savings over investment structurally exceeds EUR 300 billion. We must channel it towards productive investments and innovative projects.

In view of these high stakes, the Eurosystem warmly welcomed the launch of a new CMU action plan by the Commission in September 2020. Its sixteen legislative and non-legislative initiatives will help turn Europe into a genuine single financing market. The main issue now is to ensure the concrete implementation of the CMU. We still need to better prioritise our actions ex ante, and monitor them ex post. The CMU will not be implemented overnight and remains a long-term project. Developing a monitoring framework with selected priorities and indicators is therefore warranted, especially as the CMU enters an important legislative phase in 2022.

As part of the CMU, we have another major financial stability issue to tackle over the next few years: European banks' overreliance on third-country CCPs for the clearing of financial derivatives. Around 80% of interest rate swaps denominated in euro are still cleared in the UK; this situation cannot continue forever. For fear of market disruption, the Commission recently decided to extend equivalence for UK CCPs until end June 2025. However, Commissioner Mairead McGuinness made it crystal-clear that this extension was the last one, and that the three next years were to be used specifically for a rebalancing of clearing to the EU. I could not agree more. The public consultation launched by the Commission is a unique opportunity to put forward constructive proposals, on both sides of the coin: on the demand side, through well-calibrated prudential incentives for market participants; and on the supply side, notably with the extension of the scope of clearing, for products and entities. We have a collective responsibility to reduce systemic risk and we have to act now.

As a conclusion, let me take a take inspiration from the recent Adam Mc Kay and Leonardo di Caprio movie "Don't look up" to provide a broader perspective. We may be coming out of a storm called Covid, which has heavily disturbed our traditional landmarks and consumed a lot of our energy. We may be facing another crisis in geopolitics. But we must not forget to "look up" at the stars to see where we are in our journey and to remember where we are going... The two "great transformations" ahead of us require a Financing Union in Europe. The time to act is now. I thank you for your attention.



François Villeroy de Galhau

Governor, Banque de France

Speech at Eurofi Gala Dinner

David Wright

Ladies and gentlemen, some silence would be most welcome. Eurofi is as noisy and as active as it always was, which is much appreciated. First of all, let me thank, as Didier has, all our members and all our guests. We are honoured that you are with us.

I have the honour to introduce our speaker this evening, who is the Governor of the Banque de France, François Villeroy de Galhau. He has been the Governor of the Banque de France since November 2015. He has had a very distinguished career, ladies and gentlemen, through many of the offices of state in France, including working in the private sector before becoming the Governor of the Banque de France.

He has been a great supporter of Eurofi ever since he has been the Governor. He has always come to our meetings and always been, if I may say so, among those who have left us with some really interesting thoughts. François today, which of course is a very black day for Europe, we need L'espérance d'un européen. The reason I say that is that actually that is the title of a book that the Governor wrote in 2014. So nobody is more apt, I think, on this evening to talk to us than François Villeroy de Galhau. François, the floor is yours.

François Villeroy de Galhau

Thank you, David. *Bonsoir à vous tous*, *chers amis*, dear friends, *liebe Freunde*, *cari amici.* It is my pleasure to be the guest speaker of Eurofi tonight in Paris.

It is a somewhat unexpected pleasure, to be fair, because Didier told me yesterday afternoon that Bruno Le Maire, Minister Le Maire, could not come. I convey his regret, and we can understand that his political agenda has been a bit disturbed, to use a euphemism, in recent days. I had to prepare myself with short notice, and Didier gave me two tips. First, be short, and I will be. Second: start with an opening joke. Well, this was yesterday, and today is not a day for jokes, after what has happened all day long in Ukraine. I would like to express – probably on behalf of all of you and on behalf of public authorities, my colleagues, ministers, and central bank governors who are here – our total solidarity with this country that has been invaded, with this people, the Ukrainians who are so dear to us and are so close to us Europeans.

Allow me a personal confidence. I think tonight of Pierre Bérégovoy, former French Finance Minister and Prime Minister in the 1990s – probably some of you have known him. I was with him as a young advisor in Maastricht 30 years ago, and this decisive European minister was proud of his strong personal Ukrainian roots.

You can be certain that we, as public authorities, finance ministers and central bankers, are completely dedicated to doing our duty on the economic and financial front in this grave crisis; our duty to be vigilant on sanctions against Russia as well as on threats on our economies; our duty to take decisions quickly and forcefully; and then our duty to implement these decisions with perseverance and coherence. For its part, our governing council will evaluate and decide on the most appropriate monetary measures at its next meeting on 9 and 10 March.

Let me add one word. Europe and the Atlantic alliance have thus far demonstrated a great strength: their unity. To be able to decide together and quickly thanks to the European Central Bank (ECB), the Single Supervisory Mechanism (SSM), and the European Commission, is a decisive advantage. It must be a lesson for all of us tonight. We must also show this unity in implementation between public authorities and – yes – private financial institutions. We should not be wrong. This crisis may last and it will have implications for and affect each of your institutions, of your businesses. We will be all the more effective in limiting the economic and financial price if we are all aligned with the superior efficiency of market economies.

As we will face this new and heavy crisis, let me give some light, because it has been a very dark day, and express two reasons for hope and then add one word beyond the crisis. The first reason for hope is an anniversary. Probably most of you know the most French book by Alexandre Dumas, *Les Trois Mousquetaires*, *The Three Musketeers*. Tome number two is *Vingt Ans Après*, *Twenty Years Later*. This anniversary, 20 years later, is the one of the euro. We can be proud of its success. We should not forget it, and many people did not expect it, to say the least. I will quote a longstanding Conservative Member of the British Parliament who said as early as 1997 about the euro that we are 'heading for disaster'. He is a recidivist, because he repeated in 2011, so 11 years ago: 'The euro simply cannot work.' Well, here we are, 20 years later, and the euro is still alive and kicking.

If I had to sum up this success, I would share with you three simple figures. The first one is 21. We were 11 at the start of the euro. We are 19 today. No member left in the meantime, and we will be 21 after the entry of Croatia and Bulgaria – I say it for my Croatian colleague, Boris, who is here tonight. Can I stress that among the 10 new members there are the three Baltic states, of which we think with special friendship tonight?

The second figure is 1.7%. It is the average inflation over the last 20 years. Obviously, we have an inflationary challenge today, I will come back to it. But 1.7% must be compared with 4.9%: this was the average inflation in the countries of the euro area in the 20 years prior to the euro.

The last figure is perhaps the least well-known, but for me it is probably the most important: 79%. This is the support of public opinion of European citizens for the euro in the last Eurobarometer – even 82% in Germany. It was 68% on average in Europe at the start of the euro. It has been sometimes criticised as a project of the elites; it is however a popular success.

My second reason for hope, while we face this crisis today, is the successful management of the COVID crisis in the last two years. It was a huge shock, the heaviest one we had since last world war: -5.9% of GDP into the European Union in 2020; more than -6% in the euro area. The policy response, at the height of this economic shock, was strong; it was quick; it was efficient. Thanks to that we had a recovery of 5.2% last year and we returned to the pre-crisis level at the end of last year. It is a few months later than the US, but six months earlier than expected a year ago.

Then we have the issue of inflation. It is much higher in the US and you are all aware of the figures: 7.5% in the US in January, 5.1% in the euro area. If I look at core inflation, without energy and food, the gap is still more significant: 6% in the US, 2.3% in Europe. We will have probably the same level of growth as the US this year, depending on the uncertainties of the Ukrainian crisis, and the inflationary excess is much more limited in Europe.

As I quoted these figures, I cannot resist the temptation to give you the two figures for France, because you happen to be in this country, which is delighted to welcome you. France had 7% growth last year, much higher than the European average of 5%, and 3.3% inflation today, much lower than the euro average; it remains nonetheless a challenge. The path of inflation obviously holds for common vigilance, even in Europe. I want to be extremely clear tonight: rest assured that the ECB will do what is necessary to bring inflation back, firmly and durably, to around 2% within our projection horizon. We have a duty to do it, we have the capacity to do it, and have no doubt we shall do it.

One word beyond the crisis, on the French presidency. Our Europe will have to deal in the next decade with two great transformations: climate transition and digital revolution, which are reflected accordingly in the priorities of the French presidency in the economic and financial services domain. On climate transition, as you probably know, the Banque de France is a leader in greening the financial system, with the Network for Greening the Financial System (NGFS), which we created in Paris. The French Presidency has the ambition to deliver on two key texts: adoption of the Corporate Sustainability Reporting Directive (CSRD) to increase transparency on environmental, social, and governance (ESG) factors – we all know we need this transparency; second, adoption of the European green bond standard, in order to have fewer labels and less suspicion of greenwashing.

For the digital revolution, we have two ambitions on text, and we are almost there. We need a regulation on Markets in Crypto Assets (MICA), probably still more with the Ukrainian and Russian crisis, and the Digital Operational Resilience Act (DORA).

To fund these two great transformations, digital and ecological, we need – and we discussed it at length at Eurofi in these last two days – a financing union. We need the resources brought by banking union and capital market union. Let us accelerate.

Let me conclude with the imperative I started with for our Europe: unity. Can I quote the American who has been the most popular in Paris, at the end of the 18th century? During the American War of Independence, Benjamin Franklin said: 'We must, indeed, all hang together or, most assuredly, we shall all hang separately.'

I definitely prefer hanging together. Thank you for your attention.

Valdis Dombrovskis

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

Speech

Ladies and gentlemen

Thank you to Eurofi for inviting me to this flagship conference.

It is an extremely worrying time.

Europe is facing an unprecedented act of aggression by Russia targeted against a sovereign and independent country.

We condemn this invasion in the strongest possible terms.

This is about the sovereignty of Ukraine, a democratic country that is free to choose its destiny.

It is about the entire security architecture of Europe.

We are taking immediate action against this gross violation of international law.

President von der Leyen will present a new set of sanctions which EU leaders will discuss now in Brussels. This is going to be a massive and severe counter-reaction to this Russian aggression.

And this is just one rapid step which we are taking.

Given the sheer scale of Russian aggression, we will need to do even more. We will need to go even further and take further action to counter this aggression and to support Ukraine.

Nothing should be off limits. This is a watershed moment. This is a moment of truth.

Either we come up with a strong and united response – and do it now.

Or we risk moving from a world of the rule of law to a world where the only rule is 'might is right'.

Russia poses a real threat to the free world.

We should not be naive about this.

We should rethink our relations with Russia across the board.

With this aggression, Russia is turning itself into a pariah state.

All of you here this evening representing the financial sector also have a share and responsibility. As you know, the sanctions we are imposing against Russia also cover the financial sector.

Your companies and sector are critical in this as well.

The EU continues to stand, without hesitation, by Ukraine.

We will need to do all we can to support Ukraine and provide all possible aid - political, financial and humanitarian. This is not a competence of the EU - but also military.

Ukraine's needs will be overwhelming. So this EU support will have to be massive.

As you know, the EU recently announced €1.2 billion in emergency macro-financial assistance to Ukraine. And we are now moving fast to disburse the first tranche of €600 million.

But we are in a different world now.

To give you some figures: before Russia's military build-up on the Ukrainian border, there were estimates that the financing gap Ukraine is facing today is around €2.5 billion.

After Russia's military build-up, this financing gap was around €5 billion, because the very fact of the military build-up leads to the loss of investor confidence and complicates access to financial markets for Ukraine, puts Ukraine's currency hryvnia under pressure and depletes central bank reserves.

Right now, the financing gap is basically off scale.

We cannot estimate it now because events are unfolding.

But it is clear that also in our response we will need to think outside of our current framework. There will have to be much larger scale support which we need to provide.

Moving to the part of my speech which I was intending to deliver before these last events:

At this stage, it is difficult to calculate the impact on the EU's economy.

Russia's invasion has jolted financial markets and heightened uncertainty at a time when the EU economy already faces several risks such as rising energy prices and inflation.

This crisis shows the importance of Europe remaining united, strong and resilient.

And sticking to our policies: because they are working.

Despite everything, our economic fundamentals are solid. The EU economy has regained all the ground lost during the crisis. Unemployment is at a record low.

In itself, this is a major

achievement – and it is largely thanks to successful vaccinations and our coordinated economic policy response. The European Commission's winter forecast projects a rise of 4% in GDP this year following a significant 5.3% rebound in 2021.

However, there are still many risks and Russia's unjustified invasion of Ukraine strongly increases those risks. So this is something we need to monitor very closely.

Our strong fundamentals will be boosted further as countries start to put their Recovery and Resilience Plans into full effect.

It is important to maintain the close economic policy coordination that helped us to go through the worst of the crisis.

The EU will only be able to achieve its ambitions within the green and digital transitions by coordinating across the board: with national and EU authorities, Member States and - most importantly - with the private sector.

All our policies and instruments should work together coherently.

Let me just name a few elements, which you will also discuss in the next sessions.

First, we need to make good use of existing EU instruments.

Here, the Recovery and Resilience Facility can play an important role, along with other EU funding: from the Multiannual Financial Framework, InvestEU or European Investment Bank instruments.

The RRF presents a unique opportunity to encourage both public and private investment. Public funds combined with reforms can be instrumental for unlocking future-oriented private investment.

The investments and reforms identified in each national recovery plan will improve the business environment, reduce regulatory barriers and administrative burdens for businesses.

By financing additional high-quality investment on top of national investment, it will help to raise Europe's growth potential and support fiscal sustainability.

It gives a clear sign that we want to make our economies fit for the future. Large amounts of RRF loans are still available, giving the option of more support to Member States which wish to use them.

Then there is the role of fiscal policy, which should stay moderately supportive in 2022.

As you know, we expect the general escape clause of the Stability and Growth Pact to be deactivated in 2023.

All Member States need to re-evaluate their economic and budgetary strategies for the post-pandemic crisis era.

There is a broad agreement that a key objective of coordinated EU fiscal policy is to preserve fiscal sustainability.

This means reducing debt and rebuilding fiscal buffers. Both will determine how well we can respond to future economic shocks. This applies particularly to Member States with high debt levels.

But it also matters exactly how this debt reduction is carried out.

Given the green and digital transitions and the need to boost the EU's growth potential, the relevance of reforms and high-quality investment has become even more apparent.

We need both elements - to reduce debt and to invest - at the same time, if we are to enjoy a lasting recovery based on sustainable growth.

This underlines the importance of improving the composition and quality of public finances, once again, especially for high-debt Member States.

We should also remember that for whatever purpose any additional expenditure is used, the related debt will eventually have to be repaid.

We will shortly provide Member States with guidance on fiscal policy for 2023.

It will reflect the global economic situation, the specific economic and budgetary situation in each country and our broader discussion on reviewing the EU's economic and fiscal governance.

This brings me to the future of the EU fiscal rules. As you know, discussions on the economic governance review are ongoing. The primary objective remains to preserve fiscal sustainability.

There are two main elements that we need to combine, as I said: credible reduction of debt and high-quality investment. We do not envisage changing the 3% and 60% reference values of the Treaty. The main question is how fast debt should be reduced.

The EU fiscal rules should support this process without falling into the trap of becoming too complex – and without creating exemptions that make the whole set-up ineffective.

We will be looking at the so-called 1/20th rule and see how we can ensure more credible yet more gradual and realistic debt reduction pathways.

I know this it is a difficult balance to strike. But I am confident that we will be able to come up with a good way forward.

Ladies and gentlemen

We should obviously look beyond the public sector to meet our investment needs. It will clearly be the private sector and private investments that drive the adjustments and transformation.

This brings me to the last element: the importance of having a resilient financial system.

The reforms that we have put in place in the past few years can help the EU financial sector to withstand the kind of market turbulence that we are seeing now.

The right conditions must be in place to generate the financing that Europe needs for the future, so that we can:

- advance towards a sustainable recovery;
- meet the goals of the green and digital transitions;
- build strong job-rich economies;
- keep EU companies globally competitive.

Here, I am referring in particular

to our overarching goal to promote the openness, strength and resilience of Europe's economic and financial system.

This is about remaining open for global cooperation, business and trade, while defending our interests, rights and values.

The Capital Markets Union and Banking Union are at the heart of this strategy.

Europe needs a strong, versatile and integrated financial sector.

We needed it before the pandemic struck. We need it even more now for the recovery - so that the private sector can access the funding needed to invest in the green and digital transitions as major sources for potential growth.

Deep, integrated and well-functioning capital markets will help us to build strong job-rich economies, fund technological innovation and keep EU companies globally competitive.

And of course, we need them to deepen and diversify sources of funding - for companies of all sizes.

Banks remain the main funding source for EU economies. They have to be able to provide credit anywhere in the EU to households and businesses, including SMEs.

An integrated and completed Banking Union would also increase the ability of the private sector to absorb shocks.

It would allow banks to diversify their exposures to different regions, sectors and sovereigns.

We should make more progress on both projects. This will allow us to create synergies between private and public investments.

Ladies and gentlemen: I will conclude here – and wish you a successful remainder of your conference. Thank you

Paolo Gentiloni

Commissioner for Economy, European Commission

Speech

It is a really extraordinary and sad day. This morning, we all awoke to news that turned our blood cold. We have seen scenes that we believed and hoped would remain in history books: air-raid sirens wailing in the capital of a European democracy, tanks crashing across the borders of a neighbouring country, missiles shattering apartment blocks and civilians lying dead in the streets of European cities. Even if the warning signs have been all too evident, this is still profoundly shocking and profoundly wrong.

Our message to President Putin in response to this outrage is unequivocal: you will not succeed. The rule of force will not prevail on the rule of law. You will not divide us. We stand united with the people of Ukraine and, as President Von der Leyen announced earlier today, the Commission is putting on the table for discussion at the European Council meeting in two or three hours from now in Brussels a new package of massive and targeted sanctions that will limit Russia's access to capital markets and to technologies crucial for the Russian economy. It is clear that these events will now dominate the ECOFIN meeting tomorrow too. Our discussions will not take place in a normal environment. The environment will be clouded by incredible uncertainty.

Nonetheless, let me turn to the subject of the big issues that we have to confront in our economies, despite this new, enormous, geopolitical uncertainty – les grands enjeux, if you will, that we have ahead of us. I think we have three main challenges: first, delivering on the green and digital transition; second, enhancing Europe's resilience in the face of geopolitical and strategic challenges; and third, ensuring our labour markets and skills are fit for purpose. These challenges will compel entire sectors to undergo major transformations. They will require us rethinking our supply chains and will demand new skills as well as reallocation of the labour force. It will not be easy and it will not be cheap to address these challenges.

The additional investment needs to achieve the twin transition, for example, are, in our estimates, around €650 billion per year from now until 2030 – almost 5% of EU gross domestic product (GDP). Boosting our capacity in strategic sectors like batteries, semiconductors and cloud technology will require hundreds of billions of euros in investment by the end of the decade. Making sure that no workers are left behind and that everyone can thrive in this new landscape will call for increasing spending in education, upskilling and reskilling. It is daunting, no doubt, but necessary to make our economies more sustainable, more competitive and more resilient – in other words, necessary if we are still convinced we should build back better.

It is in this context that, in my opinion, we should look at reviewing our economic governance in the Union. The experience of the past decade has exposed the limits of our common framework. In the wake of the last crisis, public investments in Europe bore the brunt of budget cuts and fell to zero in net terms. Too quick fiscal consolidation stopped the recovery in its tracks and opened a period of low-for-long growth. Our framework also failed to encourage governments to build fiscal buffers in good times, nor did it succeed in stimulating demand in those countries that had the fiscal space to invest.

In spite of significant efforts and in spite of respecting the deficit limit of 3% of GDP, public debt ratios did not decline sufficiently, as prescribed by the Stability and Growth Pact (SGP), and so this increased the divergences between debt levels in the EU, even before the pandemic hit our economies. Finally, our fiscal rules became much too complex. I am always fascinated by the definition given by one of the most senior officials in the Commission working with these rules, who compared them to the Sagrada Familia.

The challenges we face have only made the need to discuss our economic governance more pressing and acute. The first challenge concerns the vastly increased investment needs that I already mentioned. Of course, the Recovery and Resilience Facility will be a big help, but it will not be enough, and we must bear in mind that this instrument has a limited lifespan of up to 2026 for its conclusion, which is tomorrow. Nationally funded investments will, therefore, continue to play a key role.

The second challenge concerns the pandemic's legacy of much higher debt levels. Let me be clear: in my view, it should also be a priority to have a clear path to lower debt levels, not least for highly indebted member states. Sound public finances are essential. Continued fiscal adjustment over several years, combined with investments and reforms, is needed to sustain growth in high debt member states. The rebuilding of fiscal buffers needs to be gradual. Too abrupt a consolidation would undermine the recovery, with negative effects on potential growth and market sentiment and, ultimately, on debt sustainability. This message is, of course, all the more important given today's developments, despite the fact that we still do not know how these developments will influence the macroeconomic picture.

When looking to the ongoing review of our rules, I am confident that reconciling the investment challenge with the debt challenge is possible, if we design a true Stability and Growth Pact, not a stability or growth pact. This means upgrading our framework to encourage growth-enhancing investments. It means revising our rules to make sure we bring down high debt levels in a gradual and realistic way. There is no other way to bring down high-level debt, as, unfortunately, the years behind us show. Stability without growth is illusory. Growth without stability is unsustainable.

Two weeks ago, we celebrated 30 years since the signing of the Maastricht Treaty, and this summer will mark 25 years since the birth of the Stability and Growth Pact. Our fiscal rules are a reflection of the economic and political circumstances of their time. It is only natural that they should evolve and be adjusted to today's very different circumstances and the new challenges we are facing. That is what led the Commission, last autumn, to reopen the review of our economic governance. I am encouraged by the constructive spirit in which this debate is taking place, of course with all the unknowns that the new situation is bringing. Next week, we plan to publish a communication that provides guidance for fiscal policy in 2023, which will need to take into account this increased uncertainty. Before the summer, we will set out our proposals on the review of the rules.

Ladies and gentlemen, the pandemic was a reminder that we are all in the same boat. Europe's response to the unprecedented recession of 2020 was successful, and I think we should be proud of that. Everyone – national governments, EU institutions, finance ministers and central bankers – rowed in the same direction. Looking ahead, I am convinced that we can achieve our ambition for strong, sustainable and inclusive growth in Europe, provided we continue with this spirit and provided all our policies and tools are geared towards this goal. This must include our Stability and Growth Pact. We cannot tackle the challenges of tomorrow with the tools of yesterday. We have to show that we are able to move beyond the old divides and write this new chapter together, so let us show the world that, here too, Europe stands united. Thank you.

Roberto Viola

Director General, DG for Communications Networks, Content and Technology, European Commission

Speech

Ladies and gentlemen, good afternoon. It really is a strange feeling to be at a physical conference again. You are not on screen – you are real. I am no longer used to this, I must confess.

Many thanks for inviting me. I thought that I could bring something special to this first new physical meeting. I remember that, last year, it was an online conference. Today, we approved the proposal of the new regulation which is called the Data Act. The aim of the Data Act is, basically, to regulate, in terms of framework, whatever has to do with data and transactions.

Let me give an example. If you buy a car these days, the question is whether you are buying the data that comes with the car – yes or no? Are you the owner of the data? Can you decide where the car can be repaired – yes or no? Do you own the utilisation data of the car? Those are the questions that the Data Act tries to answer: the question of balancing the rights of the producer and the rights of the users – the rights of the user to repair. For instance, take an industrial robot. Of course, the user of an industrial robot is very interested in the usage data. Since everything is connected, it is very important that we establish clear rights and obligations of the two parties.

The Data Act also covers the relationship between large and small companies when it comes to data contracts: what the obligations are and what the right balance is. It also covers something very important for the financial sector, which is cloud and IT-system portability. We have done work in terms of self-regulatory codes around porting in the cloud environment in the past. Now, with the Data Act, this becomes an obligation. We have seen it in the telecom sector in terms of what the obligation to port your number meant. That immediately sparked competition in the mobile sector.

The reason why we have a very vibrant mobile sector in Europe is that you can change very quickly, and the companies are very well aware, which is why they offer big incentives for you to stay. We want the cloud sector to be like this. I heard many of you coming to my office and complaining about lock-in of cloud vendors and IT systems, so it now becomes a right to move from one cloud provider to another. Special arrangements for data in the financial sector will stay. This new Data Act will not rewrite the second Payment Services Directive (PSD2) regulation, but, in future, these special rules for the financial sector will have to be aligned with the general provisions of the Data Act.

There is one very important element that should be of interest to you, which is that, for the first time ever in European law, we introduced and legalised smart contracts. This is the first legislation in the world that looks at smart contracts. First of all, it says it is absolutely legally okay to have a smart contract, and then introduces four or five essential characteristics in terms of usage and control of a smart contract, which, we hope, will now accelerate the possibility of using smart contracts as a way of having innovative payment systems – what we call the Internet of Payments – and a new web of cooperation between financial and industrial actors in many different sectors.

In this respect, we have another important element of our strategy, which is to make sure that we guarantee a level playing field when it comes to the Internet economy. We have actors that are very successful, and there is no problem in being successful in a liberal society, but success and size come with responsibility. In the platform economy, we call these successful companies gatekeeper companies.

If a company operating in the financial sector needs the activation of the radio function – what is called the near-field communication (NFC) – this cannot be at the will of the gatekeeper company. This must be available to everyone, and that is the Digital Markets Act. We have proposed that the basic features of a gatekeeping platform are open to whoever wants to access them on a level playing field. We hope that the final agreement on the Digital Market Act looking at how companies access platforms, and the Digital Services Act looking at how services are offered, will come under the French presidency in two or three months from now. This will then become European law, which means that we hope that we will realise a level playing field when it comes to accessing very large platforms from the perspective of third-party companies like financial actors, no matter whether they are big or small.

I will finish by looking at something that is our responsibility, which is cybersecurity. We are in times where we have to be very attentive to the dimension of cybersecurity, which is becoming an element of global security in terms of having secure IT systems, and also of strategic importance. It is also very important for corporations. It is a C-level responsibility. That is what we say in the new Network and Information Security (NIS2) Directive, and that is also what the twin directive for the financial sector, the Digital Operational Resilience Act (DORA) says. There needs to be C-level responsibility. Systemic risk needs to be understood by top management.

As the European Commission, we are more and more at the front line of facing systemic crises – we did it during the pandemic and, unfortunately, we are in front of a new, complex crisis as we speak – and in terms of systemic issues about our economy. That is why, two weeks ago, we presented the so-called Chips Act, which is a very new way of looking at things. We said that Europe must be much more resilient when it comes to microelectronics. This is a combination of us being ready to invest to step up recession development and even to contribute to building factories in Europe, but then the private sector has to come in.

The very same day we signed an agreement with the European Investment Bank (EIB), we invited international investors to invest in Europe and in making Europe more resilient in terms of chip production. We will do the same with raw materials. Wherever we spot a systemic crisis, it is important that we are able to deploy the same collective response we applied to the pandemic. We are also looking at a number of new technologies, such as artificial intelligence, quantum technology and super-computing, which are important developments for the financial sector. You can be reassured that we will be your partners in doing our share, which is, of course, the public side of things, and make sure that we advance. Many thanks for your attention.

Klaas Knot

President, De Netherlandsche Bank

A global Europe to meet global financial stability challenges

Thank you Didier, it is great to be back. As you indicated in your kind introduction, this time I am speaking here in my capacity as Chair of the Financial Stability Board, although with a nod to my other hat, as President of De Nederlandsche Bank. But whether you stand on top of the BIS tower in Basel – where the FSB is housed -, the Eurotower in Frankfurt, or the Toorop building in Amsterdam, the view is not fundamentally different. In fact, many financial stability risks we face today are not only common across Europe, but are global in nature. And these global issues require global cooperation, which is why they are at the top of the FSB's agenda.

Today I want to talk about these global issues, what the FSB is doing, and how Europe can play its part. I will be discussing these issues against the backdrop triggered by the Russian invasion of Ukraine. Developments keep evolving as I am speaking, and I do not want to engage in any speculation about what might happen. But we need to be alert that the dramatic shift in the geopolitical landscape may also affect the functioning and resilience of the global financial system.

One of the first priorities for policy makers worldwide is to navigate their economies out of the Covid pandemic. The economic fall-out of the pandemic seems to be subsiding, and the extraordinary fiscal and monetary support measures that kept economies afloat are being gradually unwound. But, as the economic recovery is proceeding at an uneven pace across regions, this unwinding process is increasingly likely to be asynchronous. This creates the potential for cross-border spillovers. Moreover, since the onset of the pandemic, both public and private sector debt have increased, while asset valuations have grown amid a continued search for yield. This has made the global financial system more vulnerable to a disorderly tightening of financial conditions. A concern that has been accentuated lately by the return of high inflation. The job of the FSB here is to monitor and analyze developments closely and facilitate global coordination of policies, where necessary, to minimize the risk of a disorderly exit.

At the same time as we need to chart a course out of the pandemic, we need to strengthen resilience in the non-bank financial intermediation, or NBFI, sector. A sector that now represents almost half of global financial assets and is evolving rapidly. Enhancing NBFI resilience offers significant benefits, not least during the transition to a post-Covid world. First and foremost, it will contribute to a more stable provision of financing to the economy. Second, it will enhance the ability of the financial system to absorb different types of shocks. And a resilient NBFI sector reduces the need for the types of extraordinary central bank interventions we witnessed in March 2020. The FSB is therefore working on vulnerabilities in specific NBFI areas. This includes money market funds, where we have developed policy proposals to enhance their resilience. And it includes open-ended funds, where we are working with IOSCO to assess whether recommendations to address structural vulnerabilities are effective. We will use the insights to develop a systemic approach to NBFI risks and policies to address them.

We also need to remain vigilant to new threats to the financial system, particularly those that will have a transformational impact on our economies such as digitalization and climate change.

Digital innovation offers opportunities for more efficient and inclusive finance, for example in global payments, but it also creates potential new risks. In particular, markets for crypto-assets are fast evolving and could reach a point where they represent a threat to global financial stability. It is critical that we address risks in crypto-asset markets holistically and avoid fragmented policy approaches that could give rise to regulatory gaps and arbitrage. The FSB is stepping up to the plate to deliver effective and risk-based regulatory approaches for all types of crypto-assets. We are doing so in close cooperation with standard setting bodies and national authorities. These approaches include reviewing the High-level Recommendation for the regulation, supervision and oversight of stablecoins, undertaking further work on so-called unbacked crypto assets, and analyzing the financial stability implications of the rapidly evolving decentralized finance.

Another feature of digital innovation is the ever-greater use by financial institutions of outsourcing to third-party service providers. While this may have provided additional resilience during the pandemic, it has also reinforced the importance of effective policies for the oversight of financial institutions' reliance on critical service providers. To this can be added the greater exposure to cyber risk. Greater interconnections in the financial system increase the surface for cyber attacks, which have escalated during the Covid pandemic. Enhancing operational and cyber resilience will therefore remain an important item on the FSB agenda.

Next to digitalization, we face the ever-present challenge to address risks to financial stability from climate change. These risks reflect the particular nature of climate change: it is global in its causes and its implications, and it is pervasive, affecting all kinds of financial assets and contracts. If we want to safeguard financial stability and ensure the financing needed for the transition to net zero, it is key that climate related financial risks are adequately priced in financial contracts. This is crucial because financial contracts price the future, and that future is about to undergo fundamental change. The FSB's roadmap for addressing climate-related financial risks aims to ensure that climate risks are properly reflected in all financial decisions. It covers disclosures, data, vulnerability analysis, and regulatory and supervisory approaches. Because there are no international standards in place yet, not least relating to disclosures, we have an enormous opportunity to get this right from the start. We should not miss it.

It is important to act early to address these big transformational issues in the global financial

system. Experience has taught us that global financial stability risks, like so many other global issues, are often best dealt with using a globally consistent approach. Not because one size fits all, but because this makes national policies more effective, provided that the global approach leaves room to be tailored to country-specific circumstances when it comes to implementation.

Because of their history, to us Europeans, this is second nature. From the Treaty of Rome to the Treaty of Maastricht, now 30 years ago, the process of European integration has always been about Europeans working together to pursue common interests. That's why we have always been a strong partner in fostering international cooperation and high-quality minimum standards. Indeed, European countries have been key contributors to the international financial architecture. From the Bretton Woods Agreement back in 1944 to the establishment of the Financial Stability Board in 2009.

When it comes to financial stability, the EU itself, but also other countries in Europe, has benefitted greatly from its commitment to multilateralism. The centre pieces of the European financial regulatory framework as we know it today are based on the G20 reform agenda that followed the financial crisis of 2008. These reforms have served the European financial systems well during the Covid pandemic. Greater resilience of major banks at the core of the financial system has allowed the system to absorb, rather than amplify, the economic shock. And in turn, this helped European economies weather the storm.

As we have seen, today Europe and the world need each other more than ever in keeping the financial system stable and safe. Focusing on the EU, how can it contribute to making this global agenda a success?

First of all, the EU can play an active role in implementing the lessons learnt 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. Also, any exit strategy will have to bear in mind the risk of spillovers to other countries from uncoordinated actions.

Next, the EU should aim to lead by example by implementing reforms in a comprehensive and consistent manner. In particular, the EU could make further progress in implementing the Basel III standards in accordance with the internationally agreed framework.

In addition, policy makers need to strengthen the regulation of non-bank financial intermediation. For an internationally consistent approach, it is important that the FSB's recommendations on money market fund reforms are taken on board in the upcoming review of the EU's Money Market Funds Regulation.

Moreover, the Covid pandemic has once again highlighted the unfinished agenda of increasing the growth potential across Europe, completing the European banking union and the need to break the interconnectedness between governments, the domestic banking sector and non-financial corporates. Additional measures are needed to develop the European Capital Markets Union and facilitate private risk-sharing.

Finally, the EU can play a leading role in supporting the transformation of the financial system. With the Sustainable Finance Strategy, Europe is leading the way, for example with the development of a green taxonomy and incorporating climate risks into prudential regulation and stress testing.

When it comes to meeting the challenges of rapid digitalization, the EU is making important progress on regulating crypto-asset markets, and creating financial oversight of critical third-party service providers. Europe's hands-on experiences with these initiatives can provide valuable input for the global discussions.

The financial system has proven more resilient in light of the pandemic. This has illustrated the benefits of our collective, global reform efforts. The FSB has set out an ambitious work program to deal with the structural challenges of this age. The EU is already taking these challenges head on. This makes me optimistic. We are working towards the same objective. In the road towards that objective, we should make sure that everyone is on board. This means we need European policies that fix European problems and can serve as an example for others, but that are also compatible with a coordinated global response.

This is not only good for the world, it is also good for Europe. Because European ambitions can only succeed if they are part of a larger, global effort.

Perhaps no one understood this better than Jean Monnet, a great Frenchman and a great European of the 20th century.

Of course we all know Jean Monnet as one of the founding fathers of what would become the European Union. But what is less known is that he was also quite a global guy. Even at a young age, he had traveled the world to explore new markets for his family's cognac business. During the First World War, he worked closely with the Americans to coordinate the food supply of the allied troops in France. During the Second World War, he served in Washington as a liaison between the British and American governments on economic support to the UK. He was one of the architects of the land-lease act and of President Roosevelt's famous 'Arsenal-for-democracy' speech. Right after the war, he realized that any plans for European cooperation would only work if they were compatible with American ideas, thus securing the much-needed Marshall aid.

So Monnet's later vision of Europe was very much based on what he had learned on the world stage during the decades before.

That same spirit of Jean Monnet is needed today. The spirit of a global Europe. The spirit that brought forth not only the Treaty of Rome, and the Treaty of Maastricht, but also the Bretton Woods Agreement, and the post-crisis G20 reforms. Just as we Europeans chose to cooperate to pursue common interests, we need to cooperate at the global level too, to keep our financial systems safe and sound and fit for purpose in the 21st century.

Paschal Donohoe

Minister, Department of Finance, Ireland
& President, Eurogroup

Opening remarks

While it is my pleasure to join you here in person in Paris this evening for the first time in a number of years, today is a dark day.

We have seen the return of naked military aggression to our continent. The rule of international law has been usurped by unprovoked military actions that will bring enormous human suffering.

Our discussions today may seem irrelevant given what we are seeing in the Ukraine. But to me, they demonstrate the unity, strength, and depth that we have built across our European Union. Inside 40 years of being at war with each other, those same countries were negotiating the intricacies of a common market. Now we have moved on to an even more united front, and we are imposing the harshest package of sanctions ever implemented by the EU.

The EU stands absolutely united in protecting our common values and freedoms, and the rule of law, which have brought massive economic and social benefits to our citizens. It is fear of our values, freedoms, and strengths that has seen this unprovoked act of Russian aggression. A simple comparison of European and Russian living standards and economies over the past three decades illustrates how our unity and values have worked so well for European citizens, and how authoritarian policies lead to suffering and inequality.

Having said that, I'll now make some short remarks on the work and priorities of Eurogroup, the coordination of European economic policy and the outlook in the immediate term for progress on key priorities.

I will begin with an update on where we are with banking union, as there are few audiences as expert in European financial matters as this one – and for many years, EUROFI conferences have considered the Banking Union project and how to make progress.

An ambitious Work Plan on Banking Union is one of my priorities as President of the Eurogroup.

It is critical to our credibility, and to the credibility of the financial sector, that Europe's economic firepower on the global stage is reflected by a competitive banking sector that serves our citizens, our SMEs and our corporates, and a banking sector that can deliver on the ambitious investment needs of our twin transitions.

The Work Plan will be a political framework to deliver tangible progress and will serve the goals of depositor protection, robust crisis management, and a stable, resilient and competitive banking sector which is capable of facilitating broader economic growth.

Along with the promotion of retail investment and an open and strategic Capital Markets Union, a Banking Union will be critical to the future of our monetary union - as a shock absorber, to support the economic recovery and to drive the twin transition.

Every Finance Minister has different priorities for the Banking Union project. At the same time, after having talked to each of them over the past few weeks, I am impressed by Ministers' willingness to devote time and energy to finding agreement.

In March, we will have a debate on the Work Plan. It will cover four workstreams:

- set up a common protection for depositors,
- promote diversification of banks' sovereign exposures,
- improve the management of failing banks and
- create conditions for a Single Market of banking services.

As important as the content is the concept of sequencing – I hope to deliver a phased, gradual approach to build up trust and make sure we are delivering across all workstreams.

I envisage 3 phases:

- Immediate steps based on Commission proposals which will deliver tangible results and make sure we are prepared for possible future crises,
- Medium-term steps to introduce gradually – and in parallel in all four areas – core concepts of a complete Banking Union, and
- A longer-term view, where we will review the steps taken, make sure we are happy that they are delivering what we want. At that stage, if we agree it is needed, we could work on additional or even more ambitious measures.

This phased, gradual approach will allow us to build up trust and make sure we are delivering across all the workstreams. There could be checkpoints along the way to make sure we are delivering in parallel.

This is a delicate balancing act that is complex and politically highly sensitive.

I will rely on all EU finance ministers to assist in the development of proposals that bring us closer to consensus over the coming weeks with a view to delivering a political framework for progress in the coming months.

Moving from banking union to broader issues on economic policy, we have seen a very strong and rapid recovery across the euro area, where we saw growth of 5.3% in 2021 with unemployment at a record low of 7%.

Economic prospects for 2022 remain robust, despite the difficulties created by the pandemic and recent geopolitical developments.

Currently, there are two areas of key concern to all Finance Ministers – the need to monitor inflation across the euro area and the most recent developments in Ukraine will be front and centre in our minds.

Policy will remain agile and in fact a hallmark of economic policy during the pandemic has been the degree of coordination and consensus. We have seen budgetary and monetary policy working hand-in-hand.

Eurogroup has played a key role in this.

The supportive monetary policy decisions of the ECB 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.

At Eurogroup we will continue to have regular discussions and decisions on economic policy matters.

It is in this context, that we will debate the future of our economic governance framework over the next number of months. Eurogroup will play an active role in this process and tomorrow we will have a further round of discussions on euro area specific aspects of the framework.

As we look to the future, we will pursue a policy mix that supports the recovery, promotes investment, and safeguards debt sustainability. These objectives are mutually compatible, but we need to strike the right balance.

We also need to recognize the role that the private sector will play in driving and facilitating change – especially in terms of meeting the investment needs of the digital transition and response to climate change.

In many senses, this is why our work on banking union, economic governance and broader economic policies are all intertwined and co-dependent.

I wish you well in the rest of your deliberations, and hope to join you again soon.

Pablo Hernández de Cos

Chair of the Basel Committee on Banking Supervision
and Governor of the Bank of Spain

Old risks, new challenges, same objective: the work programme of the Basel Committee in 2022

Introduction

Good morning, and thank you for inviting me to speak at the Eurofi High-Level Seminar, in association with the French EU Council Presidency. It's a pleasure to be in Paris with you today.

This year will mark the fifteenth anniversary of the Great Financial Crisis (GFC). The GFC may seem a distant memory to some of us considering all that has occurred since then. Terms such as PCR tests and distributed ledger technology were outside the purview of most people back then. «Zoom» was rarely used as a verb to connect with others. And the world was only starting to get acquainted with quantitative easing programmes.

The global banking system has also undergone major changes since the GFC. The initial Basel III reforms have fundamentally bolstered the global regulatory framework.[1] As set out in a recent evaluation report by the Basel Committee, banks are now better capitalised and have stronger funding profiles than in 2007.[2] This enhanced resilience, coupled with the large-scale public support measures, played a key role in safeguarding banks during the Covid-19 pandemic. Unlike the GFC, banks continued to lend to households and businesses. They now have the opportunity to play an important role towards contributing to a sustainable and inclusive economic recovery.

Structural trends are also affecting and shaping the global banking system. The digitalisation of finance, growth in non-bank financial intermediation (NBFI) and climate change may all create risks to global financial stability and raise important supervisory questions. Many of these risks are cross-sectoral in nature, requiring ongoing coordination and collaboration with other international forums and global standard-setting bodies.

Yet, despite all these trends, we are also seeing the re-emergence of more «familiar» risks. Inflationary dynamics and the prospects of tighter monetary policy across several jurisdictions have gyrated financial markets. The risk of «snapback» changes in interest rates could test borrowers' debt service capacity, with private and public debt levels surging to historic highs. Risks of a house price correction have been building in recent years amid a substantial rise in housing valuations in a number of jurisdictions. While the drivers behind these developments may differ from historical events, their potential impact on the banking system – whether in the form of credit, market, interest rate or liquidity risk – is not unfamiliar.

And there is still unfinished business when it comes to implementing Basel III, including the outstanding standards aimed at reducing excessive variability in banks' risk-weighted assets (RWAs). We cannot afford to forget the lessons from the GFC.

So against this backdrop of both new and more familiar challenges and risks, what lies ahead for the Basel Committee in 2022 and the medium term? Four broad themes underline our strategic priorities, which I will briefly cover.

Covid-19 resilience and recovery

First, the Committee will continue its work related to Covid-19, with a view to ensuring that banks remain resilient and contribute to the recovery. The past few months have reminded us that the transition from pandemic to endemic is likely to be a bumpy one. Green shoots have sometimes failed to take root. The outlook continues to be marred by uncertainty and divergences across regions. Per capita incomes in 2023 will remain below their 2019 levels in nearly 40% of emerging market economies, in contrast to advanced economies.[3]

While the global banking system has largely weathered the pandemic to date, it is crucial that banks and supervisors remain alert to risks and vulnerabilities as the pandemic continues to unfold. This includes managing risks related to frothy asset valuations, embedded leverage and the trajectory of interest rates, with rising energy prices and supply disruptions continuing to drive inflation in several jurisdictions. Debt levels – encompassing both public and private debt – are at an all-time historic high of nearly $300 trillion or 350% of global GDP.[4] The unwinding of public support measures – which were critical in shielding banks from losses thus far – means that banks will have to increasingly rely on their own resources to absorb potential shocks.

In addition to risky asset prices, in many jurisdictions the combination of buoyant housing markets together with highly leveraged households and real estate developers is increasing banks' vulnerabilities. The risks of a sharp house price correction triggered by changes in interest rates or financial costs will test banks' resilience in the event of a debt overhang and economic slowdown.

Indeed, an increasing number of jurisdictions are deploying macroprudential measures – such as activating or increasing the Basel III countercyclical capital buffer – in response to elevated risks. Such measures seek to ensure that banking systems are able to absorb shocks and maintain the provision of key banking services in both good and bad times. Vigilance should continue to be the watchword.

We must also learn from the experience of the past few years to help guide future areas of work. The Committee is evaluating whether the implemented Basel III reforms 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. This is an important message and a further reminder that a prudent regulatory framework underpinned by well-capitalised banks is key to securing financial stability.

We have also identified some areas in the Basel Framework – including the usability of capital and liquidity buffers and potential procyclical dynamics in the risk-weighted framework – that we will continue to evaluate this year. And we are also conducting a more comprehensive evaluation of the implemented Basel III standards drawing on the evidence from the past decade. As ever, this work will be guided by rigorous empirical evidence and analyses.

Horizon scanning of emerging risks and structural trends

The second area of focus for the Committee is our continuous and proactive horizon scanning of 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.[5] Building on our report from a few years ago on the implications of fintech for supervisors and banks, we are conducting a set of deep-dive thematic analyses to gauge the impact of these drivers on banks and their strategic responses.[6] We will then consider whether any additional global supervisory or policy measures are necessary.

A related area of focus for the Committee relates to cryptoassets, a market that reached almost $3 trillion in market valuation last year, compared to roughly $20 billion just five years ago. While banks' exposures to cryptoassets are relatively low at this stage, the potential for this market to scale up rapidly and the wide range of potential direct and indirect channels of bank exposures raise financial stability concerns. The dynamic nature of cryptoasset markets necessitates a proactive and forward-looking regulatory response. To that end, 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, where we plan to consult again in mid–2022, following our initial consultation last year.[7]

The Committee will continue to work on mitigating climate-related financial risks. Financial risks from climate change are global in nature and therefore necessitate a cross-border response. A recent study estimates that G20 financial institutions have nearly $22 trillion of exposures to carbon-intensive sectors, of which on-balance sheet bank loans account for 60% of such exposures.[8] It is therefore crucial to ensure that climate-related financial risks are adequately captured in banks' risk management practices, disclosures, supervision and regulation. Given the scale, scope and time horizon of these risks, the Committee is pursuing a holistic approach to ensure that banks and supervisors adequately measure, disclose and mitigate such risks.[9]

In 2022, we plan to finalise a set of global principles for the effective management and supervision of such risks, following our consultation last year.[10] 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 Framework for mitigating such risks.

Strengthening supervisory coordination and practices

The third strategic priority for the Committee is aimed at strengthening supervisory coordination and practices. This includes ongoing work aimed at safeguarding banks' operational resilience. Covid-19 has been a real-life stress test of banks' operational resilience, as it is taking place against an evolving landscape dominated by increasing cyber threats, a growing reliance on third- and fourth-party service providers and a move towards greater remote working arrangements.

As noted recently by the Committee, it is crucial that banks continue to improve their resilience to cyber security threats and incidents, including through the widespread adoption of tools, effective practices and frameworks based on widely accepted industry standards.[11] Going forward, the Committee will oversee the effective implementation of its recently finalised principles to enhance the operational resilience of banks and the revised principles for the sound management of operational risk.[12] And we plan to publish further supervisory observations related to banks' concentration risk management frameworks and reliance on third- and fourth-party service providers.

The Committee is also carefully assessing the supervisory implications of the digitalisation of finance, including with regard to the role of artificial intelligence and big data. We plan to publish initial supervisory observations in this area in the coming months.

Another striking trend over the past decade has been the growth in NBFI, which raises important supervisory questions for the Committee given the interconnectedness between banks and non-banks. Since 2015, banks' claims on NBFIs have grown by almost 70% and now comprise almost $7.5 trillion in claims and $6 trillion in liabilities.[13] Events over the past few years, including the March 2020 market turmoil and recent episodes of NBFI 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, drawing on the lessons learnt from recent events.

Basel III implementation

The last, but certainly not least, area of focus for the Committee is to promote the full, timely and consistent implementation of all aspects of the Basel III framework, including the outstanding standards. Doing so will help lock in the benefits of these standards to ensure that banks can withstand future crises.

I have previously discussed the importance of implementing Basel III in a full, timely and consistent manner in Europe, so I will limit my remarks today to the following points.[14]

First, the gravity of the regulatory fault lines that the outstanding Basel III reforms aim to address remain as important today as they were pre-pandemic. Recall how, at the height of the GFC, market participants lost faith in banks' reported capital ratios and relied on other measures of bank strength.[15] More than a decade later, concerns about the variability in banks' RWAs continue to persist. For example, a recent report by the European Banking Authority on banks' modelled capital requirements points to a «significant» level of capital dispersion «that needs to be monitored.»[16] We cannot afford to continue to let these fault lines linger, especially at a time of increasingly elevated financial risks.

Second, it is increasingly clear that the outstanding Basel III reforms will complement the previous ones in having a positive net impact on the economy. For example, a recent analysis by the ECB suggests that the GDP costs of implementing these reforms in Europe are modest and temporary, whereas their benefits will help permanently strengthen the resilience of the economy to adverse shocks.[17] It also finds that potential deviations from the globally agreed Basel III reforms – for example, with regard to the output floor – would significantly dilute the benefits to the real economy. It is therefore incorrect to assert that there is a trade-off between bank resilience and economic growth. The former is a fundamental prerequisite to achieving the latter.

Third, implementing Basel III in full and consistently is a powerful symbol of jurisdictions' ongoing commitment to multilateralism. It is in our collective interest to implement Basel III in a timely way, so that we are able to focus our attention and resources towards emerging risks and structural trends affecting the banking system. Fifteen years after the GFC, we owe it to our citizens across our jurisdictions to demonstrate that we have adequately addressed the fault lines in the banking system. In that respect, the Group of Central Bank Governors and Heads of Supervision – the Committee's oversight body – recently reaffirmed its unanimous expectation of implementing all aspects of the Basel III framework in full and consistently, and also underscored the importance of implementing these standards as soon as possible.[18] The Committee will continue to monitor the implementation of Basel III as part of its Regulatory Consistency Assessment Programme.

Conclusion

In conclusion, we find ourselves at a juncture characterised by new challenges and the re-emergence of more familiar risks. The transition from pandemic to endemic is likely to bumpy and uncertain. What is certain, however, is the Basel Committee's commitment to close and effective collaboration, driven by our mandate to strengthen the regulation, supervision and practices of banks worldwide for the purpose of enhancing financial stability.

Thank you.

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1. See Borio et al (2020) for a summary of the Basel III reforms.
2. See BCBS (2021f).
3. World Bank (2022).
4. IIF (2021).
5. See Hernández de Cos (2019).
6. See BCBS (2018).
7. See BCBS (2021e).
8. See Moody's (2021).
9. See BCBS (2021c, 2021d).
10. See BCBS (2021h).
11. See BCBS (2021g).
12. See BCBS (2021a, 2021b).
13. See FSB (2021).
14. See Hernández de Cos (2021a, 2021b and 2022).
15. Barclays Capital (2012).
16. EBA (2022).
17. Budnik et al (2021).
18. See BCBS (2022).

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--- (2021d): Climate-related financial risks – measurement methodologies, April.

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Verena Ross

Chair, European Securities and Markets Authority

The major challenges facing securities regulators

Good morning, ladies and gentlemen,

I am delighted to be here today, back again at Eurofi in person. After almost two years of virtual engagement, it is great to once again see so many faces, both new and old, here in Paris for this important event.

The pandemic posed new challenges for society. The health crisis has caused considerable suffering that will remain with us for some time. The economic crisis linked to the pandemic led to historic levels of economic contraction, both in the EU and worldwide.

The world of finance was not immune to this systemic shock, and its resilience was severely tested during that period. Thankfully, the system, and in particular market infrastructures, held firm. To me this was a confirmation of the importance of the post-financial crisis regulatory reforms. However, the events also illustrated that the resilience of some parts of the financial system needs to be further enhanced.

Alongside our regulator counterparts in banking and insurance, we as securities regulators have a fundamental role to play in ensuring the resiliency and integrity of the financial system. Securities regulators oversee the functioning of capital markets, and in a system that relies heavily on investor confidence and market integrity, we must always be on the front foot. Even if the challenges faced by capital markets are wide ranging, society relies on us as securities markets regulators and supervisors to manage and mitigate the risks that could threaten the functioning of the market.

Being on the front foot means that we must operate with foresight and tenacity, adapting to the challenges presented in an ever-changing world.

The twin transitions towards a more digital and sustainable economy are two such challenges, which I will address today.

Both digitalisation and sustainability are rapidly transforming the way in which the financial sector operates. In doing so, new and exciting opportunities for investors are arising. But as securities regulators, we must also remain conscious of the risks that investors face while navigating these new environments.

Besides digitalisation and sustainability, there is a third topic I would like to touch on today, the need to safeguard financial stability. At such a critical time for the financial services sector, and the economy as a whole, securities regulators must also remain focused on our duties to monitor, understand, and assess the risks not only to investors, but also to markets and financial stability that may lie ahead.

Protecting investors during the digital transition

Innovation drives progress, and financial markets are no exception to this. New technologies, such as blockchain and cloud technology, combined with new FinTech entrants and new digital distribution models, are changing the traditional value chain of financial services. This can deliver cost reduction and efficiencies for firms, as well as optimise choice and accessibility for investors.

The digital transition in financial services has been underway for some time, but the pandemic accelerated it to new levels. Managing personal finance is continuously being made easier and more intuitive though customer friendly digital apps. Stocks or investment products can be purchased in just a few clicks, while you sip your morning coffee (that you just bought by tapping your phone). Convenience is key.

This financial revolution also brings capital markets within reach of new parts of society, changing the demography and behaviours of investors. Trends during the pandemic showed that younger, more tech savvy people were investing more in stocks or other financial instruments, such as crypto assets. This was driven by a spike in savings rates, while at the same time people spent more and more time online during the lockdowns.

Attracting more retail investors to participate in financial markets is a good thing and is one of the key objectives in building the Capital Markets Union in the EU. However, this trend also presents new risks, which securities regulators must address. ESMA has observed an increasing level of consumer complaints in relation to financial instruments over the past couple of years, which correlates with the large increases in retail investor trading. We have also seen the influential power of social media in promoting questionable investment strategies and driving market volatility to extreme levels, for example, during the Gamestop event in the US.

Celebrities and online influencers are increasingly promoting complex and risky products, like crypto assets, while anonymous online chat forums peddle dubious investment tips. Fear-Of-Missing-Out (or FOMO for those more au fait with modern lingo), can then pressure individuals to invest in products they may know little about. Some products or platforms do not have appropriate disclosures for investors to make informed decisions. At the same time, many of these new digital platforms take advantage of the fact that trading feels just like a simple game. And just like gambling, this can be addictive and have dire consequences.

Finance at our fingertips brings clear benefits – but opportunity and risk are finely balanced. [As Thomas Edison said, "the value of an idea lies in the using of it".] The litmus test for many new digital innovations in finance will be whether they can enhance the consumer experience. But equally, can they also provide the level of protection and security that must be afforded to investors in the modern digital age?

Regulation should not stifle innovation, but regulators should play a key role in reigning in bad behaviour and improper practices. Our combined efforts are needed to raise wider societal awareness on the risks in modern financial markets. We need to uphold strong standards of investor protection, while encouraging learning and participation. As an example, we need to ensure that the information provided to investors is adapted to the digital age, giving them easy access to compare products, find helpful information and not be swamped by legalistic documents. We also need to remain ready to react where there are signs of potential consumer detriment and will continue to issue warnings where relevant.

Ensuring green choices for green investors

The digital transformation and broadening of the investor base also help facilitate another challenging, but important, global initiative – supporting the flow of finance towards helping to tackle climate change.

The urgency in building the sustainable finance framework has resulted in a flurry of legislative, regulatory and international standard setting activity. Of course, a clear legal framework is vital in order to oblige both non-financial and financial firms to disclose the information necessary for investors to make sustainable investment choices. The challenge for securities regulators is to ensure effective, timely and clear implementation of these rules, and then to supervise and enforce them effectively. In parallel, as the importance of ESG ratings and data continues to grow, we must enhance our oversight of these providers to increase trust in their services.

Securities regulators are very mindful of the challenges that persist during this transition. Inconsistent application or interpretation of rules, inadequate transparency and comparability, and the lack of suitable data are all challenges which we must confront. [Pardon the non-sustainable pun, but regulators must remain firmly at the coalface in driving forward and completing this work.] And a global problem requires a global solution, underpinning the need for international cooperation at bodies such as IOSCO.

The resulting opportunity for businesses is clear. They can tailor investment products to match a growing investor demand to make green choices, while also contributing to the global environmental, social and governance (ESG) agenda. On the flipside, if firms seek to exploit the opportunity in a way that does not reflect a real commitment to ESG outcomes and investor preferences, this will have a detrimental impact for the entire sustainable finance project and threaten investor trust and confidence.

Investors therefore need to be

safeguarded and firms held accountable, to ensure goals are aligned. Earlier this month, ESMA published its sustainable finance roadmap where we prioritised tackling greenwashing and promoting transparency in advancing the sustainability agenda in the EU. Greenwashing occurs when a firm or investment product misrepresents its sustainability characteristics or profile. As a result, investors may be given the impression that what they are investing in is green, while the reality is different. Regulators are determined to tackle this. Transparent and reliable disclosure rules and standards are the first important step - coming fast at both EU and international level; the skills and capacity of supervisors are continuously being improved to enhance scrutiny; and investors are being empowered to hold companies accountable for their sustainability commitments.

Our ESMA roadmap also underlines the importance of monitoring and analysing ESG markets and identifying trends and risks. This will be key in helping national authorities and firms build ESG factors into their own risk analysis work, for example, climate scenario analysis for investment funds.

Building the sustainable finance framework in the EU is both urgent and essential. It is complex and multifaceted, and thus presents numerous challenges for all of us - policy makers, regulators, companies, and investors. It is nonetheless an imperative task as the EU strives to meet its commitments on tackling climate change.

Understanding risks and building resiliency

Finally, I want to reaffirm the need to be prepared for new and evolving challenges by continuously improving our monitoring of risks and vulnerabilities that threaten the stability of the financial system. Securities regulators, alongside our prudential siblings, have an important role to play in this regard.

In a world that runs on data, good quality data is also the essential ingredient to effective risk analysis. Detailed reporting requirements now constitute a key component of financial sector legislation. I know many firms complain about the burden of these reporting requirements, but - let me assure you - this data allows ESMA and national regulators to better understand risks and scrutinise market activity. In this context, it is vital that we continue to streamline data reporting and enhance our data capabilities, to ensure the timely detection and mitigation of those risks, based on robust and accessible high-quality data. ESMA is therefore putting every effort into enhancing data-driven risk analysis, policy making and supervision in the EU.

However, knowing where the risks are is not enough. This insight, and our experiences from crises of the past, must be used to instigate relevant policy action to prevent those risks materialising in the future.

The 'dash for cash' during March 2020 highlighted shortcomings in some parts of the financial system, such as short-term funding markets and money market funds. We witnessed how this sector could amplify shocks and could pose risks to financial stability in stress situations. The vulnerabilities of certain investment funds, combined with the interconnectedness with other parts of the financial sector, reinforces the need for reform, for example, to improve resilience and liquidity risk management for money market funds and open-ended funds. On the back of FSB policy proposals for money market funds last year, ESMA has recently published its views on how to implement these reforms at EU level.

On the other hand, CCPs continued to play an important role in cushioning rather than exacerbating shocks in the financial markets. During the stress period in March 2020 they dealt successfully with record volumes of clearing and settlement activity. It is nonetheless necessary to continue reinforcing the resilience of market infrastructures, for example, by putting in place a suitable recovery and resolution regime or by reviewing the adequacy of anti-procyclicality measures. Likewise, in view of the systemic importance of CCPs for the EU as a whole, we must continue to think about the risks stemming from our reliance on CCPs outside the Union as well as the appropriateness of the current supervisory framework within.

Conclusion

Ladies and Gentlemen, being here in Paris, the home of ESMA, during the French presidency of the Council, I cannot resist embracing the words of French Nobel laureate Albert Camus, when he said "La vraie générosité envers l'avenir consiste à tout donner au present" - "The true generosity towards the future is to give everything to the present".

ESMA, together with securities regulators in both the EU and globally, is ambitiously confronting today's challenges, in order to ensure safe, reliable, efficient and open financial markets for the future.

Harnessing the forces of digital and sustainable finance in a safe and trustworthy way can I believe truly lead to a more inclusive and socially conscious financial market.

Some of the challenges we face may be new, but our resolve to learn and adapt is not. After all, smooth seas do not make skilful sailors. We remain vigilant, agile, and passionate in pursuit of our goals of enhancing investor protection and promoting stable and orderly financial markets.

Thank you.

Ambroise Fayolle

Vice-President, European Investment Bank

Speech

Thank you so much, Didier, and I apologise for Werner Hoyer who had to obviously stay in Luxembourg today. I want to thank Eurofi again for the invitation.

The terrible situation in Ukraine is clearly a major fault line, not only given the human and geopolitical consequences, but also for the European Union (EU) economy. The silver lining is to see how the EU and its North Atlantic Treaty Organisation (NATO) partners are sticking together in this difficult situation and how they respond with one voice to the aggression by Russia. There can be and should be no doubt about our determination to stand up against such clear violations of international law, no doubt about our sense of partnership and unity at the EU level, with the European Commission and the European External Action Service, and no doubt about our solidarity with Ukraine and all neighbouring countries and regions that are or will be affected in the future.

This brings me to the next fault line: the high energy prices and how policymakers will respond to them. High energy prices are indeed a big concern for many consumers and businesses these days, but as the European Union we have ways to deal with them. I am glad to see how the European Commission and many member states are taking active steps to cushion the price shock and look for ways to diversify the energy mix in the Union. I am confident that this will lead to a massive reduction of dependence on Russia energy imports in hopefully the near future.

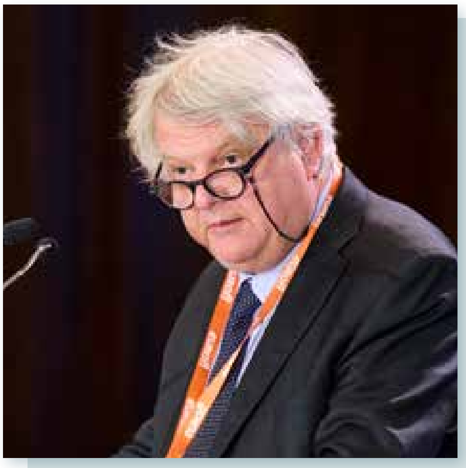
However, the higher energy prices bear another risk, which is that some, often those who were never convinced of the need to move away from high-emitting fuels, are using this as an excuse to backpedal on our climate commitments. This would be a terrible mistake. The green transition should be seen as 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, even more so given the situation at our eastern borders, but we must avoid interventions that reduce incentives for green investment or that in general increase uncertainty about climate policy going forward.

The risk of asymmetrical recovery is the last fault line that I will mention and 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 firms will be once the exceptional policy support measures are fully removed. What we can say is that severe impacts on firm revenue have so far been quite concentrated in terms of sectors and even in terms of geography, but there is still significant uncertainty as to how much asymmetry will emerge once the economy recovers, and whether this will cause systemic risk in some locations.

This brings me to my last question: how do we ensure that we stay clear of the risks outlined above? Public investment has played an important stabilising role in the past two years. Our research shows that, for example, where digital infrastructure was better, firms have been more likely to digitalise as a response to the pandemic. We need to maintain the momentum of high-quality public investments, including by maximising the impact of the Recovery and Resilience Facility (RRF). This implies achieving an effective implementation of the RRF and European coordination, but also a pipeline of high-quality projects that will be key for us.

Yet, no matter how impressive public investments in the EU, we will not be able to close these enormous investment gaps if we do not manage to bring the private sector onboard. We are also in need to boost high-risk private sector investment in innovation and in particular in new climate technologies, which remains too low. Our engineers at the European Investment Bank (EIB) estimate that about 50% of the mission reductions needed by 2050 depend on technologies that are not yet available in the market, so we need to support them. 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. This is also key for our strive towards more energy independence as well as EU competitiveness.

I will close here, Didier. Let me finish with one final comment. We have not only to think about those firms and regions that are pushing ahead. We need really to think hard about how to ensure that no one is left behind. This is what we call the just transition. We have committed at the EIB to help more those less developed regions where the needs are higher to get to climate neutrality, and we will certainly deliver on this commitment, because this is key for our climate ambitions.



Luigi Federico Signorini

Senior Deputy Governor of the Bank of Italy and President of the Insurance Supervisory Authority (IVASS)

Outcomes of Italy's G20 Presidency

Good afternoon, ladies and gentlemen. I do appreciate this opportunity to discuss some key steps taken during Italy's G20 Presidency in 2021. To keep this speech within reasonable limits, I need to be selective. I shall briefly recap the main outcomes of the work of the G20 Finance Track, and then focus on the results obtained in two areas of direct concern for financial markets, i.e.: (i) strengthening the resilience of non-bank financial intermediation (NBFI), and (ii) preparing the financial sector for a world that is starting to fight climate change seriously.

Italy took up the G20 Presidency in the midst of the pandemic crisis, at a time when global economic activity was suffering from the resurgence of infections and remained well below its pre-Covid levels. Many low-income and developing countries in particular were lagging far behind in their recovery.

In this context, the Italian Presidency defined three overarching priorities for the Financial Track of the G20:

- to provide quick, strong and cooperative action to step up the policy response to the pandemic, and to lay the groundwork for a more resilient global health system in the future;
- to resume the discussion on climate change within the G20, profiting from the new attitude of the US administration in favour of multilateralism as well as from the swift rise of interest in the topic at the global level;
- to secure an agreement on international taxation.

On the first issue – the response to Covid and future preparedness for global health emergencies – in 2020, thanks to the extraordinary public support extended to households and firms in many jurisdictions, as well as to the prompt coordinated response of monetary and other financial policies to the crisis, the world economy had recorded a strong recovery. Contrary to what happened at the time of the global financial crisis of 2008, a financial meltdown was avoided this time and the financial system continued to provide critical support to the real economy.

A return of the pandemic weighed on the world economy in the winter of 2021. However, continued strong, coordinated policy action, and the experience accumulated during the first wave of the pandemic, ensured that the economic fallout from the second and further waves was more subdued. The rapid roll-out of vaccines in developed countries led to a gradual lifting of restrictions on economic activity and to a resumption of investment and consumption with far fewer bankruptcies than expected, although at the cost – consciously incurred – of a one-off increase in public debt. Many advanced countries have now reached, or are close to reaching, pre-crisis output levels.

Under the Italian Presidency, the G20 also took action to help the weakest economies that had been disproportionally hit by Covid-19. It provided support to multilateral mechanisms, ensuring wide access to tests and vaccines. In addition, to address the structural weaknesses highlighted by the pandemic, it established a new Panel on prevention and preparedness that advanced proposals to improve the mobilisation of funding and enhance coordination between Health and Finance Ministries and international organisations. Work to deliver a shared solution on these issues will continue in the next few months under the Indonesian Presidency.

The G20 also agreed to extend the suspension of debt service payments for 50 countries until the end of the year, and to renew efforts to operationalise the common framework for the treatment of the distressed debt of some eligible countries. While the latter has encountered some difficulties, last October G20 Ministers and Governors reiterated their commitment to make progress. The G20 also agreed to make 650 billion dollars available in additional reserves through a general SDR allocation, with rechannelling options to allow low-income countries to receive further support.

On the second issue – the fight against climate change – our Presidency began at a time of swiftly rising awareness of the issues raised by climate change among savers, investors, financial market operators and the public at large. The attitude of G20 delegations was (and is) also changing. It is no surprise that countries differ widely in their priorities and sensitivities on this issue, but there appeared to be a worldwide surge in the feeling that a conversation on actions needed had to be held within the G20 framework in a multilateral format.

The Italian Presidency, of course, cannot claim to be the prime mover of any of these global developments. However, I think we can fairly say that the Presidency quickly sensed the new spirit, and saw the opportunity to channel it into a concrete discussion of steps to take. Under our Presidency, the Sustainable Finance Study Group has been re-established and upgraded to a fully-fledged Working Group, under the co-leadership of the United States and China. There was also an important financial-market side to this endeavour; I shall come back to this in a moment.

On the third issue, international taxation, to address the issues posed by globalisation and digitalisation, the G20 reached an important agreement on a minimum level of taxation and rules for the reallocation across jurisdictions of taxes on excess profits of multinationals. Work on the operationalisation of the framework is ongoing, with a commitment to full implementation by 2023.

Let me now turn to achievements of more direct concern for the financial markets, and focus on two key priority areas of the Italian Presidency.

The first area concerns strengthening the resilience of what was once known as 'shadow banking', and is now called the non-bank financial intermediation (NBFI) sector, or sometimes 'market-based finance'.

Since the global financial crisis, market-based finance has grown rapidly, and today accounts for almost half of total financial assets. This is by no means a bad thing in itself: it makes the financial system more diverse and thus potentially more efficient and resilient. However, NBFI comes with its own risks, which need the regulators' and supervisors' attention. With its expansion, certain vulnerabilities of NBFI – concentration, interconnectedness, liquidity mismatches – have also been growing in importance. We had been stressing for years the need for rethinking the supervisory framework for NBFIs; to go beyond traditional conduct supervision and embrace a financial stability perspective.

Bolstered by the reforms implemented after the global financial crisis, the banking sector entered the pandemic with stronger capital and liquidity buffers, which supported its ability to provide continued critical lending to the economy. Post-financial crisis regulatory reforms have affected the non-banking sector to a much lesser degree.

The events of March 2020 confirmed the concerns about NBFI. They exposed structural fault-lines in the non-bank sector that helped to amplify market stress and increase procyclicality. These include liquidity mismatches in money-market funds and open-end investment funds invested in less liquid assets. The disorderly unwinding of highly leveraged positions by some non-bank entities contributed to amplifying the effects of the liquidity stress (the 'dash for cash'), with spill-overs affecting even markets for traditionally safe and liquid government bonds. Orderly market conditions were only re-established after massive central bank intervention.

These issues have been thoroughly analysed by the Financial Stability Board (FSB). In a 'Holistic Review' published in November 2020, the FSB identified certain weaknesses of the non-bank sector that needed to be addressed. The FSB has laid out a work plan to strengthen regulatory safeguards, with the aim of limiting the need for central bank intervention and avoiding moral hazard.

Under the Italian Presidency, the G20, based on the FSB work, endorsed a package that provides jurisdictions with a framework for assessing and addressing vulnerabilities in their MMF sector, and with an agreed menu of policy tools. Some reforms are already being envisaged in the main jurisdictions, such as the EU and the US. Global reviews will be conducted jointly by the FSB and IOSCO by end-2026, with the aim of assessing the appropriateness of the measures adopted by all jurisdictions and evaluating the need for further action at the global level.

Ideally, we would have liked to see the G20 to take an even bolder step and adopt from the start a set of global mandatory standards for MMFs, thus further enhancing the resilience of the sector and limiting the room for market fragmentation and regulatory arbitrage. We recognised, however, that jurisdictions were not yet prepared to go all the way to global standards. In our capacity as the G20 Presidency, we worked hard to ensure that a first, important agreement was reached. We also ensured that there was a commitment to reconsider the matter over time, on the basis of the results achieved.

Looking ahead, work on NBFI will continue in a number of directions. Better data and analyses are needed to improve our understanding of NBFI vulnerabilities and of appropriate policy tools. The FSB is committed to examine suitable policy approaches to address vulnerabilities in open-ended funds, margining practices and short-term funding markets. It will be incumbent on the current and future G20 presidencies to steer this work.

The second area, as I said earlier, concerns the role of financial markets in catalysing the flow of funds needed to enable the climate transition.

The good news is that the interest of private capital for sustainable investment is growing at a fast pace. The less good news is that the efficient allocation of climate-friendly capital is hindered by insufficient availability of granular, reliable, internationally comparable information. Sustainable financial investments rely on (i) company disclosure practices that are neither harmonised nor easily auditable, and (ii) scoring systems that are heterogeneous across different financial providers, largely subjective and sometimes opaque. As a consequence, the risk of confusing information and misleading claims ('greenwashing') is not immaterial.

Another important issue for financial authorities is the need for adequate consideration of environmental risk in financial institutions' risk management, in supervisory rules and practices, and in economic modelling. Many central banks and supervisory authorities, including the Bank of Italy, are making efforts to improve their actions, also benefiting from the exchange of experiences at international level.

The G20 Sustainable Finance Working Group has undertaken several important initiatives. In its 2021 Report, it set practical recommendations in three priority areas: (i) strengthening the comparability and interoperability of approaches; (ii) improving reporting and disclosure; and (iii) enhancing the role of international financial institutions in supporting the goals of the Paris Agreement and of the United Nations Agenda 2030.

As a key legacy of the Italian Presidency, the Group developed the first G20 multi-year Roadmap on sustainable finance to guide future works at international level. This year, the Indonesian Presidency are promoting new analyses on sustainable finance, building on the work plan detailed in that Roadmap.

Further initiatives under our Presidency included requesting the IMF and other international organisations to consider climate-related data needs in preparing a new Data Gap Initiative, and the Financial Stability Board to report on disclosure challenges and data gaps on climate-related financial risks. The FSB was also requested to develop its own Roadmap to tackle climate-related risks for financial stability, to provide a coordination mechanism for standard setting bodies and international organisations to improve firm-level disclosures, data availability, methods and scenarios for vulnerability analyses, and regulatory and supervisory practices and tools.

Let me just add that, while enhancing sustainable finance is very important, fighting climate change is first and foremost a job for general public policy. As I mentioned earlier, within the G20 framework we were and are committed to promoting fruitful cooperation on actionable policy proposals. A key focus should be the design of a global carbon pricing system, including setting up carbon tax plans and removing fossil fuel subsidies.

In these first months of 2022, the recovery has become increasingly vulnerable to downside risks, including new, negative developments in the pandemic, inflation, increases in energy and food prices, and bottlenecks in the manufacturing and transportation of goods, as well as unfavourable geopolitical developments. It is important for the G20 to maintain a cooperative approach aimed at minimising the risk that heterogeneity in recovery strategies may result in an undesirable spill-overs.

Let me spend my last few minutes on a question that may legitimately be asked, and that many of us, involved in lengthy discussions often stretching over several meetings, might have asked themselves. Within the G20 framework, are we actually doing what is needed? Are we addressing the most important economic and financial issues in an efficient, effective way?

Despite all the frustration that we might feel at times, when consensus proves hard to reach, and despite the failures that do occur from time to time, I think we can give a positive answer to these questions.

First, whatever the concrete details of the agreements that political leaders are actually able to reach (and, as I have argued, we do count the results of the Italian Presidency as genuinely meaningful achievements), and even when agreement proves elusive, the G20 maintains its value as a multilateral forum where the leaders of the major world economies can frankly talk to one another about the key economic and financial issues of the day. At the very least, this provides a framework within which mutual trust can be pursued, whatever the difficulty of the times. But it is especially useful in a crisis. It has repeatedly proven its value when there is a recognised, urgent need to provide coordinated responses, as happened in 2008-9, and occurred again in the last couple of years, including in 2021, when the G20 acted to secure funds for vaccines and suspend the debt service for the most vulnerable economies.

Second, the G20 has promoted a format for discussion and coordination of policies in some key areas. One good example is the work of the Financial Stability Board. Established at the time of global financial crisis, it started with the overhaul of the regulatory and supervisory regimes of the financial system, in particular of the banking sector. It has since moved on to assess and address emerging risks from a variety of sources, including most recently crypto-assets, non-bank financial intermediation and climate-related financial risks. It is now taken for granted that there is an international dialogue on all these issues and a 'Board' that coordinates actions by the Standard Setting Bodies and gives policy advice to national authorities. No wonder the FSB is now considered a successful example to be possibly followed in other areas, health for instance. Yet, this is the result of discussions we had and efforts we made, not something that sprang up spontaneously.

Finally, I would say that G20 discussions and commitments, once they are reflected in hard-to-earn consensus on communiqués, do work as a focal point for peer pressure and for international reputation. Any country can easily fall short of, or even renege on, their commitments, which in the end do not have the force of law. However, this does not mean that doing so comes at no cost, and the difficulty experienced in finding consensus on any commitment proves that this is indeed the case.

Jon Cunliffe

Deputy Governor, Financial Stability, Bank of England and Chair of the CPMI

Speech

I was going to talk today a little bit about crypto. I am going to talk about crypto, broadly defined, but I will concentrate some of the remarks on stablecoins, which is one aspect of the use of crypto technology in financial services.

Last week, the Financial Stability Board (FSB) released its latest assessment of the risks to financial stability from crypto assets. In a nutshell, the assessment was, 'Well, this is not a financial stability risk globally at present, but crypto markets are evolving rapidly and could reach a point where they pose a threat to financial stability. Given the speed and the breadth of the evolution of crypto technology in financial services, it may now be time for the regulatory community to go up a gear or two and act in a pre-emptive and timely manner. That judgement was endorsed by the finance ministers at the G20.

The FSB report, which echoes a number of similar calls from national regulators, including myself, is in my view an inflexion point in the way in which, in the regulatory community, we approach this technology and the possibilities for its use. Today, I wanted to talk briefly about three things: what lies behind that inflection point, on which I will be brief, because you can read the report and it goes into more detail than I can possibly do today; what 'pre-emptive and timely' consideration of policy means in practice for the people who have to do it; and what crypto and crypto technology could offer us in finance in terms of efficiency, functionality and competition.

Looking first at what has brought us to this point, I would highlight three things. One is simply the growth in crypto assets. We are talking here mainly about unbacked crypto and Bitcoin and, to a lesser extent, Ether. Over 2021, it grew, depending on how you calculate it, by 3.5 times to $2.6 trillion, which is still a relatively small part of the financial system but substantial enough to make a difference. There are 9,000 crypto coins. When I spoke in this matter in October, it was 8,000. They are, of course, highly volatile. Bitcoin doubled in value between July and November of last year, and then halved in value by late January this year, as yield curves went up and prospects of higher inflation became apparent.

I will just observe in passing, to those who have claimed to me over the years that Bitcoin is a hedge against inflation for central bankers in particular, that it is behaving like a risky asset and is correlated much more with moves in equity markets than with moves in gold, which you might think of as the traditional hedge. Certainly at the moment, is not acting as a hedge against central bankers. Alongside this, we have seen growing use of stablecoin as a means of payment within crypto markets.

The second point is that we have seen fast growth in the integration of the conventional financial sector with the crypto world. There are a number of points here. Banks want to offer more crypto services to wholesale trading banks. Some of that is custody and trading, which does not involve balance sheet, but also a number of banks are thinking about offering market-making and on balance sheet services. Payment firms are offering on-ramps and off-ramps between crypto and fiat. Institutional investors are starting to think about whether they should have some crypto in their portfolio and what form it could be in to enable them to invest, hence some of the interest in exchange-traded funds (ETFs). We have had crypto hedge funds for a while, but the bigger, conventional hedge funds are now getting more involved in this, and incorporating the asset class into some of their trading strategies. None of this is large-scale yet but it is definitely happening, and seems to be happening quite quickly.

The third driver behind that G20 FSB assessment is that we are seeing the emergence of what you could call an alternative financial system that sits within the crypto world. This is going further than the creation of cryptoassets. Through the use of the public blockchain and distributed ledger technology (DLT), smart contracts, financial services like credit, derivatives and insurance are now being offered on the public blockchain, using crypto assets as the means of settlement. There is a lot of hype about it, and it is in its infancy, but it does raise the prospect that we could have an alternative financial system operating, offering the sorts of things we see in conventional finance and outside the perimeters of existing regulation.

Those are the drivers behind the G20 FSB assessment. I said the key words are 'pre-emptive consideration of financial regulatory responses'. As regulators, we want to have the benefit of the technology, but we do not want to repeat the experience that we have seen in other areas of technological disruption, in that, by the time we understand the risks and think about the regulation, the technology has become established in one particular form and we then have to retrofit the regulation on it. If you look at some of the things that are happening, for example, around social platforms and social media, you can see just how difficult it can be to retrofit standard on privacy, competition and other areas of regulation once an innovation has taken root in a particular form.

What does 'pre-emptive consideration of policy action' mean? I will make a general point and then some specific lessons from the experience of the Committee on Payments and Market Infrastructures (CPMI). First, I am going to start with the regulator's mantra of 'same risk, same regulation'. For me, this has to be the starting point of how we think about this. Regulators should aim to be technology-blind and should focus on what is being done, not what technology is being used to do it. Of course, the technology itself may have particular risks and we need to address that, but when we think about whether there are risks here to be managed, it is the function being performed, not the way it is being performed, that should guide us.

In that respect, I have heard calls, directly and indirectly, for specific crypto regulation and the setting up of a specific crypto regulator, the argument being that people like me, who are used to regulating the conventional financial system, just do not understand what is going on here and, as a result, if it is left to us to do the regulation, we will stifle innovation. I have to say that that would be an enormous error, because it opens the possibility of massive regulatory arbitrage between a financial service offered using one technology and the same service being with a different technology. If we allow technology to drive differences in regulation, we will be in for a very difficult time indeed.

In my view, it is imperative that the standards for risk management that are applied to financial services in the conventional world, if I can call it that, are applied to the crypto world. In other words, 'same risk, same regulation'. While that is easy for me to say, it is very hard in practice, for a number of reasons, and I will give two examples. First, the existing regulation may just not work in the crypto world, and you cannot apply it. In terms of 'same risk, same regulation', if it means the same regulation, we may find that very difficult to do.

The second is that functions that are integrated in conventional finance can be deconstructed in the crypto world and put together in a different way or distributed among different entities, or sometimes no entities at all. As a result, the financial service being offered can cross or blur regulatory boundaries, or sometimes just fall between the cracks of regulatory boundaries, deliberately or otherwise.

To address this, we have to take the mantra of 'same risk, same regulation' and develop it a little bit. First, we should talk about 'same risk, same regulatory outcome'. In other words, the risk is managed and mitigated to the same level, even if the regulation has to operate in a different way. On the second point, the crossing or falling between the boundaries of regulatory perimeters, the different standard setters and regulators for banking, payments, securities and possibly for insurance need to work very closely together to ensure that crypto financial services that cross boundaries are regulated consistently in a manner that ensures risks are mitigated to the same level.

I do not think that there will ever be one crypto regulator naturally, because it is a technology that can be applied to so many different things, but if we want to implement 'same risk, same regulation' and extend our existing standards to this new world, we have to work together from the outset.

That is why the role of the FSB is crucially important, because only the FSB has the vantage point to say, 'where are the overlaps, the gaps and inconsistencies?' and can ask the regulators and standard setters to address them. It is equally important that the standard setters work together from the outset to share their approaches to particular aspects of the regulation and to try to build in that consistency as they do the detailed work of extending the standards to this new area.

I am pleased to say that last week's FSB statement really established the FSB role across the spectrum of crypto activities, which deals with my first point, and I am also pleased to say, speaking with my CPMI hat on, that the standard setters – the Basel Committee, IOSCO and the CPMI – recognised the need to work together and we are already putting in place the mechanisms to enable us to have those conversations.

I will give two examples of both of those things from the stablecoin world, where CPMI/IOSCO have issued guidance on how we apply the international standards for payment systems – or principles for financial market infrastructures (PFMI), as they are called – to stablecoins being used in systemic payment systems.

The first example is around the fact that regulation does not really work in a crypto world. The PFMI says that systemic payment systems should settle in central-bank money or in commercial bank money. That is to manage the risk around the settlement assets. Stablecoins will not be central bank money, and many of its proponents do not propose it to be commercial-bank money, so what standards should apply if a stablecoin is being used as a settlement asset in a systemic payment system?

What the CPMI consultative report proposes is that stablecoins that are used in that way must have some of the features that make particularly commercial-bank money robust enough to be used as a settlement asset. This means that they have to give the holder a legal claim to redeem the coin for fiat money, at par, on demand and within the day. If you set up a stablecoin to do that, you bring about the robustness that you have in commercial-bank money and ensure that you get the same level of resilience that you have in a different way. This moves us on from 'same regulation' to 'same regulatory outcome' as you cannot just apply the standard there.

On the second point about blurring the boundaries, the consultation paper proposes that, for systemic stablecoin payments systems, we deal with that in two ways. The first is that we make the operators of the payment itself – the mechanism that transfers the settlement asset from one entity to another – responsible, as we make banks and others responsible, for managing the risks in the whole chain on which the operation depends. That can include the issuers of the stablecoin if it is issued by one entity and transferred by another. It can include the wallets in which the stablecoins are held because, unlike commercial-bank money, where the claim is on a commercial bank, and you have to hold it in an account at that bank, stablecoins offer the prospect that the settlement asset can be issued by one entity and held in a completely different one. We could make the operator of the payment function responsible for managing the risks across the chain.

Second, the consultation document proposes further work that I hope we will be set in train this year between the different standard setters, so that, where other standard setters have responsibilities and we could rely on their standards, we would be able to do that. We would also be able to ensure that there was no inconsistency between the way we were treating the same thing. I will give you an example. The PFMI say you should settle in commercial-bank money if you cannot settle in central-bank money. As payment systems regulators, we do not regulate commercial bank money. We leave it to the Basel Committee and the banking regulators and supervisors to do that. Would we be able, in talking to them, to get to a point where we could depend upon other standards where something is crossing a number of boundaries? This work is crucial to 'same risk, same regulation', and the work has begun. We have started those conversations.

I have said a great deal about risk but I have not said anything about opportunity, because my comfort zone is to talk about risk and it is less comfortable for central bankers and regulators to talk about opportunity. In taking this forward, it is equally important that we do not lose sight of some of the benefits that these developments can bring. I talked about the CPMI/IOSCO work to extend international standards for payments to stablecoin payment systems, but as part of our work on the G20 agenda to improve cross-border payments, the CPMI is also looking to assess what benefits cross border stablecoins could bring to improving cross-border payments.

We will be producing a report later on in the year to assess the benefits that a well-managed and well-regulated stablecoin could bring to cross-border payments. I do not know yet what the assessment will be, but I am sure that we should not rule out or close down the possibility now that new technology and new players, including non-bank and non traditional payment service players, can make a huge contribution to some of the improvements in cross-border payments in terms of speed, reliability, access and cost, which we need particularly for low-level and low-value retail payments and remittances.

I do not want to go into all the frictions that exist in the cross-border payments system or to suggest that stablecoins or other new technologies like central bank digital currencies (CBDCs) are a silver bullet that will solve all of these problems. I talked about CBDC this morning and observed that I have never seen anything that is a silver bullet, but it is clear to me that we will need a number of approaches to deal with cross-border payments. There is plenty of room for improvement in correspondent banking, including by using some of these new technologies, and there is plenty of opportunity in linking up the faster payment services that have now been set up in a number of jurisdictions, without even turning to the new technologies. New technologies and new players could give us some much-needed competition in this area, and they may, by offering alternative rails, be able to offer solutions in some of the areas where we need them.

To conclude, while I think last week's FSB statement helps in terms of putting in place the regulatory framework, it also helps because, if we can put in place that framework, and if we can think about the risks and how to manage them in a consistent way – 'same risk, same regulation' – we can create a framework in which innovation can flourish and we can reach some of the benefits that I think this technology may have to offer. I will stop there. Thank you.

Mike West

President, Moody's Investors Service

The post pandemic financial landscape

Hello, I'm Michael West, President of Moody's Investors Service and it's my pleasure to join you today.

The pandemic provides a stark reminder that we face a wider range of complicated and inter-connected risks than ever before.

I'd like to start with observations on three key features of the post-pandemic financial landscape: the banking system, corporate debt markets, and sovereign balance sheets.

So let me take the European Banking Sector.

The European banking sector has come through the pandemic in good health. Capital has increased, and after a brief spike in bad debts, non-performing loans have continued their long-term decline. Liquidity is abundant and earnings exceed pre-Covid levels. This leaves the banking sector well-positioned to support an ongoing economic recovery.

It's a different story with respect to non-financial corporations, where debt has increased significantly in the public and private credit markets, and particularly within the leveraged finance segment, where credit profiles are weaker, and where covenant packages have loosened. Nonetheless, due to abundant liquidity and policy support, the global corporate default cycle was shorter and milder during the pandemic compared to previous cycles.

And lastly let's turn to the sovereign balance sheet. In the past two years, we have seen that as governments stepped in to support healthcare, economies and societies, sovereign debt increased significantly. However, the low interest rate environment has meant that for advanced economy sovereigns, the cost of carrying this additional debt is relatively low, whereas emerging market sovereigns face somewhat greater debt servicing costs.

Let's turn our attention here to future financial stability.

As supply chain disruptions persist and inflation remains elevated, the interest rate outlook is evolving. While some central banks have started raising monetary policy rates, we expect a more gradual pace of eventual monetary tightening from the ECB. However, financial markets have already tightened, with long-dated yields rising.

Looking ahead, as financial conditions tighten we may witness occasional bouts of market volatility. These would pose risks to financial stability in the event that liquidity tightened significantly for a sustained period, causing financial asset price declines and spillovers into the real economy. However, a gradual increase in interest rates accompanied by continued growth would not cause financial disruption.

Another important trend relates to disintermediated finance.

Globally, we are seeing a shift towards disintermediated finance, which gives businesses access to more funding sources. Still, Europe remains heavily reliant on the banking system.

Disintermediated finance presents significant opportunities for Europe. The EU is a net exporter of capital, and further deepening of capital markets could provide a stronger incentive for the private sector to keep funds in Europe.

Steps to boost disintermediated finance in Europe, and - more broadly - to drive the Capital Markets Union agenda would complement the planned Next Generation EU initiative and amplify its benefits.

We have to mention another priority for us all, and that is climate change and the transition to net zero.

Banks' and capital markets will play an important role in financing climate resilience, mitigating the impact of climate change and the transition to a low carbon economy. Financing will be required to retrofit factories, decommission assets, improve energy efficiency and build climate resilience in infrastructure

Over the coming years, financial institutions will need to increase climate risk assessments and set clear goals for reaching net zero in their financed emissions.

Better disclosures will allow for better data analysis 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.

However, let's not forget cyber risk.

Along with climate, cyber risk is another issue that threatens the reputation and financial profile of every corporation and government.

The financial services sector, in particular, is a prime target for cyberattacks.

Even for non-financial companies the risk of cyberattacks, particularly ransomware attacks, is growing, while a cybersecurity talent gap makes it harder to build defenses. Finally, cyber insurance is poised for change as premiums continue to climb, while the scope of coverage narrows.

A key challenge is that financial markets have a limited ability to quantify the threat. Organizations need more help in identifying, measuring and managing the financial impact of cyber risk.

And with new risks emerging all the time, resilience can be just as important as preparedness. Building resilience will help organizations that come under attack to maintain operations, limit the damage and recover more quickly.

So let me wrap this all up.

It is clear that we are facing more risks than ever before.

In our inter-connected world, failing to manage risks effectively can cause significant financial and reputational damage.

After the last two years of disruption in Europe and around the world, Eurofi gives us a valuable opportunity to discuss risks – and the opportunities – that lie ahead on the road to recovery.

I'd like to thank Eurofi for the opportunity to speak to you today. I wish you all the best for a successful event.

Theodor Weimer

Chief Executive Officer, Deutsche Börse Group

Speech

Ladies and gentlemen, I think it is my turn now. Honourable ministers, members of parliament, distinguished central bank governors, ladies and gentlemen, dear colleagues and friends, it is an honour and in fact a privilege to be here today. Relance, puissance, appartenance: this triad is the model of the Council Presidency of our host nation, France. It is about sovereignty as a union; it is about the future of our society, our values and community; and it is about the future of the EU as the focal point for global business.

A familiar project has of course made it up to the top of the agenda: the Capital Markets Union (CMU). Although we have been discussing it for years, frankly we are not making much progress. Is this due to a lack of will? Is it due to a lack of ability or skill? I hope it is neither. However, if we are serious about the CMU, I believe we need to change our perspective; we need to change the sense of urgency; quite frankly, we need to change our strategy. To quote Commissioner McGuinness, what we need is to strengthen EU financial market infrastructures. As the CEO of Europe's largest financial market infrastructure operator as well as the largest stock exchange and, quite frankly, the largest clearing house, I would like to share with you 10 brief observations on the capital markets and their significance for the EU. I would like to apply a rather bird's eye perspective, because there is a certain tendency for us to get lost in detail. These are intended as talking points to stimulate the discussion, deliberately running the risk of being a little bit provocative.

Let me start with observation one. With or without CMU, Europe's capital markets are already of vital importance to its future, and that importance will increase further. The capital markets are not merely a playing field for bankers and investors anymore. They are the engine that drives our global competitiveness. It is important to recognise their significance for Europe, as even before the pandemic we were suffering from weak economic growth and high levels of debt. We also know that the capital markets facilitate our citizens' participation and the prosperity generated by our companies. All major tech companies, which we are talking about so much, from the youngest unicorn to the oldest IT firm, owe a big part of their success to the capital markets.

Observation two is that, despite years of effort, we are going through a rough time. Europe is falling behind globally rapidly. We need to take a sobering look at reality. First, in 2021 we saw 2,700 initial public offerings (IPO) globally. Merely 12% of these new listings happened in Europe. Second, the number of listed companies in Europe is declining. In the EU, it dropped by 15% between 2009 and 2019, which is an exit in one decade of more than 700 listed companies. Thirdly, in the US the market capitalisation of all listed companies amounts to more than 150% of gross domestic product (GDP) – we are all aware of it – as opposed to the famous 50% in Europe. That is a factor of three times. Fourthly, the EU's capital markets are also highly fragmented, with over 650 trading and execution venues in Europe compared to 100 in the much bigger, larger and deeper market in the United States.

Observation three is about Brexit. Brexit makes the existing challenges faced by Europe's capital markets considerably more severe. Brexit has further weakened the capital markets on the European continent. In losing the UK, we lost an important voice for strong capital markets in the European Union. The question is, 'Who is going to step in?' Despite all the differences we are currently navigating with the UK in other policy areas, in terms of capital markets there is a lot for us to learn from the Anglo American world. Not only can we learn from the UK and United States, we must learn, if we want to remain competitive on a global scale. Consequently, the EU 27 must significantly step up their efforts regarding the capital markets agenda while increasing the focus on our own sovereignty and creating a consistent regulatory framework in their own interests. I just alluded to what has been said in the previous session on the Markets in Financial Instruments Directive (MiFID). If you have 27 different regimes, it will lead you nowhere. The City of London – we should all be aware of this – is launching new consultations on a daily basis to rework the current regulatory regime and reality. For us within the EU 27, this means we need to organise ourselves much better. If we continue in our current vein and pace, we will not be able to keep up with our competitors.

Observation four is that the EU's priorities cannot be achieved without the support of the capital markets. We all know that. This is especially true for the two central tasks of our time, the climate emergency and digitalisation. It is a challenge too great to be borne by our banks alone. Trust me: I know what I am talking about. I was the CEO of a large bank in Europe for nine years, and I can tell you that the banks are completely overburdened. Equity and risk weighted assets (RWA) are precious. Even if you have increased equity, they cannot and will not resolve the transformational challenge. Individual countries are equally overburdened. National debt is already reaching its limits. The only way to mobilise the necessary investment is through the capital market, which is why I really welcome the clear objective stated by Bruno Le Maire, the French Minister of Finance, and quite frankly a very determined architect of the future European economic model. He stated – and we all know it – that for every publicly invested euro, we must secure at least three euros of private investment via the capital market. We can debate it, but the long and the short of it is that he is simply right with his request.

Observation 5 is this. To succeed in this endeavour, we need a cultural shift in the European Union. We must stop demonising the capital markets. It is not us but many others who are not invited to this elite conference. It is a notion shared by citizens, politicians and regulators as well as entrepreneurs, academics and other groups. Many of them still think that only manufacturing and producing companies are good companies. Within the EU, we lack the basic understanding that well-functioning financial markets are a necessary condition for functioning product markets and thriving economies. In the Anglo American world, this insight forms part of the political mainstream for leaders from politics, industry and finance. In the UK and the US, they are working together closely. We are missing something in this regard. The EU younger generation, fortunately, is more open to the opportunities of the capital markets, which is good, and, quite frankly, they are more demanding.

In conclusion, my observation six is this. It is imperative to attract wider circles of society into the capital markets. I therefore welcome the European Commission's push for a retail financial strategy. This process will require an increase of investment in economic education and especially in financial education. We need to empower and enable our citizens, our young people, to be able to invest safely, smartly and sensibly and we need to provide them with a wide range of attractive products and incentives to do this. We also must ensure that there is transparency and plausibility in the EU capital markets.

That brings me to observation seven. Transparency, integrity and plausibility are not merely nice to haves. These are must haves. We should strive to avoid conflicts of interest among platform operators. The prominent example – we all know it – is payment for order flow, a practice that is, at the end of the day, at the cost and expense of investors. We need to stop fooling ourselves. We are very far away from having transparent capital markets in the European Union. Let me provide you with three facts which underscore what I have just stated. First, contrary to the political goal, transparency across the European Union equity markets is now at a significantly lower level than it was before MiFID. Only 35% to 50% of the trading volume is executed on transparent trading venues. Secondly, more than 10 years after the global financial crisis, 92% – please recall this – of the European Union's derivatives trading is over the counter (OTC). It has risen, which is again entirely against and contrary to the prevailing political will. Why is this the case? Thirdly, we have also created an EU bond regime, a bond markets regime, where only 3% of bond instruments are considered transparent. The regulatory framework we have created not only continues to tolerate conflicts of interest and opacity; it actually encourages them. We must accept that the EU operators of regulated markets are artificially placed at a disadvantage. Is there a level playing field? Jesus, it is nowhere to be seen. The European Securities and Markets Authority (ESMA) market structure report clearly shows that those benefiting are Chicago, New York and London. They are the global investment banks, especially stemming from the United States.

Observation eight is closest to my heart. An effective EU capital market needs strong and major stock exchanges capable of competing globally, especially with the strongest US stock exchanges. Interestingly, however, stock exchanges are regarded as part of national DNA, which means each country is eager to have their own stock exchange, preferably, of course, in your own capital. It is an understandable aspiration, but in an increasingly united Europe, whatever 'united' means, it should no longer be the goal. Rather, a sovereign Europe should work together to create globally competitive EU stock exchanges. There is no other way for us to succeed against our UK and US competitors. In the US, the capital markets are today driven by three global exchanges: CME, ICE and NASDAQ. We can no longer afford the luxury of having many fragmented markets and the luxury of having more than a few exchanges. Even those few exchanges need to get challenged. Some will now argue that the past bad experience with major banks should be taken as a warning. This is wrong, because stock exchanges are frequently lumped together with banks. As I said, it is wrong. Why is it wrong? In times of crisis, stock exchanges have time and again proven to be a reliable anchor of stability. They have never required government assistance. Being without proprietary business, stock exchanges have no conflicts of interest. Stock exchanges are neutral, they are independent and they ensure transparency. They ensure best prices, true competition and the most efficient allocation of capital.

That brings me to my next observation, observation nine. Policy-makers and regulators should make a greater effort to create an internationally competitive arena for EU stock exchanges. They are the thought leaders and innovators of the capital markets. It was actually – this is kind of a marketing block here – Deutsche Börse Group that introduced electronic trading in the 1990s. In this spirit, we are today leading the EU capital markets, and I am determined to lead the capital markets further towards the digital future. The future of the capital markets is in the hands of organisations that intelligently set up and regulate stock exchanges, and of course their associated infrastructures, central clearing counterparties (CCPs) and central securities depositaries (CSDs). European regulation must above all be mindful of global competition in view of the upcoming Listing Act and further CMU measures. The European Commission, fortunately, does recognise the importance of capital markets. Incidentally, it is also high time to emphasise more strongly the benefits and advantages of efficient and effective regulation, which brings me to my last point.

The historic transformation in global capital markets through ESG and digitalisation opens up a unique opportunity to the EU. The EU is a world leader on integration and adherence to an ESG framework. We can actively tap into this regulated leadership to shape a future orientated and competitive capital market. This is all the more important, as ESG risks will have a significant impact on the future development and sustainability of business models, economic locations and, last but not least, societies. The future of capital markets is in the hands of organisations that intelligently set up and regulate stock exchanges and their associated infrastructures, clearing houses and securities depositaries, as I said before. Policy-makers and regulators should make a greater effort to create an internationally competitive arena for EU stock exchanges. They are the thought leaders and innovators. As I said, we are the leader. We have been the leader and we want to move ahead. Well organised and regulated exchanges will also significantly contribute to the reduction of the current excess liquidity in Europe. What are we working on? We want to take away liquidity by inventing and enabling new asset classes like fine art, music or e sports, and of course real estate.

In closing, ladies and gentlemen, I would like to summarise the three most important points. First, the EU's capital markets play a vital role in securing our future. Second, EU stock exchanges and infrastructure operators are the backbone of the CMU and of our future sovereignty. We need policies and a regulatory framework that face up to reality and aid our evolution rather than hamper it.

Ladies and gentlemen, at Deutsche Börse, we have defined our purpose: We create trust in the markets of today and tomorrow. Trust is the foundation of all of these aforementioned objectives. For us as Europeans, these are the priorities which we must remain focused on. They deserve our full commitment, and we need to speed up significantly. The time for debate is over. We need to act decisively. Thank you very much for your attention.

Didier Cahen

Thank you so much, Dr Weimer, for this outstanding speech. Are there any questions in the audience?

Participant

I thought your description of the fragmentation of capital markets in Europe was very interesting, with the 600 venues and all that. Could you tell us maybe how you see further integration of these capital markets? What would be the drivers? Is it just unified legislation or will more be needed? Is it to do with supervision or maybe other aspects?

Theodor Weimer

That is a great question. Let me be blunt here. Firstly, we need to create a legislative and regulatory framework which allows further consolidation. Secondly, we need to further consolidate. We have, structurally, a fragmentated market. We will not get over it. If you have the double whammy of a fragmentated market plus a highly fragmentated structural situation, you will never, ever succeed. I was a partner at Goldman Sachs 10 or 15 years ago. It was always very clear that we could win against Europe. Why? It is because the fragmentation creates smaller profit pools and lower prices, by the way. If you compare the big difference between the United States' investment banks and the European investment banks, the pricing level is much better. Therefore, we think we can have a fragmentated market plus a fragmentated organisational structure. We have to change this. That is reason why I pointed towards the stock exchanges. We cannot afford anymore to be that fragmented.

Frank Elderson

Member of the Executive Board and Vice-Chair of the Supervisory Board, European Central Bank

Prudential pathways to Paris

Many thanks to the organisers for letting me participate remotely in this panel alongside such distinguished speakers. And thank you to the Chair of the panel for allowing me to open the discussion with some remarks on the importance of transition planning. I fully appreciate the irony of what I'm about to say, what with you in Paris and me here on-screen, but we are all on the path to Paris. Citizens, firms, banks and prudential supervisors alike are working towards the climate goals agreed in 2015 as the EU and national governments roll out policies implementing the Paris Agreement.

In previous speeches, I have stressed the need for banks to put in place transition plans compatible with EU policies implementing the Paris Agreement – plans with concrete intermediate milestones to enhance banks' long-term strategies and decision-making. More and more banks are already doing this themselves, while the European Commission also called for enhanced transition planning in its sustainable finance strategy published in July 2021.

For ECB Banking Supervision, the main concern that needs to be addressed by these transition plans is the level of banks' risk exposures and the effectiveness of their controls. Have the exposures been sufficiently mitigated and are they prudent? As climate-related and environmental risks become increasingly widespread and more material, banks will, inevitably, be exposed to them, through both physical and transition risks. Banks therefore need adequate risk mitigation measures in place. This is what we need to assess as the prudential supervisor.

Introducing a legal requirement for banks to have a clear, detailed and prudent transition plan in place would increase the consistency of the regulatory and supervisory framework and contribute to maintaining a level playing field. Needless to say, we are very happy to see that this is exactly what the European Commission has proposed in its review of the Capital Requirements Directive, which is now with the co-legislators.

But it doesn't stop there. For banks to be able to manage their transition risks adequately, they need to have information on how their customers are performing relative to a Paris-aligned transition path. This is where the European Commission's proposal for a Corporate Sustainability Reporting Directive comes in. The ECB welcomed this proposed directive in a legal opinion and it is now awaiting approval by the co-legislators.

The current standards on sustainability disclosure are insufficient to ensure that sustainability-related financial risks are properly understood and priced by market participants. The proposed Corporate Sustainability Reporting Directive is a necessary step to address the gaps that currently hinder the development of appropriate sustainability policy, risk assessment and risk monitoring frameworks for the financial sector. This is because it will not only explicitly ask large banks to disclose their transition plans, it will also ask banks' corporate clients to do the same. This last point is crucial, as it will enable banks to assess the climate-related and environmental risks in their asset portfolios. These disclosures are therefore an important element in ensuring that banks manage all material risks, in line with what we as the prudential supervisor expect them to do.

The climate-and-environmental puzzle is still highly complicated, but we can now see the pieces slotting into place. Against this backdrop, it is crucial that the elements included in the Commission's proposals are implemented in actual binding legislation entering into force without undue delay. This will smooth the path to Paris for all.

Exchanges of Views

How to improve Economic and Monetary Union

Paschal Donohoe - Minister of Department of Finance, Ireland & President, Eurogroup
Irene Tinagli -Chair & MEP, Committee on Economic and Monetary Affairs, European Parliament
Jacques de Larosière - Honorary Chairman, EUROFI
Vitorio Grilli - Chairman of the Corporate and Investment Bank EMEA, J.P. Morgan
David Wright - President, EUROFI

David Wright (Chair), President, Eurofi

David Wright (Chair) highlighted the importance of the panel and introduced the panellists. The topic is how to improve economic and monetary union given increasing economic and financial fragmentation. David Wright (Chair) invited Paschal Donohoe to open with some remarks.

Paschal Donohoe, President, Eurogroup & Minister for Finance, Ireland

Paschal Donohoe noted the return of naked military aggression to Europe. The rule of international law has been usurped by unprovoked military actions that tragically will bring enormous human suffering. That poses the question of the value and worth of these discussions, given the scale of the events unfolding. However, it is because of what can be seen to be happening elsewhere that there is a need to be reminded of the huge value of unity, strength and the depth of what all have built across the European Union.

Within 40 years of war on the continent, all moved to the point where they were engaging and negotiating with each other on, for example, the intricacies of a common market. Europe has moved on to an even more united front, and shortly there will be the imposition of the harshest package of sanctions ever implemented by the European Union. The European Union will stand absolutely united in protecting its common values and freedoms, and its rules which have brought such massive economic and social benefits to all Europeans.

Paschal Donohoe wanted to make some remarks on the work and priorities of Eurogroup, the coordination of European economic policy and the immediate outlook for progress on key priorities.

An ambitious work plan on Banking Union (BU) is one of Paschal Donohoe's priorities as President of the Eurogroup. It is critical for the credibility of the financial sector and the EU's economic scale on the global stage, which needs to be reflected in a banking sector that can serve EU citizens, small and medium-sized enterprises (SME), corporates and can deliver on the ambitious and vital needs of the twin transitions to a more digital and a lower-carbon future.

The work plan aims to be a political framework to deliver tangible progress, and to serve the goals of depositor protection, robust crisis management, and a stable, resilient and competitive banking sector which is capable of facilitating broader economic growth.

Along with the promotion of retail investment, and an open-end strategy Capital Markets Union (CMU), a Banking Union is critical to the future of the EU's monetary union as a shock absorber to support economic recovery and to drive the twin transition.

Every finance minister has different priorities for the Banking Union project. At the same time, at every European Council that Paschal Donohoe attends he receives the mandate to make progress on the same project. Having talked to all of the finance ministers over recent weeks, there is clearly further willingness to devote time and energy to agreement on this project.

At the March Eurogroup meeting there will be a further discussion on a potential work plan. This work plan will cover four work streams: commitment to a common protection for depositors, how to promote diversification of bank sovereign exposures, improving the management of failing banks and how to create the conditions for a single market of banking services.

The concept of sequencing is as important as the content. The hope is to deliver a phased and gradual approach that is more capable of developing trust and creating an environment in which there is delivery across all work streams.

At this stage Paschal Donohoe envisages three phases. There are the immediate steps based on Commission proposals to deliver tangible results. Then there are medium steps to introduce gradually, and in parallel to all four areas, the core concepts of a more complete Banking Union. Then there is a longer-term view where the steps taken are reviewed to ensure that what is wanted has been delivered. At that stage, if it is agreed that they are needed, additional measures can be worked on.

The aim of phasing is to allow for a build up of trust, which is critical, and to make sure that in building this trust there is delivery across all work streams. Accompanying this approach, there could be checkpoints along the way to make sure there is parallel delivery. This is a delicate balancing act. It is complex and highly sensitive politically. Paschal Donohoe will continue to rely on all finance ministers, particularly after the efforts of the last year on this project, to assist in the development of proposals that bring consensus closer, with a view to delivering a political framework for progress in the coming months.

Regarding other issues on economic policy, there has thus far been a very strong and very rapid recovery across the euro area. There was growth of 5.3% last year and unemployment at a record low of 7%. Economic prospects for 2022 remain robust, but there are now two key areas of concern to all finance ministers: the familiar challenges of monitoring inflation across the euro area and the most recent and most grave developments taking place in Ukraine, which will be front and centre of ministers' minds when they meet in the morning.

As this is addressed, policy will need to remain agile. Agility has been a hallmark of economic policy during the pandemic, as it has led to coordination and consensus. This in turn has created an environment in which budgetary and monetary policy are able to work together. The Eurogroup has played a critical role in this.

Paschal Donohoe noted that the supportive monetary policy decisions of the European Central Bank (ECB) were coupled with swift, decisive and coordinated actions by ministers. Eurogroup will continue to have regular discussions and make decisions on these matters. It is in that context that the future of economic governance will be debated over the coming months, and the Eurogroup will play an active role in this process. Looking to the future, a policy mix will be pursued which supports the recovery, promotes investment and safeguards the sustainability of debt.

These objectives are mutually compatible, but the balance must be right. The role that the private sector will play in driving and facilitating change must be recognised, especially in the capital needs to meet the investment needs of the great transitions. This is why work on Banking Union, on economic governance and the broader economic policies are so intertwined and co-dependent. It is this integration and dependency which will continue to be used as a source of mutual benefit as new and grave challenges on the European continent are confronted.

David Wright

David Wright (Chair) invited Irene Tinagli to comment on the key issues for improving the monetary union given the current context.

Irene Tinagli, Chair, European Parliament Committee on Economic and Monetary Affairs (ECON)

Irene Tinagli thanked Paschal Donohoe for his extraordinary efforts with the Eurogroup in trying to get it unblocked and to make progress. The different perspectives among the member states can be seen in the Parliament as well as among different political groups and different delegations, so Irene Tinagli appreciated the complexity of the issue. However, by now, and especially with the past couple of years, all should be aware of what is at stake and the urgency of moving forward.

The difficulty is finding a strategy for moving forward. The question is what the priorities are, bearing in mind that some things are interlinked and need to be addressed together. If only one thing is done at a time the EU may end up stuck in the pros and cons of that single issue and not move forward. Therefore, it is important to have a more holistic, comprehensive and pragmatic approach, bearing in mind the final objective.

The Banking Union will also need progress with the CMU. There is one aspect in particular that can be beneficial for both, which is to create a real, common, safe asset. This instrument would provide a stabiliser and the possibility for a high-level shock absorption capacity. It would also help to ensure an effective transmission of monetary policy decisions. This was seen with the bonds issued in the past year and a half for the Recovery and Resilience Facility (RRF). The high quality of the bonds has been seen along with how attractive they are to investors.

The second issue, building up on a European safe asset, is the issue of fiscal capacity. This would be crucial for complementing the action of the European Central Bank and guarantee, not only in the short and medium term but also in the long term, coordination between monetary and fiscal policy, the importance of which has been demonstrated in the past couple of years. Being able to put this policy mix in place and have these diverse instruments, both monetary and fiscal, has proven how many positive effects there can be. At one of the last ECON committee hearings, Paschal Donohoe answered a question from an MEP, which was critical about the deployment of policy instruments, by highlighting the difference between the response to this crisis and how long it took to get over the past great recessions. Having this policy mix is important, so it is important to think about how to guarantee this capacity and policy mix for the future.

David Wright

David Wright (Chair) asked Vittorio Grilli to comment.

Vittorio Grilli, Chairman, Corporate & Investment Bank, EMEA, JP Morgan

Vittorio Grilli was encouraged by the detailed plan described by Paschal Donohoe and its ambition. BU is crucial and it is a cornerstone for much of the political and economic ambition of Europe, not just as an enabler of the digital and lower-carbon transitions, but more generally for the competitiveness of Europe as a whole and of its own banking sector.

The financial and banking sectors are in a deep transition globally. In order to face those transitions from a position of strength the BU seems to be very important. Banks are facing increasing competition from nonbanks, such as payment companies and fintechs and exchanges and BigTech, which are outside the banking regulatory system.

There is also a technological transition that will impact the financial sector. There are the cryptocurrency and digital coin issues which are all very complex challenges that will require further steps in the direction of a true BU.

Vittorio Grilli stated that with the challenges from the perspective of the financial and banking sector it is a pivotal point on monetary union and also monetary policy. There has been extreme success in dealing with the last two years and a major changing pace of coordination between fiscal and monetary policy. That has been the essence of the resilience of the European economy, as well as the global economy because other areas of the world have effectively done the same.

With the Ukraine crisis there is more thinking about when the right time is and to what extent the monetary stance should be changed. Much debate in financial markets is on exactly how this reversal of action will take place. As the initial measures were unprecedented this reversal is also unprecedented, and therefore will represent many challenges. However, the current situation is thanks to this policy and the strength of the economy, the financial market and the banking sector. Banks are now very well capitalised and very well supervised. There are many tools at the disposal of regulators. This reversal of policy will take place in a banking sector which is strong and more able to face these challenges.

Vittorio Grilli noted that there are issues about the speed and sequencing of the unrolling of the asset purchases programme and the change in interest rate position, both of which will impact the real economy. For the financial crisis of 2010/2011, initially the weak points and the challenges were within the banking sector. Now the banking sector is probably the strongest asset the real economy can rely on; the concern is how the real economy will stand this reversal of policy, compounded with what has been seen on the market which, unfortunately, Ukraine will compound, namely increasing energy prices. There are clear bottlenecks in the supply chains. These are important challenges for the real economy. The question is how that will play with the change in stance in both monetary and fiscal policy.

That is the challenge. The real economy is going to face real challenges, and the question is if this change or the removal of this extensive support can be done without altering the good state of health of the economy, both for the real economy and the finical sector. However, the starting position is one of strength for the banking and financial sector. Additionally, changes in interest rates will also change interest rate margins and will add to the health of the banking sector, which even in the face of changing monetary policy could still be very supportive of the economy. Even with changes in monetary stance it will take a long time before it is possible to return to the previous position. This gradual approach is also an element of optimism.

David Wright

David Wright (Chair) invited Jacques de Larosière to comment.

Jacques de Larosière

Jacques de Larosière noted, regarding the capital market in Europe, that he has a slightly divergent view from many in the Commission. The problem of the capital market is less a regulatory issue than it is a practical, operational or concrete issue.

In Europe it is usually believed that more regulation is needed in order to reduce the European legal obstacles or inefficiencies. An inordinate amount of energy is spent trying to agree new regulation. It is very difficult because each country believes it is right so there is not much progress. This is not the problem; it is not regulation. Europe does not have a proper capital market because investors are attracted more to foreign markets. The question is why. The Union has a payment surplus. It has an excess of savings, and those savings go away. They do not percolate much into Europe.

One of the reasons for this concerns interest rates. Jacques de Larosière asked about this on a previous panel and was not satisfied by the answer as an investor does not choose to invest because of remuneration and interest rates. However, if that candidate for an investment is taxed and told it is not going to bring anything to them in terms of remuneration and is going to be taxed by a negative interest rate, that is a major deterrent. Keynes was haunted by that problem. He used to say that interest rates must be low enough to allow the system to invest, but not too low because then there is a liquidity trap. A rational person who is told that putting money in a bond will not bring any remuneration will prefer to keep their money in liquid instruments, accounts in banks. This is happening every day. The figures provided by Eurofi are staggering. The portion of financial savings of households that is totally liquid goes up rapidly. Investment in longer-term obligations and the things approved of, such as climate change, do not attract any appetite.

If Europe wants to remain the only region in the world with negative interest rates, then it must be asked why it would be thought surplus savings in Europe will remain and work there as long as they are not remunerated, whilst in other parts of the world the remuneration is significantly higher. The statistics of the Organisation for Economic Co-operation and Development (OECD) indicate that for the last 10 years the 10-year interest rate in the United States was steeper than the European one by 2%. That is very significant for an investor that has to prove to his client that he is doing a good job. It is okay to chisel at the regulations between the countries on capital matters, but if the basic condition to keep the money in Europe is not there due to this taxation of savings, Europe is not going to get anywhere.

It is thought there is a Banking Union because there is a unified bank supervisory system, and while that is true and a good thing it is not enough. The essence of a Banking Union is to allow bank groups to develop their business in single markets so they can capitalise on their strength in order to expand their activity. However, in order to do that the business model must be as consolidated, as universal or as global as the balance sheet. Ring-fencing of capital, owned funds and liquidity constraints at the host level lead to double buffering, inefficiencies and duplication in the use of capital whilst the unification of the balance sheet remains. The balance sheet is not for subsidiaries; it is at the global level. There is a discrepancy between the balance sheet of the group on the one side and the compartmentalisation of the business activity through ring-fencing.

Jacques de Larosière explained that friends in the banking sector had highlighted three matters that are difficult to understand. The first is the global systemically important banks (G-SIB) buffers and the alternative score. It should normally be calculated like in the United States on the basis of the Banking Union. The notion of the Banking Union involves group operating in different countries. The calculation should not be scattered among different host entities. However, this appears to be impossible in Europe, so it is a problem.

The second matter is the internal minimum requirement for own funds and eligible liabilities (MREL) obligations. They may well increase because of a new method related to the calculation of the deduction of own funds held in subsidiaries. This is a very technical point.

Lastly, the distribution of dividends in banking groups could also become a host decision and not a global decision for the bank itself. If the EU goes that far it becomes a localisation scattering and a division of the group in as many entities as there are subsidiaries, which is a major step backwards from the time Jacques de Larosière was familiar with when there was a Banking Union, but it was not called that. Now there is a Banking Union without the reality of a Banking Union.

David Wright

David Wright (Chair) asked Paschal Donohoe for his closing remarks.

Paschal Donohoe

Paschal Donohoe noted the importance of gradualism. When thinking about the Banking Union project, Paschal Donohoe and his fellow ministers put great effort into reaching agreement the previous year but were not successful for a number of reasons. The issue of gradualism in how to make progress is very important. A gradual and sequential approach needs to be taken to build something that currently is not strong enough in the project, and that is trust. There needs to be trust regarding how different stages are delivered and trust regarding how to move to the next stage.

Paschal Donohoe is a politician and represents politicians who are trying to reach agreement on a very complex and challenging project. The narrative about this, and the way to make progress, concerns how it is a source of better organising and directing savings and capital, not for the benefit of banks themselves but for the benefit of investment, jobs, living standards and the role of Europe in the world. That is the pitch. That is the paradigm. When thinking of all of the technical subjects in Banking Union, what has to be returned to is the purpose of the efforts, which is living standards, competitiveness and how to invest in a better future. There has not been enough progress in Banking Union recently because efforts have not been connected to that purpose.

Finally, as was acknowledge by all speakers, the progress already made with Banking Union should not be underestimated. At Irene Tinagli's committee in the European Parliament, when the progress of Banking Union is discussed Paschal Donohoe noted the efforts in that regard are amongst the reasons why, after two years of a pandemic, European banks are not part of the problem. They have shown that they are part of the solution. This is due to decisions the banks themselves took, but it is also due to the institutions in place through the efforts in Banking Union. With the efforts that the members of Eurogroup and all finance members involved in the Banking Union project are making, it is being demonstrated that this can be achieved. That is where the efforts will lie in the coming months.

Reforming the Stability and Growth Pact

Nadia Calviño - Minister of Economy and Digitalization, Spain
Klaus Regling - Managing Director, European Stability Mechanism
Tuomas Saarenheimo - President, Eurogroup Working Group, Council of the European Union
Gintarė Skaistė - Minister of Finance, Republic of Lithuania
Jacques de Larosière - Honorary Chairman, EUROFI

Tuomas Saarenheimo (Chair), President of the Eurogroup Working Group (EWG), Council of the European Union

Tuomas Saarenheimo (Chair) noted that during World War 2 the Commander-in-Chief of the Finnish armed forces, Field Marshall Mannerheim, who led the Finnish war efforts for four years, had lunch with the central command every day. There was one rule for that lunch which was to not speak about the war. In that spirit, the panel is not speaking about the war; instead, it is talking about the Stability and Growth Pact (SGP).

Political discussions for the SGP are at the halfway mark. In the coming months deliberations should be encapsulated by outputs. It is therefore a good moment to discuss this issue. The panel will discuss two broad issues. The first is whether there is a need to change the SGP. Here the questions concern how to reconcile the SGP with the present high and divergent public debt ratios and how to reduce them in a sustainable and growth-friendly manner. There is a question about the future of specific thresholds three and 60. There is also the question of heterogeneity and how to address that.

The other part of the discussion is about the quality of public finances. There the questions concern how to promote better quality and composition of public finances, what the role of the European Union is in promoting better quality national public expenditure in member states and what the role might be of national fiscal frameworks in doing the same. Tuomas Saarenheimo (Chair) asked Nadia Calviño to comment.

Nadia Calviño, Vice-President and Minister for Economy and Digitalization, Spain

Nadia Calviño highlighted the need to deal with these issues that are important for the future. The SGP must be reviewed. Nadia Calviño agreed with Paolo Gentiloni, who was emphasising the word 'and'. It is the Stability and Growth Pact. That summarises everything.

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. We need to create fiscal space and we also need to undertake an unprecedented investment effort to drive the necessary green and digital transitions.

To succeed, we should draw lessons from the past. As Paolo was making his speech, Nadia Calviño thought about Spain as an example of the difficulty of reducing debt to gross domestic product (GDP) ratios without growth. There is also the risk of public investment being the first casualty of wrongly approached fiscal consolidation policies. In previous crises, public investment and other growth-enhancing expenditure were the first victims of fiscal consolidation policies. In the case of Spain, public investment and private investment also dropped significantly from 2008. They never recovered, dragging potential growth and prosperity for several generations. Indeed, this has been worsening and reducing the capital of the country, which means infrastructure and education, and it also means health, as the country had to discover when the pandemic hit. The lessons of the past have to be learned to avoid making the same mistakes.

The second lesson is the positive experience there was in the response to the pandemic. There was coordinated action, which explains the effectiveness of the actions taken since March 2020. It has been realised that everyone is in the same boat. This is a pertinent reflection for the current situation. Ownership by the countries of the reform programmes and the investment programmes are key to making them effective on the ground. These are good lessons going forward in terms of the review of the rules.

Nadia Calviño noted that this debate should have a forward-looking approach. There should not be a return to the old trenches and debates of the past that have wasted so much energy and led to a confrontation between north and south, rich and poor, new and old member states, east and west and any other division that can be imagined. The old rules cannot be applied as such in the new reality. This forward-looking approach is needed with a pragmatic and realistic starting point. Nadia Calviño agreed with Paolo's assessment and believed that around the table there is a good, positive spirit in all member states about the need to approach this with realism and pragmatism. That is more promising than some of the debates of the last 15 years which have led to very complicated rules with clear shortcomings that should be addressed before they become fully operational again.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) asked for Gintarė Skaistė's views.

Gintarė Skaistė, Minister of Finance, Lithuania

Gintarė Skaistė underlined that in previous SGP discussions some years ago, there had been a clear schism between Member States with more difficult fiscal situations and the others, like Lithuania. However, the situation is changing. The mindset of people is changing. How the situation is perceived is changing.

When thinking about stability and growth, both 'stability' and 'growth' have to be kept in mind. We must not forget the "G" in the "SGP". Stability and long-term fiscal sustainability is very important and there is a need for safeguards, but growth should not be forgotten. Also, there are very ambitious goals for the green and digital agendas at the European level, and, when talking about the goals and targets that have to be achieved, the financial resources needed to get there should be considered as well.

Lithuania is a good student, because it has had low debt levels and balanced budgets in the past years. Being a good student, we want the same for other countries, we want to have rules that everybody can feel domestic ownership towards. We have to be realistic –the current rules may not be implementable in some countries anymore. From the perspective of a minister in a country, where there is a debt level above 100%, the current debt reduction rule would never be implemented in practice (as it implies large scale fiscal consolidation), and it is not credible anymore because of that. There has to be consideration of how to change the rules that are not credible so everybody can follow them. Just pointing a finger and saying someone is not following a rule when it is not implementable anymore makes Gintarė Skaistė somewhat uncomfortable.

There can be a discussion about additional flexibility for productive green and digital investment as well, but with the necessary safeguards that are both quantitative and qualitative. The evaluation of the quality of investments would be key in this regard. Experience with the Recovery and Resilience Facility (RRF) instrument could be helpful in this situation. We have to see how implementation is ongoing and whether the goals are being achieved, namely, the milestones and targets, and then we can determine to what extent we can rely on the RRF experience aiming for additional flexibility to promote investments.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) invited Klaus Regling to comment.

Klaus Regling, Managing Director, European Stability Mechanism (ESM)

Klaus Regling noted that he has been discussing the Stability and Growth Pact for 25 years, and it is always about stability and growth for the very simple reason that without stability there is no growth. The starting point remains correct. However, Klaus Regling raised five points to help structure the debate.

Firstly, fiscal coordination in the euro area is needed because there is centralised monetary policy and de-centralised fiscal policy.

Secondly, the rules that guide the SGP need to be made simpler and more credible so that they can be better understood by politicians, the public and financial markets. Reforms are needed and overdue. As Paolo Gentiloni highlighted, the SGP will have its 25th birthday this year. It is perhaps a good time to think about reform.

Thirdly, though Klaus Regling agreed in principle that the mood is good and there is pragmatism, without consensus on how to reform the current legal framework will remain in place, and that would require the European Commission to make full use of flexibility and continuously take ad hoc decisions. That is exactly what the Commission does not want to do. All efforts should be made to find consensus for reform. That is also much better for transparency, for the political debate and for financial markets.

Fourthly, the current debate is heating up, and the Commission will soon come out with recommendations based on the 800 proposals they received on how to reform. This current debate is trying to tackle too many problems, so there is a risk of losing the focus of the SGP, which remains debt sustainability correctly understood. The good news is that debt sustainability can now be maintained with a higher debt level than was possible 25 years ago, but the focus should remain.

There is a public debate about other objectives that should be achieved with the SGP. The SGP should achieve many objectives, like more counter-cyclical policies, more public investment to promote growth and more expenditure for green and digital transformation.

All of that is very laudable and positive, but they should be subordinated to the key objective of debt sustainability.

The European Central Bank (ECB) may be a good example here. It has one primary objective. When that is achieved the ECB is encouraged to also support other objectives. There is a hierarchy here. That also means that, to the extent that good expenditures promote growth or prevent ecological costs in the future, those good expenditures contribute to lowering the debt ratio and promote debt sustainability. That should obviously be taken into account in the debt sustainability analysis, so even when there is this hierarchy, good expenditure and more public investment show up in a positive way.

Klaus Regling concluded that, when looking at the other objectives, it should be remembered that there are other important frameworks and tools that may be more suitable for meeting them. There is the EU budget; the European Semester and country-specific recommendations. There may be a desire for consideration of a new facility for macroeconomic stabilisation that could be added to the toolbox. The SGP on its own cannot do everything and that should be accepted.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) asked Jacques de Larosière to comment.

Jacques de Larosière

Jacques de Larosière suggested a fiscal framework is needed, because monetary union implies fiscal cooperation at a minimum, barring the ideal of fiscal union. A monetary union cannot afford inconsistent negative externalities stemming from uncoordinated fiscal decisions in different states. That would not be a cooperative system; it would be a hazardous, selfish-directed system.

The SGP has been experienced for years, and it did not work well because it was not respected. That was not because the rules were necessarily wrong. It was not respected because the system was based on one-size-fits-all. There were a few figures or percentages. The figures were abstract and not necessarily related to local needs, situations and realities. Therefore, there was not a sense of ownership. It was considered something external to comply with, and it was not felt to be necessary. Countries like France and Germany gave the wrong example at the beginning, because they insisted that the Commission exempt them from the rules, which had a terrible contagious effect.

If that analysis is true, a more tailor-made system with specific, well-adapted norms is needed, which would be the result of a dialogue between each member state and the Commission. This does not mean giving up all of the present norms. For instance, the 3% limit for deficits in normal times should be kept because it is a relatively important and doable norm.

Jacques de Larosière proposed that every year the Commission examines, with each interested country, the progress made on fiscal sustainability and, more importantly, the definition of the right vital objectives. For example, a country that has an excessively high ratio of public expenditures to GDP would be required to use this excess related to the eurozone average in a period of time, such as five years. Other countries which do not necessarily have this problem of too high expenditures but has a too high public debt compared to GDP would have to reach an agreed primary surplus.

The ownership problem is essential. The ownership problem can only be solved through common trust between the Commission on the one side and the state on the other. Having spent nine years on them, Jacques de Larosière vividly recalls what the International Monetary Fund (IMF) used to call Article 4 examinations. Each year, the IMF looked at the intricacies of the economic situation and the policies of the member states. The staff of the IMF was completely independent; there was no question about that. It was not possible to soften or water down their reports. It would have been impossible, and Jacques de Larosière would never have accepted it. The staff was free to say what it wanted, but it did so in a dialogue. It did not just expose the tools and say, 'That is what you have to do.' It was the result of a dialogue. At the end, the member state agreed on the gist or the thrust of the Article 4 examination, because it was very difficult to disagree given the rationality that presided over the exercise.

The country did not necessarily apply what was said in the Article 4, but if it turned a blind eye to the gist of the Article 4, which everybody agreed upon, for several years then it entered into the problem of lost credibility. If the European Union is a cooperative game where everybody tries to achieve what is the common interest, then turning a blind eye to this sort of Article 4 examination, as Jacques de Larosière was proposing, becomes a problem less so for the others but more for the one turning a blind eye to it, because it is not cooperating.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) noted that Nadia Calviño was the first to speak about ownership and has written about the need for the rules or the strategies to be homegrown. Tuomas Saarenheimo (Chair) asked how Nadia Calviño would ensure that this homegrown consolidation strategy does not become an eternal exercise in backloading adjustment.

Nadia Calviño

Nadia Calviño concurred with Jacques on the need to be more tailor-made when doing the assessment, and that there should be a more constructive dialogue that actually leads to the country owning these reforms, proposals or rules. The issue is how to make sure that that leads to actual consolidation, and that will depend a great deal on the situations of each of the countries.

Nadia Calviño thought, as Gintarė Skaistė was speaking, about the labour market reform that has just being passed, which was a very difficult exercise. It took many months of negotiation, but it was achieved and this was a long-lasting recommendation by all European institutions, the IMF and others. An agreement was reached with social partners. Having this broad social agreement about what needs to be done and having a target are key elements that facilitate broad, social and political agreement. Nadia Calviño agreed with this kind of approach because it also leads to or facilitates consensus at a national level. Although it would take hours to explain how the labour market reform managed to pass, it was achieved.

Currently there is an 'alignment of the planets'. The talk of Article 4 reminded Nadia Calviño of the fact that 15 years ago it would never have been dreamt that the IMF would be talking about inclusive and sustainable growth. All institutions and all governments around the table in the G20 meetings were talking about inclusive and sustainable growth, and that is an important political change of mindset that provides a new opportunity for having better growth that ensures stability and growth.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) noted that Gintarė Skaistė spoke about the need to recognise the special role of productive investment, green and digital investment. At the same time, the desire is to make the framework simpler. Tuomas Saarenheimo (Chair) asked how Gintarė Skaistė would incorporate this special treatment without making things more complicated.

Gintarė Skaistė

Gintarė Skaistė suggested keeping in mind both qualitative and quantitative safeguards. Talking about qualitative safeguards is quite challenging. Whereas, talking about quantitative safeguards is rather straightforward. The numbers can be discussed quite easily. Regarding a qualitative assessment and whether an investment is good or not, the experience of the Recovery Resilience Facility (RFF) can be used. Of course, the RRF has not been fully implemented yet and its success remains to be seen. But the basis is good to work on. A virtuous circle can be achieved where improved enforcement will lead to better fiscal strategies and those will lead to easier enforcement in the future.

Within the framework of the IMF's Article 4, Lithuania has received, in essence, the same recommendations for 10 or more years. Nobody wanted to implement them because it was difficult politically. However, when all of the reforms are connected with appropriate funding, it is easier. Furthermore, all of the country specific recommendations that were set to Lithuania by the European Commission are covered in the RRF plan.

The RRF instrument is a challenge in itself, especially from the implementation perspective. If it works, more trust can be built among Member States. If it does not work, it may provide valuable insights in how to achieve better outcomes in similar future endeavours.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) noted that Klaus Regling spoke about how the complexity has hampered implementation and asked whether that was correct in Klaus Regling's experience, and whether the problem of implementation enforcement has been that governments do not know what they are expected to achieve, or have not been able to anticipate the numbers that come out of Brussels, or whether it is just that meeting these numbers has been politically difficult.

Klaus Regling

Klaus Regling replied that it is mainly the latter. Quite often the political will was not there, and therefore it was easy to hide behind the complexities. That is one thing, but it is also important to have a Stability and Growth Pact that can be understood by the public, by the media, by parliamentarians and by financial markets. The number of exemptions and exceptions that have crept into the pact over the last 25 years have prevented that. Sometimes the Commission is blamed for that. That is not fair. It is the Council that decided on that and then the Commission had to implement it. That is a strong reason to return to simpler rules.

Ownership is really useful. That was also learned when the European Stability Mechanism (ESM) programmes were implemented. In countries where there was ownership, such as Ireland, the programme ended a year early. In countries like Greece where ownership was not as clear it took eight years. Ownership is important, but that requires political will. The Commission and Eurogroup need to explain to the country what they think should be done. The complexity of the rules does not help, because if it is not popular in the country and the public does not understand, ultimately the Pact requires parliamentarians to vote on it. There are trade-offs. Ownership is great, but without political will it is difficult to achieve. A case can be made for simpler rules that are easier to understand so that countries cannot hide behind complexities.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) noted that Jacques de Larosière's advice for creating ownership was to create country-specific strategies in dialogue with the member states by making use of the experience gathered in Article 4. However, Article 4 is not rule-based. It is customised. Tuomas Saarenheimo (Chair) asked the extent to which Jacques de Larosière wants to maintain a framework of rules instead of a framework of consultation.

Jacques de Larosière

Jacques de Larosière was not sure he could answer that. The cement of ownership was given by Nadia Calviño, and that is growth. If the gist of the examination by the Commission does not lead to more growth, then ownership can be forgotten about. It is very important to place the exercise under the notion of improving growth.

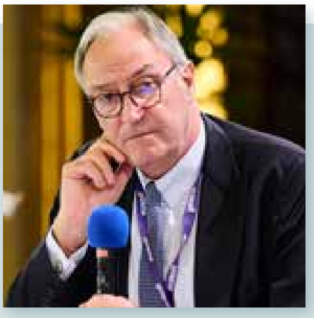
It must be sustainable growth because there cannot just be growth for the sake of growing. Creating microeconomic imbalances will eventually hurt growth, so it has to be done in the right way.

The ownership problem is very important. Many countries that did not respect the rules had no ownership at all. They just said there were external prescriptions that they did not believe in and which do not address the needs of that country. Therefore, they just set them aside. That has to be changed. The best approach is having a thorough examination.

The 60% had no meaning because the borrowing capacities of a country like France are much bigger than that. People in the treasuries thought they could borrow much more than 60% and for it to be okay. This was an element in the ownership; the 60% should not be kept but should be tailor-made.

Tuomas Saarenheimo

Tuomas Saarenheimo (Chair) summarised that there is a sense of pragmatism and realism in this discussion. That is something that was not present 10 years ago for the previous reform. There is much less division. The words that have appeared in this debate have been part of the political debate. There are a number of points of agreement and ownership is one of them. No one disputes this. There is an understanding that ownership is not something that can be spoon-fed. It grows from within and there has to be work with countries in order to create it. Growth is elementary. Sustainability is not just about austerity; it is about creating conditions for growth. How to get from this position to agreement on new rules is something that will be found out in the coming months.



Exchange of views

Bernie Mensah - President of International, Bank of America

David Wright - President, EUROFI

David Wright

Ladies and gentlemen, I have the great pleasure of having with me Bernie Mensah, who is the President of International for the Bank of America, member of Bank of America's executive management team, and Chief Executive Officer of Merrill Lynch International. He has a major role at Bank of America. Bernie, welcome, and thank you for your support of Eurofi, which is greatly appreciated.

I apologise for the background noise here. There are demonstrators in the lobby, but they are not going to stop us having an interesting conversation.

Bernie, you are absolutely at the forefront, with your clients, of managing sustainable finance. How do you see things after COP26? Are we making progress? Do you sense a change of momentum or do you see more downside than upside?

Bernie Mensah

Thanks, David, and thanks for giving me this time. It is good to have some background noise. It reminds us that we are in person versus on the Zoom calls that we have had over the last couple of years, so I will speak a little more loudly and maybe it will drown them out.

All the work running up to COP26 was manifest in COP26 and it was a good convening point. Through that point and beyond, the whole agenda around climate has really accelerated. The EU has taken a lead. As we all know, the EU is in the middle of implementing a lot of the things that it had talked about, which is good. The UK is also very engaged. The US, which had been a little bit behind, is also really coming to the table. It is taking a bunch of cues from EU regulations as well as the UK. Finally, I would say that the corporate sector and all of our clients – and those of other financial institutions, I am sure – are very much engaged.

One thing that I would say is that we are spending a lot of time not with the biggest clients who have the resources to be engaged but with a lot of terrific but more medium-sized and smaller clients who need the resources to really implement these things.

David Wright

Do you worry about fragmenting standards? Is the world moving to enough convergence here that will avoid an awful lot of deadweight cost in different markets? Is that something that worries you?

Bernie Mensah

Yes, I do worry about the different approaches that might be taken, in both senses: lower standards and gold-plating. We need to be careful in terms of how we take these rules. Some of the arguments around taxonomy, etc, are very public. There will be costs. For banks like ours, which operate across the globe in over 100 countries and have a physical presence in quite a few, it is always in our interests to make sure that these things are harmonised.

I am not sure if this is a perfect analogy, but sometimes when I think about the Internet, I think that a bunch of people very quietly created the rules, and then we all turned up and started to interact with the Internet. We then found out later that the rules were not really fit for purpose, and now we are trying to figure out how to control it. Here, we are trying to set the rules right at the beginning, before we get going, so there are a lot more arguments to be had. Hopefully, we will get the right framework to start with and it will be harmonised.

David Wright

When you think about this massively important transitional set of issues, we have heard here that we need a plan or some procedure. How do you see this? Who should take the lead here in terms of setting and delivering the framework?

Bernie Mensah

I would, of course, prefer all participants who are engaged to be iterating to what the best solution is. Of course, we need the regulators. We need things like COP26 to set the agenda. I would not advocate for one emperor, as it were, who lays out all the rules. That is a tough thing. It comes back to the analogy that I gave, which is that, as we are all around the table, making our cases for all the different aspects around disclosure of gas and nuclear, border-adjustment taxes and carbon offsets, etc, it is important that we have those arguments and that all stakeholders are heard.

The really big thing that we are all trying to grapple with at the end of the day is a just transition. Out of these rooms and beyond all of the demonstrations are people who are having to adjust their lifestyles or pay a cost for the fact that we are trying to get the temperature below a certain level. I am quite positive, because I think the right people are at the right table. It might be inconvenient, but the different voices are being heard.

David Wright

Today, if we just take the example of natural gas or nuclear, it must be very difficult to decide whether you can give credit or finance to that sector, because it is being evaluated in the context of the Commission's taxonomy. I hear that there is more political dispute in Europe about natural gas. If a project comes to you, how can you decide whether it can be financed without a definition of the taxonomy and the standards?

Bernie Mensah

That is a really good point. I may or may not speak for other institutions, but we do not want to be the instrument by which climate policy is set. Banks are, by definition, and quite rightly, incredibly highly regulated, and so it is an easy lever to reach to for public policy and for advocates to say, 'We are going to drive the strategy by asking the banks to apply capital to this type of lending versus another type of lending'. We do not want to be caught in that. When we talk through Scope 1s, 2s and 3s, etc, what we determine and how we lend can absolutely define the progress of this.

We set certain frameworks. We engage with a lot of different stakeholders and groupings that are out there. We subscribe to many forums, such as the International Business Council or the Glasgow Financial Alliance for Net Zero (GFANZ). As a bank, we have said we want to fund that transition. We are focused on it being a just transition. We have set our own net zero targets.

I am sensitive about a couple of things. To my mind, this does not result in huge additional capital requirements in aggregate for the banking sector, which I think is well-capitalised, even in anticipation of climate risks coming ahead. Secondly, we are hoping not to be the enforcers, as it were, through capital actions.

David Wright

Turning to another subject in order for us to benefit from your wide knowledge, there is a huge amount of change going on in the payments space. We have central bank digital currencies beginning to emerge and certainly being researched enormously. How do you see this evolving? What is the right approach here? We heard this morning that there are 250 different payment systems. I do not know if that was in Europe or around the world, but a huge number. How do you see this, sitting in your seat?

Bernie Mensah

Payments are super-important to us. As a bank, it is a sector that we focus on an enormous amount. We are one of the largest payments providers globally, not just in the US but outside. We interact outside the US largely in the corporate/institutional/sovereign space. Increasingly, a lot of our corporate interactions will be B2C. If we are banking, for payments purposes, some of the largest digital-payments entities globally, as we do, given the size and scope that we have, we increasingly need to provide services for them that allow them to reach their customers seamlessly.

It is terrific that there are fintechs in place. It is really, genuinely terrific – I am not just saying it – that it is being disrupted. It has been expensive to some extent, and it has been inefficient to some extent. Insofar as new technologies come into play to make payments faster, cheaper, more efficient and more convenient, insofar as we all carry computers around in our pockets, and phones that allow us to interact, it is not just me sending some money to my kids or buying a book on Amazon. We have large corporates that are executing $100 million-type payment transactions on their phones, in a mobile fashion. That is all terrific.

It is a space where we in the commercial sector need to compete. The big banks need to provide the best service and be agile, and the fintechs are welcome to come into the space. Clearly, there is space for all of that, because they are out there, doing very well, and are very well-capitalised. We are a little envious of some of their valuations, but that is terrific.

Very different things are things like crypto. A very different animal are central bank digital currencies. With respect to that, there are some very thoughtful actors in the EU and the UK – you might have Sir Jon Cunliffe soon – who are really thinking through how that will interface with the traditional role of banks, which is to gather deposits, make credit decisions and allocate capital in the wider community. I would put central bank digital currencies in a different pocket, to be developed, but very thoughtfully.

David Wright

It is going to be a swirling space for some time, for sure. I always like talking to you, Bernie, particularly because I want to get your view about how you see capital markets developing in Europe in the post-COVID period. Are you beginning to get more optimistic about what is happening? Do you see things that really make you think, 'This is interesting' from your bank's point of view, or are we still stuck in the refrigerator and making no progress?

Bernie Mensah

In Europe?

David Wright

In Europe.

Bernie Mensah

COVID has been difficult, but I am definitely seeing progress in the sense that there is a renewed energy around some of the issues that need to be dealt with. That may simply be from my perspective. One of the interesting things over the last four or five years is that a lot of the large global institutions have been a lot more integrated or engaged in a more detailed way in the development of the European financial markets. We have had to because of some of the settlements post-Brexit, etc. We have a significant office in France now, which we have been building out, and we have been investing in Frankfurt and Milan as well. It might be that actors like us are more engaged and seeing more, but my sense is definitely that Europe is having to take responsibility – and I do not mean this to sound wrong – for its capital markets in a way that it perhaps did not before. That is a good thing.

We have also seen, over the last six or seven years, a huge increase in capital in the global financial markets, if you take the US markets. It is something that cannot be ignored. I often use the example of the automobile sector, if you look at the market capitalisation of Volkswagen versus Tesla, for example. I do think that, at the macro level, from the regulatory point of view, there is great engagement. At the corporate level, the interaction with capital markets as a benchmark, a pricing mechanism, a solution and a capital-allocation mechanism is increasing in importance every day. All of our engagement is helping to drive capital markets in general and in specific areas such as securitisation.

The EU is an incredibly wealthy region, with a huge amount of savings that I would suggest are not as efficiently deployed as, perhaps, in the US. A lot of the savings get exported, by the way, and then get reimported back into the EU to be deployed. It is really important that those aggregate savings, which are huge, have a decent return for the demographics of the EU and for all of those requirements. When they are not, it is not easily visible, except in forums like this, with people who are following it closely. It is a huge cost and it can be a huge drag.

David Wright

Finally, would you put a lot of emphasis on building the securitisation markets in Europe? You mentioned that. Many people feel that here is one opportunity among many, where Europe really could build long-term liquidity in some markets. Would you agree with that?

Bernie Mensah

I would, and it is something that I am spending more and more time on. In fact, I was just catching up with some colleagues earlier today on it, and just rescoping the markets. It is interesting when you talk about securitisation here, because there are a lot of old hands who have been on the journey. A lot of eyes will roll and say, 'Gosh'. I am sure that there are a lot of barriers, and I suspect that a lot of them look at me a little naively and say, 'Welcome to the party'. I have been in the markets a long time and I do know quite a bit about them.

There was a large securitisation market before 2008. There is a large covered-bond market that exists today. There is the capital output floor of 72.5%, which is going to be phased in in and will impact banks in Europe that are relying on internal models. We need European banks to have not just the liquidity but the capital benefits, because, if you just take ESG, which we started the conversation on – full circle – the capital requirements that would be required to come in to drive the infrastructure investments that will lead us to a new place from a green point of view are huge. Whether you call it infrastructure financing, covered bonds or securitisations, it is the same mix. It is an incredibly important climate-transition tool, apart from everything else.

David Wright

Thank you very much, Bernie, for your thoughts, which are greatly welcome. I know many people here would agree very much with what you have said. Thank you again for being with us and for your support. It has been a pleasure.

Bernie Mensah

Thank you, David.

David Wright

You may even have silenced the crowd.

Exchange of views

Jean Lemierre - President, BNP Paribas
David Wright - President, EUROFI

David Wright

A very warm welcome to Jean, President of BNP Paribas. Jean, we greatly value your presence but also your continued support of Eurofi. Every Eurofi I have been to, you have been to, and I am greatly appreciative of that.

We enter a post-Covid, post-crisis period in theory. Let us assume that the external events are what they are, but how do you now see the progression, Jean, all things being equal of the European Union, from an investment and financing point of view? How are we doing? Are we in shape to provide the massive amounts of financing we are going to need for the transition to the ecological economy?

Jean Lemierre

It is always good to be here and to answer your questions.

You are right that there is a post-crisis. I hope we are not walking to a new crisis with the invasion of Ukraine by Russia. It is too early to know, but these events are unprecedented, at least for the near past, and we never know where it could go to. We see that it has today a big impact on the markets and may have an impact on growth through the price of energy, depending on the evolution of the conflict.

You know that I have spent eight years being the President of the European Bank for Reconstruction and Development (EBRD), being very close to these countries and investing into these countries, and of course, I could not have expected such a situation.

You are right to say that, beyond this, we have gone through the sanitary crisis reasonably well, if we forget one minute, which we should not do, the pain that many people have suffered at a personal level. The economy has gone through this well, and the banking industry has been useful. Lessons were learned from the previous crisis and the system was stronger. Now the economy recovers.

The main point you have made is a need for financing, financing investments and financing growth. Massive investment is needed for digital, green, and competitiveness. It is a positive agenda for Europe.

To deliver, Europe needs first a banking sector in good shape. We have to make sure that we have a well-functioning single market for bank financing in Europe. I do not use the word “banking union”. I prefer to make reference to the single market which has always been the driver of Europe, since the beginning.

We have made progress. The Single Supervisory Mechanism (SSM), and the Single Resolution Mechanism have been created. There is still the last mile to be made. It is very difficult for national member states to abandon their role to European entities. But they have built them and they appointed teams to manage them. They are strong institutions and have now a track record. So trust should be fully there. Trust will unlock a lot of potential. I have in mind of course the home / host debate.

David Wright

Indeed. I will now turn to investment, Jean. You are right, the numbers are colossal. How is that? Do you feel that people in Europe understand that this has to be provided through the private sector, through banks, through the Capital Markets Union? Do you think that that political awareness is there? Do you think the urgency is there to develop markets that can deliver the capital we need or not?

Jean Lemierre

I have answered half your question, David. But banks are the basis of the financing of the economies in Europe. We need to make sure it works well, and once more, progress has been achieved, but we are not yet where we should be. Hopefully we shall be soon.

Will it be enough? 10 years ago, an increase of capital requirements was designed to make the European banking system safer, but at the same time there was a need for a Capital Markets Union. Europe has massive savings and they should be channelled to finance our long term needs. How can we do this? Normally in a market economy it is done partially through the banking industry. The limit is the capital requirement in the banks. Then capital market are used. That is the reason why the capital market is full additional to banking Union.

It is the answer to your question. Banks know how to structure an asset timewise, risk-wise, profitability-wise, and they know how to place it. Securitisation is simply a tool. You take assets, you structure them, and you then offer to people who have savings.

It has been done very successfully in the US. Europe can do the same with appropriate risk taking and level of capital.

There is a common agreement on this, but it is still difficult. It is a rather low-hanging fruit, so we should try to reap it quickly.

David Wright

Just pursuing the securitisation issue, Jean, you really consider that this as an absolute key issue to build capital markets in Europe, build liquidity, aid the competitiveness of the banking sector. What else? Are you happy with, or can live with the new Basel proposals? What else would make this change and facilitate the investment cycle?

Jean Lemierre

The Commission has made the proposals, after long discussions. We should now move forward, keeping in mind market activities should not be harmed if Europe genuinely wants to develop the Capital Market Union to finance its needs for investment.

David Wright

I have a broad question, Jean, on monetary policy, because monetary policy is changing, with inflation. What are your reflections about how to manage these very difficult decisions in the time ahead? Of course, we are now in an even more uncertain situation, externally.

Jean Lemierre

I normally do talk about monetary policy, so I will use two words to answer your question : timely and orderly. The difficult task of central bankers today is to make sure that we have a clear understanding of the situation.

This morning, their task has become even more difficult with a geopolitical crisis on top of the exit from an unprecedented sanitary crisis. The priority is to give a clear message against inflation, without any slippage which could be damaging at the time some assets are leveraged and the risk of lower growth may increase.

David Wright

I am going to ask you one more question, if I may, Jean, because I remember you very clearly, way back in 2000, with your finance minister at the time. As a compliment of the Euro to press forward with capital market integration. We set up the Lamfalussy process, etc, and then Jacques de Larosière. My sense is that our institutional processes in Europe are just too slow. We do not seem to have the ability to move forward quickly. I am not saying this is easy. Of course, everybody wants democratic control, but we seem to have wound ourselves up in procedure and red tape, to some extent, that is hindering us taking timely decisions, what you talk about, timely decision, and I am not talking about monetary. Is that your sense?

Jean Lemierre

Over the last 20 years, Europe has shown a genuine capacity to make decisions when needed in crisis time. And today we have a challenge, which is climate change. If this is not to avoid a major crisis, I do not understand what it is.

There is a sense of urgency. The need for green investment should be a strong incentive to move on questions like Banking Union and a Capital Markets Union.

David Wright

Jean, thank you so much for being with us. It is always a great pleasure for all of us to listen to your thoughts. Thank you again for your support of Eurofi.

Exchange of views

Xavier Musca - Deputy Chief Executive Officer, Crédit Agricole
David Wright - President, EUROFI

David Wright

Good evening, everybody. I have the great pleasure of having with me here on the stage Xavier Musca who will be well known to you all. He is the Deputy Chief Executive Officer of Crédit Agricole. Xavier has had what can only be described as a stellar career: Director du Trésor, Director of Cabinet of Francis Mer. He became the Chair of the Economic and Finance Committee where I saw him many times during difficult times, and he became the Secretary General of the Élysée in 2011. Xavier, thank you so much for being with us and thank you to Crédit Agricole for your continued support of Eurofi, which is greatly appreciated.

We are going to talk about the more macro conditionality for a successful European transition towards the green economy and Crédit Agricole, if I am not mistaken, Xavier, is one of the pioneers in France from the banking perspective. My first question was to ask you about how you see the big and main conditions for this transition to work.

Xavier Musca

Thank you very much for your kind words and for this introduction. Just a couple of simple remarks to answer your question. The first one is that the real challenge is to invest into sustainable energies. I am saying that because when you listen to the debate today, from time to time you have the feeling that the main objective is to reduce our exposure to coal, gas and oil. This is indeed necessary, but I think that an important part is lacking, which is that we will have to invest massively in a new and more sustainable economy. I think the real debate should be about how we ensure that these investments are made, what financial conditions and what social conditions. If we do not resolve all these issues on these problems, we will fail.

I have one well-known figure to remind you here: €500 billion of added investments in Europe are required during the next years if we want to reach our environmental transition objectives in 2050. The real question is how we realise it. It will be difficult. Why? When you look at public investment, considering the fact that we have accumulated a huge debt at the moment due to the Covid crisis and during the previous crisis, we will have to diminish the level of the public debt vis-à-vis GDP. We will have to finance these new investments for transition, and the states will have to reimburse the NextGenerationEU (NGEU) contribution. It will be a huge effort for the states, and notably a huge effort at the moment at which precisely interest rates will rise.

Conditions are extremely difficult. My view on that is that one of the first conditions will be to continue the support from the EU. For instance to postpone the reimbursement of the contributions of Member States to NGEU and to prolong this NGEU procedure, maybe limiting it to green investments. It would mean that 28% of public investment in green infrastructure would be covered by such a repayment deferral, so I think that is the first thing to be done. That is for the public sector.

Then for the private sector, the real issue, in my view, is all that has been debated today. Everyone knows the taxonomy is not yet clear and the problem of the availability of data. If we want to incentivise people to invest into sustainability, they have to get reliable data so that the financial institutions could send the right information to the investors. Banks should also not be discouraged to invest and to finance investments, and that is linked to the whole structure of financial regulation which may discourage the financing of investments by heavy capital requirements.

The real question is also about the availability of investments. We have to be very cautious about incentivising our customers to channel money towards green funds if there are not enough green investments realised on the ground. Then there is also the conditions for social acceptance of this transformation of the economy. Something strikes me: no one says that if you invest more, it means that there will be less to be consumed.

All in all, through higher interest rates, higher taxes, etc., there will be less for consumption and more for investment. That is not easy to manage from a social point of view. On top of that, you will get all the problems raised by the transfer of people from one sector to another.

David Wright

Do you think that there is sufficient political recognition at the highest levels that the private sector has to provide the majority of this capital that is needed? I get the sense sometimes that, for example, if one looks at the Capital Markets Union, the Banking Union, these projects are pretty well essential for what we have to do here, yet it is stasis. We do not move forward. Do you think enough people understand that the capital markets have to function better in order to do this job?

Xavier Musca

First, there is not only the financial sector and the capital markets, but there are also the non-financial sectors. If it takes seven years in France to create a wind farm, you get bottlenecks at different places. You have to remove them if you want to foster sustainable investments. Second, the approach concerning the role of financial markets, banks, and investors is often negative, 'You should not invest in that company or finance it', rather than to reflect about how to facilitate the investments of corporates in sustainable projects, provided that obviously they are economically viable and financially profitable.

This leads to what you mentioned, the structure of financial markets, but also the availability of data and the clarity of the taxonomy. Indeed, uncertainties will prevent people from investing, or we could be in an even worse situation, in which people invest in something that is labelled as green and then criticised as being greenwashing. Then you have the backlash, which will hamper all our efforts.

I see my friend Pervenche Berès sitting here and I will pronounce words which are very surprising for someone who is considered a conservative like me: I think that some degree of planning is necessary. What I mean is, since you have a situation in which what you have to manage is long-term investment without appropriate price incentives – because we do not yet have adequate carbon tax at the European or international level –, you enter into something in which you have to direct investment through a convergence of interests and vision between social partners, governments, Europe and the private sector, including banks, investors, and producers.

If you do not have this sort of collective approach, which existed in France years ago, you run the risk of being inconsistent in managing this transition, because, again, you have to align the interests and the policies of different stakeholders.

David Wright

You would see this as a long-term European plan to drive investment through both the public and private sector for decades ahead.

Xavier Musca

Yes, I think so. I think that it does not have to be at the national level; it has to be a deep-rooted European consensus on the way to manage the transition, to invest and to take care of the social consequences. In this regard, the 'Fit for 55' proposal from the Commission is going in the right direction. However, it has to be also encapsulated in all the member states' policies, both on the investment side, the fiscal policy, and a revamping of our welfare system. Indeed, part of the population will need reskilling to move from one sector of the old economy to another belonging to the sustainable economy.

Let us take, for example, carmakers. You can expect that the number of people working in this sector will decrease, but that other jobs will be created in the new economy. An interesting study shows that, depending on the policy you follow, you can either have a decrease in GDP and jobs by 0.4%, because of the transition, or you can create 1 million jobs. The difference comes from the consistency, or the inconsistency of the policy followed.

David Wright

I think you are absolutely right to underline the social dimension of this transition and, frankly, I have not seen very much attention paid to it. There is another condition too Xavier, which is that we can do all this in Europe but how do we deal with our trading partners if they do not do the same? Do you think the idea of carbon border adjustment taxes is the way forward, assuming we cannot agree to global standards that are fairly applied around the world? Would you agree with that?

Xavier Musca

I think that the carbon border adjustment mechanism is necessary because a simple way to decarbonise an economy is to get rid of its industry and to import massively. But this would be a simple transfer of carbon emission from one place to another. The question is, if we want to green our economy and not just only green the balance sheet of the banks, you have to ensure that the decisions you take at the European level are not pushing jobs outside Europe. It is absolutely necessary for social cohesion reasons. You have to demonstrate that you are not creating mechanisms which, at the end of the day, will suppress jobs, but rather something which transform these jobs into more sustainable ones and improve the future of the economy. I recognise that is all very difficult to do.

David Wright

Listening to you, Xavier, it strikes me that the social dimension and the programmes here are going to have to be massive. Is it reorienting the European social and regional funds, maybe even making them bigger using the extended NGEU programmes? If this transformation really takes hold it is so large, effectively.

Xavier Musca

Yes. It is very difficult for me to design what should be done precisely, but my conviction is that, at a national level, the welfare system should be revamped to support the categories of people hit by the transition. I think that, as you mentioned, Europe will have its role to play. I think that the banks will also have their role to play. Let us take a few examples. You will have less people buying their cars, because buying a car will become more and more expensive. Usually electric cars, notably small cars, are more expensive than petrol cars. We bankers have to move towards financing reuse, reconditioning, and leasing, incorporating that in a global programme rather than simply financing the purchase of a car. It is also our role as bankers to frame the new products, the new approaches of the customers, adapting to the change of needs and the new constraints on customers.

David Wright

Finally, very briefly, Xavier, if I may, are you optimistic we can do this in Europe? Do you think it is doable?

Xavier Musca

Well, I am extremely optimistic. First of all, because I trust the people who are now in charge of Europe. Second, I am optimistic because today in Eurofi the fact that this issue of sustainability is one of the most important and the most discussed one shows that there is a shared consensus on the importance of the subject and on the need to address it. Third, I am optimistic because when you see what has been done on the taxonomy, on NGEU, etc., the panorama has changed quite dramatically during the last years.

The real question is about consensus and about speed. There is an anecdote I like very much about general Marshall, who was a famous American general of the Second World War. After he left, he was touring conferences and once he was asked, 'Could you explain to us how you win a battle?' He said, 'That is very difficult. I do not know, really, but I can explain to you how you lose a battle. Two words: too late.' Thank you.

David Wright

Thank you very much.

Exchange of views

Patrick Thomson - Chief Executive Officer for EMEA, JP Morgan Asset Management

David Wright - President, EUROFI

David Wright

Ladies and gentlemen, take your seats please, because we have the pleasure of an interesting discussion for the next 15 minutes with Patrick Thomson. Welcome Patrick, who is the Chief Executive Officer, EMEA, at JP Morgan Asset Management. I was looking through your CV, Patrick. I calculate you have been with JP Morgan Asset Management for 27 years. Is that correct?

Patrick Thomson

It is.

David Wright

So you have a wealth of experience. Patrick, I was wondering whether we could start with a subject that interests me a lot. I am very much supportive of what the Commission has put forward for European Long-Term Investment Funds (ELTIFs). Is this going to be the sort of long-term investment vehicle that can translate into bringing the necessary investment for transition and the new sustainable economy? Are you optimistic about this in JP?

Patrick Thomson

Firstly, thank you very much for having me, David. It's lovely to see you again. *C'est un grand plaisir d'être ici en France.* I would also like to single out the comments just made by the previous speaker, which I thought were very thoughtful. I totally endorse the approach by the European Securities and Markets Authority (ESMA) in terms of investor protection, consumer care and embracing the digital economy.

To answer your question specifically, ELTIFs offer a significant opportunity, but one that is fraught with risks. Picking up again on the previous comments around getting retail investors to invest and save more, this is clearly a very good outcome for the European economy. Of course, one has to be careful about the sorts of products that are delivered to those investors, and to make sure that the disclosures and necessary consumer protections are in place. Of course we fully support it, and I am very optimistic about the ability for savers, and particularly retail savers, to participate in long-term investing both within and outside Europe.

Here one thinks of an asset class like infrastructure perhaps, which has a clear public benefit, but it is an illiquid investment. One has to be careful about the way that one distributes those products, and to make sure that the consumers understand that because it is an illiquid investment, you might not get your capital back at a time of your choosing. Of course, like any investment, it is subject to risks, so I think making sure that those are clearly understood and well communicated is a very important part of the responsibility that we have as asset managers; ensuring that the public is educated.

I would probably make one other comment around that, which is that I do think that Covid has provided an extraordinary opportunity to educate our clients, investors and savers around Europe. People are much more digitally aware, and the firms that embrace that and are able to educate their clients and customers will be able to deliver better outcomes for them.

David Wright

To follow up on the ELTIFs, the Commission has made its proposals to modify the conditions for ELTIFs. I have heard very positive comments about these amendments from various parts of the market. I absolutely understand your comments on the retail side, but from the wholesale professional side, is this going to trigger a market, and the definition of a product, which could in the longer term match the Undertakings for the Collective Investment in Transferable Securities (UCITS) label?

Patrick Thomson

First, I can make an observation on UCITS generally. For us as a company, UCITS is very much the gold standard. Almost 30% of the assets that we manage here in Europe are on behalf of investors outside of Europe, who use the UCITS label as a form of guarantee and reassurance around the quality of those products. Again, to the extent that ELTIFs can be part of the Alternative Investment Fund Managers Directive (AIFMD) and the reputation for sensible, consistent regulation that we have here, I think that will encourage a lot more confidence in ELTIFs.

I think it is fair to say that ELTIFs have had a slow start. I do think some of the proposals will encourage more savers into that, but I would also make a further comment on sustainability. I think there is an incredible opportunity here to encourage people to save for a more sustainable outcome. For those of us who were at COP26, I was very struck by the numbers required to move the economy to net zero by 2050. It is $125 trillion, and when you break that down it is effectively three to four trillion dollars a year of increased spending. Now, that is almost three times what was spent in 2021, so these are monumental numbers.

David Wright

These are global figures.

Patrick Thomson

Yes, these are global figures. However, what I think is very encouraging, and what I am very optimistic about, is that this is an extraordinary opportunity for savers and customers in Europe to participate in allocating capital towards helping companies transition to net zero. Again, if there is proper regulation and consistent disclosure standards, that is an extraordinary opportunity for savers.

David Wright

Let us take the standards here. We saw the Chair of the International Sustainability Standards Board (ISSB) here yesterday, impressively outlining the work, but are we going to get a consistent set of standards? The role of the asset management industry in pushing companies that you invest in strikes me as being one of immense importance. For example, in the United States or in Europe, are you going to use the power that you have to drive adherence to these standards?

Patrick Thomson

Like a lot of asset managers, we have substantially increased our resources in stewardship, which really gets to that point. We are very engaged, as a lot of my peers are, in making sure that companies are delivering exactly what they say in their financial reporting. We want to be able to verify that. We are using different tools and techniques, and I will give you an example. We are now looking at other data streams such as complaints from NGOs. If you have a company engaging in activity and saying it is doing one thing, it is always good to verify that with a set of NGOs, who can effectively collate data to verify some of those claims. That is just a small example.

I think the use of forensic science to track the behaviour of companies is becoming much more active in the asset management industry, but underpinning all of this, and one of the most crucial things that we would ask regulators for, is a consistent set of disclosures. The ability for us to evaluate companies globally on a consistent set of disclosures will basically allow us to make informed choices around the companies that are actively engaged in moving to transition. I would encourage, to the extent humanly possible, a consistent set of standards that can then be applied across global investment markets.

David Wright

That is the big challenge. My feeling is that we will get some good standards from the ISSB, but not everybody is going to apply them in the same way. There may be a minimum, but then there will be differences on the top, which will make your life much more difficult. Look at the difficulties in Europe, for example, on finishing or completing this phase of the taxonomy with natural gas and nuclear, which is possibly going to take a further four to six months before the Council and the European Parliament hopefully sign off. It is a swirling world.

Patrick Thomson

It is, but I think that underpinning all of this and why I am so optimistic is that our clients want this. Fundamentally, we are responding to them. Again, just to remind everybody, we act on behalf of our clients, of course. It is not our money; it is our clients' money, and the fact is that more and more clients want to see their money being put into companies that are either transitioning or making steps towards a greener future. I am very encouraged by that, because I think in some cases it is almost outpacing the regulatory and reporting reforms that we talked about.

A great example would be the policies around introducing the Sustainable Finance Disclosure Regulation (SFDR) in March of last year. I would commend the Commission on that, because that had an enormous impact on the asset management industry. Fundamentally, if your funds are not Article 8 or Article 9, there is a question mark about their viability today. Think of that, because that has really happened in the last 12 months.

I am very encouraged, because that is unambiguous evidence for me that customers want this outcome. Of course, they want to see their money generating returns to help them meet their own requirements in retirement, or whatever their investment and savings needs are, but they want to do it in a sustainable way. Again, I think all of it is pulling in the same direction, and asset management companies who actually embrace and understand this, or who get into the detail around disclosures, and demonstrate and evidence the sustainability of their products to their clients, will be the endgame winners.

David Wright

Changing hats a little bit, we are seeing a huge growth in the private markets and private credit markets. Do you think that the UCITS rules and other rules for funds are sufficiently nimble and balanced to take care of investing in these type of assets, or do you think change is needed?

Patrick Thomson

There is an AIFMD review ongoing, and I applaud the work that is being done to review that post-2020, which was a real-life stress test for these products. Again, we encourage the idea that getting more savers to invest in longer-term products makes sense, where appropriate. There are, however, some challenges with private markets. Disclosures and consistent standards are less common. There is a well-known arbitrage going on in the private markets at the moment, whereby if you have a publicly listed company with perhaps some high-carbon assets such as a coal mine, what the company can do is simply sell it to a private equity buyer or a management buyout. The listed company then looks better from an Environmental, Social and Governance (ESG) perspective because it is emitting less carbon. Of course, the fact is that the coal mine will continue to emit, and in some cases increase, emissions, because they are not subject to the same regulation that a publicly listed company is.

One has to be very careful, and I would encourage regulators to think in the AIFMD review about the nature of disclosures, although, one needs to be careful about not overwhelming retail clients. We have seen in the past that the intent to disclose can actually lead to unintended consequences, so a balanced approach to make sure that investors in private markets know what they are investing in would serve that point well.

David Wright

So a much broader swathe of disclosure requirements across both publicly listed and private companies is what you are appealing for here.

Patrick Thomson

I think a more consistent set of disclosures; it does not necessarily need to be broader. Companies already disclose an awful lot of information, and asset managers have to as well. I think it is more related to the manner in which those disclosures are actually presented to customers. Again, there is an opportunity here. One thinks here of fintech companies. Challenger banks is a good example, whereby they use technology, nudges and different digital interfaces to ensure that clients are engaged with their savings, and they give them a requisite amount of information. Making sure that the information is succinct and to the point rather than the volume of information is a key point here.

David Wright

I have a slightly broader question, Patrick, because of your great knowledge here. When I look across the scene, it seems to me that Europe is not doing too badly on the fund side and the UCITS side. We have good proposals now on ELTIFs and even AIFMD and so forth, but the one area where we are not doing well at all is in the private pension markets. We are not creating deep pools of capital. I believe the 401(k) mass is hugely important in the US capital market. Securitisation is not functioning in Europe. What do we have to do here to really deepen and dynamise the capital market? It is a very broad question.

Patrick Thomson

Yes, I think it is a great point, and I would point to a couple of systems. I think Australia and the US are good examples of places where people are engaged with their savings. For me, it is all about engagement. There is a component about regulation where you need to broaden and deepen and facilitate service providers to be able to provide pensions. That is a critical point, but you also have to have a customer base that is actively engaged. Culturally in the United States, people are aware of what their 401(k) plan is. They are interested in it and they are invested in it. Again, for me it goes back to investor education and engagement. If you can get people engaged with their savings, and you get them to understand that putting the money in the bank and sitting on cash is not a sensible long-term investment strategy, then I think that will facilitate and promote a broader and deeper pool of capital, which will then be put to good use in serving people's pensions.

David Wright

What is the trigger to do that? How do you get people to do that? Is it education? Is it financial literacy? We have talked endlessly about this for years and years. Should finance be mandatory in schools? Surely yes.

Patrick Thomson

It is a combination of things but, as I said, I do go back to the point that I think Verena made very well. We now operate in a digital world. You are seeing fintechs appear all over the world that are taking advantage of that ability to connect with customers to make life simple, understandable, a good customer journey and a good customer experience. To the extent that we can do that, I think that will solve part of the problem.

David Wright

It was a great pleasure to see you here, Patrick. Thank you for coming. Thank you for your support of Eurofi, which is greatly appreciated. For the next edition we will be in Prague, and I am sure and I hope you will be with us.

Patrick Thomson

Merci beaucoup.

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Publisher: Didier Cahen

Design & Production: Daniela Craciun, Virginie Denis & Initial Production

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The European think tank dedicated to financial services

- A platform for exchanges between the financial services industry and the public authorities
- Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector
- A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors

OUR OBJECTIVES

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

OUR APPROACH

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two-yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proved over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

OUR EVENTS AND MEETINGS

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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We thank the **French EU Council Presidency** and **the partner institutions** for their support to the organisation of the Eurofi Paris Seminar

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