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VIEWS
THE EUROFI MAGAZINE

SEPTEMBER 2022

ZBYNĚK STANJURA

Minister of Finance,
Czech Republic

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EUROFI POLICY NOTES

PUBLIC AND PRIVATE SECTOR VIEWS

THE EUROFI VIEWS MAGAZINE

SEPTEMBER 2022

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

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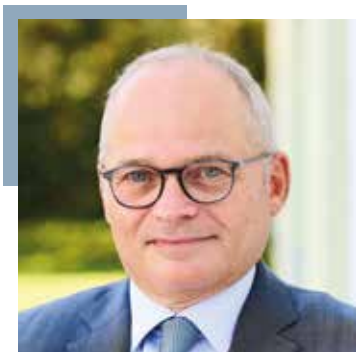

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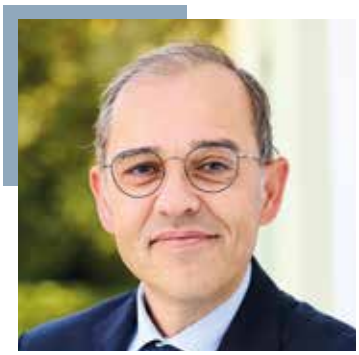

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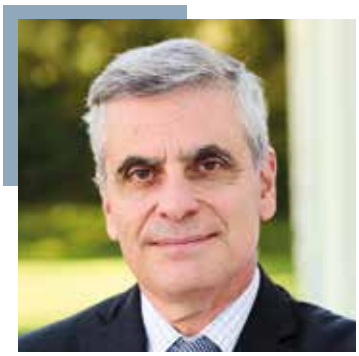


JEAN-MARIE ANDRES

This new edition of the Eurofi Magazine is published at a time that continues to be very challenging for Europe. The invasion of Ukraine by Russia is severely setting back the global recovery and European economies are experiencing the greatest shockwaves of the conflict among developed economies due to trade and energy dependencies with Russia prior to the conflict. Inflation is also continuing to surge, economic activity is slowing, and the risks of stagflation are increasing in the EU.

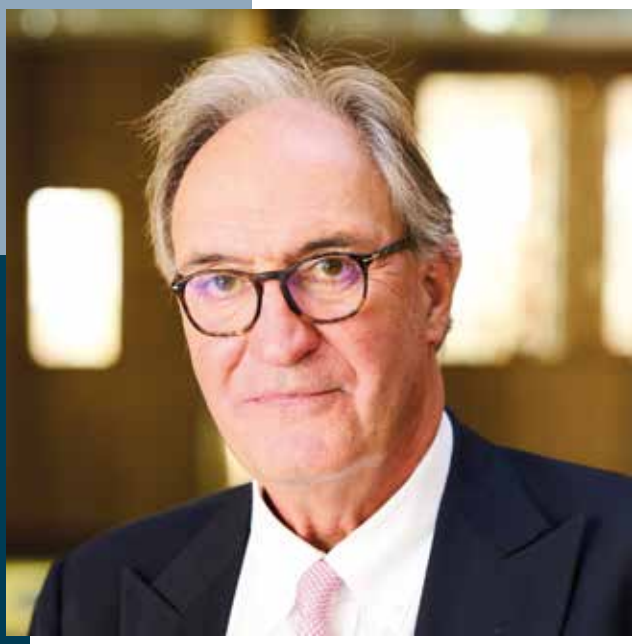
The appropriate policies for fighting inflation and relaunching growth in the EU and how to enhance the role that the financial sector may play in supporting the financing of EU economies are thus the central themes of this publication, gathering views from a large group of public and private sector representatives. The ways to achieve a more competitive and integrated banking and capital market in Europe and leverage digitalisation and sustainability trends, which are increasingly impacting and driving the financial services sector, are also extensively covered.

One particular challenge in the EU is the relaunching of productive investment, which is essential for creating sustainable increases of productivity and supporting the green and digital transformations and is being hindered by interest rates that remain low despite the on-going normalization, continuing to favour a preference for liquidity over productive investment among investors. The "Next Generation EU" Recovery plan is providing significant resources, but money alone will not ensure recovery if the conditions for investment do not improve more significantly.

A second major challenge is enhancing the so-called "strategic autonomy" of the EU in terms of financing - i.e. its non-dependence on foreign jurisdictions - and achieving this in a context where Brexit has increased the fragmentation of European financial markets and where digital solutions provided by third-party tech players are becoming increasingly structural in the financial services sector.

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

We are grateful to the 200+ public and private sector representatives who have provided us with input on these important questions for this Magazine, and we are sure that you will read their thoughts and proposals with great interest. The Eurofi Secretariat has also published several papers on these topics in the latest edition of the Eurofi Regulatory Update, which we invite you to read.



DAVID WRIGHT

President, Eurofi

Welcome to EUROFI Prague! Welcome to one of the most fascinating and culturally rich cities of the world. We are indeed honoured to be hosted in Prague and we thank the Czech Presidency of the European Union in advance for their warm welcome and for their invaluable assistance to set up this event.

6 months ago we assembled in Paris for our first significant post-Covid event. On our minds then in particular was the shock of the unprovoked and blatantly illegal Russian invasion of Ukraine. The EU began that week to further define and implement its Russian sanctions regime as EU Finance Ministers met concurrently in Paris at the informal ECOFIN meeting.

Since then the war, the killing, the vicious, wanton destruction in Ukraine have got far worse; an end is not in sight, nor even the prospect of any form of peace negotiations. Energy and many commodity prices have soared, as has European inflation with double digit numbers quasi-certain to emerge over the winter. In addition, the whole of Europe has felt the effects this summer of the hottest weather on record, extensive and destructive wild fires, water shortages, canals drying up, latterly some violent floods - further evidence, if any was needed, of the perils of global warming.

We can expect a wave of strikes to begin this autumn which will ratchet up and intensify as governments seek to maintain some control over public expenditure. Fuel poverty, as winter approaches, could drive many of the poorest into an even more deprived and dire economic situation. Economic growth in the EU is already stuttering and slowing under the weight of these forces as interest rates edge upwards, albeit too slowly, to help choke off inflation.

European policy makers this winter face a set of very difficult and unenviable choices. Slow the economy and risk a rise in unemployment and some sectoral economic fissures (eg commercial property) which will be certain to impact most new job seekers, the younger generation and the most vulnerable? Risk further significant rises in public debt which for a growing number of EU countries is already approaching sustainability and red line limits? Or hope for an end to the war soon, play for time and a subsequent fall in energy prices and inflation by using energy price caps and temporary subsidies targeted at the poor?

In this sulfurous economic and financial context two factors seem crucial to me. The first is maintaining, indeed deepening European solidarity combined with decisive, timely decision making at the highest EU institutional levels. The second is for Member States to continue to implement their NGEU structural reform programmes efficiently and strictly on time. By doing so, belief in fundamental European structural reform will grow and market confidence, international and European, will be enhanced leading to further productive investment in the future.

The EU's solidarity over Russian sanctions, over its energy supplies, over COVID vaccine distribution, NGEU and EU bond issuance has been impressive to witness. But this winter will demand much more common European thinking, sharing and action. For example, the EU's Russian sanctions have not yet caused enough constraining economic and financial damage to the aggressor and should be tightened further, including even tougher financial sanctions on Russian financial institutions. The EU will also struggle to remain united as it weans itself off Russian hydrocarbon supply. But it is vital that it does. Indeed, the EU needs to turn Russian energy blackmail into an opportunity to accelerate the transition out of carbon into the new green economy.

Another example, if the new, incoming U.K government decides to pursue an illegal and continuously hostile policy towards the EU, the Union must remain firm, principled and united, as it has done throughout the Brexit saga.

The EU can also greatly help itself, strategically, financially and economically, by completing the banking and capital market unions, both of which, when combined with the NGEU will greatly enhance its medium-term economic prospects and strategic autonomy power.

Frankly we have been talking for far too long about both projects. The reality we face today is one of insufficient progress and lack of political commitment at the highest political levels to deliver. We do not even have a simple, clear timetable for their completion. These two highly beneficial European projects are moving far too slowly, both open-ended with no conclusions in sight. A quick look at the forward calendar tells us we have only 20 months left in this European political cycle before another 9 month delay will kick-in following elections to the European Parliament and the formation of a new Commission in the second half of 2024. We simply must do better, accelerate the work now and move forward quickly and decisively under the Czech, Swedish and Spanish Presidencies to come. The geopolitical situation underlines that time is not on our side. More positively, as mentioned above, the EU has shown throughout its history that it can act together when really needed. We need this spirit of solidarity right now to complete these two urgent, vital projects.

EUROFI Prague has a very full strategic and topical 2 1/2 day agenda. It covers topics of crucial economic, financial and financial importance for the European Union.

I count on all of us in Prague to debate the issues constructively and openly and I thank all speakers and participants in advance for their contributions to help build and cement European integration and solidarity.

Q&A

ZBYNĚK STANJURA
Minister of Finance,
Czech Republic

Rethink, Rebuild, Repower: finding answers to geopolitical and economic challenges

What are the priorities of the Czech EU Presidency in the economic and financial areas?

First and foremost, the Czech Presidency's priorities respond to current geopolitical and economic challenges associated mainly with the Russian aggression against Ukraine. At the same time, they also reflect the long-term positions promoted in the EU.

In the economic area, we will focus on the ongoing implementation of the Recovery and Resilience Facility (RRF) and the rapid adoption of targeted amendments to the RRF Regulation in the context of REPowerEU. Based on the Commission inputs, we will deal with the economic governance review and preparation of the 2023 European Semester cycle.

In financial services, we will support the financial market stability at both national and EU levels. In the banking sector, the Presidency considers implementing the Basel III package to be crucial and will strive to achieve a general approach. As for the CMU, we will seek to progress, among others, in the field of the MiFIR review. We are preparing to defend the position of the Council in trilogues on EuGBSs, ELTIF regulation and AIFMD revision. In recent years, we have witnessed the exponential growth of data-driven innovations, so the digital finance topic is among our priorities, too. The EU already benefits from its Open Banking, but the potential of financial data goes well beyond current uses. When it comes to taxation, we will generally aim to simplify the tax system, fight tax evasion and reduce the number of unjustified tax exemptions. In the case of indirect taxes, we see the intensive work on the amendment of the Energy directive and the start of negotiations on the revision of the Directive on taxation of tobacco products as key. In the field of direct taxes, the priority will be to work on the proposal implementing the OECD/G20 global agreement (Pillar II).

Regarding combating money laundering and terrorist financing, we will actively support creating a more effective and comprehensible legal system. Our Presidency will also continue negotiating the CBAM and focus on reaching a political agreement. Ongoing debates on measures to support the climate and digital transformation will also be part of the work.

Finally, a key task will be to agree on the EU budget for 2023. Furthermore, the ECOFIN Council will cover the discussions on the possibilities of introducing new EU own resources from 1 January 2023. Our Presidency stands ready to lead the discussions on the reconstruction of Ukraine as well as on short-term financial support.

What are the monetary, fiscal and economic priorities for fighting inflation and achieving sustainable growth in the CEE region and more generally in the EU?

More than two years of pandemic and the last few months with Russia's military aggression against Ukraine have adversely influenced the macroeconomic developments across the EU. Both the pandemic and conflict in Ukraine have exacerbated imbalances in our economies, especially in supply and demand chains, which have manifested themselves in rising prices. The Russian invasion has further exacerbated the problems associated with inflation and increased pressures on public finances. In the following years, the monetary policy should remain accommodative in most economies, while macro-prudential policies should help limit financial vulnerabilities. Support measures to mitigate the impact of the pandemic and energy crisis should remain targeted and temporary, and we should return to compliance with fiscal rules as soon as possible.

Fiscal discipline and the quality of the common fiscal framework are crucial for the proper functioning of the Economic and Monetary Union. After the pause caused by the fallout from Russia's aggression against Ukraine, I believe it is appropriate to return to responsible budgetary policy

and start building up budgetary reserves for future adverse shocks. This approach applies to the CEE region and the EU as a whole. We should also make effective use of all the EU funds and work hard on reforms that have been delayed due to the pandemic.

With regard to inflation, it is primarily the central banks that are supposed to take care of price stability, and they should ensure clear communication of their policy stances as well. The government's job is certainly not to contradict their efforts. The Czech government is focused on helping the most vulnerable and we will continue to do so. The right way is to decrease budget deficits as they tend to increase inflation and prolong the state of high prices.

What role should the EU play in the reconstruction of Ukraine and what financial resources should be mobilized for this purpose?

I believe the EU should play a fundamental role in Ukraine's reconstruction. A prosperous Ukraine is of the utmost interest. In this context, it is crucial that the European Council has confirmed Ukraine's European perspective and granted it candidate status. Since the Russian aggression, the EU has stepped up its support in the form of macro-financial assistance, budget support, emergency assistance and humanitarian aid. In the short term, the EU committed to providing Ukraine with up to EUR 10 billion in 2022 to address its immediate financial needs. Regarding long-term reconstruction, the EU intends to lead a major international effort to rebuild Ukraine in cooperation with international partners, international financial institutions, and close coordination with Ukraine. We should frame the reconstruction effort in a high-level strategic reconstruction plan, which would outline key reforms and investments necessary to build a prosperous and sustainable future for Ukraine.

Managing the refugee crisis and Ukraine's post-war recovery is one of the main priorities of the Czech Presidency. I stand ready to lead the discussions on the reconstruction of Ukraine also during the informal meeting of finance ministers in Prague in September. The post-war reconstruction should focus on restoring critical infrastructure, ensuring basic services, strengthening resilience and economic recovery and stability in Ukraine. Strong EU cooperation with Ukraine and securing the necessary financial resources will be crucial. We should be ready to find new financing sources, use any available resources, and be flexible in their use. The Czech Presidency will also support the EU's efforts to defend Ukraine's sovereignty and territorial integrity by using all instruments and programmes offered by the EU, including the strengthening of sanctions. We will pay attention to effective European cooperation and solidarity so that the long-term integration of refugees into the societies of the Member States is successful.

What should be the main elements of a reform of the Stability and Growth Pact? What measures would finally make it effective?

I believe that there is some room for improvement of the current rules. The reformed rules should be easier to understand and more transparent. Under the current framework, the Commission has too much discretion in enforcing the rules.

The Czech Republic considers it essential to implement a budget-responsible economic policy and to ensure the long-term sustainability of public finances in all Member States. We will regularly discuss the topic of budgetary responsibility at the ECOFIN Council and the Presidency stands ready to work on a legislative proposal as soon as it is released. The reform of SGP is a matter of common rules binding all Member States and as such it should always be discussed by all EU countries, not solely by the euro area. I also think that after the pause caused by Russian aggression against Ukraine, it is appropriate to return to the topic of responsible budgetary policy. Since the EU's fiscal rules were introduced, it has not yet happened that all member countries have been able to agree that the economic situation is favourable enough to start saving and creating budget reserves. We should learn from this and move from the mode of "waiting for good times" to the mode where we manage the public finances responsibly, even in a less than optimal situation.

In my opinion, the persistent increase in the debt ratio in EU countries clearly shows that the budgetary rules are not working as they should. I do not think that shifting the maximum debt level towards a higher limit is the appropriate answer. This will only push the problem further into the future. On the other hand, I understand that complying with the debt rule can be difficult in certain situations. Therefore, we should discuss a less stringent debt reduction benchmark.

Q&A

VALDIS DOMBROVSKIS

Executive Vice-President for an Economy that Works for People, with responsibility for Trade - European Commission

Perspectives on the EU Economy

In the Eurozone the single currency and national economic policies coexist without a strong cement of economic coordination. How can an appropriate policy mix be achieved in this context and what are the lessons learned from recent crises in this regard (Covid crisis, Russia- Ukraine war)? How important is the achievement of a stronger convergence of fiscal and structural policies and what further actions are needed?

Within the Economic and Monetary Union (EMU), monetary policy is dedicated to price stability, common fiscal rules aim to ensure debt sustainability, while national economic policies are coordinated in the context of the European Semester.

During the COVID-19 crisis, the EU's policy response showed the strong complementarity between fiscal and monetary policies when their objectives are aligned. By preserving financial stability and favourable financing conditions, monetary policy contributed to a more effective transmission of fiscal policy support to the real economy. Government interventions, with EU support, also reduced the risk of a severe impairment of the transmission of monetary policy, especially through income and liquidity support measures.

More recently, following notably Russia's illegal and unjustified war of aggression against Ukraine, the euro area economy has been hit by recurring supply shocks that risk making high inflation persistent. In this context, the interaction between monetary and fiscal policies remains critical and so it is vital to maintain a consistent policy mix. Inflation expectations must continue to remain anchored around the ECB's 2% target. And national fiscal policies should reflect the need to avoid amplifying the inflationary effects of ongoing supply and demand shocks. Social partners also have, in this respect, an important role to play.

The ECB's efforts to ensure a smooth monetary policy should be complemented by responsible fiscal policies. In line with the Eurogroup's statement on fiscal policy orientations for 2023, fiscal policies should aim to preserve debt sustainability and promote sustainable growth.

The quality and convergence of structural policies also plays a major role in cementing the growth and stability of the euro area. The Recovery and Resilience Facility is bringing forward important steps in the implementation of long-standing country-specific recommendations adopted by the Council in the context of the European Semester. Recent shocks underscore the importance of pressing ahead with the reforms and investments foreseen by the Member States in their recovery and resilience plans.

Looking forward, the Commission intends to provide orientations on possible changes to the economic governance framework in Autumn. The goals are clear: more sustainable public finances, together with more dynamic and resilient economies, which would also reinforce the ECB´s work on price stability. Of course, it is important to ensure a broad based consensus among EU Member States about the future fiscal rules.

What are the measures put in place to support the financing of the green and digital transformations in Europe and complete the financing provided by banks? Are negative real interest rates an obstacle? Should securitisation be further developed?

Following a series of reforms, EU banks are now much better capitalised and have improved their asset quality, including by reducing the share of non-performing loans. Even so, there is still room to free up balance sheet space to make the banking sector more efficient in tackling the twin transition challenge.

In addition, while banks are important channels to fund the twin transitions, the asset management and insurance industries will be pivotal for channelling private capital and support investment needs in the years ahead.

There is also a great deal of private capital sitting idle in Europe. Households have high levels of private savings, while corporates have been amassing cash for years due to the low cost of capital.

The Capital Markets Union action plan seeks to improve the EU's financial system so that it best contributes to addressing Europe's immediate and long-term challenges.

As part of the CMU, the Commission wants to ensure competition and transparency in the financial services sector for these savings to flow towards the most cost-effective and profitable investments. By creating the conditions for a better financial system, we will be able to mobilise private savings quickly and efficiently. By enhancing financial literacy, product transparency and financial advice, the upcoming Retail Investment Strategy will empower retail investors to participate in the capital markets, so that they can invest in a safe way for better returns.

Negative real interest rates are another factor. They weigh on private savings, particularly in the EU because retail investors traditionally rely on low-risk and high-liquid bank deposits. The Retail Investment Strategy could facilitate a more efficient and effective allocation of retail savings towards bank deposits and allow retail investors to diversify financial portfolios. However, if central banks continue to raise nominal interest rates and inflation recedes, real rates will gradually rise too.

The sustainable finance strategy aims to channel private funds into sustainable investments, including through the taxonomy system to identify sustainable activities, disclosure requirements to provide information to inform such investments, and standards for specific products – such as green bonds, and benchmarks.

The EU is also at the forefront in the digitalisation strategy for the financial sector. New technologies are vital for allowing capital markets and traditional banking to boost the efficiency and sustainability of financial flows and to fight financial exclusion.

In addition, we are considering how to provide more direct support for investments in SMEs that want to list on capital markets - such as the SME IPO fund, focusing on innovative SMEs.

On securitisation: this can help banks increase their capacity to lend to the economy. After the last financial crisis, rules were introduced to make sure that securitisation is not detrimental to financial stability. We are monitoring market developments to understand whether further reforms may be needed to create new funding opportunities.

What are the priority areas where the EU's financial autonomy needs to be reinforced and what progress has been made towards this objective over the last few years?

If we consider the achievements made in under 10 years and where we started, the EU has made remarkable progress in all these areas.

Our banking sector is now better capitalised, more liquid and efficient. We have common rules for supervision and resolution. Still, we need to complete the Banking Union to create the basis for a truly single EU banking market and to enhance financial stability.

Regarding the Capital Markets Union, we have largely delivered on our previous action plans and are moving ahead with the 2021 plan.

Making progress with the CMU will be critical for developing a range of financial services in asset management, corporate finance and investment banking, for example. This will increase the EU's capacity to mobilise capital across Member States and finance innovation.

There are other important areas in the financial sector that are worth considering, including the digital euro, on which the Commission and the ECB are working together, in close cooperation with the European Parliament and Member States.

We also need to strengthen the international role of the euro and our financial industry's global foothold. It cannot mean going it alone but, rather, accepting and managing our interdependence in the best possible way, while safeguarding open markets. It is important, for instance, that the EU financial market infrastructures have the capacity and the resilience to serve both EU and global customers in many areas.

How can the EU's strategic autonomy be reinforced in the financial sector and what are the implications of Brexit in this regard?

Ensuring Europe's open strategic autonomy in the financial sector calls for strong political support and willingness to make EU-level reforms on sensitive issues like taxation and insolvency. In addition, the EU should introduce incentives to allow its financial market infrastructure companies to develop their capacity and competitiveness in a global market.

Following Brexit, London is no longer the EU's main international financial centre. There are now smaller financial centres spread across Member States. Supporting the development of local and regional capital markets will remain a focus. They are the basis for deeper cross-border capital markets in Europe. In fact, benefits can be achieved by interconnected financial centres, where market infrastructures become integrated and service customers across multiple Member States.

What is vital for the EU is that it has a financial sector which works for our economy and people, and which allows capital and savings to flow smoothly across Member States. A model of interconnected and specialised EU financial centres is certainly compatible with a deep single market for capital: our ultimate goal.

Q&A

MAIREAD MCGUINNESS

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

Boosting resilience in the financial sector in uncertain times

This year - 2022 started with a real sense of optimism. The world's major economies, including the EU, were firmly on the road to recovery after the heavy toll of the Covid-19 pandemic. In the EU we expected to see solid growth thanks to sustained demand, propelled by NextGenerationEU and supportive monetary policy. And provision of credit to the economy was helped by the high capitalisation of banks and temporary flexibility in regulatory and supervisory requirements.

But at the end of February, Russia's illegal and unjustified invasion of Ukraine shocked the world. And our economies and financial systems took a hit. The EU, in close cooperation with its allies, responded by imposing an unprecedented and wide-ranging set of economic and financial sanctions. These measures have inflicted real economic and financial harm on Russia, and more effects will be seen over the medium term.

How is our financial system coping against this backdrop? As the European Banking Authority has recently acknowledged, the impact on the EU in terms of financial stability should be manageable. The direct exposure of euro area financial institutions to Russia is largely contained.

This does not mean that the war does not have consequences for the EU. The second-round effects from lower growth, increased uncertainty, volatility in financial markets and asset repricing are more difficult to assess. The war is putting pressure on energy and food commodity prices, setting the EU economy on a path of higher inflation and more moderate economic growth.

The Commission has revised its economic growth forecast for the EU to 2.7% in 2022 and 1.5% in 2023, although this scenario is subject to a great deal of uncertainty. Average annual inflation is expected to be 8.3% in the EU this year. A resilient financial sector is crucial to navigate these new, more uncertain waters.

The Versailles agenda and resilience in the financial sector

The Versailles Declaration was adopted by the EU leaders in March in response to Russia's military aggression against Ukraine. It lays out a strategic plan for building European sovereignty, reducing our dependencies and designing a new growth and investment model for 2030. It will have profound implications for our financial sector as well.

It is clear that financial market players across the EU must reduce their dependencies on Russian counterparts and mitigate the risks stemming from exposure to Russia. Many have scaled back this exposure, while others have now fully exited the Russian market.

At the same time, the financial sector plays a critical role in the effective implementation of the sanctions regime. Banks, investment funds and other important financial players must make sure they have the necessary internal controls and governance in place to comply.

We are acutely aware of just how challenging this can be. The Commission is working closely with financial supervisors and financial institutions to provide clarifications and ensure consistent implementation across the financial sector.

As we look beyond the immediate financial risks of Russia's aggression, we also need to ask ourselves: how can the financial sector help us reduce our strategic dependencies? How can we make sure that our European financial markets and institutions will be even more resilient and stable in the future? And how can we make Europe's economic base more resilient, competitive and fit for the green and digital transitions?

To reach these goals, we need a truly integrated Banking Union and a well-functioning Capital Markets Union. We will need stronger and more integrated financial markets to meet the huge financing needs, private as well as public, of the green and digital transitions, and diversify our energy supplies.

For instance, REPowerEU, our plan to rapidly reduce our dependence on Russian fossil fuels, requires additional investments of EUR 210 billion between now and 2027. Channeling private investment to support these policy goals is crucial.

Banking Union - moving forward

The European banking system has remained resilient in this challenging market environment, thanks in no small part to the reforms implemented after the global financial crisis. We need European banks to keep supporting Europe's economy, including by mobilising investments for rapid digitalisation and to tackle the climate crisis, as well as the new challenges brought about by war in Europe. Moving towards a complete Banking Union will bring more stability to the sector and foster its investment capacity.

The opportunity to agree on a work plan for the completion of the Banking Union did not emerge from the Eurogroup in June as had been anticipated.

However, the Eurogroup did agree to proceed with fixing the second pillar of the Banking Union by reviewing the crisis management and deposit insurance framework.

The Commission has already started to work on legislative proposals to reform this framework. We need to make sure that any failing bank can exit the market smoothly, while protecting financial stability and taxpayers' money, and improving the confidence of depositors.

While the proposals will not include a European deposit insurance scheme - the third pillar of the Banking Union - we remain convinced that it is a cornerstone of the framework for dealing with banks in crisis.

Strengthening the Capital Markets Union

It is essential to make EU capital markets more efficient and allow companies to access more diverse sources of funding – notably equity funding. The Commission has been doing its part to strengthen and integrate EU markets through the Capital Markets Union. Over the coming year, we will present new initiatives aiming to improve retail investor participation, introduce a standardised EU-wide system for withholding tax relief at source, streamline the rules on company listing and further harmonise rules on insolvency proceedings.

After Brexit, we are relying on different financial centres across Europe, focusing on different parts of the financial services ecosystem and leveraging their different strengths. But we still need to build up the EU's financial sector capacity and reduce our over-reliance on UK capital markets in some areas such as clearing.

Better possibilities to share and diversify risk between asset classes, as well as geographically, will strengthen our economic resilience. Whilst market financing can be vulnerable to bad news, it also rebounds quickly and helps the economy to re-adjust, thus providing much needed support to meet the financing needs of companies and uncovering investment opportunities.

Digital finance - the benefits and risks

Resilience cuts both ways in digital finance. On one hand, digital finance can contribute to a more resilient society and economy. Fintech solutions have helped broaden and speed up access to finance during the COVID-19 pandemic. Digitalisation and new technologies are transforming the European financial system and the way it provides services to Europe's businesses and citizens.

On the other hand, resilience needs to be embedded in digital finance to protect our economy. As more and more people access financial services online, the EU cannot afford to have the operational resilience, trust and security of its digital financial infrastructure and services called into question.

The co-legislators have now reached a political agreement on the Commission's proposals to regulate crypto-assets and strengthen the operational resilience of financial firms. Looking ahead, we will stay focused on strengthening the competitiveness and resilience of our digital economy. Over the next year, we will focus on unlocking data-driven innovation through open finance and support the introduction of a possible digital euro. At the same time, we will continue to aim at ways to ensure a level-playing field – key to stability and resilience - as new market players and tech firms increasingly enter the world of financial services.

Q&A

ELKE KÖNIG
Chair, Single Resolution Board (SRB)

Banking Union: CMDI can build further on solid ground

"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity".

These words, from the 1950 Schuman declaration, are still very pertinent today. As Chair of the Single Resolution Board (SRB), I have long wished to see the third pillar of the Banking Union, the common deposit insurance, EDIS becomes a reality. However, that plan is now on hold.

It seems as though Schuman could have been talking about the Banking Union way back in 1950 – for it appears that it will not be completed "all at once, nor according to a single plan". The Eurogroup President, Paschal Donohoe, did his utmost to deliver a single Work Plan, yet the political dynamics meant that we will proceed one-step at a time, beginning with the review of crisis management and deposit insurance framework (CMDI)[1].

As a premise to those steps, we should recognise that the Banking Union has already delivered much for financial stability.

In the past decade, the EU has faced several crises: most recently, Covid-19, and the Russian war in Ukraine. It is not by chance that our banks largely weathered the economic consequences well. The swift and coordinated fiscal and monetary response by the EU, national governments and central banks was key. Having the Banking Union and the Single Rule Book in place was an additional layer of comfort at this time.

In less than a decade, we have made significant steps with the first pillar of the Banking Union, the Single Supervisory Mechanism (SSM) established high supervisory standards right across the Banking Union, and enhanced the banks' positions. [The latest stress test confirms this increased resilience[2]].The second pillar, the Single Resolution Mechanism (SRM), led to banks becoming not only more resilient, but also more resolvable. The progress is clear: at the end of 2022, nearly all banks under our remit met their intermediate MREL targets. It is key that those resources can be reliably mobilized in a crisis.

The Single Resolution Mechanism was designed to deal with bank failures as efficiently as possible. The Sberbank and Banco Popular cases showed that, the SRB - in cooperation with the other authorities - could devise a solution that successfully achieved all resolution objectives including the protection of the taxpayer.

These are remarkable achievements for a relatively young Banking Union. However, we must be on our guard and make sure we don't slide back on what we have already achieved. It took the U.S. over 80 years and multiple crises in order to arrive at its well-functioning bank failure management regime. Let us try and learn from them and others rather than try and go down the route of making every mistake for ourselves.

This does not make us complacent, but it should give enough confidence to legislators to use the upcoming CMDI review to take steps forward in enhancing the Banking Union tools and foster market integration while working towards an agreement on EDIS.

The tools to deal with failing or likely to fail banks are resolution, when it is assessed to be in the public interest, and normal insolvency proceedings (NIPs). While the former is harmonised at European level and centrally managed by the SRB for the Banking Union, the latter is subject to different national legal frameworks, systems and authorities[3].

In line with the legislators' expectations, the SRB has expanded its public interest assessment (PIA) over time. As of today, the SRB plans for resolution for almost all banks under its remit.

Resolution tools have proven their value for so-called mid-size banks. The sales of Banco Popular and Sberbank's subsidiaries are a testament to that.

Resolution is not a free lunch. The MREL necessary to ensure an orderly resolution as well as an operational for resolution must be met. High quality debt instruments are important, particularly as equity is loss-absorbing and might not be

available anymore at the time a bank is failing. Only after bailing in the banks' MREL and eligible liabilities, can one consider external sources. The law already provides for the Single Resolution Fund (SRF) and the DGS as external resources. Yet, the use of DGS funds in resolution is de facto extremely restricted due to their super-priority in the creditors' hierarchy. If this was removed, and a general depositor preference was introduced, the DGS could still be protected by their position in the hierarchy, but they would also be able to step in in lieu of deposits and DGS funds could be used to support market exits, after bail-in and before the SRF, where needed.

The funding cascade is unchanged: first the funds of the bank, then the funds from the industry. DGS funds would be used in resolution only when this costs the DGS less than their pay-out to depositors, according to the international best practice.

The safeguards need to be clearly stated, but the potential benefits, too. Stronger resolution transfer tools would facilitate timely market exits of unviable banks, ultimately making both the banking sector and the economy healthier. This could help to make a decisive step away from the use of public funds. Compared to national solutions, and in the absence of EDIS, the use of DGS in resolution also ensures a harmonised and predictable framework. Lastly, the possibility of cross-border sales (even if partial), and having the SRF in the background, would give scale effects and result in more efficient crisis solutions.

This is not to say that DGS should be used only in resolution, or that no bank should be wound down at national level anymore. On the contrary, national NIPs will remain the sensible solution for smaller banks that fail. There are many examples in recent years where banks have been wound down in a swift and effective way under national insolvency procedures, without using public funds. Yet, the system can be improved taking lessons from the successful examples. If a full harmonisation of those procedures is unlikely (however desirable) in the short term, targeted changes would still help. These should be aligned with the framework of the SRB to the greatest extent possible to avoid target conflicts.

In conclusion, I would note that if –regrettably- not all interests have yet aligned on the third pillar, a more fragmented second pillar is certainly in nobody's interest. Recalling the optimistic but pragmatic quote of the Schuman declaration, I would encourage legislators to reflect on the concrete achievements of the Banking Union, build on them, and take pragmatic steps forward with the CMDI.

Our "ceterum censeo" is and remains EDIS.

Let us hope it won't be put in place only in a moment of crisis.

[1] https://www.consilium.europa.eu/nl/press/press-releases/2022/06/16/eurogroup-statement-on-the-future-of-the-banking-union-of-16-june-2022/
[2] https://www.bankingsupervision.europa.eu/press/pr/date/2021/html/ssm.pr210730~3d4d31f8e8.en.html
[3] https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/191106-study-bank-insolvency_en.pdf

Q&A

KLAUS REGLING
Managing Director -
European Stability Mechanism

The quest for a more resilient and autonomous European Union

What are the fiscal priorities to increase public risk sharing within the EMU and progress towards a Fiscal Union?

During the last decade, several crises have triggered significant institutional innovations which led to a deepening of our Economic and Monetary Union (EMU). This has strengthened the resilience of the euro area. However, more can be done to reduce vulnerabilities to future shocks further. More private and public risk sharing are essential in this respect.

Regarding public risk sharing, there is a need to establish a central fiscal stabilisation capacity. Such an instrument could enhance risk-sharing without creating permanent transfers or debt mutualisation. It would help the euro area cushion asymmetric shocks affecting one of its members, complementing national fiscal buffers.

At the same time, increased risk sharing should be accompanied by stronger incentives to comply with common rules and by enhanced monitoring of national fiscal policies. Agreement on a fiscal capacity could make up part of a package on a redesigned EU fiscal surveillance framework.

During the last 15 years, important steps have been taken towards a fiscal union. Although a full-fledged fiscal union is not realistic, and even not needed for a good functioning of EMU, the mentioned additional steps towards a fiscal union would be instrumental in making EMU more resilient.

What are the main priorities for progressing toward cross-border private risk sharing and encouraging an active and integrated banking and capital market in Europe?

To achieve a fully integrated banking system in the EU, where capital and liquidity can be allocated freely, thus creating strong risk sharing via markets, progress is needed on three fronts.

First, the European Deposit Insurance Scheme (EDIS). EDIS would remove the contingent liabilities of national governments that are currently backing national deposit guarantee funds. Setting up EDIS would bolster trust. Currently, different levels of protection at the national level means the euro does not have the same value across the euro area. This is not in line with the spirit of a monetary union.

Unfortunately, the introduction of a fully-fledged EDIS is unlikely to happen any time soon. Progress on EDIS is impeded by the unsolved debate among member countries on the regulatory treatment of banks' sovereign exposures. The link between banks and sovereigns has been the subject of intense debate since the sovereign-debt crisis. The euro crisis has shown that this link can be a source of major instability. Banking union policies have addressed this link by mitigating the risks of a public bailout and protecting taxpayers from the cost of bank failures. The risk from sovereign to banks, however, should be addressed in a wider discussion on EU economic governance including fiscal rules and fiscal stabilisation.

Second, it is important to complete the second pilar of banking union by making the backstop effective. The ESM backstop provides a sizeable buffer for bank resolution (1% of covered deposits with a cap of €68 billion) and ensures their immediate availability. Whether called upon or not, this safeguard would reassure markets and considerably reduce the risk of contagion. It is operationally ready but requires the ratification of the amended ESM Treaty.

Third, we need to limit ring-fencing policies. Ensuring an efficient allocation of liquidity and capital within banking groups is key. To reassure host countries, additional safeguards may be needed for banking groups with subsidiaries located in different member states. Purely contractual arrangements between the parent company and subsidiaries are not seen as sufficiently effective, as they may be difficult to enforce in

times of crisis. To strengthen confidence, group recovery and resolution plans should be reinforced.

Progress is also needed to converge toward an integrated capital markets union.

The limited size and liquidity of domestic markets constrain the availability of funding sources. Barriers to the free flow of capital between EU financial markets need to be reduced to ensure an efficient allocation of capital and limit market fragmentation.

Progress is needed in four areas.

First, a more unified markets regulation with a single rulebook for supervisory practices under the umbrella of the European Securities and Markets Authority (ESMA) could be a catalyst for a well-functioning capital markets union. The Single Supervisory Mechanism was a game changer for Banking union. ESMA could play a similar role in the de-fragmentation of European capital markets.

Second, the harmonisation of certain parts of the national insolvency proceedings would significantly improve the ability of financing parties to access effective and homogenous enforcement regimes. Enhancing legal certainty and making collateral recovery proceedings more predictable would enable investors to adequately price the risks and increase cross-border demand for securities in a genuine single capital market.

Third, to boost market size and liquidity, it is also necessary to simplify the taxation process. Divergent and lengthy refund procedures for taxes withheld in cases of cross-border investments are a strong deterrent to a single capital market. In addition, a tax-induced bias in favour of debt-financing instead of equity-financing not only leads European companies to rely mostly on banks for funding but might also incentivise too-high leverage and thus increase systemic risk.

Finally, a true single market cannot exist without a more integrated view of EU trading. Presently, investors face high costs to have full visibility of shares or bonds traded in different financial centres. Consolidated data on prices and volume of traded securities in the EU would improve overall price transparency across trading venues.

What are the key drivers to deliver European financial autonomy by the end of the decade? How to move forward?

Finalising banking union and establishing a capital markets union are the most important prerequisites for achieving European financial autonomy. This would strengthen the international role of the euro, which, conversely, would reduce reliance on other currencies. It would also help lower transaction costs.

Strengthening European financial market infrastructure is another important element. A case in point is central clearing. Clearing houses are key in ensuring market stability. However, a failure by the central counterparty due to a shock that exceeds its prefunded and callable resources could have systemic consequences. Brexit revealed the high dependence on extraterritorial service providers. Clearing of euro-denominated derivatives is still largely done from London.

Re-energising the European Payments Initiative would also be important. This private sector initiative to create a unified payment solution for European consumers and merchants has recently faced some headwinds as some banks withdrew from the project. The initiative's core concept, to join forces to reach the necessary scale to offer competitive pan-European payment solutions and overcome national legacy payment systems and thus become a credible competitor to the major players, which are located outside the EU, is significant.

Finally, the creation of a digital euro, issued by the Eurosystem, would also strengthen monetary sovereignty and the role of the euro as a means of cross-border payments.

What should be the respective role of monetary policy and domestic fiscal and structural policies to address financial fragmentation in the euro area?

The mix of slower growth, tighter financial conditions, and elevated uncertainties risk increasing fragmentation within the euro area. Monetary policy instruments are in place to reduce fragmentation, which is imperative to ensure a good transmission of the single monetary policy. Credible and prudent fiscal policies also are fundamental to reduce fragmentation risks.

Currently, the euro area is facing different challenges than during the pandemic. When the pandemic hit, fiscal and monetary policy could act in sync, as inflation was low. Now, we are concomitantly facing an economic slowdown and high inflation. The risks of stagflation are real. While a tightening of monetary policy aims to bring inflation to its medium-term objective, fiscal policy needs to become more targeted.

Another vital component is economic growth. This is where the EU's economic recovery package comes into play. EU member countries have developed long-term plans for structural reforms to boost potential growth. These plans need to be implemented fully. Additional instruments, such as a fiscal stabilisation function, could also help increase fiscal buffers and alleviate pressure on monetary policy.

Finally, integrated capital markets would contribute to a better allocation of capital across the EU, which would promote potential growth and increase risk sharing via markets, which would reduce vulnerabilities and promote convergence.

Q&A

JACQUES DE LAROSIÈRE
Former President, Eurofi

Central banks are still far behind the curve and need to move more quicky

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

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

Can we ignore the financial vulnerabilities created by zero interest rates, the inexorable rise in global debt and the "search for yield" when productive investment has performed poorly over the past 15 years? Does the resumption of activity in Europe require the extremely accommodative stance of monetary policy?

Can we stop inflation in Europe with increasingly negative real interest rates? Is the priority mission of central banks to protect States from fiscal difficulties by financing their deficits rather than to protect the purchasing power of citizens by fighting inflation?

B. Bernanke, in 2004 (just before he succeeded Greenspan) said: *"Monetary policy cannot offset the recessionary and inflationary effects of rising oil prices at the same time. It has to choose".* So the question is: how do you choose?

Option one: Let inflation rise to protect GDP growth? This option should only be considered if growth was strongly down, unemployment was rising dangerously, %and the economy was moving further and further away from full capacity in a low inflation environment. This is not the current environment in the US and the euro area.

Second option: Tightening monetary policy: this is advisable if inflation has become a serious risk in itself. This is the case today. Inflation in the Eurozone reaches an annual rate of 8.9% in July 2022 (compared to 8.6% in June), while real interest rates become more negative due to ECB policy and high inflation.

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

The social significance of persistent very accommodative monetary policies should not be underplayed. Do they help reduce societal inequalities? In fact, the opposite is true; they tend to make societal disequilibria worse because the beneficiaries have been those who have the income and capital to profit from inflated financial and asset markets. Not poor people.

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

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

Inflation has risen sharply in recent months and should be more persistent than thought which would endanger the economic rebound: indeed, inflation is lowering notably real incomes and % of rising inflation, which has caused negative real rates to fall still further.

Central banks are still far behind the curve and need to move more quickly. If central banks fail to act now, the economic rebound could be running into severe problems. Inflation is eroding real incomes and should prompt destabilizing wage demands from income-pressed workers.

For more than 10 years central banks have been comparing inflation rates (CPI or core) with nominal interest rates to calculate real interest rates. The real fed funds, for instance, was calculated as the current fed funds rate minus 4 quarter core PCE inflation. As B. Nelson, chief economist of the Bank Policy Institute explains in a note issued on 29 July, by this measure, monetary policy is more stimulative now than it ever was over the period plotted (1992-2012) by a wide margin.

It would now be incorrect to abandon such an approach and focus on monetary neutrality by comparing nominal interest rates with central bank expectations set at 2%. There is no agreed measure to calculate inflation expectations but, in any case, keeping the 2% of inflation expectations would be obviously inadequate. All this leaves the Fed and the ECB not in a neutral approach but in a very stimulative one.

The question many people ultimately ask is "Isn't inflation the miracle cure for debt?" The higher the inflation, the lower the debt burden in real terms. This is what happened after the great conflicts of the 20th century, to the detriment of creditors. Why not consider a similar solution today, when the capacity of central banks to finance public debt has become massive?

Faced with this question, two remarks are in order:

1. This reasoning is based on unlimited inflation: one must be prepared to suffer very high double-digit inflation to neutralize a debt that is out of all proportion to that of the past. Such a solution is not without risk:

   - Social risks and the development of populism; even if salaries can be protected from inflation by indexation, the same cannot be said for income from financial investments. Thus, an important category of the population ("the middle classes") will see the ineluctable decrease of their income.
   - The investment horizon is blurred and altered for entrepreneurs in an uncertain inflationary context.
   - The exchange rate falls with the development of inflation, which increases the cost of imports ("imported inflation").

2. The recessionary effect of inflation should not be underestimated: consumption tends to decrease with the sustained rise in prices and the loss of purchasing power; the margins of companies in strong competition are reduced, investment is sluggish because of the fall in real rates and the lack of clarity on the outlook and stagflation is taking hold...

Another question that we have been hearing regularly for months is the following: "If inflation and its recessionary effects on growth are rising, is this the right time to tighten monetary policy? The risk is that we will have more recessionary effects".

The answer, in our views, is this:

- Interest rates in real terms are dangerously low, at -7% - the easing of monetary policy that results from high inflation creates massive distortions: Investment (essential for growth) cannot be restored with such a severe "taxation" of savings. Yet investment is the key to reducing the output gap between potential and actual growth.
- Zombie companies (left alive because of interest rate subsidies) are reducing global productivity. Real estate prices will continue to inflate with very low interest rates making mortgages so cheap. Stock buybacks will continue to grow ($267 billion in annual buybacks at the end of Q1 2021 and now $319 billion at the end of Q1 2022).

So, the right question seems to be "if we let inflation rise even higher and allow very accommodative monetary policy, what do we gain?"

Not more long-term growth: because of the "liquidity trap" (savings are kept liquid since long-term projects do not pay off) and because high inflation reduces purchasing power and therefore demand. The consequences of this "liquidity trap" are devastating: the preference of retail investors - especially in Europe - for liquidity assets and diverts long-term productive investment. Households with modest incomes will prefer liquid assets, while richest agents will search for yields by investing in speculative assets.

What we would get is more "inflation", the kind that results from supply-side bottlenecks, war and commodity price shocks, and which is met with a sharp increase -post covid- in demand. This inflation, if allowed to run unchecked, could be dangerous and feed (through wage indexation) the "spiral" of the past. Indeed, it is difficult to imagine that in such an inflationary environment, wages will not significantly increase in nominal terms.

So the only possible answer is to do everything to reduce inflation and raise interest rates. This would be a signal of central bank independence on both states and markets, but also be the first step to a more productive post-pandemic period of higher growth and productive investment. Raising rates would have a much smaller effect than letting inflation flourish.

As long as interest rates in real terms remain negative, the nominal increases implemented can only generate extremely weak recessionary effects. In addition, if a recession occurs central banks would have the necessary margin to cut rates, whereas if they do nothing or almost nothing monetary policy will be powerless to deal with a recession.

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

Normally, central banks policies should tighten when inflation threatens, and overheating is apparent. Instead, we see the opposite: a significant de facto loosening. The climbing of inflation from 2% to 8% in Europe with still no significant upward adjustment in nominal interest rates results in a huge further monetary stimulus.

The European Central Bank is raising rates more moderately and later than the Fed. Indeed, although average inflation over 12 months in Europe is now in the same range as in the US, there is a strong reluctance on the part of the ECB to raise its rates. This is because "fragmentation" (the probability of a rise in spreads in the event of a rise in key rates) weighs heavily on the ECB's decision.

The fear of the reappearance of spreads in Europe should not dominate the decision-making process. Indeed, sooner or later, structural spreads - based on the past accumulation of fiscal and structural deficiencies - in Europe will appear on the markets. The ECB is certainly concerned with moderating "excessive" market rate differentials between European countries. But does it have an obligation to erase forever all traces of interest rate differences in the appreciation of the markets? If so, the central bank would have to buy securities issued by highly indebted countries without limit. If this were to be proposed, it would be difficult to reconcile with the Maastricht Treaty, as some member states – known for their fiscal discipline - place greater emphasis on the objective of monetary stability (believing that the ECB should not monetize public debt). Moreover, such an open-ended decision would discourage member states from undertaking structural reforms.

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

If the idea is to give checks to all economic actors or freeze energy prices in order to abolish all the effects of inflation, we would be condemned to an endless spiral of high inflation, due to the monetary creation thus produced, and low growth. Indeed, from a certain stage of public indebtedness, the recipe of stimulating demand by increasing public spending and deficits works with increasing difficulty, as the credit rating of the stimulating country deteriorates and the fiscal multiplier weakens.

If fiscal policies were to remain expansionary, central banks would have to tighten monetary policies even further to curb inflation and reduce inflationary expectations exacerbated by this fiscal stimulus. In this respect, the issue of revising the Stability and Growth Pact appears central and urgent.

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

In over-indebted countries, governments must take corrective actions to ensure a path of primary fiscal balances and reduce unproductive and inefficient public spending. We do not need more redistributive expenses. We must rein them in and allow adequate space for public investment. The revision of the Stability and Growth Pact is of paramount importance in this respect. Postponing discussions on the revision of the Pact delays the solution, exacerbates tensions within the market (due to the lack of benchmarks) and only complicates the resolution of problems that are likely to become even more acute.

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

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Ultimately, the paradox of the euro is that a single currency and national economic policies coexist without a strong cement of coordination. Ultra-accommodating and asymmetric monetary policy has been used to overcome the contradictions of this paradox, but the price of this permanent rescue is costly. It is essential to ensure convergence of fiscal and structural policies. An intelligent revision of the Stability and Growth Pact should help to resolve these contradictions and thus make the euro sustainable.

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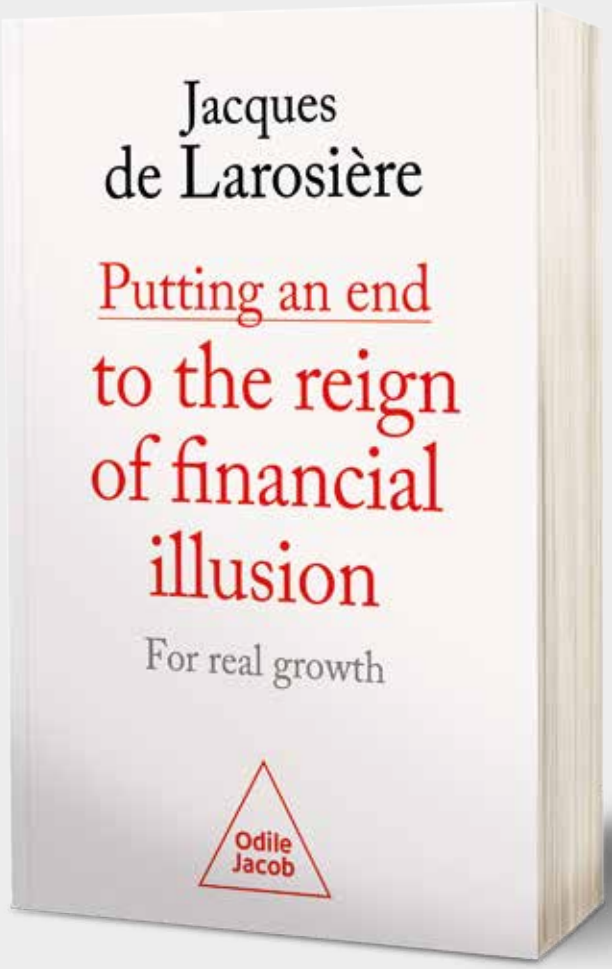

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1

CHALLENGES FROM THE RUSSIA-UKRAINE WAR AND THE POST-COVID ECONOMIC CONTEXT

ISSUES AT STAKE

The invasion of Ukraine by Russia is severely setting back the global recovery and European economies are experiencing the greatest shockwaves of the conflict among developed economies due to trade and energy dependencies with Russia prior to the conflict. Inflation is continuing to surge (reaching +8,9% in July 2022 in the EU), economic activity is slowing, and the risks of stagflation are increasing.

The Covid-19 crisis has also increased the heterogeneity of fiscal performance across EU Member States and led to a substantial increase in debt levels, which is a source of under competitiveness.

Raising long term potential growth and leveraging the opportunities offered by the green and digital transitions requires investments that are dependent on an appropriate remuneration of risk and also an improvement of the flexibility and competitivity of European economies through sustainable fiscal policies.

The Next Generation EU package, if well implemented, should be useful in this respect. However, Central Banks need to move quickly in their normalization of monetary policy to avoid sharper corrections at a later stage and corrective actions must be taken in over-indebted countries to ensure a path of primary fiscal balances and reduce unproductive public spending. Reforming the Stability and Growth Pact is also an urgent necessity to reduce the risk of debt crisis spillover across Member States and make sure that each country's debt remains sustainable.

RUSSIA-UKRAINE WAR: INFLATION AND GROWTH IMPACTS

ODILE RENAUD-BASSO

President - European Bank for Reconstruction and Development (EBRD)

What EBRD is doing to support Ukraine, its economy and its courageous people

The war of aggression waged by the Russian Federation on Ukraine and its people is a human and geopolitical catastrophe which strikes at the heart of Europe. It is also a major geopolitical event which has - and will continue to have - incalculable repercussions, not only for Ukraine but also for its neighbours, which are hosting millions of refugees, and for the whole world thanks to the war's impact on the energy and food security of many countries, already weakened by two years of Covid.

If we are to meet these major challenges, the unity and coherence of development actors is all the more critical. Many institutions and countries have been providing much needed budgetary assistance to the Ukrainian government. With its private sector mandate, the EBRD has a complementary focus to support economic activity and vital infrastructures.

Over 30 years the EBRD has become Ukraine's largest international investor. During this terrible war we are still increasing the Bank's risk exposure and are one of the few institutions that have continued to do so. We are committed to investing €1 billion in Ukraine this year and are ready to do more, thanks to the generous support of our shareholders and donors.

We continue to support trade flows, to keep vital electricity and railway infrastructure functioning, to provide gas supplies, and to support the Ukrainian pharmaceutical and agribusiness sectors. We also continue to support our corporate clients and municipalities. And we stand ready to continue to provide support to the real economy for a protracted period of time, because it is our duty to help the Ukraine weather these dire times.

But we need also to prepare for the country's reconstruction. The EBRD will be ready to significantly scale up its investments in the country with a focus on the private sector, transforming state-owned enterprises, supporting SMEs and historically competitive sectors such as agribusiness and metallurgy. Our efforts will be geared towards preserving Ukraine's human capital. We will also be ready to rebuild critical vital infrastructure, as well as restoring safe working conditions at Chernobyl and other nuclear facilities.

Beyond investments, reforms will be more relevant than ever to sustain the transformation of the country to support better corporate governance, de-oligarchisation and strengthen the rule of law – but also to build back better. In that respect, it is clear that Ukraine ownership will be key and that the EU integration process will provide a strong anchor to sustain reform momentum. Here also, policy dialogue and support to reforms have for years been at the core of EBRD's action in Ukraine. The flagship Ukrainian Reform Architecture programme, with more than 200 experts embedded in the administration – led by the EBRD in partnership with the EU – has supported key reforms since 2016.

In all these areas the Ukrainian people can count on the EBRD. We are ready to play a pivotal role within the inner circle of those reconstructing their country. With Ukraine, the European Commission, EU member states and the G7 all represented in our governance, we are a natural vehicle to channel the support of all of Ukraine's friends to sustain the real economy and the reform efforts.

The EBRD is committed to investing €1 billion in Ukraine this year and is ready to do more.

We stand ready to mobilise our balance-sheet even more and to manage further donors funds to combine investments with reform and policy initiatives. By leveraging our private sector focus and knowhow in transforming state-owned enterprises and banks, we will work with Ukraine and its partners to rebuild investors' confidence and orient the Ukrainian economy towards a modern and sustainable model aligned with a low carbon transition and best practices in governance.

This crisis obliges the international community and institutions to act coherently and collaboratively and design an efficient and inclusive recovery process, building on all partners' respective mandates and expertise. You can count on the EBRD to play a key role: our shareholders, our teams, our partners, all are mobilised to support Ukraine and its courageous people.

ROLF STRAUCH

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

Macro policy challenges for the euro area

Following the easing of the Covid-19 pandemic, the global economy has faced a new shock. The war in Ukraine has resulted in a major geopolitical transformation, with widespread economic consequences. Commodity prices – particularly for energy and and food – have increased significantly since early 2022. Inflation is reaching new highs, not only in Europe, but also in the US and other parts of the world.

Major central banks embarked on a sharper than expected monetary policy normalisation, giving rise to recession fears and volatility in financial markets. Economic growth projections for the euro area have been revised downwards during the course of 2022. The most recent European Commission forecast (Summer 2022) predicts 1.4% growth for the euro area in 2023, 0.9 percentage points lower compared to the Spring Forecast.

The main downside risk to this forecast is linked to the duration of the war in Ukraine and its consequences for energy supply. Covid-19 also remains a significant risk; the possibility that the resurgence of the pandemic in Europe could cause renewed disruptions to the economy cannot be excluded. Lockdowns in China, supply-chain disruptions, and drought in Europe may also have an adverse effect on economic activity.

For the euro area, which is an energy importer, the increase in energy prices entails a transfer of income and wealth abroad. The deteriorating terms of trade has led to a real income loss, reaching magnitudes comparable with the major oil price shock of the 1970s. This loss amounted to about 2.5% of GDP up to the first quarter of 2022, the biggest terms of trade loss on record.

Although GDP growth in the euro area is decelerating, the region's economy is demonstrating considerable resilience, which is based in particular on four elements.

First, historically low interest rates in recent years have had a positive effect on debt sustainability. The debt service in the public budgets - the main factor to assess debt sustainability - is at its lowest level in half a century in all euro countries, despite much higher debt levels. As average maturities on public debt have increased, debt service costs will remain low for some time, and higher market interest rates will translate only gradually into a higher effective interest burden for governments.

Second, the euro area's labour market has proven to be exceptionally strong. The unemployment rate is at an all-time low (6.6% in May 2022), thanks to labour market measure and buoyant demand during the pandemic and the recovery. Female participation in the labour force continues to increase, adding to an overall positive trend in labour participation.

Third, the banking sector has shown resilience in the current uncertain environment and is expected to withstand even a severe shock from an adverse macroeconomic scenario. Banks' capital and liquidity positions are strong, and non-performing loans continued to decline.

Finally, the disbursement of Next Generation EU funds to EU Member States over the next few years will provide a unique opportunity to sustain the recovery, achieve a higher growth potential, improve medium-term fiscal positions and address risks of divergence.

Improving productivity in Europe is key to remaining competitive and maintaining economic growth.

These areas of strength will continue to bolster the euro area economy; however, effective policy measures are necessary to address the complex challenges. In the short and medium term, monetary policy actions aimed at reducing inflation should be accompanied by fiscal policy that includes temporary and targeted measures aimed at supporting exposed and vulnerable groups.

In the long term, the EU should make good on its commitment to cut its reliance on Russian fossil fuels by 2027 by accelerating the transition to renewable energy. The decarbonisation of the energy system, along with increasing energy efficiency will provide strong impetus to achieve Europe's climate goals.

Furthermore, Europe needs to find ways to improve productivity. This is key to remaining competitive in the global economy and maintaining future economic growth. To that end, investment in innovation and the modernisation of our economies is essential, particularly through the implementation of digital technologies.

ALFRED KAMMER
Director, European Department -
International Monetary Fund (IMF)

Macroeconomic policy challenges and priorities for Europe

The war in Ukraine has disrupted Europe's strong economic recovery from the COVID shock while adding to inflationary pressures. Anemic external demand due to weaker growth in China and the United States, and tighter financial conditions at home, are further weakening growth and confidence, shrouding the outlook with high uncertainty amid pronounced downside risks. This environment requires a well-calibrated policy response.

Across the EU, monetary policy should focus on keeping inflation expectations anchored and preventing wage-price spirals, to avoid sharper, costlier tightening in the future. Still, the exceptional uncertainty calls for a risk management approach to setting interest rates. While monetary policy should continue to normalize under most scenarios, its path should remain flexible and data-dependent.

Monetary policy normalization in the euro area also increases "fragmentation risks": those of an unwarranted widening of sovereign and bank spreads in some euro area countries that impede the transmission of monetary policy. The Transmission Protection Instrument announced by the ECB Governing Council at its July meeting should help the ECB normalize monetary policy in the environment of high uncertainty, while preserving financial stability.

The pandemic and the war have increased public debt ratios across emerging and advanced Europe. This increase is expected to reverse in the coming years in advanced economies with lower debt (those with debt below 90 percent of GDP). In advanced economies with high debt and in emerging Europe, however, public debt is expected to stabilize at higher levels or to increase further.

With this in mind, fiscal policy needs to reflect country circumstances. In high-debt countries, consolidation should start in 2023 under most scenarios. In lower-debt countries, the appropriate fiscal stance will depend more on cyclical conditions. To anchor fiscal policy, a reform of the EU's fiscal rules is urgent. The framework needs to be better at preventing debt distress while allowing for sufficient macroeconomic stabilization.

Energy policy is taking center stage. Surging energy prices have worsened the terms of trade in Europe and are expected to increase the cost of living for households by 7 percent in 2022 relative to what was expected a year ago. Country policies to soften the impact of high energy prices have varied, with price-suppressing measures being widespread. In some countries, the fiscal cost of these measures since the summer of 2021 has exceeded 2 percent of GDP. Going forward, energy measures need to be targeted at the most vulnerable, and high energy prices should be passed onto consumers to help price signaling and promote energy efficiency.

IMF analysis indicates that a full and extended shut-off of Russian gas to the whole of Europe would cause a shortfall of around 12 percent of typical winter consumption of gas. Gas shortages would be distributed unequally, with parts of Central and Eastern Europe most affected. Greater gas sharing within Europe could distribute the burden more evenly, although infrastructure bottlenecks limit the room to reallocation of supplies. Furthermore, voluntary gas-saving by households, and well-designed rationing schemes that let downstream and gas-intensive industries bear more of the brunt of cutbacks, can limit the economic impact of the gas shortfall significantly.

While monetary policy should normalize, fiscal policy needs to reflect country circumstances.

Regarding structural reforms Europe still needs in order to achieve sustainable growth, the focus on energy security should coexist with a continued commitment to the green transition. Although the two objectives may impose divergent demands on public investment in the short term, the medium-term synergies between the green transition and energy security seem clear. Full implementation of ambitious structural reforms envisaged in the EU member states' Recovery and Resilience Plans is key to support the green and digital transition and lift the EU's medium-term growth prospects. More broadly, long-standing structural reforms aimed at boosting productivity and easing factor reallocation through more flexible labor and product markets remain crucial.

This contribution has been co-written by Alfred Kammer, Lev Ratnovski and Frederik Giancarlo Toscani , IMF

DECLAN COSTELLO

Deputy Director-General, Coordination of Economic Policies of Member States - DG for Economic and Financial Affairs, European Commission

Europe's recovery from the crisis: new challenges ahead

Before the Russian invasion of Ukraine, the EU economy was on track for a prolonged and robust expansion, following a swift recovery from the COVID-19 crisis. Russia's war has dramatically changed the picture. Economic uncertainty has increased significantly. Renewed supply chain disruptions and commodity price pressure are driving inflation to record highs, which in turn is eroding the purchasing power of households and triggering a faster response of monetary policy than previously expected.

The shocks unleashed by the war are setting the EU economy on a path of lower growth and higher inflation. According to the latest Commission Summer 2022 Forecast from July, real GDP in the EU would grow by 2.7% in 2022. For 2023, GDP growth is expected at 1.5%, a downward revision of almost one percentage point compared to our spring forecast in May, reflecting the unpredictable evolution of energy markets, tighter financing conditions, a much sharper deceleration of growth in the US and the re-emergence of localised lockdowns in China related to COVID-19.

In light of intensifying and broadening inflationary pressures, the inflation outlook for the EU and the euro area is revised upwards. We now expect inflation in the euro area to reach 7.6% in 2022, before falling to 4% in 2023. For the EU as a whole, we project inflation to reach 8.3% this year and 4.6% next year. Despite the near-term acceleration in inflation, market-based inflation expectations over the medium term have recently moved back towards 2%.

It is clear that we are faced with a challenging economic environment and risks are tilted to the downside. Without downplaying those risks, there are also factors supporting growth going forward. Labour markets have shown remarkable resilience and continued to perform strongly in the first month of the year. In addition, the large excess savings accumulated during the pandemic will help cushion the impact of inflation on consumption.

Importantly, the Recovery and Resilience Facility (RRF) is only one year into implementation. The significant financial support for high-quality investments and enabling reforms that will be disbursed through the RRF over the next months and years will help foster growth across the EU. So far, we have disbursed more than EUR 100 billion to Member States for achieving concrete milestones and targets in the implementation of their Recovery and Resilience Plans. While it was initially designed as an instrument for Europe to emerge stronger from the COVID-19 crisis, the RRF provides an effective response to the newly emerging challenges. Around 40% or almost EUR 200 billion of the total allocation to Member States will be spent on climate-related measures, including investments on renovation and energy efficiency, clean power and networks, as well as sustainable mobility.[1] These investments will be key to address our vulnerabilities and to protect households and businesses from future energy price shocks.

In addition to the RRF, we are mobilising substantive new resource with the REPowerEU plan. It is our EUR 300 billion plan to win independence from Russian fossil fuels. By the end of this year, we want to slash EU demand for Russian gas by two thirds. Well before the end of this decade, we want to phase out Russian oil and gas completely. We will do this by diversifying our gas supplies towards trustworthy and reliable suppliers, increasing our energy savings, and massively scaling-up renewable energy. The RRF will be instrumental in that regard. Member States are invited to complement their existing Recovery and Resilience Plans with targeted REPowerEU chapters that include new actions to deliver on the REPowerEU objectives, while continuing the swift implementation of the agreed investments and reforms from the plans.

The Recovery and Resilience Facility will help our economies withstand new headwinds.

While the EU is entering challenging and uncertain times, the recent experience during the COVID-19 pandemic gives reason to be optimistic that we can collectively face and overcome these newly emerging challenges. It was the strong coordination of policy actions at national and EU level that made our response to the pandemic so effective. Just as during the pandemic, solidarity and coordination will help the Europe withstand the current and future headwinds.

[1] Based on the first 25 plans adopted by the Council, equivalent to EUR 491 billion.

LUDEK NIEDERMAYER

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

The many challenges of post-Covid recovery

The unprecedented combination of unique factors put clouds over the economic recovery post-covid. The most important factors include the impact of lockdowns combined with substantial state support for people and firms, large disturbances in the supply side of the economy and interruptions in global trade. Russia's attack on Ukraine is attacking global security and contributing to unprecedented growth in energy prices (specifically in the EU).

High-energy prices and supply-side disturbances are among the main causes of inflation reaching (or exceeding) double-digit figures and causing a substantial decline in real income. Consequently, there is a decline in consumption (the US suffers a second quarter of negative GDP growth). There are only two not overly positive scenarios - a continuation of substantial real-income drop and inflation falling, leading to shorter or longer recession, or income recovering quickly (via wages or even public income support) and economic growth suffering less with inflation staying high.

Central banks play an essential role, having an exclusive responsibility to keep inflation under control. It might be too early to say the inflation spike is their fault, as some factors were hard to predict and the „game is not over", but as a former central banker, I see some disappointing aspects. Central banking has become too politicised and as a result, Boards are overly reluctant to take necessary measures, fearful of political consequences, often resulting in a more radical action afterwards. In addition, the concept of forward guidance developed in times of low inflation is unfit for the current situation, where a prompt reaction is the most effective response. Still, I strongly believe that, in the medium run, the central banks will deliver low and stable inflation. However, in the future, other factors can play a significant role in setting the tone of economic development.

The transformation to a sustainable, less Greenhouse Emissions intensive economy must be the task for today and not tomorrow. Done properly, it can boost the EU economy and increase its competitiveness. Conditions are there, clear policies will be soon set to create an environment for businesses and citizens, and technology is available. In any circumstances, we need structural reforms to increase potential growth across the EU. Stronger push through, e.g. the conditionality of the RRF, is the right approach, yet, one could notice that very often, populism and short-termism win over right decisions on the government level.

Many new challenges must be addressed at the EU level, including dealing with multiple „leftovers" from the past. For me, the principal ones are the revision of fiscal rules and the completion of the Banking Union.

In the first area, we should not aim for rules relaxation but an increase in transparency, enforceability and clear guidance, even for the ordinary fiscal governments' decisions. I believe the rules proposed by the EFB, which served as the basis for the European Parliament's report on the review of the macroeconomic framework, are the appropriate outset. The case for the completion of the Banking Union, especially the gradual creation of EDIS, is clear. The politicians responsible for overpolitisation of the debate leading to blocking even a gradualist approach are doing a very bad service to EU citizens. If not addressed, both issues can complicate EU efforts to pass through the current turmoil without high costs.

To deal with existing crises, we must have the courage to do the right things at the right time.

What we experience today is a combination of factors impossible to predict. Moreover, in the future, we could be challenged by shocks of unexpected origins. Nevertheless, it is clear that competitive economies, dynamically adjusting to new circumstances, will do better in any situation. Countries with an „orderly fiscal house" will be able to cope with crises better and will suffer lower financial risks, including costs of debt service. To benefit from a strong and functioning EU and its single market, member states must find agreements and move forward in difficult areas.

We, as Europeans, can succeed in the climate transformation and react adequately to existing threats, such as the current energy crisis. To do so, we must have the courage to do the right things at the right time. In the past, we did it and it would be a shame to fail this time.

MICHAEL WEST
President - Moody's Investors Service

Adhering to EU policy is key to de-risking European credit profiles

The complexity of current economic and financial conditions in Europe is compounding economic uncertainty. Global credit conditions have turned more negative amid rising geopolitical tensions, elevated inflation, supply chain disruptions and slower economic activity.

These developments increase recession risks and remain the key headwinds to economic growth. They also underscore one of the euro area's key long-term challenges: the heterogeneity of its members' credit profiles. The differences in economic, institutional and fiscal strength are key drivers of bond pricing and credit spread differentials in the euro area. They reflect market perceptions of the differences in national fiscal discipline and governments' willingness and ability to enact structural reforms and rebuild fiscal space during good economic times.

While, at the EU level, the policy coordination that takes place during the European Semester, and the Stability and Growth Pact, have the potential to address this vulnerability, a lack of policy tools is probably not the barrier to reducing the significant differences in credit quality among member states. In Moody's view, adhering to the existing EU rules will be a key driver to de-risking sovereigns' credit profiles.

In practice, some countries have been bound by the EU's fiscal rules and therefore have reduced debt during periods of economic expansion and, more recently, during periods of low interest rates. In contrast, a number of larger member states have not been particularly constrained by their fiscal rules and have failed to rebuild the fiscal space lost over the past decade, despite a period of historically low funding costs.

Newer policy tools, namely the Next Generation EU (NGEU) economic recovery programme, offer another opportunity for some of the EU's most indebted countries to improve their credit fundamentals. While Moody's expects some member states to make the most of this opportunity, it is still too early to determine if all recipients will be able to satisfy the conditionality of the programme and absorb the large volume of funds that have been made available.

For this reason, Moody's views the structural reform component of the NGEU as being as important as the investment funds themselves in boosting longer-term growth potential. In many cases, the reforms and investment priorities are mutually reinforcing.

Looking ahead, systemic risks in financial markets remain elevated. Russia's invasion of Ukraine has heightened economic uncertainty and commodity market volatility. The surge in energy and food costs is weakening the purchasing power of households, raising input costs for companies and dampening investor sentiment.

Among sovereign debt issuers, debt sustainability will be especially challenging for many frontier market sovereigns as their borrowing costs climb while their economies still have not fully recovered from the COVID-19 pandemic crisis. Central banks have withdrawn a significant amount of stimulus and become more aggressive in raising interest rates to counter elevated inflationary pressures. This implies that growth prospects will be weaker, particularly for countries with vulnerable energy supplies.

Adhering to the existing EU rules will be a key driver to de-risking sovereigns' credit profiles.

In addition to taming euro area-wide inflation pressures, the ECB faces the complicated task of preventing contagion between euro area sovereigns as economic growth stumbles and political uncertainty across the monetary union increases.

The Transmission Protection Instrument enhances the ECB's crisis-fighting toolkit, while recognizing that sovereigns' funding costs will be different within the euro area because of fundamental differences in credit quality.

The toolkit is well established, decisive and well-coordinated making it an important tool for all member states and most crucial for those countries with high debt, rising interest costs and weaker institutions.

DINO KOS

Special Advisor to the Chief Executive Officer - CLS Bank

Generating a "positive real interest rate" – What can policymakers do?

The war in Ukraine is having, and will continue to have, devastating humanitarian costs. Those costs are the most pronounced of all – and diplomatic and other efforts should be directed to ending this conflict. The impacts of the war are manyfold: on food supply, on the availability of energy and supply chains more generally, and on inflation which is rising across most countries in Europe at the fastest rate in 40 years. While foreign ministers seek solutions to end the fighting, what can economic policymakers do to alleviate the costs emanating from the war in Ukraine while assuring that inflationary psychology does not become embedded?

Unlike inflation in the United States driven by massive stimulus spending and income support programs that fueled demand, inflation in Europe is driven by a mix of factors, including large supply chain disruptions. Therefore, the standard formula of raising interest rates to the level of inflation (or above) to curtail demand is probably not appropriate.

If the war in Ukraine was the only factor driving up European inflation, then the policy response would be primarily, maybe even solely, about restoring supply or identifying alternative sources over a period of time. Monetary policy would not necessarily play a major role. However, the Eurozone all-items HICP began to rise in early 2021. The HICP was rising at a 5.9 percent year-on-year rate in February 2022 as the war began. In other words, inflationary pressure was already asserting itself before the war-related disruptions exacerbated matters.

The divergence of US and eurozone monetary policies has resulted in much wider interest rate differentials and the depreciation of the euro, which traded at its lowest levels in two decades. A weak euro helps exports but also makes imports more costly and thus contributes to inflationary pressure. This element will persist since US rates will likely continue to rise.

All of which is setting up the European Central Bank (ECB) for an unenviable and difficult task. The global economy is slowing – including China, which previously acted as a locus of demand. However, high inflation points – and rising inflationary expectations – means policy will continue to tighten. Even if the result is a period of stagflation, that is the lesser of evils relative to the alternative where inflation rises to 1970s levels and then cannot be reined in without imposing a major recession.

So if interest rates need to keep rising, how much do policy rates need to exceed the inflation rate to generate a "positive real interest rate"? The ECB should increase interest rates in the coming months to continue normalizing interest rates. It should also monitor market signals such as the shape of the yield curve, the value of the euro and inflationary expectations, and be ready to slow down, temporarily pause or even stop the tightening cycles in response to incoming data and other indicators. That peak in interest rates may well be short of the spot inflation rate. While this statement may sound "dovish", it's actually an acknowledgement that a good portion of current inflation is indeed caused by supply factors that tighter monetary policy cannot cure.

Other steps will need to be taken by those responsible for energy and other supplies, and if those efforts can restore more normal distribution patterns, then the portion of overall inflation derived from this factor will decline swiftly. In such a scenario, the headline inflation rate (currently about 9 percent) could be cut in half. While policymakers cannot count on this scenario, it should not be dismissed. Hence, a formulaic and pre-ordained set of interest rate increases could be deeply counter-productive.

The formula of raising interest rates to the level of inflation to curtail demand is not appropriate.

Instead, the better course is a pragmatic approach that seeks to balance the need to moderate the current rise of inflation with the risk of an overly tight policy merely exacerbating the near-term challenges of rising energy prices that act as a tax increase on consumers. That balance will then give the ECB the optionality and flexibility to stop in a favorable scenario or indeed to tighten more aggressively if conditions warrant. What is clear is that forecasting models cannot adequately capture all the uncertainty, thus calling for a gradual, flexible and alert approach.

The views expressed in this article are those of the author, not those of CLS.

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MONETARY AND STAGFLATION CHALLENGES

MÁRIO CENTENO

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Monetary policy, supply shocks and financial fragmentation

The critical question for monetary policy right now is whether it is possible to tame inflation with (rather) negative real interest rates. Persistently high inflation has resulted in low real rates; this induces an anticipation of consumption and investment that could feedback into inflation. Why are several central banks only normalizing interest rates instead of clearly seeking positive and possibly high real interest rates? Can this policy bring inflation to target?

A clear tightening or even too fast a normalization could unwarrantedly destabilize the transmission mechanism and the real economy, making it harder to achieve the inflation target beyond the short run. In face of supply shocks, monetary policy ought to be patient; more so given its unprecedented nature. The unjustified invasion of a European nation, Ukraine, by a nuclear and autocratic Russia, the persistent supply bottlenecks, and an incomplete pandemic recovery call for prudence. The new ECB's monetary policy strategy has rightly confirmed its medium-term orientation: the inflation target is to be attained over the medium term (not at each point in time).

Even with large shocks and hence unusually high levels of inflation, it is likely that this policy of slow normalization is consistent with inflation converging to target, albeit through an orthogonal mechanism to outright tightening. If the slow normalization leads to nominal rates that are compatible with the natural real rate (given the inflation target), then inflation cannot be high for a long time as realized real rates must eventually converge to the natural rate. This is a consequence of the well-established long-run neutrality of nominal interest rates; it is what markets expect right now.

In face of unprecedented supply shocks, monetary policy ought to be patient.

Markets expect policy interest rates to increase moderately and inflation to fall to 2%. Markets see monetary policy has credible and that large (or even positive) deviations of real interest rates from neutral levels are not necessary to counter inflation. More prosaically, the effects of the unprecedented supply shocks will eventually dissipate without imprinting inflation expectations. We cannot take for granted that inflation expectations will remain anchored under every circumstance; that is why we should be ready for a strong response if inflation expectations destabilize.

The Transmission-Protection Instrument improved our policy toolbox; a stronger response is now possible, while containing unwarranted financial fragmentation. It is a powerful backstop aimed at preventing runs on sovereign debt. It allows for a clearer separation between market stabilisation and policy stance goals. It enhances the efficiency of stance-related policy actions.

The evident necessity of this instrument stems from the remaining fragilities of our economic and monetary union. The remarkable steps taken after the global financial crisis have come to a halt. But it is critical to complete the three pillars of the banking union (supervision, resolution and a common deposit insurance). A review of the crisis management frameworks for banks cannot be overlooked. Further private risk-sharing, including through (mostly consensual) elements in the capital markets union should remain a priority. Additionally, building on the success of the NGEU, to reinforce the coordination of fiscal policies among member-states, fiscal risk-sharing should be based on common debt and budgetary instruments.

These advances would improve the fiscal/monetary coordination by distinguishing more clearly the tasks of each policy and alleviate the burden that has constantly fallen upon monetary policy.

Risk sharing is perhaps more critical than further advances towards fiscal and economic coordination. The pandemic taught us that centralized monetary and fiscal policies can coordinate, and mutually reinforce each other, without any formal arrangement.

YANNIS STOURNARAS

Governor - Bank of Greece and Member of the Governing Council - ECB

Monetary policy normalisation and its smooth transmission across the Euro area

The argument that monetary policy should be tightened when inflation rises hinges on inflation being demand driven.

In the euro area, inflation has been driven by the supply-side. The appropriate monetary policy response was to ride out the succession of supply-side shocks, in order to minimise the costs to employment and output of these shocks.

Therefore, in December 2021 the ECB began to gradually normalise its policy.

Since then, and up to June this year, its Governing Council took a series of decisions in this direction. It has ended net purchases under the two asset programs, removed the easing bias of its forward guidance, did not prolong the very favourable terms on targeted longer term refinancing operations, and have been phasing out collateral easing measures. As a result market interest rates have risen across the entire time spectrum.

Incidentally real interest rates should be measured as a difference between nominal interest rates and expected, not current, inflation. Expected real interest rates have risen substantially since the beginning of monetary policy normalisation.

Let me first say that the needle on the ECB compass is on our objective – that is, 2 per cent inflation in the medium term. It is difficult to tame inflation because it is a complex process, reflecting multiple shocks hitting the economy, mostly imported energy shocks. Nevertheless, I believe that inflation has reached close to its peak and will begin a steady deceleration.

My view is mainly based on an assumed moderation in energy and commodity prices and a gradual easing of the supply bottlenecks. According to June projections at the ECB, inflation is expected to peak this year, but to gradually decline in 2023 and converge towards target in 2024. A similar profile is expected for core inflation.

This inflation profile is mirrored in all measures of expected inflation, reflecting wage moderation, reduced real disposable income, slowdown of economic activity and a worsening economic outlook.

How can monetary policy face the dilemma of bringing inflation down to target, while ensuring a soft-landing amid rising fears about economic recession?

Determined to eradicate high inflation while safeguarding the smooth transmission of monetary policy.

In a historic move in July, which marked the end of the eight-year-long era of negative rates in the euro area, the Governing Council decided to raise key policy rates by 50 basis points.

In the forthcoming meetings, a further progressive normalisation of policy rates will be appropriate, in a meeting-by-meeting approach. Both the timing and the pace of moves will depend on the evolution of our assessment with respect to inflation risks, which may reflect supply disruptions, but also contractionary pressures on prices.

Let me now turn to a very important pledge we have made at the Governing Council, ever since we first embarked on the gradual process of policy normalisation: any resurgent fragmentation risks that would undermine the smooth transmission of the normalisation of our monetary policy across all member-states of the euro area must be forcefully confronted.

This summer, the Governing Council acted forcefully on this pledge on two occasions.

The first occasion was in June, when flexibility was applied in reinvesting redemptions coming due under the Pandemic Emergency Purchases Programme (PEPP), with a view to maintain the functioning of the monetary policy transmission mechanism. The PEPP reinvestment flexibility can be seen as a reflection of gradualism in addressing risks to transmission. It is a first line of defense to counter risks to the transmission mechanism related to the pandemic.

The second occasion was in July, when the Governing Council announced the Transmission Protection Instrument (TPI). The TPI is a very powerful tool that will support the effective transmission of the ECB's single monetary policy across all member-states of the euro area as monetary policy is normalised. It is designed to counter deteriorations in financing conditions in parts of the euro area which are not warranted by country-specific fundamentals. It would be activated when and to the extent needed to counter fragmentation risks.

The euro area has been at the epicenter of strong and successive fragmentation episodes. A major reason for that is in my view that our economic and monetary union is incomplete. In the absence of a complete banking, capital markets and fiscal union, we would have faced a distinct possibility of further fragmentation episodes in the future if we had not adopted the TPI.

In its July decision and building on the separation principle, the Governing Council remained determined to progressively normalise policy rates to an appropriate, broadly neutral level while safeguarding the smooth transmission of monetary policy across all euro area member-states.

MĀRTIŅŠ KAZĀKS

Governor - Bank of Latvia
and Member of
the Governing Council - ECB

Monetary policy normalization: a journey into the uncertain

The euro interest rate hike that took place in July was widely lauded as the start of the journey. Every journey has its starting point, its end, and the road in between. The success will be determined by our ability to calibrate and manage all three of them.

Of course, normalization started already in December 2021 with our decision to slow asset purchases. The rate lift-off started as promised, but with a larger step than initially communicated, eliminating negative policy rates in one go. Upside risks to inflation had strengthened since our previous meeting, and it was important for the ECB to take a larger step, as our commitment to delivering on price stability should prevail over short-term tactical considerations.

These events have highlighted the limitations of forward guidance on the future policy course. Calendar forward guidance that is linked to a particular period of time can be very effective, but at the expense of limiting policy flexibility. This matters less when policy rates are close to the effective lower bound and there is not much policy space anyway. But when interest rates are on the way up, the effectiveness of explicit policy commitments declines considerably, especially during times of high economic uncertainty.

It is important to note this when calibrating our next policy steps. Rather than trying to set expectations of specific interest rate changes over the future policy meetings, it is more appropriate to focus on explaining our policy reaction function. That is, to articulate the developments in the economy that will shape our decisions on the future interest rates.

For me, the persistence of core inflation and its impact on inflation expectations along with wage dynamics will be key to determine whether a steady pace of interest rate hikes should be maintained, going forward. On the other hand, the risks of a broad-based and protracted recession with a reductive impact on inflation would point towards a slower pace of rate hikes or a pause.

The current path is that of policy normalization, not yet a genuine tightening.

Where is the end point of this policy cycle? It will be determined by the data, and what they imply for price stability. The current market expectations reveal a general feel that the terminal rate (i.e., the highest level of interest rates during this economic cycle) matches broad estimates of the natural rate (i.e., the level of interest rates at which monetary policy is neither expansionary nor restrictive). Hence, it is monetary policy normalization, not yet a genuine tightening. With the market's forecasted rate hikes, in the nearest future overall monetary policy stance will still be accommodative.

During the recent monetary policy strategy review, the Governing Council unanimously supported a symmetric commitment to 2% inflation target over the medium term, meaning that negative and positive deviations from the target are equally undesirable. That also implies no hesitation to step above the neutral rate and tighten if our assessment so requires. But not yet, it is too early to say.

Finally, how smooth is the monetary normalization journey likely to be? Given the incomplete EMU architecture, there are risks of unwarranted volatility and equilibria that are suboptimal from the perspective of long-term functioning of the euro area economy. While spreads as such are justified, the current incomplete institutional framework may give rise to additional challenges for smooth implementation of monetary policy.

This is where our new Transmission protection instrument (TPI) comes in. It is aimed to address unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area. It is a powerful instrument, and our commitment is bold; though I hope we will not need to use it. But we shall not hesitate to use it, if necessary. However, it will not amount to a blank check. Our motivation for using the TPI will always be to preserve the singleness of the monetary policy, and our ability to deliver on our mandate. Other challenges, such as debt sustainability, will have to be addressed with other measures and indeed by other relevant parties.

All our actions so far have shown an undisputed commitment to a successful functioning of the euro. But we also expect similar degree of commitment from other players. This will ensure the success of this journey and contribute to the wellbeing of citizens of the EMU in the long-term.

EDWARD SCICLUNA

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

Steering between Scylla and Charybdis once again

Over the course of the past year, euro area headline inflation (HICP) climbed well above the ECB's 2% target. While the ECB's commitment to stable prices applies over the medium term to account for the supply side dislocations that are behind the current spike in the price level, an annual rate of increase of consumer prices above 8% warrants a normalisation of the very supportive monetary policy stance of the Eurosystem.

A too slow withdrawal of accommodation risks entrenching a high inflation regime and prompting second-round effects on wages, further fuelling price instability and eroding households' purchasing power. At the same, the necessary normalisation of the policy stance must be implemented considering the uncertainty prevailing in the global economy and over the level of the neutral rate of interest.

The charting of the near-term monetary policy course leading up to the July meeting of the ECB Governing Council has led market participants to ponder over the implications that a tightening of the stance would have on more fragile euro area member states, where yields on sovereign bonds would be repriced to the upside, leading to a widening of spreads vis-à-vis safe assets and endangering the singleness of the euro area monetary policy.

Spreads' widening risk stems from both idiosyncratic and common factors. As to the former, several euro area member states display weaker fiscal and macroeconomic fundamentals and are thus subject to higher compensation by investors to rollover their debt at maturity. On the other hand, the euro area does not qualify as an optimal currency area as per Robert Mundell's seminal article of 1961. As such, preserving the smooth functioning of the currency union requires a continuous effort on the part of European and national authorities, and at least to complete the monetary union. In July, the ECB Governing Council made this commitment explicit with the introduction of the Transmission Protection Instrument (TPI). Such instrument has been conceived to ensure that the monetary policy impulse is transmitted evenly across the union, thus preventing the ongoing normalisation from falling disproportionally on households and firms domiciled in more vulnerable jurisdictions.

> ... drawing the line between warranted and unwarranted interventions represents a major challenge.

While there are clear monetary policy justifications for this instrument, drawing the line between warranted and unwarranted interventions represents a major challenge. In principle, shielding member states from an undue tightening of financing conditions is not only desirable but fair. Markets are prone to self-fulfilling speculative dynamics that hardly reflect the creditworthiness of an issuer. By increasing financing costs to unwarranted levels, markets dynamics could weaken public finances. Herd behaviour could even push an otherwise solvent and liquid borrower into illiquidity and insolvency.

At the same time, moral hazard concerns dictate that narrowing spreads below what credit fundamentals warrant is not justified, as it would amount to monetary financing – strictly prohibited by the Treaty – and because it would discourage more vulnerable member states to engage in necessary reforms to overcome structural impediments to growth and insure the sustainability of public finances. Furthermore, provisions must be put in place to minimise the Eurosystem's risk exposure.

Fine tuning the protection of the transmission mechanism between the Scylla of unwarranted market speculation and the Charybdis of moral hazard is crucial.

Overall, the Governing Council's decision to add a transmission protection instrument to the toolkit enhances the resilience of the euro area and favours the return of inflation to target. Simply put, without a smooth transmission of the policy stance, the Eurosystem cannot steer market rates in line with its mandate. Purchases under the new facility will not interfere with the desired policy stance. Thanks to this new tool, the euro area sharply reduces the risk of falling into a crisis of the likes we have seen a decade ago. Such a disruptive event would hurt all member states alike, and it would weaken cohesion amid escalating international tensions at Europe's borders.

Over the longer-term, a properly managed TPI will favour growth-enhancing structural reforms by preserving stable funding conditions for national governments and for private actors. Such conditions will allow national governments to run fiscal policies in line with the long-term sustainability of public finances, enhancing the stability of the economy.

A more stable macroeconomic environment would engender opportunities for private actors, especially if accompanied by pro-competitive reforms and by the finalisation of the Capital Market Union and of the Banking Union.

CHRISTIAN STAUB

Managing Director Europe - Fidelity International

The role of private investors in public policy transformation

"Inflation is like toothpaste," said Karl Otto Pohl, who led the Bundesbank through the 1980s, "once it's out of the tube, it's hard to get it back in again."

Even Pohl did not have to contend with today's rates of inflation, which come as the European economy is squeezed by several strong, external forces. Rising energy and food prices, continued supply chain disruptions, and tighter global financial conditions to weigh on economic growth in the Eurozone. The pressure will not fade soon. European forward-looking gas prices are compounding concerns over energy supplies later this year.

So, the core challenge will be to balance multiple priorities across monetary, fiscal and energy sustainability channels.

Private capital, a global force

As asset managers, our job is to manage whatever market regime we encounter on behalf of our clients. But we also believe the investment industry can play a supportive role as events compel these policy transformations. This is particularly the case with private markets, which have grown to become a global force supporting change, alongside public markets and state intervention.

The total volume of private capital more than doubled to almost $9 trillion by the end of 2021 from around $4 trillion at the end of 2015 and is projected to double again by 2026 according to data from Preqin. Correctly harnessed, private capital can be directed towards the aims of public policy, particularly those related to the transition to net zero and energy security.

The private markets are being used to access a wide range of climate-aware investments aimed at reducing carbon emissions, often focused on the infrastructure and energy sectors, particularly in renewable energy sources such as solar and wind. At the same time, private capital in the real estate sector will play an increasingly important role in funding the necessary building renovations to minimise energy use and emissions.

And not before time. A full four fifths of existing European commercial real estate stock must be renovated to meet climate targets, but currently only 1 per cent of buildings are undergoing the necessary energy-efficient upgrades each year. Real estate accounts for about 38 per cent of energy consumption, and 29 per cent of all greenhouse gas emissions in the EU, according to the Carbon Risk Real Estate Monitor, and so plays a crucial role in decarbonization efforts.

> Private capital can play a central role in supporting Europe's public policy objectives.

The retail perspective

Policymakers are not alone in facing dilemmas. Retail savers and investors are faced with tough decisions too. The current inflationary environment, coupled with weak growth and volatile markets, has injected a measure of uncertainty. Savings, in the form of bank deposits, increased on aggregate in Europe during the Covid-19 crisis but are losing value fast. Maintaining purchasing power in a period of inflation will require a mix of cash and investment.

Before this current period, inflation had remained below 2 per cent for around a decade, and so many younger investors will not have experienced stark price rises. Investor education, particularly on the hidden risks of leaving savings to wilt in low interest accounts, are urgently needed to improve outcomes in financial health over the medium and long term.

With digital innovation progressing at pace and increasing the ease with which retail customers can access different investment options, private assets will become more accessible to a wider range of people, increasing the diversity of investment options available for those who want to put their savings to work. Overall, private capital tends to be locked up for longer periods of time.

Forging closer partnerships

These long-term investments need long-term projects. The European Investment Bank is already doing work in this area, and we are supportive of its aims. Last year the bank provided more than 15 billion euros in support of investments in sustainable energy and natural resources, and, for example, launched its Green Rail Investment Platform. But by fostering closer relationships with private investors, and by educating institutions on the long-term ambitions of sustainable projects in the pipeline, Europe can achieve so much more.

The external pressures currently gripping inflation and growth may take a while to normalise, but they will force innovative approaches in support of policy objectives.

Harnessing the power of sustainable private investment will help achieve net zero targets, contribute towards greater energy security and stabilise economic growth. Private capital must therefore play an ever-greater role in funding the long-term infrastructure projects, property renovations and emerging clean technologies that will drive the European economy in the next decade.

PHILIPPE HEIM
Chairman of the Executive Board - La Banque Postale

The current crisis strongly prompts the need for a just transition

The Eurozone is experiencing inflation at historical level. Price increases are largely shared internationally and stem from several causes. Strains first came from disruptions in relation with the Covid crisis. Then, the outstanding level of growth in 2021 led to a lack of supply capacities. From Fall 2021, several technical issues and extreme weather conditions pushed gas and electricity prices upward. Finally, from February 2022, the war in Ukraine not only led to historically high energy prices but also affected industrial raw materials, components, and food exports prices.

During the Covid-19 crisis, institutions worldwide have been reacting very promptly to further contain economic damages. The historical NGEU agreement, combined with the ECB substantial action (through its PEPP and APP programs) were decisive to that end. Hence, it comes with little surprise that public debt amounts have become substantially higher (+15% in the euro area). It also fueled money creation, helped financial markets recovering strong performances, thereby bolstering inflation.

In the face of a "high-for-long" inflation, central banks had to choose between curbing inflation, thereby slowing down economic growth, or maintaining a loose stance with the related costs. Depending on the jurisdiction, they all opted for a more or less stringent tightening. While warranted, such decisions inevitably bear side effects: growth decrease, rise of both recession risks and unemployment rates.

For its part, the ECB took a sharp hawkish turn on July with the first interest rates hikes since 2011. In addition, the newly announced Transmission Protection Instrument is welcome. It aims at prompting a uniform and smooth transmission of monetary policy within the Eurozone, thereby limiting the fragmentation risk. Indeed, Eurozone government bond yields hit fresh multi-year highs on June while spreads widened amid concerns about accelerated central bank monetary tightening.

Looking ahead, the forthcoming winter will be a hard one. In particular, EU Member States are dealing with complex choices regarding their energy mix. As long as the war in Ukraine lasts, shortages in gas supply might unfortunately become the "new normal" especially for those most dependent on this energy. High prices too: metals prices are reaching record highs. That of lithium exploded by more than 400%. Labelled as "Greenflation", such phenomenon could even slow down current efforts towards the energy transition. But the ECB's stance on this remains extremely clear: costs of climate change will be substantially higher if no significant action is taken.

Structural reforms have become even more pressing to lift long-term growth potential.

All aspects considered, consequences of inflation are already and regrettably mostly felt by low-income citizens and the middle class. Therefore, the key challenge is how to mitigate its unevenly distributed impacts. That is the reason why ensuring a "Just Transition" is critical.

Going forward, different levers of action exist. Firstly, as stated by President Christine Lagarde, the ECB recently took further steps to incorporate climate change directly into its operations. To start with, the Eurosystem aims to gradually decarbonise its corporate bond holdings on a path aligned with the goals of the Paris Agreement.

That said, she also made it clear that fiscal policies must act as a strong complement by providing targeted and temporary support. To this end, one may wonder whether the strike force of the NGEU should not be broadened. Indeed, the pooling of debts makes it possible to reduce risks within the Eurozone, thereby strengthening solidarity between its members.

Secondly, structural reforms have become even more pressing to lift long-term growth potential. At the euro area level, completion of both Capital Markets & Banking Unions is key to unlock major financing capacities toward the energy & digital transitions. At French level, as stressed by Governor François Villeroy de Galhau, we need to intensify professional training as well as reinforcing educational pathways. Indeed, it is vital to address the structural deficiencies of French labor market to close the gaps in hiring difficulties and persistent young people unemployment. It is a unique opportunity to provide French economy with skilled workers, in particular in the fields of energy & digital transitions.

Thirdly and lastly, financial actors clearly play a decisive role to make sure that no one is left aside of the energy transition pathway. At the crossroads of the economy, banks need to adjust their business models to integrate positive externalities as a lever of performance as well as to develop tailored products and services according to the specific needs of all their clients. By reflecting this mindset directly into their governance, they send a powerful signal: purpose and income are mutually reinforcing, not opposed.

In short: significant efforts are needed on all these fronts. They are essential prerequisites for laying the foundations of a more sustainable and inclusive growth.

FOSTERING INVESTMENT IN THE CURRENT MACRO-ECONOMIC AND GEOPOLITICAL CONTEXT

HARALD WAIGLEIN
Director General - Ministry of Finance, Austria

Contribution of the financial sector to the environmental and digital transformation

In the upcoming years major steps forward in terms of digital and sustainable transformation are required, otherwise the competitiveness and the resilience of the economy are at risk. Banks will play a major role in providing funding for the sustainable and digital transformation. Considering existing enormous savings, liquidity is not deemed to be the problem. The current geopolitical uncertainty and the impacts of the pandemic - with all its consequences in terms of production and supply shortages, rising commodity prices as well as high inflation – makes potential investors cautious or reluctant, but may also be a stimulus to accelerate ESG investments. Therefore, appropriate and reliable framework conditions and policy guidance are a prerequisite to meet investors´ needs, avoid green-washing and foster confidence. Above all, this requires swift and proactive action by political decision-makers.

In light of the complex global conditions it is not surprising that the process of decision-making is becoming lengthy and controversial. But each time a decision is being delayed it is a missed opportunity with negative effects. In order to give companies and investors planning security, the overarching goal should be to create as quickly as possible a consistent, but also to a certain extent flexible framework that is reliable in the medium and long term. At the same time, due to time constraints, one should refrain from examining every detail of a policy measure down to the last detail.

Whereas countries are free, by way of national tax law, to create fiscal incentives for sustainable or digital investments and the flexibility for action has increased due to the interest rate turnaround, the effort to create a suitable framework for the financial market must be a joint one.

Swift and proactive action by political decision-makers is required.

An appropriate framework must be based on common definitions, standards and quality data as transparency is a key feature for targeted investments and risk management. It should enable financial institutions to assess and minimise their economic risks, including climate and environmental risks, and to increase resilience. The European Commission´s Action Plan for Sustainable Finance as well as the Renewed Sustainable Finance Strategy have already launched important initiatives defining a common understanding of what is sustainable and promoting disclosures. Transparency is key for the management of risks and in a broader macroeconomic perspective for ensuring financial market stability. Prudential requirements should follow a risk-based approach reflecting underlying risks and support institutions' stress-resistance while not being used for other policy purposes.

Transparency is also key to minimise the systemic failure to internalize environmental costs at the expense of the deterioration of planetary resources. Moreover, transparency enables compliance with sanctions against Russia. Investment decisions themselves, however, should remain with the investor or the company and not with the financing bank, while banks as stakeholders have a role to engage to companies' innovation orientation towards sustainable developments.

While the framework for a sustainable financial market should create appropriate conditions for investments, the Green Deal and the Next generation EU as a European example should stimulate the green transition in a risk-based manner. It should be a principle that all steering measures are based on common definitions, standards and quality data and have realistic, but at the same time ambitious timeframes.

The Recovery and Resilience Facility (RRF) reflects the Green Deal sustainable growth strategy. While it mandates that Member States dedicate at least 37% of their expenditure to measures contributing to climate objectives, many have already overshot this target in order to accelerate the green transition. A substantial total of Euro 224.1 bn. of expenditure is estimated to be allocated to the green transition pillar.

However, it is essential that all these investments are complemented by structural reforms which facilitate the framework for these investments, such as a legal commitment to renewable energy production or eliminating red-tape for businesses in green investments.

The first green bond issuance by the European Commission in 2021 for the purpose of financing the share of climate-relevant expenditure within the RRF marks a major milestone as it represents the world´s largest green bond issuance ever. It also echoes the commitment to sustainable finance and encourages sovereigns and companies to enter the market with further green bonds issuances. The RRF has the potential to decarbonise the transport sector responsible for considerable greenhouse gas emissions and facilitate the renovation wave for infrastructure and housing. And here the circle closes, because these financing priorities are also important to meet the challenges with regard to the geopolitical crisis.

MARKUS FERBER

MEP - Committee on Economic and Monetary Affairs, European Parliament

Financing the twin transitions

The twin transitions towards a carbon-neutral and more digitalised society pose significant challenges for the European Union, in particular on the financing side. Even conservative estimates estimate that hundreds of billions of Euro of investments will be needed in the next few years. In light of record-level public debt in many EU Member States and rising financing costs due to higher interest rates, it is clear that the twin transition cannot be financed by public money alone. While there are certain programmes such as the EU's recovery and resilience facility, which specifically encourage investments in digital and sustainable projects, as well as targeted support programmes such as InvestEU or certain EIB programmes, the heavy lifting will have to come from the private sector.

In theory, this should not be a huge problem as many investments in high-demand projects in the area of digitalisation and sustainability should have an attractive return profile. In practice, there are obstacles though: one is that the kind of long-term investment that is needed to move the green and digital transitions forward is very illiquid and therefore often penalised in prudential regulation for precisely this reason. This is something we can change and have already attempted to do in the capital requirements directive and the capital requirements regulation by introducing a dedicated infrastructure supporting factor that should also benefit sustainable and digital investments.

Such a solution is definitely superior to a dedicated prudential treatment of sustainable investments that are hard to define and not per se less risky. This is why ideas such as green supporting factor or the inverse, a brown penalising factor, should not be pursued. In a worst-case scenario, such tools could even have undesirable side-effect effects such as creating a green asset bubble that might eventually even compromise financial stability.

A more promising avenue than tweaking prudential regulation is to harness the power of markets by improving market transparency and overcoming information asymmetries so that investors interested in making investments in long-term sustainable projects can do so with confidence and little effort required. That is the basic idea that is underpinning the European Union's taxonomy for sustainable finance. However, the smart idea to create the definitive EU-endorsed market standard for green investments has by now been compromised by getting far too prescriptive and by including economic activities that are unlikely to ever be endorsed by the market. Some of the policy choices made in relation to the taxonomy mean that the standard is unlikely to take off and will just remain one standard among many.

The twin transition cannot be financed by public money alone.

Independent of the specifics of the projects being financed, it takes well-working financial markets to finance a flagship project such as the twin transition. In that context, completing the Capital Markets Union and thus ensuring easier access to financial markets becomes even more important. Fortunately, there are a few legislative initiatives in the pipeline that could boost long-term investments specifically.

The most prominent one is the revision of the regulation governing European Long-Term Investment Funds (ELTIF). This kind of instrument, while a sensible investment vehicle for investors pursuing a long-term strategy, has so far not really taken off the ground. Investment options were too limited and access was restricted to only a small part of the overall market. The Commission proposal and the respective positions of the co-legislator aim to rectify those shortcomings and make the ELTIF more accessible to broader parts of the markets. This will hopefully also boost the assets under management making ELTIFs a viable tool to help finance the twin transitions.

The second initiative that could conceivably boost long-term investments is the European Single Access Point (ESAP) that aims to establish a single access point for public financial and sustainability-related information about EU companies and EU investment products. If done right, this could be a valuable instruments for investors to identify potential investment opportunities within the EU. Such a transparency tool could indeed make European markets more attractive and help attract dearly needed capital to finance innovative European companies that strive to implement the twin transitions.

Lastly, insurance companies tend to be the perfect long-term investors as their business-model is long-term by nature. The ongoing Solvency II review is therefore a golden opportunity to strengthen insurance undertaking's capacity to invest long-term.

GINTARĖ SKAISTĖ

Minister of Finance of the Republic of Lithuania

Green transition is the only sustainable path to Europe's energy resilience

Today it would be difficult to find a government in the EU that rejects the need for the green transition and for good reason. There is no doubt that climate change is happening and it will cause serious consequences if we do not get it under control. At best it will cost us much more than investments needed today and at worst it will burden future generations with an existential crisis.

In addition, Russia's war against Ukraine has clearly shown how unreliable our fossil fuel supply is and brought about shortage concerns. It has also demonstrated Europe's strategic vulnerability – dependence on imported Russian fossil fuels, which is used as a geopolitical instrument in the current context. This dependence is also largely behind the record inflation levels witnessed today across the EU. The current situation highlights that the only sustainable way to reduce our reliance on imported energy and have more predictable energy prices is to move fast with the green transition.

Lithuania has already taken steps to meet these challenges. Some of them have been enacted swiftly with immediate effects, like the complete ban on Russian energy imports – gas, oil and electricity. We have been able to make these decisions today due to forward-looking decisions in the past. For instance, investments into development of critical energy infrastructure, which substantially boosted Lithuania's energy resilience – LNG terminal and gas and electricity links with Poland and Sweden.

Yet this is not sufficient in the current context – we are thus doubling our efforts to implement the green transition. We have set a target to meet 90 percent of domestic electricity demand by renewables by 2030, thus increasing domestic generation capacity and reducing our CO_2 emissions substantially. We are also investing strategically into energy efficiency measures – such as renovation of multi-apartment buildings – and expanding the infrastructure for electric cars.

The Commission has estimated that the green transition will require around 520 billion EUR investments per year until 2030. In Lithuania alone we will need 14 billion until 2030. Naturally, a question whether we can afford such a price tag arises. However, the main question should not be "can we afford it?" but rather "what is the most efficient way of mobilizing the resources needed?"

Current geopolitical realities remind us once again that the green way is the only way forward.

Given the size of investments required, we need to take full use of available public resources, including the RRF and other EU funds, as well as national resources. Lithuania has allocated 2.2 billion in our 2021-2027 EU funds Investment program and 841 million in our RRF plan towards this goal. In this context the REPowerEU initiative is very timely – and has the potential to generate additional funds for the green transition and energy diversification. Domestically we are also working towards mobilizing additional funds by pursuing a green tax reform, which should also have a behavioral effect on businesses and citizens.

Yet we should not limit ourselves to public funds, which will evidently not be enough to fill the gap. A key task for policymakers is to also mobilize private resources and achieve synergies with public investments into the green transition. With that aim in mind, in Lithuania we are developing a sustainable finance ecosystem, which will enable attracting private investors. Concrete steps in this regard include establishing the Green finance institute, which will function as a de facto think-tank and provide much-needed expertise and analysis, establishing a centralized and easily accessible sustainability database, as well as adding a strong sustainability element in the existing and new financial instruments.

I strongly believe that facilitating the green transition must be a cross-cutting effort. In this vein, we should give due attention to this issue in the ongoing review of EU fiscal framework. More concretely, there is a need to discuss the potential to treat green investments more flexibly – which would need to be accompanied by firm qualitative and quantitative safeguards. The importance of quality of the green investments cannot be overstated, as it will in essence determine whether our transition goals are met. Here the commitment-based RRF model could prove useful.

To conclude, I am confident that with joint efforts and innovative thinking we will be able to collectively make a breakthrough in implementing the green transition and overcoming the challenge of mobilizing the vast resources needed for this goal. In essence, we have no other choice – the current geopolitical realities remind us once again in a stark manner that the green way is the only way forward.

JOANNA COUND

Managing Director,
Global Public Policy Group - BlackRock

Towards a more sustainable and more resilient Europe

In 2019, EU leaders announced their goal to make Europe a global leader in sustainability and technology. The policies and investments needed to reshape our economies to realize these long-term aims are challenging, but feasible with deliberate and consistent public and private efforts. Heightened macroeconomic volatility and the current geopolitical backdrop, against the context of record debt levels and energy security concerns, further complicate the task. The new macroeconomic reality will need to be factored into the overall strategy: it will likely both reinforce the non-linearity of Europe's journey towards net-zero but accelerate the transformations from the path implied by current policies.

Digitization and the response to climate change are key drivers of private investment, changing companies' cash flows and market values, and leading to massive reallocations of resources, as demand and supply patterns shift across companies and sectors. As an asset manager, our fiduciary duty includes helping our clients navigate the green and digital transitions and achieve sustainable long-term returns, assisting them to position their portfolios to seize opportunities, and be resilient to risks. In addition, new investment strategies and vehicles - such as those which pursue infrastructure investments in energy transition and energy security, as well as digital and community infrastructure, sustainable mobility, and the circular economy – allow our clients to drive forward the twin transitions. We see increasing appetite from large European institutional investors for strategies that deploy capital across a much longer time horizon, providing the flexibility required to support these transitions.

It is critical that investible opportunities are available to meet this newly mobilized capital in Europe. Regulatory frameworks such as Fit for 55, Next Generation EU and REPowerEU are key to unlock investment opportunities in both public and private markets. Creating regulatory incentives for innovation and the commercialization of new technologies is critical and requires: clearly defining the expectations of how industries and sectors need to adapt their businesses to meet the aims of these transitions; developing ambitious, yet credible, sectoral transition pathways to give the visibility needed for companies and investors; and encouraging collaboration among the financial sector, corporates and policymakers. BlackRock is co-leading efforts to support financial institutions' use of sectoral pathways as part of the Glasgow Financial Alliance for Net Zero (GFANZ).

Digitization and climate remain key drivers of investments in Europe, despite macroeconomic context.

Financial regulation in Europe has also changed practices in the financial sector, and made sustainable investing and the green transition a key part of the dialogue between asset managers and their clients. But the number of reforms and the level of complexity in the implementation of the EU Sustainable Finance Action Plan bring real challenges.

The future role of the EU Taxonomy for environmentally sustainable activities remains a key question, given the challenges around data, the efforts needed to finalise the technical screening criteria for the four remaining environmental objectives, and their adoption by the European Commission. Issuers and investors also face many questions regarding implementation and the interpretation of some criteria. More fundamentally, perhaps, it will be important for investors, issuers, and policymakers alike to understand better the data that emerges from Taxonomy-related disclosures, and how this can be used to identify better the risks and opportunities associated with the transition.

The EU has demonstrated its commitment and leadership in recent years moving from setting increasingly ambitious climate targets to planning climate action. Although facing the most significant crisis in decades with the war in Ukraine and risks of recession, the region continues to move ahead with plans to simultaneously boost energy security and advance the green transition.

The combination of technology, changing societal preferences and regional climate policy in Europe could, over time, translate into more ambitious climate policy in other regions, notably by lowering the cost of switching to low carbon.

Lastly, given European investors' strong interest in sustainable investing, Europe can help deploy capital for the transition, perhaps most importantly, in emerging markets and developing economies.

LAURENT ZYLBERBERG

Director of Public and International Affairs, Caisse des Dépôts (CDC) & Chair, ELTI

Invariants, changes and uncertainties, what role for NPBIs?

We know, for sure, that Russian invasion is a game changer in many fields: geopolitics, defence, finance and well beyond. But does that mean that everything we said before have to be thrown to the bin? It's not so obvious, lot of invariants are still active and drive our global environment.

At least, five invariants are still at work in the current EU macroeconomic context and this new situation, far from making them obsolete, has reinforced their importance:

1. **Climate crisis is more significant than ever, and things are worsening at an accelerating pace**

   In this perspective, climate and ESG criteria are increasingly important when it comes to investment decision but there is a risk of disappointment: the time lapse between investments and their effects is negatively regarded by public opinion and suspicions of greenwashing are never far. Shall we add that this suspicion is not always undeserved?

2. **Long-term investment in Europe is cruelly insufficient considering the multiplying and increasing needs of our societies.**

   The need for long-term investment is widely acknowledged but, expectations related to yields are clearly too high. The competition between long-term and short-term investments generally remains at the advantage of the latter. We will see if the return of inflation will roll the dice again.

3. **Public finance, as an enabler, is needed as the private sector alone cannot meet the goals.**

   National Public Banks and financial Institutions (NPBIs) proved during the last crisis that they are key actors for financing long term investments needed by the green and digital transitions. They are all the more useful than the public debt explodes in Europe and leveraging on private money is vital.

4. **Digital and green transition will only be achieved if we reduce, and not increase, inequalities between winners and losers whether they are countries, regions or individuals.**

   Ongoing transitions are not only technical, but they also have political components, we ought to acknowledge that during last decades, increasing inequalities fuelled crisis on crisis. As globalisation is not an all-winners game, long-term investment, with their positive externalities, shall be publicly supported.

> "We cannot solve our problems with the same thinking we used when we create them" Albert Einstein.

5. **Europe's political and financial integration is insufficient for supporting a sustainable investment momentum.**

   Capital Market Union and Banking European Union are under discussion for many years. What is at stake is not only a global financial integration but firstly to develop European capability to foster investment. Despite lots of progress, we shall acknowledge that the investment momentum is not dynamic enough.

Having said that, it is also true that many things have changed in the last months and make things even more complex:

- Free money is over. Inflation is back with higher interest rates and its related consequences: an increased cost of capital, a loss in the economic valuation of assets on the one hand, a higher price for time and for risk-taking on the other hand.
- War is back in Europe with its immediate and future costs that might impair the global capacity for investment. The rise of risk in Ukraine of course, in the neighbouring States but also in Europe and globally.
- European Union demonstrated its ability to keep unity for overcoming two past crisis (Brexit and Covid-19) and, despite difficulties, is still united in the current and deadliest one.

In this new world, uncertainties are raising, investments for ensuring digital and green transition are needed but easy money is fleeing away. Public finance should focus on efficient projects, making sense to public opinion and having a high potential of exemplarity. For ensuring this we need:

Co-operation.
It is of essence, in order to select projects of European common interest. As an example, the biggest five European NPBIs are working together with the EIB Group for setting up a follow-up of Marguerite fund dedicated for green investment.

Leverage
Attracting private money and developing synergies between public instruments is vital in order to reinforce public fire power: this is the principle behind European instruments such InvestEU.

Innovation
New world means also new challenges, during Covid-19 crisis we rediscovered the importance of shortening supply chains, in the meantime reindustrialisation is regarded as part of sovereignty. And new sectors such as defence industry appear as major.

If we want to accelerate new investments in green and digital transition and at the same time answer to new challenges, we will probably have to change our paradigms. For many years all financial actors expected high yields and somehow reduced risks. This is probably over. In finance, like elsewhere, "we cannot solve our problems with the same thinking we used when we create them" Albert Einstein.

CHRISTIAN REUSS
Head - SIX Group Services AG

Accelerating the Green Transition: stock exchanges as an enabler

Climate change threatens to unleash all sorts of instabilities across global capital markets. Losses arising from damage caused by extreme weather events are increasingly common, while longer-term problems – such as liability risk and stranded asset risk – may inflict significant damage.

To mitigate these risks, companies need to embrace sustainable business practices. So how can the financial services industry channel greater investment towards ESG (environmental, social, governance) and the transition towards net zero? We at SIX Swiss Exchange are convinced it will take a joint effort of governments, regulators, stock exchanges and – ultimately – investors.

Market forces will be the primary driver of the green transition

In the past, considering ESG factors in the investment process usually implied giving up potential upside because it was mostly risk mitigation. This may now be changing as more investors start to actively screen for these factors also in search for yield. Empirical studies (e.g. by Fidelity and Morningstar) indicate that ESG-focused companies do indeed outperform organisations which do not integrate ESG into their business models.[1]

Beyond producing positive returns, institutions and asset managers are coming under pressure to provide sustainable outcomes to investors who want to make a positive contribution. Clear indicators of a shift towards ESG investments are the growing number of sustainable indices and corresponding funds as well as the increased issuance of green or sustainable bonds.

Regulators further fuel the green transition

While market forces are increasingly incentivising investors and corporates to assimilate ESG, so too are governments and regulators across the globe, introducing rules and requirements not only to reach ESG goals but to create whole new ESG based economies.

The challenges are numerous: curbing green-washing, finding the right balance of requirements to increase capital flows into sustainability purposes without creating red tape, and settling the quarrel between promotion of genuine green technologies vs. transition to green(er) approaches.

Looking at the new EU ESG framework, we emphasize the need to tackle the complexity to create a wide comprehension and acceptance from market participants and to enable them to comply with the requirements. Harmonization – across jurisdictions – is key to increase effectiveness and reduce complexity and costs for the market, i.e. issuers and investors.

> By performing their core functions, exchanges play a key role in supporting the green transition.

How stock exchanges support the transition

Any prospering economy will have a well-functioning stock exchange at its heart, enabling capital raising and price formation, connecting companies and product issuers with investors and their capital, and operating efficient, liquid and transparent marketplaces.

By performing these core functions, exchanges can – and should – also play a key role in supporting the green transition. Recent research by The Economist on how to mobilise the global investment chain for social impact assessed the role of exchanges in contributing to social change, showcasing how they serve as a bridge between investors and issuers.[2]

A key area where stock exchanges can help channelling the much needed global private capital flows towards more responsible investments is by contributing their experience in creating standards. Harmonized information is a prerequisite for effectively and cost-efficiently identifying, comparing and valuating companies or investment products.

The more closely frameworks and standards can be aligned and implemented across different jurisdictions, the bigger the possible positive impact will be, as the additional transparency will benefit both issuers and investors. That's why SIX Swiss Exchange is a member of a number of industry groups, which are looking to promote harmonisation in the ESG space.

Another opportunity for stock exchanges to create momentum for ESG is by providing education and training to its key stakeholders, i.e. both issuers and investors. This helps the former to understand and comply with the latest regulatory developments, and the latter to identify sustainable investments and take informed decisions.

Focusing on the future for ESG

ESG is now a central tenet in the investment process. It's not the role of exchanges to introduce compulsory ESG reporting for listed companies or impose their own ideology via other interventions. Such value judgments are best left to investors as the ultimate decision-makers. And if the free market is found wanting, the necessary interventions into the market are best left to democratically-elected, representative governments. But exchanges – in a supporting and neutral role – can play an invaluable role in shaping globally harmonized standards and facilitating better transparency between issuers and investors on ESG related matters.

[1] Matthew Jennings, 2021 & Sunniva Kolostyak, 2021
[2] Economist Impact, 2022

JEAN-JACQUES BONNAUD

Treasurer - EUROFI

Public funds alone will not be sufficient

Normalizing the monetary policy in Europe to achieve positive real interest rates, relaunching the securitization on a larger scale in Europe - that would increase the lending capacity of banks - and strengthening the Capital Markets Union in order to provide a complementary source of financing for companies, are key conditions to foster invetsment in the green and digital transition.

The green transition is an opportunity to put Europe on a new path of a sustainable and inclusive growth. In addition to tackling climate change, it will help reduce energy bills and dependence on fossil fuel imports, thus improving energy and resource security of the Union.

This transition will require considerable investment with a long term horizon (renewable energy production, decarbonization of industry, thermal renovation of housing and buildings...) and often with low financial returns. The quasi economic stagnation in Europe and the level of publicv indebtedness in certain EU countries reduces the capacities of the states to invest more than in the past unless EU countries put more emphasisis on the quality of public spending than on quantity and ensure a composition of public finances that is more growth-friendly. The energy transition will also reinforce in the short run the rise in the prices of energy (due to the cost of the intermittency of rewable energy production) and metals (due to strond demand for metals for electric batteries, green electricity production, networks...). However, an inflationary environment is not conducive to long-term investment because it blurs the investors' horizon.

Public funds alone will not be sufficient. The Next Generation EU (NGEU) recovery package should contribute to this green and digital transformation. But NGEU alone will not be able to reorient our economy towards the future and accelerate productive investment: It has a capacity of € 750 billion until 2026 but the Commission estimates that the additional private and public needs related for achieving the green and digital transitions will be nearly 650 billion per year until 2030. According to the EU Commission, the green transition alone accounts for €520 billion per year.

Bank balance sheets will not be enough to finance this major transformation either. Indeed, the increase in the balance sheets of European banks in the last 10 years has been +2% per year on average. With a consolidated balance sheet of the sector around €28,000 billion in the first quarter 2021, annual growth in same pace would make it possible to approximately €560 billion per year of capacity additional funding. If that amount seems to correspond to orders of the size of the loans needed for financing the traditional economy, it is in very insufficient fact, since it would come back not to finance anything else!

Normalizing monetary policy in Europe, relaunching the securitization in Europe and strengthening the Capital Markets Union are key conditions to foster investment in the green and digital transition.

Europe benefits from a large pool of savings which could contribute to finance these investments, provided that such savings are not taxed but remunerated. On average over 20 years we have €600 bn/year of total household financial investments in the whole EU.

But these savings go currently outside the EU and finance the rest of the world and in particular the United States. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita-capital countries (Spain, Italy, Portugal, Greece). This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between the eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area reflect the persistent doubts of some investors in Northern Europe about the solvency of states and companies in other countries, as well as the lack of a genuine Banking Union and integrated financial markets.

The facts show that growth has always been accompanied by a return on savings. However, we live in an environment where real interest rates have been negative for over 20 years. Similarly, the monetary scoreboard prepared by Eurofi underlines that the persistently low interest rates of the last two decades did not foster by themselves more productive investments. They encouraged-particularly in Europe - savers to keep their financial assets in liquid instruments.

In addition, inflation is more persistent than thought which endangers the economic rebound: indeed, inflation is lowering real revenues, prompting destabilizing wage demands from income-pressed workers.

Finally, it would be illusory to believe that monetary creation would be able to finance investments in key digital technologies (cyber security, cloud computing data spaces, semiconductors etc.) or in the decarbonation of EU economies. Given the levels of public debt in most EU Member States, financing these investments by securities purchases of the Eurosystem could only lead to an increase in inflation, which could only reduce long-term investment, as the future would be too uncertain for businesses.

Member states face many challenges in the fiscal area: they should not only improve the overall equilibrium of their financial accounts, but also drastically improve the quality of their expenses. This effort implies a severe political effort. But a success in this direction would at the same time stabilize the international value of the euro, thus encouraging investors to stay more in Europe.

We thank **the partner institutions** for their support to the organisation of this Forum

BNP PARIBAS

J.P.Morgan

GROWTH CHALLENGES IN THE CEE REGION

LĪGA KĻAVIŅA
Deputy State Secretary on Financial Policy Issues - Ministry of Finance of the Republic of Latvia

Economic impact and policy implications for Latvia of the war in Ukraine

The most important consequences of the war in Ukraine are lost lives and the humanitarian crises associated with the huge numbers of displaced people. The war caused also numerous significant economic implications.

Prior to the Russian invasion in Ukraine, Latvia`s economy had already started to recover from the Covid-19 pandemic. In 2021, GDP increased by 4,5% and economic recovery was higher than projected, provided by favorable developments in external markets as well as extensive support measures preserving businesses and jobs, and providing support for the most affected population groups.

A significant contribution to GDP growth gave private consumption, which increased by 4,8% and was driven by both the easing of restrictions and the rise in average wages and government support measures. In second quarter of 2021, Latvia`s economy had already returned to the pre-pandemic level, but the recovery varies widely across sectors. A strong economic expansion of 6,7%, year on year, continued in the first quarter of 2022.

Russia`s brutal war has created new geopolitical and economic challenges with high uncertainties, slowing growth and rising inflation, high energy prices and risks to energy supply, refugee inflow and new public spending needed. The impact of the war on Latvia is greater than the EU average, as Latvia borders with Russia and, although significantly lower since the 2014, still has historic economic co-operation ties. Businesses in Latvia had to withdraw from Russian markets and economy faces the need to reorient itself away from Russian energy resources.

Shifting away from Russia's market had started already after the annexation of Crimea in 2014. Russia`s share in Latvia`s total exports has steadily decreased from 11,8% in 2014 to 6,8% in 2021. Last year, Latvia's exports of goods to Russia accounted for 7,3% of total exports at current prices, while Belarus`s and Ukraine`s share was 1,1% and 1,4%, respectively. The share of Russia in the exports of services was even smaller, e.g., 5,3%, considering the recent decline in Russian cargo transit through Latvian ports and Latvia`s exit from the non-resident banking business.

Government policy and investment play an increasing role in promoting economic development.

In the Latvian business reality, companies have already shown good ability to adapt and reorganize their business, shifting their exports from sanctioned countries to the new markets, thus against the odds the economic slowdown may appear less significant than initially estimated.

Manufacturing and exports volumes continued to grow strongly throughout the first half of 2022, though some slowdown is expected in the second half of this year. Despite various difficulties, Latvia`s export of goods and services exceeded by 6.2% last year, although it is below EU average of 10.4%. Strong contentment with stable growth rates in manufacturing, IT, and in number of services sectors prevail.

Just after the certain pandemic-caused supply-chain challenges started to fade, the war in Ukraine created a new negative supply shock in the world economy. That in turn confronted economies with soaring inflation due to the energy and food price spike across global markets. We anticipate fluctuations to continue in the coming months largely affected by geopolitical tensions in the region. According to the European Commission's forecast, the average annual inflation for Latvia will reach 15% in 2022.

The extent of the economic impact of Russia`s war in Ukraine will depend on the duration of the war. As hostilities in Ukraine and soaring prices undermine consumer and business confidence and may limit private investment and spending in the region, government policy and investment play an increasing role in promoting economic development.

In case of Latvia the war has underlined the importance of defense capabilities and importance of energy security, minimizing dependence on imports of energy from Russia, as well as the acceleration of green and digital transition.

RRF and other EU funds in addition to national budgetary resources will support the implementation of the crucial investment and reform measures. For example, sustainable mobility aiming to help overhaul transport networks in Riga's metropolitan area. Energy efficiency projects and upgrade of the electricity grid will help to resolve the energy security issues.

The cumulative impact of RRF investments on real GDP level is estimated as substantial. By 2029, the real GDP level would be by 2,8% lower without RRF investments. The Latvia`s Cohesion policy allocation after 2020 together with grant allocations from new instruments (RRF, REACT EU, Just Transition Fund) is around 6,9 billion euro. RRF and other EU fund investment provide a significant contribution to the Latvia`s economic growth, which will be moderate without those investments.

ŁUKASZ CZERNICKI
Chief Economist -
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Macroeconomic outlook for Poland: impact of war in Ukraine and long-term challenges

The war in Ukraine has hindered the recovery of the Polish economy after the pandemic recession. There are multiple ways in which Polish economy is affected by an ongoing war in the Ukraine: uncertainty and worsening economic sentiment, lower global GDP growth, rising commodity prices, problems in global supply chains and costs of accepting refugees. During first two months of the war Poland hosted approximately 2-3 million of refugees, seeking temporary shelter what urged Polish government to launch special PLN 11.3bn of budget expenditures due to the act on assistance to citizens of Ukraine in connection with the military conflict on the territory of this country.

Actually there are about 1.2-1.3 million war refugees from Ukraine in Poland, mainly women and children. According to UNHCR[1], in Poland there is the biggest number of refugees from Ukraine registered for temporary protection.

As a consequence of the war, political decisions aimed at phasing out from Russian energy resources together with the disruption of supply chains have an inflationary impact on the Polish economy since imports encompass key raw materials and intermediate goods. Inflation is predicted to reach the peak in the second half of 2022. Uncertainty and lack of optimism regarding economic prospects might also influence investment decisions of Polish companies . However, there are also upsides of the current situation for the Polish economy. For instance, the presence of refugees strongly bolsters private consumption. Also it should be emphasised that the situation on the labour market is very good and employment is growing.

The harmonized unemployment rate used for comparisons with other EU countries reached 2.7%. The unemployment rate is remaining at historically low levels. Among the EU countries, only in Czechia it is lower than in Poland. Moreover approximately 280 thousands of Ukrainians started working in Poland since the start of the war.

Poland will face some structural challenges in the upcoming years. In the aftermath of the ongoing war, a few hundred thousands of workers can join the labour force mitigating skills shortages in sectors such as trade and HoReCa. Simultaneously part of Ukrainian men left Polish labour market causing substantial skills mismatches – scarcities in typically male-dominated industries like construction and transport sector. Also, major threats to the future growth of GDP comprise factors like aging of society and on low participation rates among EU-countries.

In the long run, the influx of Ukrainian citizens may have a positive outcome, smoothing the negative impact of aging on labour supply in Poland and boosting potential GDP growth.

However, in the long run, the influx of Ukrainian citizens may have a positive outcome, smoothing the negative impact of aging on labour supply in Poland and boosting potential GDP growth. Fortunately, integration of refugees with the Polish labour market will be simplified due to language resemblances and former waves of Ukrainian migration to Poland. Actual data show that integration process is surprisingly good – since the beginning of the war, more than 300,000 people from Ukraine have started work in Poland. Comparing this number to the registration numbers assigned to persons aged 18-65 (approx. 635 thousand people), the employment rate can be estimated at 45-50%. These are much better records than in previous waves of refugees in Western Europe.

Another issue affecting the Polish economy is that rising interest rates might hinder private investment. Some support for the (private and public) investment in the coming years could come from NextGenerationEU program. The instrument should help post-COVID-19 economies to become greener, more digital, more resilient and better prepared for the current and further challenges. It meets the needs of the Polish economy very well – Poland has to catch up especially in the transformation of energy sector. Poland is supposed to receive as much as €23.85 billion in Total Grants Payments and €11.51 billion in Total Loans Payments.

Thanks to NextGenerationEU, the Polish real economic growth would increase this year by 0.1 pp., 0.6 pp. in 2023 and even more in following years, mainly because of an impulse for public and private investment and spillover effects.

[1] https://data.unhcr.org/en/situations/ukraine

DEBORA REVOLTELLA
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From shock to shock – building firms resilience and adaptation, for a more sustainable growth in Central and Eastern Europe

The war in Ukraine is having far-reaching economic consequences in Europe and in Central and Eastern Europe. The global equilibrium is impacted by dramatic changes in the geopolitical context. A persistent energy price shock combines to growing concerns for energy and food security. Inflationary pressures are elevated and persistent, particularly in Central and Eastern Europe, where a combination of structural and shock related factors coexist. Global and local financial conditions start tightening, while, at the same time, labour shortages are by now entrenched. Uncertainty dominates and expectations for a substantial deceleration in global growth materialise.

The war related economic shock adds to pre-existing structural challenges. Digitalisation, climate change and aging, all add to the need to transform the growth model, shifting to a more internally led and sustainable pattern of growth. As the new shock adds to pre-existing conditions, a structural understanding of the strengths and weaknesses of businesses across the region is crucial.

All over Europe, during the pandemic, firms showed resilience. Indeed, the strong policy support allowed firms to withstand the shock, retain their workers and be ready to restart as the acute phase of the pandemic passed. What is remarkable in Central and Eastern Europe is that resilience was not only associated to government support. Indeed, access to credit lines and access to intra-group funding were additional sources of resilience for firms. The pandemic also offered an opportunity for firms to transform. During the pandemic, firms used policy support to transform and become more-digital. Interesting, structural features mattered. Firms that were integrated into global value chains, with high levels of productivity, innovation and digitalisation and better management, adapted faster.

Firms in Central and Eastern Europe lag behind in green management practices, specifically in setting targets for energy use and emissions.

The new shock is likely to be an accelerator of pre-existing trends. Rises in energy costs and risks for energy shortage combine to very tight labour markets. The region is also witnessing the structural transformation of key industrial sectors, like automotive, which was traditionally behind its own growth model. Indeed, economic success in this region has been linked to firms' integration in global value chains. This integration has led to more innovation, with evidence of causality through better management and transfer of technologies. Remaining competitive means quickly adapting to the challenges of the future. This means progressive upscaling in the global value chains model, investing in digital infrastructure and speeding up the digital transformation of the economy. This also means a strong focus on skills.

Resilience to the new shock also calls for mastering the energy crisis, through a combination of energy efficiency and energy security moves. Firms in Central and Eastern Europe lag behind in green management practices, specifically in setting targets for energy use and emissions. Measurable and realistic environmental objectives would help firms improve their environmental performance. Firms in the region lag behind their peers on environmental, social and governance practices. External factors, such as customer pressure and energy taxes, play a more important role in determining the quality of green management practices.

Providing a business environment conducive to green investment will nudge all firms to improve their green management practices, as well as their corporate ESG responsibility more broadly. For the transition to sustainable growth and a green economy to be a success, the private sector needs to apply its ingenuity, investment and entrepreneurship to the endeavour. On the other hand, policymakers need to provide a business environment that is conducive to green investment and nudges all businesses to improve their management practices and, more broadly, their corporate responsibility on environmental, social and governance matters. This is a crucial point in time as the energy shock and energy security might lead to a reversal of the trend towards decarbonisation. Providing a clear path and aligning incentives towards the green transition remains key.

Continued development of the financial sector will be essential, not only to support firms during crises, but also to relieve credit constraints that limit firms' growth during normal times. Targeted financial and advisory support can reduce constraints and increase firms' investment opportunities, particularly for young and innovative firms. This would increase firms' resilience to shocks and contribute to mitigating currently heightened risks.

MUNIR NANJI
Central Europe Head – Citi

Resilience and transformation — Cautious optimism in Central Europe

The world is at an inflection point as financial markets are beset by mounting uncertainty stemming from the global pandemic, geopolitical conflict, and expectations of recession across the globe. All this has prompted downward revisions of economic growth forecasts for 2022-2023.

But where is Central Europe in the big picture? Defying expectations, the region achieved solid GDP growth in one of the most complex environments in living memory. Fresh FDI continues to pour in, not only from Europe but increasingly from Asian markets as well, into sectors that Central Europe has been known for and some of the most cutting-edge industries like EV production. This is partially due to the resilience regional economies have developed throughout their history, just as much as the pragmatism of local regulators who have been tightening monetary policies and limiting price increases while rolling out energy security measures.

While there is room for cautious optimism, stakeholders should remain watchful of rising inflation. Central Europe is looking at some of the highest levels on the continent due to its energy dependence reinforced by supply chain disruptions and towering housing prices.

This coming winter will test the resilience built by these economies – but this will not be the first challenging winter and there is hope EU-wide and bilateral arrangements will be made to ensure adequate natural gas supply.

Another trend to monitor is the state of globalization. Will it slow down or continue unabated? Are nearshoring and friendshoring going to be the determining trends? The jury is still out. However, while Central European markets are benefiting from intercontinental trade right now, a retrenchment driving intra-European trade could prove equally beneficial to them.

Digitization and ESG are becoming front-and-center for governments and the private sector across the region – and Citi is in a pole position to support these ambitious transformation strategies.

Across Central Europe, Citi supports public sector, financial institution and corporate clients to raise financing through public or private markets, to access flow-based products, as well as providing advisory services. As the most global financial institution, we are the first point of contact for international organizations who want to access this dynamic region as well as local companies looking to expand.

Citi is in a pole position to support these ambitious transformation strategies.

We have a big role to play via engagement with regulators and clients alike. We are supporting our clients in a dynamically changing environment, while connecting investors with sustainable opportunities for growth.

Sustainability is a key part of our ambitions, which we anchor in three priorities: financing climate solutions; measuring, managing and reducing the climate risk of our client portfolio; and reducing the environmental impacts of Citi's own operations.

Just last year, Citi made a $1 trillion global commitment to sustainable finance, half of which targets environmental finance and the other half social finance, in alignment with the United Nations Sustainable Development Goals.

To reduce our own footprint, Citi is targeting net zero by 2050. As a bank, we aim to minimize our carbon footprint, but we are also looking to work with clients who are pursuing similar sustainability commitments.

Citi provides advice, transition financing, as well as ESG and KPI benchmarking for our clients to achieve their goals. This work aligns closely with the objectives of the current EU Presidency sitting in the Czech Republic. The synergies arising out of our shared ambitions are tremendous, spanning across advisory, sustainability financing, as well as digitization.

An example of our involvement in supporting sustainable investments and public private partnership in digitization is City Builder, a platform developed by Citi Ventures that enables users to explore locationbased investment opportunities. It provides investors with tools and information about investment projects to determine where their investments will make the greatest social impact, in areas such as affordable housing and key infrastructure.

Despite the vicissitudes in the external environment, we see clear opportunities in digital, energy and sustainability in Central Europe that make it a key part of Citi's global network and an important market in EMEA. Citi has a longstanding commitment to the region since 1985, and was one of the first foreign banks to be established here. Our investment in technology and effective use of data are high on our list of strategic priorities as well as continuing to strengthen our team in the region.

PETER PALUS

Member of the EFC/EWG, Head of the Financial Unit - Permanent Representation of the Slovak Republic to EU

Reconstruction of Ukraine as a double opportunity

If the senseless war in Ukraine is to have any positive consequence in a wider context, may it be a modern and prosperous Ukraine in a stronger European Union. Timely recovery and reconstruction of our eastern neighbour must be EU's strategic priority. Of course, with the ongoing war, immediate focus lies on humanitarian and military support, as well as mobilisation of financial assistance to cover the liquidity gap and maintain the basic functions of Ukrainian government. In parallel to these relief efforts, a credible reconstruction strategy needs to be launched as soon as possible.

A strategy built on three pillars – reforms, investments and technical assistance – will not only help rebuild and modernise Ukraine, it will secure its path towards the EU. Timely reconstruction effort will allow for a more effective alignment with Union's key priorities in the area of green and digital economy, particularly as the current crises pose additional challenges to our transformation goals.

Structural reforms are the cornerstone of any meaningful reconstruction. In the case of Ukraine, fundamental reforms aimed at strengthening the democratic principles and rule of law coupled with smart investments will be crucial for further development of the country. Providing technical assistance will be key here. While not coming with substantial costs, expert assistance can contribute to paradigmatic changes in the functioning of the state. Slovakia can serve as an example of a country, which benefited from international assistance in crucial stages of its development. In the EU accession process, Slovakia has received inter alia technical assistance from the World Bank and the Union' s PHARE programme to build and improve the quality of public institutions and their functioning.

As a member of the EU, Slovakia continued to benefit from the Structural Reform and Support Programme (SRSP) and the subsequent Technical Support Instrument (TSI), which significantly contributed to improving the governance of public investments and quality of government's spending in general. The Slovak example therefore proves, that the vision of EU membership coupled with active assistance from international partners can significantly contribute to implementation of fundamental structural reforms and modernisation of a country.

Timely recovery and reconstruction of our eastern neighbour must be EU's strategic priority.

For Ukraine, a comprehensive reconstruction plan coupled with natural synergies stemming from growth of FDI and transfer of know-how would provide a fundamental impulse for the development of the economy, enhancement of competitiveness, addressing corruption, strengthening of public institutions and democracy in general. From a geopolitical perspective, a reconstruction plan designed this way would also pave the way for Ukraine towards the EU.

Ukraine's modernisation and EU integration will have major stabilising effect for the Union and the CEE region in particular, both in the area of security and economic activity. We should draw inspiration from the EU enlargement since 2004, which proved to be a major economic impulse not only for the "new Member States", but also the original members in western Europe. The benefits can be seen from a broader perspective of the EU as a whole, most significantly in the expansion of the internal market, but also regionally, as neighbouring states and regions – Lower Austria in case of Slovakia – particularly benefitted from the enlargement. A concrete example can be seen in Austria's banking and insurance institutions, which developed from regional to EU players as a result of EU enlargement in the region.

Reconstruction of Ukraine and its accession to the EU could therefore also contribute to solving one of the key structural challenges of Member States like Poland, Slovakia, Hungary and Romania – massive regional disparities. In fact, many of the least developed regions of the EU are the ones bordering Ukraine.

Providing a helping hand and a clear European vision for Ukraine should therefore also be seen as a unique opportunity to address the outstanding challenges of the EU itself.

TOMÁŠ SALOMON

Chief Executive Officer - Česká spořitelna & President - Czech Banking Association

Quo Vadis Banking?

The Czech banking landscape must adapt and harness all of the opportunities that rapid technological advancement has to offer, just like every bank around the world. We all know that; but let me tell you a story from a slightly different angle. Not so long ago, local banks were the disruptive driving force by themselves, not the ones adapting in the wake of change led by others.

Local banks can track their roots back into the early 19th century. They were established in Napoleonic War-torn countries to promote savings and build prosperity for people that had been completely excluded from banking services. There was a rapid and vibrant development later during the 19th century, when banks helped to finance many enterprises that are still successful today, such as breweries, or more broadly the industrial revolution in the Czech lands in general. However, their focus was much more wide-ranging than just industry; banks stood behind the great infrastructure projects like building railroads. Suddenly, goods and people were able to travel at a pace unimaginable earlier, supporting commerce. However, this vital tradition of being close to the community was nearly broken during the centrally planned Communist economy, which brought massive consolidation of the banking industry.

So, starting with the 1990s, local banks had to find a way back to their customers. Frankly speaking, sometimes it was a bumpy ride - especially before 2000, when the local banking sector had to ask the government for help, as bad debts had skyrocketed. However, the positive side was that the banks had their balance sheets cleaned up and were offered foreign capital. This opening up brought not only money, but also skills and new capabilities.

Local banking has been reborn like a Phoenix from the ashes. Since then, the local market has flourished, with no bail-out needs even in the crisis years of 2008-2009. Banks slowly but surely, step by step, improved and eventually mastered their branch-based business model. Banks were nearly super-stars in return-on-equity terms, alongside very sound capital bases, able to withstand any major adverse economic scenario.

Czech banks became an irreplaceable part of the local economy. However, they were sort of victims of their own success. The price they paid for such economic success was an increasing distance from their clients and slowly but surely sliding into a commodity game, where products are basically the same and the only difference is the price. How to escape this commodity bank trap is still a question without a proper answer.

Czech banks: How to build on disruptive success in times of digitisation and commoditisation pressures.

However, we can guess regarding some of the factors that any answer to this commodity question should include (in order to be as disruptive and successful as the earlier-mentioned banks in the 19th century). To start, it will have to employ and fully utilize technology as a main driving force. This is not only because client expectations are formed by companies that are masters of technology, such as GAFA, but also because the main beneficiary of such a focus should eventually be the client, not the bank.

We are definitely at the starting point, but there are already some promising examples of such products and solutions. For example, Bank ID; using internet banking credentials, we enabled our clients to utilize services offered by the government and public companies in a digital manner, eventually saving their time. The second success factor for again being disruptive is to remember that the world is not static, but rather a very dynamic place to be and to do business in. Thus, iterative improvements of solutions based on the real-time feedback of our clients is a must. And by feedback, I do not mean the action-triggered email questionnaires that we send to clients.

And finally, the third success factor (frankly speaking, this is a very important area) - there is a great opportunity to be a reliable partner not only for big infrastructure projects that are necessary for the future success of the Czech Republic in the global economy. It is not only about brick & mortar projects, but also about the shift toward a higher added-value economy and many other, still untapped areas.

I won't lie, the journey to again be disruptive and replicate the success seen at the beginning of the 19th century won't be easy. There will be a lot of trial and error on the way. Honestly, there are hardly any other segments that could change the course of the economy or society with such an impact as banking. Best of luck to all of us who set sail for this journey! Bon voyage!

REVIEWING SGP AND COMPLETING EMU

ALESSANDRO RIVERA
Director General of the Treasury - Ministry of Economy and Finance, Italy

It is time for a central fiscal capacity to foster economic convergence in EMU

Since its foundation, the Economic and Monetary Union (EMU) has allowed to achieve noticeable improvements in the welfare of European citizens, but one cannot deny that economic convergence among and within Member State has occurred in a limited way, and often divergence prevailed.

This certainly was the case during the 2008-2011 financial crisis, when, due to coordination failures at EU level, Member States were forced to enact austerity measures, which turned out to be self-defeating. The proposed sequencing was wrong: fiscal consolidation at first, and then economic convergence and growth.

Since then, two other important shocks have hit the EMU: the pandemic in 2020 and the Russian invasion of Ukraine at the beginning of 2022. Both shocks were common, external, of no economic nature and without moral hazard issues. Nevertheless, they put a strain on the capacity of the EMU to promote resilience and convergence.

Making the most of past errors, the 2020 EU policy response proved unprecedented in many respects: entity, width, timeliness and effectiveness of the measures agreed. Thanks to well functioning coordination mechanisms, common objectives have been attained with clarity and coherence, leading to a sound and effective policy strategy.

However, both SURE and Next Generation EU (NGEU), the main building blocks of the common response, are considered extraordinary and temporary measures; by contrast, introducing structural and permanent tools would be a prerequisite to foster economic convergence and to avoid fiscal and financial fragmentation within the area. Moreover, timeliness constitutes one key element for an effective policy response, and this would be far better achieved if ready-to-use tools were already at disposal of policy makers, with no need to start new intergovernmental negotiations whenever a common response is appropriate.

The creation of a central fiscal capacity should be part of a wider reform of the EU economic governance. Of course, a thorough review of existing fiscal rules is needed to make them suitable for current challenges. First of all, rules need to allow counter-cyclical fiscal policies, both in good and in bad times. Second, they should provide the right incentives for investment, in order to achieve a robust and sustainable economic growth and to complete the twin transition. Last but not least, they should require a gradual, credible and sustainable reduction of public debt over time.

More in detail, an effective fiscal capacity should be tasked with absorbing symmetric as well as asymmetric shocks, and with supplying the European public goods needed to complete the green, energy and digital transitions. It should be of adequate size and covered by genuine European own resources in the long run; the issuance of common debt, whose advantages in terms of avoiding financial fragmentation are well known after the NGEU experience, should be taken into account. Finally, it should be based on grants rather than on loans, so as to maximize the stabilization capacity and promote convergence within the area.

There are many ways to address the risk of moral hazard: the NGEU model could be an example of a new institutional approach that combines national efforts and ownership with an effective multilateral control mechanism. Such a solution could be of inspiration in the case of the new permanent tools.

Creation of a central fiscal capacity should be part of a wider reform of the EU economic governance.

Finally, it should be noted that all Member States would benefit from a central fiscal capacity: first of all, through the spillover effects, which will translate more convergence and a higher economic stability in each Member State into a better functioning of the internal market and a more thriving performance of the entire area; secondly, through the clear signals of unity and solidarity, which will strengthen both social cohesion and Europe's external perception. Such factors should convince us that completing the European architecture will be a positive-sum game rather than a zero-sum game.

HARALD WAIGLEIN
Director General -
Ministry of Finance, Austria

The debt bias inherent in the architecture of EMU

A common fiscal capacity is often portrayed as the solution to the euro area's economic woes. The theoretical foundation is the optimal currency area (OCA) theory, which describes the ideal characteristics to maximise the benefits from monetary integration. Yet the set of criteria for an OCA includes more than fiscal transfers, e.g. price and wage flexibility, labour and capital mobility, economic openness, diversification and similarity in inflation rates. The euro area is far from an optimal currency area in a number of respects, notably as regards wage flexibility and labour mobility, whereas the EU budget already provides non-negligible transfers. Still, policy makers are less eager to advocate labour market reform than to call for an expanded fiscal capacity.

Economic reality rarely matches the textbook model. And the conditions for optimal currency areas defined in the 1960s may disregard the workings of today's financial markets. This is why aligning economic reality to the model is not a sure path to success. Rather, policy makers should understand why the public debt problem is so persistent in the euro area.

Othmar Issing in a 2006 speech entitled "Europe's Hard Fix" got to the heart of the problem: there is a "debt bias" inherent in the design of the euro area, due to the elimination of exchange rate risk from national debt. Issing at the time referred to the dramatic narrowing of interest rate spreads, which started with the run-up to the EMU. According to him, the smaller premium that less prudent governments had to pay on their debt presented a problem for the union. He had proven right.

After Mario Draghi eventually put an end to the sovereign debt crisis ten years ago, governments have gotten used to narrow spreads again and public debt ratios have climbed to unprecedented levels. By 2022, with public debt more than 30 pp of GDP higher than in 2006 and inflation at levels unseen for decades, spread widening rather than spread compression is the source of trouble.

The widening of spreads, which typically accompanies crises in the euro area, is the consequence of markets reacting too slow and weak as long as risks remain contained, and too sudden and disruptive when risks start to materialise. Sovereign bond volatility is the price of not being exposed to exchange rate risk. There is no doubt that shielding the real economy from fiscal, financial or external shocks is more challenging in such an environment. And yet the benefits from being a Member of a currency union should allow to set aside fiscal buffers to be used in those situations.

Fiscal rules have to ensure less-than-full exploitation of the euro's funding advantage. This is the key role of the Stability and Growth Pact. The activation of the General Escape Clause at the beginning of the pandemic was justified. But now we cannot wait for crisis-free times to reactivate fiscal rules. When a storm arises, you have to sail your ship with a working navigation system. No captain would turn it off permanently. We need to follow the rules again as soon as possible in order to get safely through these times.

We would not need to fundamentally rewrite the rules. The Pact has enough flexibility to cater for exceptional circumstances. But we need to improve enforcement. As a result of non-enforcement in recent years, especially in good times, the rules have lost bite and credibility, and became to be seen as a burden rather than a protective shield against uninterrupted spending appetite.

Fiscal rules have to ensure less-than-full exploitation of the euro's funding advantage.

Whatever rules we agree on, they must safeguard the long-term sustainability of public finances and be implemented forcefully, particularly in periods when markets are calm. This is the only way for euro area Member States to regain and protect their capacity to respond to shocks. EU governments have just started implementing the 800bn EUR Recovery and Resilience Facility, which is a test balloon for fiscal risk sharing in crises situations.

Discussing any further steps towards a fiscal capacity is premature as long as the impact of the Facility has not been assessed and the repayment of the Facility has not been agreed.

EUROPEAN OPEN STRATEGIC AUTONOMY

IRENE TINAGLI
Chair & MEP - Committee on Economic and Monetary Affairs - European Parliament

A new Banking Union for a truly autonomous European financial sector

The autonomy of the European banking sector has been at the center of public debate for many months now. However, this very discussion is often the subject of many misunderstandings. To address this issue, therefore, it is necessary to define precisely what we are talking about. I believe that autonomy must be assessed on the basis of the ability of the European banking system to efficiently and effectively support the real economy of the EU as a whole.

If we use this definition, it is clear that the situation in the EU is not good. European finance is still largely segmented along national lines, with savers and investors depending heavily on national banking systems. Data show that this phenomenon is predominant in all big Member States, with some difference for the smaller ones. In 2019, the market share of the top five US banks was 43% of domestic consolidated assets, compared with only 23% for the top five in Europe. Fewer than ten cross-border mergers and acquisitions' deals have been signed since 2014, compared with 180 domestic deals over the same period. A historic low.

This situation is having a serious impact on our banks and might have negative consequences in the medium and long run. The market share of the six major US investment banks in Europe towards their six major European competitors has increased from 44% to 58% in the last seven years. Larger groups are key in this historical phase of strong innovation. Since most of the investment in digital transformation are fixed, size is a decisive advantage.

The problem of nationwide fragmentation of the banking sector is not new on the European political agenda. The Banking Union was intended to be a response to this problem. Unfortunately, after a strong initial impulse having achieved an efficient first pillar, and an important but still improvable second pillar, Banking Union now lacks momentum and remains incomplete.

Why is the Banking Union important for tomorrow's challenges?

Why is the Banking Union project at a standstill? In my opinion, the main reason for this lack of progress lies in the fact that in the last 8 years the Banking Union project has changed its very nature. Its creation was a consequence to the sovereign debt crisis in Europe and its impact on the bank-sovereign nexus. The Banking Union was considered the necessary tool to break the link between banks and sovereigns. At that time, the main problem was the "too-big-to-fail", and that was the main obstacle to be removed in order to proceed with greater financial integration.

In a short time, however, the problems to be solved as a prerequisite to advance with the Banking Union project became others. First, a lot of attention has been devoted to NPLs, which led to an ad hoc roadmap by Member States, with a combination of legislative initiatives and enhanced supervision powers by the SSM. Once the NPL issue was sufficiently settled, we started talking about regulatory treatment of sovereign exposures. Curiously, breaking the link between sovereign and banks, that was the main aim of the Banking Union, becomes the pre-requisite to advance in the Banking Union. As this is a highly controversial issue, and with potential implications that would go well beyond the prudential perimeter, it has ended up being a boulder that has prevented any initiative towards greater banking integration.

In order to unblock the debate on the Banking Union we should address the issues from another angle. The question we must ask ourselves is perhaps: why is the Banking Union important for tomorrow's challenges?

Moving towards a true single banking market through cross-border restructuring is above all a matter of strategic autonomy. Genuine Pan-European banking groups could operate more effectively, raise their profitability thanks to scale effects and better face up to foreign competition, especially from the USA.

Moreover, Banking Union would decisively enhance private risk sharing within Europe. The political discussion remains primarily focused on public stabilization mechanisms, such as a possible common fiscal capacity. Let me stress that private stabilizers are important as well. Banking Union would enable, in conjunction with progress towards a CMU, a better channeling of our abundant savings toward the EU targets in terms of digitalization and green transformation of our economies.

How do we go about moving the Banking Union forward? I believe that all Member States should abandon the respective red lines, and should make an effort and identify new objectives that will make it possible to move towards greater financial autonomy for the Union. The roadmap endorsed by the Eurogroup in June, was an important step, because it allowed us to identify some priorities. However, it leaves open many issues. The same problems we had in advancing on the complete Banking Union project (risk sharing vs risk reduction, home vs host, ...) will recur in the reduced and less ambitious version proposed by the roadmap. We must proceed differently if we really want to be successful.

VITORIO GRILLI

Chairman of Italy & CIB EMEA - J.P. Morgan

The Banking Union and CMU as pillars for EU strategic resiliency

Well-functioning financial markets are key aspects of the overall Strategic Resilience of Europe. Especially now that the world is in a place of political and economic turmoil due to the ongoing war in Ukraine, post-pandemic recovery, a cost of living as well as a climate crisis, there is an increased need for stability at a time of uncertainty. EU Financial Resilience is a key aspect of ensuring that Europe stands ready to weather current and future storms.

From my perspective as former Finance Minister and a Member of the European Commission's CMU High-Level Forum, the completion of the Banking Union and CMU will be the key pillars to underpin financial resilience in the EU - although it is clear that the road to get there may be long.

The current status of the EU CMU project can be summed up along to following lines. The ambition is huge, and the potential is great. Strong capital markets help support the economy, reduce pressure on banks and complement bank lending, and create more long-term wealth for European households. And the potential benefits are obvious. The think tank New Financial estimates that significant progress towards the CMU could double the current levels of activity. Any such increase (or significant progress towards it) would significantly reduce the reliance of the EU economy on bank lending, drive innovation, and boost investment in jobs and growth.

As the Commission's CMU Indicator Dashboard shows, a lot of work has been done over the last years. A first phase of securitisation legislation is now implemented, and we are looking forward to improvements in the coming years. Other parts of the CMU are still coming down the pipeline. Good progress is being made on ELTIF, covered bonds and private pensions. The discussions around the ESAP, which will establish a European-wide company data registry system, are near completion, and we look forward to proposals on solvency reform later this year to help harmonise aspects of corporate insolvency procedures across Member States. We are also looking forward to the upcoming proposal for the EU Listing Act to improve access to capital for companies by making the listings of securities easier.

Still, there is no silver bullet that will deliver the CMU. Instead, the CMU will be a decades long project of patiently chipping away, whereby all the initiatives listed above will all be part of that journey. We hope the need for strategic resilience will help inject a greater sense of urgency and political momentum across the EU to develop bigger and better capital markets.

Well-functioning financial markets are key aspects of the overall Strategic Resilience of Europe.

At the same time, we need to ensure that Europe is stronger when it comes to the flow of capital across the Member States. This brings me to the second pillar of EU Financial Resilience – the Banking Union. Again, we have seen good progress achieved, especially the creation of the single supervisory and resolution mechanisms. The recent agreement to work on a proposal to strengthen rules for bank crisis management and national deposit guarantee schemes (CMDI) is a very welcome one. Although I know this is a highly political issue, I hope that EU policymakers will continue to press ahead in finding a common position. Delay is not helping us reach our joint goals.

A key aspect of EU resilience will be to remain open to international financial markets. The participation of global firms in the EU system brings added competition and market depth, to the benefit of EU clients. The involvement of firms such as J.P. Morgan in EU capital markets supports the EU's aspiration of US style capital market financing for the EU economy. For example: in 2020 one third of loan issuances to EEA clients were provided by non-EEA firms, split broadly between US, UK, and other banks; a 'healthy' mix. Importantly, non-EEA firm market share in syndicated lending was more-or-less stable between 2019 (36%) and 2020 (33%)Part of the concern about "reliance" on US banks relates to the incorrect perception that all non-EU banks retreat to their home markets in times of crisis.

J.P. Morgan is committed to the EU ad its businesses through all economic cycles. We increased lending by >20% during Covid in 2020. Additionally, we have recently completed the consolidation of our EU presence into a single legal entity, known as J.P. Morgan Societas Europaea (JPMSE), which operates a network comprising 14 branches across the EEA and the UK, making us among the top 20 ECB supervised banks with a total capital base of around €34 billion.

In short, we are present in Europe, spread over the continent, employing people and are here support the EU in its goals for resilience. Thank you to those of you who continue to push ahead on these aims. Together we can make a difference and make Europe stronger than it is today in the financial area.

EMMANUEL MOULIN

Director General of the Treasury - Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

A competitive financial sector is key to ensure autonomic strategy

Building a truly European strategic autonomy has been a political goal for the EU since 2020, and the concept is particularly relevant for the financial sector.

One, massive needs for financing are needed for the post-pandemic recovery, the transition to a green economy, and the need to support the digitization of economic actors.

Two, the European financial sector is currently undergoing massive changes such as the digitization of their business models, as well as an evolving competitive landscape.

Three, the EU itself is growing increasingly dependent on the external provision of some essential financial services. Accordingly, in April 2022, the Council adopted ambitious conclusions on European financial strategic autonomy, which covered, inter alia, considerations on the way forward to build a strong and competitive financial sector, while limiting risks arising from excessive reliance on third country institutions.

Our first priority is to build a more integrated financial sector. I believe that we have already made some progress in this regard. Under the French Presidency, the Council adopted its position on three of the four proposals made last November by the Commission as part of its Capital Markets Union package, which aim at supporting the development of attractive investment vehicles that are easily accessible to retail investors to allocate more capital to real assets, and at facilitating investors' access to information on companies all over Europe. From this perspective, the agreement on EU standards for non-financial reporting will support the EU's strategic autonomy agenda, as it will be fully adapted to EU companies' and investors' needs.

Moreover, in February, 18 Member States committed to implement the Scale-up Europe initiative, in order to develop 10 to 20 European funds active in the late-stage segment, including the European Tech Champions Initiative (ETCI), which will invest mainly in European technology companies. We also expect the upcoming Commission proposal for a "Listing Act" to foster attractiveness of public markets, which should make it easier for companies to raise funds.

> Financial strategic autonomy is key for Europe to meet its financing needs in the long-term.

Finally, we largely support the intention from the Commission to harmonize better insolvency proceedings in the Union, as it remains one of the key barriers to cross-border investments. However, without a genuine Banking Union, such actions will remain insufficient to achieve a fully integrated European financial sector. France has been supportive of the Eurogroup president's attempt to unlock political discussions on the matter, but to date, we have not been able to transcend national differences.

The second priority is to make sure that we build a strong and competitive European home-market for financial services, by ensuring its capacity to largely meet the European economy's financing needs. At Council level, discussions on the transposition of the Basel III accord into European law have been progressing fast, while an agreement was reached on Solvency II in June. I hope that the final agreements with the European Parliament on these texts will support the banking and insurance sectors' capacity to provide sufficient funds to the European economy. Moreover, a strong European home-market should limit its dependencies on third-country essential services, which could create financial stability risks in times of financial market disruption.

I look forward to the upcoming EMIR proposal, which should allow to build a more competitive clearing market in the EU. I also expect the advice from the EBA on the dependence of the EU economy on non EU banks to help policy makers address some of the vulnerabilities of the EU financial sector and identify policy priorities. In that regard, it is key for the funding of large European corporates to still be able to rely on large European investment and financing banks, as demonstrated during the Covid crisis.

Finally, **the third priority is to ensure the EU financial sector fully embraces the digital transformation,** which means the regulation should encourage innovation and digitization of the sector. Under the French Presidency, we have reached political agreement on MiCA, providing a framework for EU financial players providing crypto-assets services, and DORA, which will aim at mitigating the risks linked to the use of technology third-party providers. In addition, current initiatives on instant payments, open finance, digital euro and artificial intelligence should contribute to the EU leadership in this area and adequately accompany the digitization of financial players in the EU.

Financial strategic autonomy is key for Europe to meet its financing needs in the long-term and ensure the prosperity of its economy. To that end, completing the integration of European financial markets, supporting competitive and resilient financial markets, and encouraging the digitization of the sector are some of the main drivers to consider in order to ensure its success.

FRANCO PASSACANTANDO
Deputy Chairman – Euroclear S.A.

European financial autonomy: a means to an end

Successful financial markets are those that allow economic agents to diversify investment and borrowing opportunities, globally. Policies aiming at increasing autonomy must guarantee a market that remains open. The search for financial autonomy should be considered not as an end in itself but as a means to achieve the objectives of EU policies such as:

- Improving the financial sector's capacity to support the European economy at a time that war in Ukraine and COVID-19 create huge investment needs;
- Strengthening the resilience of the financial sector by reducing old vulnerabilities and preventing new ones from emerging;
- Fostering the capacity of Financial Market Infrastructures (FMIs) to minimize transaction costs;
- Reducing dependency on third countries for key services and technology.

Most importantly, autonomy means creating the capacity to support the vital European values of ensuring a green transition and supporting the international role of the euro.

The factors that currently limit the EU financial autonomy are well known, including excessive reliance on bank funding, an incomplete banking union, delays in the Capital Market Union (CMU), and inadequate risk sharing – to name a few. While there is an urgent need to fill these gaps at a political level, market operators can also play a key role.

Conceptually, we believe a major financial centre in the EU could achieve high levels of liquidity and efficiency, comparable to those of New York or London. However, this option is unrealistic and may not be even desirable in an ever-growing digital world. An alternative to a single EU financial centre is to connect individual financial centres, by creating data platforms that could allow interoperability and information sharing. Part of Euroclear's strategy, approved by its Board, goes in this direction by envisaging the development of an open shared data platform for the services it offers to its ecosystem of issuers, investors and broker/dealers.

Further progress in the CMU would represent the most important contribution to the European financial autonomy. We support the Commission's CSDR refit to simplify the passporting process that currently makes the provision of cross-border financial services highly complex. We also greatly welcome the most recent work by the Commission that seeks to overcome disparities in the withholding tax procedures amongst member states. New digital technologies could also help limiting manual processes, while enhancing transparency and communication between tax authorities.

An alternative to a single EU financial centre is to connect individual financial centres, by creating data platforms that could allow interoperability and information sharing.

The Euroclear group is the world's leading provider of domestic and cross-border settlement and related services for bonds, equities, and fund transactions. The Euroclear group holds assets under custody on behalf of clients for a value of €37.6 trillion and in 2021 settled transactions for a value of almost one quadrillion euros. Euroclear plays an essential role in attracting international investors into Europe through its multi-currency settlement and its multi-assets collateral management services, and hence contributing to the resilience and liquidity of European markets.

Some of our recent initiatives contribute to key European strategic objectives.

Euroclear Bank (EB) has decided to migrate to the TARGET2-Securities platform - one of the ECB's pivotal instruments to establish a single capital market. The migration, which will take place in phases, will allow EB to offer securities settlement in EUR central bank money to its global clients. They will then be able to tap into the whole range of TARGET services for collateral and payments.

Euroclear also supports the European Green Deal. A recent study, commissioned to PwC, revealed that FMIs can play a crucial role in developing solutions that permit issuers and other market participants to embark on the ESG journey. Euroclear will integrate ESG metrics into existing products across the value chain, and it has recently invested in Greenomy to enhance its sustainable finance strategy. We expect Greenomy's work to facilitate the reporting on sustainability-linked data and as such help increase transparency of sustainable issuances.

Financial instruments and even the very concept of money are going through a profound transformation with the advent of digital technologies. The tokenisation of assets could widen the range of securities been processed by financial markets. On the securities side, a proper regulatory framework is necessary to avoid market fragmentation and improve operational efficiency. On the cash side, the creation of wholesale Central Bank Digital Currencies could expand the range of operators which would have access to central bank money and extend operating hours.

Different routes can be explored, and we stand ready to contribute to this process either by participating in experimentations, as done with the Banque de France, or by building on our well established links with TARGET.

GEDIMINAS ŠIMKUS
Governor - Bank of Lithuania

An open strategic autonomy must be ensured in the EU's financial sector

Initially limited to matters of defense, the concept of strategic autonomy has in the past years found echoes in all EU policies. We are moving towards less trade with geopolitically more risky countries, with a goal of greater independence in the production of essential goods and digital sovereignty. At the same time, the EU strives for deeper integration and must avoid protectionism, aiming for an open strategic autonomy.

According to the European Commission, the EU should be „open where we can, but autonomous where we must". The financial sector is one of the key areas in which such an open strategic autonomy must be ensured. Financial and real economy sectors go hand in hand, and without fostering autonomy in both, the macroeconomic stability and resilience of the EU cannot be ensured. Achieving this aim requires a complex dance of dependencies and capabilities.

The EU's financial sector is large and very open internationally. This openness spurs competition; however, to date, the European financing model is still heavily skewed towards bank financing. Too few European companies go public, and when they do, they tend to use third-country exchanges to raise funding. Excessive reliance on third-country critical service providers, such as central counterparties clearing derivatives and third-country digital technologies, creates financial stability risks in times of market disruption. We must therefore take the necessary steps to tackle such dependencies.

In this pursuit, however, we must not simply replace one dependency with another. We should avoid the pitfalls of picking national or binational winners, focusing on national goals rather than European ones, and setting standards in areas where we are not technologically competitive.

Let me expand on this idea. While one could see a point in cautioning that „if we don't build our own champions in all areas – digital, artificial intelligence – our choices will be dictated by others"[1], we cannot proceed by simply picking national champions and allowing them to compete in strategically sensitive sectors internationally. Doing so would stifle innovation and put the SMEs from smaller EU member states at a disadvantage, as they would not be able to benefit from customized innovative products.

Autonomy is not about picking champions, but about fostering horizontal policies and strategies.

Instead of picking champions, the EU should identify key European ecosystems that deserve support and foster deeper EU-wide cooperation. Horizontal rather than vertical policies could be pursued, with vertical policies embraced only where they contribute to the EU-wide strategic autonomy without undermining the level playing field. While completion of the Banking Union and the deepening of the Capital Markets Union are crucial, harmonization of the legislation with regards to insolvency and taxation is of prime importance too. To this end, we welcome plans of the European Commission to present Customs and Taxation as well as further Capital Markets packages this winter.

The EU's open strategic autonomy is inseparable from the promotion of financial innovation supporting the EU's climate and digital transitions. The EU's role as a global standard-setter can be a key element in the EU toolbox to promote this. Nevertheless, we cannot just set the rules and be the referee; we need to be players as well in order to credibly shape global standards. Therefore, the EU can only use its standard-setting power in areas where it is technologically prominent and competitive.

One such area is data collection, management, and protection. Through such initiatives as the European Single Access Point as an EU-wide data powerhouse with sustainability data on European companies, or the creation of the consolidated tape for transactions taking place on trading platforms across the EU, European companies would be made more visible, accessible, and comparable. Combined with an interconnected and open technology sector in Europe, such initiatives would provide the continent with a strong position to set global standards and promote European values, as well as to maintain and expand Europe's economy.

The past few years have witnessed a need to strike an appropriate balance between achieving economic and financial autonomy on the one hand and maintaining openness and global cooperation with like-minded partners to reap the potential benefits thereof, on the other. The EU must continue working to achieve an open and stable international economic ecosystem against the background of profound changes to the global economic and geopolitical order. Experience has shown that coping with such changes takes time, leadership, and stamina.

Let us thus follow the tried and true approach of "not letting a good crisis go to waste" and institutionalize our long-term strategies.

[1] Interview with French President Emmanuel Macron at the Radio France International, September 2019.

STÉPHANE BOUJNAH

Chief Executive Officer and Chairman of the Managing Board - Euronext

Transforming the ambition of strategic autonomy for capital markets into action

The concept of strategic autonomy of European financial markets has become widely accepted in public debate. Yet, it is difficult to identify concrete measures recently taken by the EU to move towards this objective in financial services while major progress has been made recently in the areas of defence, semiconductors, health and budgetary policy.

Strategic autonomy does not mean financial autonomy, as European capital markets must remain open to foreign capital and companies. Strategic autonomy is based on having enough domestic capacity and control to transform the savings of 450 million Europeans into investments by EU companies.

Euronext provides an illustration of what it can mean in practice. We announced in June the successful completion of the migration of our core data centre from Basildon, UK, to a best-in-class and green data centre based in Bergamo, Italy. This relocation was a strategic decision made in response to multiple factors, including the dynamic created by Brexit, and a strong rationale for relocating in the EU, Euronext's core European trading activities which account for about 25% of the shares traded in Europe.

In the pre-Brexit world having London as the largest financial centre of the EU was a natural specialisation that was widely accepted. Post Brexit, Europe must make sure that within the EU there is a full architecture, from a regulatory and an operational point of view, to allow for a situation where Europeans have control over the key pillars of the financing of EU economies. Strengthening strategic autonomy should also rely on making sure that strong insurance companies, asset managers, global banks and market infrastructures are based and built in the EU.

The CMU is very much in the DNA of Euronext, as the founding principle of the integration initiated over 20 years ago was to pool European liquidity on a single platform, while retaining local infrastructure with the appropriate licensing and supervision to support local capital markets. This model is helping overcome issues of fragmentation, integrating markets and providing benefits to investors and issuers alike. It is underpinned by a genuinely European federal governance model.

It is critical to nurture, strengthen and defend a multicentre and interconnected European model.

Since the IPO of Euronext in 2014, the Group has expanded and operates regulated markets across 7 European countries, becoming a true pan-European financial markets infrastructure provider across trading, clearing and settlement.

Euronext develops the local ecosystems – particularly listings – which are so critical to public capital markets. This is in stark contrast to models from some non-EU actors which cherry pick the most profitable activity, provide access mainly to global institutions and do not bother with local specific requirements and ecosystems, nor with the financing of the real economy, in particular SMEs.

This is why it is critical to nurture, strengthen, and sometimes defend a genuinely European model with distributed but integrated and highly interconnected financial centres. If the EU is too naïve in preserving and developing its financial ecosystem, it will lose its domestic capacity in finance and turn into a simple sub-division of the "EMEA – Europe, Middle-East and Africa" zone of global groups.

From that perspective, the latest proposals to the MiFIR regulation are a source of concern especially regarding the consolidated tape. The proposed framework, if enacted, will mainly benefit players outside of Europe. This unfortunate situation demonstrates a lack of understanding of the issues caused by fragmentation and transparency in the EU which will not be addressed with a consolidated tape. Since MiFID II, fragmentation has been driven by the sharp increase in off venue Systematic Internalisation. It should be addressed by changes to market structure regulation in the MIFIR Review, in particular to limit Systematic Internalisation to where it can best benefit markets: the trading of large orders.

In order to build the EU's strategic autonomy, we must focus on Europe's aspirations for more simplification in EU rules, through, for example, the implementation of a competitiveness test and a single European prospectus for IPOs, similar to the single S-1 form in the US, as part of the Listing Act.

Now that the aggregate market capitalisation of companies listed on Euronext platforms is around €6 trillion, which is approximately twice the aggregate market capitalisation of companies listed in London, we are seeing a shift in international listings towards Euronext platforms. Companies that in the past would have considered listing in London are now selecting Euronext.

We are also able to launch new initiatives to achieve strategic autonomy such as Euronext Tech Leaders, to highlight the visibility and attractiveness of European Tech champions towards international investors.

At Euronext, we are proud to show that a genuine federal European model can be a driver of commercial success and an important contributor to the European strategic autonomy.

2

FINANCIAL STABILITY CHALLENGES AND VULNERABILITIES

ISSUES AT STAKE

The economic impacts of the war in Ukraine, the current high inflation rate, the very high levels of sovereign and corporate indebtedness in some EU countries and the risks from persistently negative interest rates in real terms (e.g. asset bubbles due to search for yield and increased leverage) dominate the outlook for EU financial stability.

Liquidity issues experienced by some money market funds and open-ended investment funds at the outset of the Covid crisis have moreover revived the debate about fund liquidity risks and more generally about the resilience of non-bank financial intermediation (NBFI), although the sector generally demonstrated resilience during this period in Europe.

Improvements to the MMF framework are being considered at the global and EU levels in order to address the vulnerabilities associated with these funds, as well as a harmonisation and greater availability of liquidity management tools at the disposal of open-ended funds. A further question is the liquidity of certain underlying markets, notably short-term markets.

Additional vulnerabilities stem from the exposure of the banking and insurance sectors to climate and environment-related risks. Regulators are endeavouring to improve the measurement and disclosure of these risks and their integration in the prudential and supervisory framework by notably leveraging emerging EU and international sustainability disclosure standards and the risk scenarios developed by the NGFS, in order to enhance the management of these risks in a sufficiently consistent way.

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

FINANCIAL STABILITY RISKS WITH HIGH INFLATION AND INDEBTEDNESS

MADIS MÜLLER
Governor - National Bank of Estonia (Eesti Pank)

New risks are emerging as policies shift

The risk outlook is changing in response to the normalisation of monetary policy and the Russian invasion of Ukraine.

Tensions are rising during this long-awaited summer. They are seen in the travel chaos as people rush to take holidays abroad despite the risk of those holidays being wasted in airports, and in the volatility in financial markets and the rising prices of real estate, food and energy.

The Russian invasion of Ukraine has put the global economy under severe stress. Despite the strong post-pandemic recovery and the corrections in financial markets in the first half of the year, financial stability has become increasingly vulnerable. The exuberant mood in the markets has dissipated quickly, but it is also important not to allow fears about the future to turn into a self-fulfilling prophecy. To prevent risks materialising, several key systemic vulnerabilities need to be monitored and policies adjusted accordingly.

The first of these vulnerabilities is the risk of further and more disorderly asset price adjustment, which according to the European Systemic Risk Board remains a severe systemic risk despite the sharp corrections in global bond and equity markets that have already been seen in 2022. Further turbulence could be triggered by an escalation of the war, stresses in emerging markets, or a pronounced slowdown in global growth combined with persistently high inflation.

Second, high inflation is reducing the purchasing power of households but may also put pressure on corporate profit margins and so reduce the capacity to borrow and to service debt. The cost of servicing debt will increase further with the inevitable tightening of monetary policy that goes hand in hand with persistently high inflation.

Third, higher interest rates will weaken the outlook for growth even as they provide some support for banks at the same time. The EU banking sector proved resilient during the pandemic and its direct exposures to Russia and Ukraine have been contained, but the need for vigilance remains. Credit risks are increasing, and the profitability of banks will be affected by the worsening economic outlook.

Fourth, climate risks and cyber risks are vulnerabilities that cut across everything and that must not be forgotten, especially at times like these. The climate transition also needs to be accelerated to reduce European dependence on energy from Russia. Cyber vulnerabilities require us to be unceasingly vigilant, as the threat of cyber-attacks is greater than ever.

How does monetary policy interact with those risks? After years of low interest rates, it is not easy to turn the cycle around without causing a certain amount of volatility. The exit from the loose monetary policy has been achieved much faster than was previously expected around the world. It is also happening in a very challenging environment in which various supply shocks are hampering the productive capacity of firms and the purchasing power of consumers, all on top of the uncertainty caused by geopolitical risks.

Risks are changing in response to the normalisation of monetary policy and the war in Ukraine.

One of the legacies of the past crisis and the prolonged period of low interest rates is the high level of sovereign and corporate indebtedness. This is certainly not a uniquely European problem, but the institutional framework in a currency union poses its own challenges when this issue is addressed. For a currency union and common monetary policy to work smoothly, governments need to adjust their fiscal and structural policies to deal with idiosyncratic developments in the different countries of the union.

Central banks often have a clear price stability mandate, but there is not really a clear direct link between policy rates and prices. There is a complex transmission mechanism that works through the financial system and through companies, consumers and public entities. This means the central banks currently have to tread a fine balance between being forceful enough in tightening monetary policy to keep inflation expectations anchored and being mindful at the same time of financial sector risk and the ability of the economy to adapt to higher interest rates.

In conclusion, it is important to stay alert. It seemed in late 2021 that the economy would have smoother sailing ahead after the recovery from the pandemic, but we clearly still have some difficult times before us.

GERRY CROSS
Director Financial Regulation, Policy and Risk - Central Bank of Ireland

Reflecting on a stark risk environment: shorter- and longer-term aspects

In the face of the significant shock of the Covid-19 pandemic, the financial system showed considerable resilience. This in the context of course of unprecedented levels of public support for local and regional economies.

The evolving risk context – including variable sectoral recovery, supply chain disruption, the potential for pandemic resurgence, and normalisation of monetary policy – has been further transformed by the Russian invasion of Ukraine and its consequences.

The exacerbation of pre-existing risks combines with the emergence of new risks to produce a context of significantly heightened risk – credit, market, and operational - to the financial system:

- the potential for significant sectoral shocks in the context of a generalised economic downturn,
- geopolitical disruption resulting in further fragmentation and increased disruption of supply chains,
- further increase in underlying inflation with the need for more impactful response and the risk of disorderly risk-price resetting, and/or positive sovereign-bank feedback loops;
- commodity market disruption impacting the financial system through (opaque) counterparty links giving rise to sudden stability risks,
- the risk of major operational disruption due to state sponsored cyber assault.

This represents a stark risk context which – both in its component aspects and as a result of the potential tipping-point dynamics inherent in it - requires close, immediate and ongoing focus.

However, there are also longer-term risks to the financial system which are equally problematic and which risk being materially exacerbated by the current situation. This is due to a combination of negative longer-term effects resulting directly from current events and the displacement or crowding-out of risk-attention to which they give rise. Two of these in particular are worth noting:

Climate

The Network for the Greening of the Financial System (NGFS) has identified three over-arching scenarios for the future path of climate change and transition as it relates to the financial system. (1) Orderly transition – we move to a net zero economy along a smooth path of well managed adaptation; (2) Disorderly transition – the bulk of the transition is left too late, and we face a forced adaptation over a very short timeframe which gives rise to very significant disruption; (3) Global hothouse – the transition fails and we face the major physical, political and economic crises which will accompany material global warming.

The current risk context – both in its intensity and its nature – poses significant risks to the climate agenda and as a result to longer-term financial stability. Not only does it mean that policy makers and financial firms are distracted at a crucial moment from this priority challenge, but it is possible that the measures taken to address the current risks may significantly adversely affect the likelihood of success. This may result from both political reprioritisation of energy transformation commitments as well from decisions to avoid the risk capital allocations needed to advance the transition. The financial system has central role to play in the transition to a net zero economy. The current risk context could, unless properly managed, amount to a significant impediment to the fulfilment of this role thus exacerbating the medium-term climate risks including to financial stability.

Disorderly disruption

The financial system is undergoing swift and deep change due to technological innovation and disruption. This has the potential to bring significant benefits and opportunities to the users of financial services and the economy. It also carries material risks that need to be actively managed. Disruption, while a positive force in the economy, by definition brings potential stability challenges to be analysed and addressed. With Big Tech firms poised to play a deepening role in the financial system and its broader ecosystem, we are at a key phase in the ongoing transition to a technologically transformed financial system.

A stark risk context requires close and immediate focus; longer term risks are also heightened.

Once again, the displacement of attention – in particular that of oversight and regulatory authorities – due to the significant risk concerns of the current moment risks undermining the consideration and interventions needed to support the realisation of the benefits and the management of the risks of rapid technological transformation.

SYLVAIN BROYER
Chief Economist EMEA, Fixed Income Analytics - S&P Global Ratings Europe Ltd.

Structural policies, Banking Union, and CMU can save Europe from a Minsky moment

Europe weathered the recent turmoil on the bond markets well. Monetary policy, structural reforms taking root, and policy initiatives have all played a role in avoiding financial fragmentation. Completing structural and policy reforms can help build further resilience.

It is usual to have bond spreads widening in a bear market. The magnitude of the widening we have seen among European sovereign bonds in the first half of the year is within the statistical norm. The same resilience can be observed downstream of the financing chain. SMEs aren't reporting any financing gap. They have access to bank loans at an average rate of 2.5%. This is less than the inflation that the ECB is expecting for next year, and the rates at which SMEs are getting funded are, depending on their country of origin, in a range that is two-and-a-half times narrower than in 2012.

This context is a major difference from the time of the Eurozone debt crisis ten years ago. That said, times are uncertain. – New developments have undermined the recovery from Covid-19 that is still incomplete. These include the war in Ukraine and a faster normalization of monetary policies than anticipated, even a few months ago.

Given that European companies in many sectors still face formidable challenges: how can Europe prevent financial fragmentation, and make sure that it does not face another "Minsky moment?"

First, we should acknowledge that Europe already has the tools at hand. On the monetary policy side, the flexibility given to reinvestment in the PEPP, TLTROs, the full allotment procedure, and OMTs, are all potential firewalls to the risk of fragmentation. On the fiscal policy side, although not a fiscal measure in itself, NextGen EU is acting as a redistributive mechanism that benefits the more fragile economies in the EU. Also, the suspension of EU budgetary rules has given member states room to absorb shocks which, it should be noted, are currently all external ones. None of the shocks buffeting the European economy today is inherent to the architecture of the monetary union, or to economic policies from member states. This is another major difference from the time of the Eurozone debt crisis.

Of course, more could be done. The ECB has a few options. An outright bond purchase program designed to cap spreads on the market for European government bonds would raise technical and legal questions. However, it should be possible to revisit the conditions attached to OMTs to create incentives for countries at risk of fragmentation to use them. Making these conditions align with the policy goals set by NextGen EU would go in that direction. A fourth round of TLTROs would also contribute to keeping bank lending conditions smooth. On the fiscal side, some proposals made by the European Fiscal Board to revamp the EU budget rules could help. These proposals suggest exempting capital expenditures that are proven to support growth from future spending or deficit rules.

Banking and Capital Markets Union would inherently make Europe more resilient to market shocks.

Nonetheless, the role of structural policies should also be emphasized. Structural policies have helped the EU to weather the recent turmoil in the bond markets, alongside monetary and fiscal measures. Economic fundamentals are better today than they were ten years ago. For instance, in Spain or France, structural reforms, which have targeted the labor market and price markups, have helped to narrow the cost competitiveness gap to that of Germany. Second, reforms of the financial system have played their role, such as the introduction of the Single Supervisory Mechanism (SSM) and the development of banking regulation. Of course, the exposure of banks to domestic sovereign risk has not declined and companies are still as dependent on bank financing. Yet, bank balance sheets are stronger today, their capital ratios are higher, and their liquidity profiles are better. This strengthens the banking sector's ability to absorb shocks.

It is therefore essential for Europe to complete the Banking Union and to move forward with the Capital Markets Union (CMU). By facilitating the circulation of ample savings, the Banking Union and the CMU would make Europe more resilient to market shocks. Once built, these structural policy pillars could relieve monetary and fiscal policies of the firefighting role they have been assigned since the pandemic.

GEERT WIJNHOVEN
Group Treasurer - ING Group

A challenging macro-economic environment: how the EU can show resilience

The world has been riding a macro-economic rollercoaster over the past three years. Unprecedented monetary policies look like business as usual in retrospect. The Covid-19 pandemic, next to being a human tragedy, was a macro-economic shock. It caused international demand and supply chain disruptions and a concerted global surge in government spending. Additional monetary stimulus, while understandable, prolonged and intensified the search for yield, sending financial asset prices to unprecedented heights and compressing risk premia.

In the EU, the pandemic's demand shock was partly curtailed by government stimulus and social security cushions. Most EU countries increased their borrowing to finance spending, topped off by the economic policy highlight of pandemic times: the €800bn of common EU debt issuance for NextGenerationEU.

Enter the post-pandemic world. Global inflation has increased substantially, mostly driven by persistent supply chain challenges and energy prices – both exacerbated by Russia's invasion of Ukraine –, labour shortages, and simultaneously, consumer demand bouncing back after lockdowns.

Europe faces a scenario where the economy struggles whilst inflation is persistently high. This creates a conundrum for central banks especially as more than a decade of Quantitative Easing (QE) has led to artificial valuations of financial assets, which face the risk of disorderly re-pricing. Bonds, including government bonds, are most susceptible. As the ECB has stopped buying additional government bonds after seven years, government net debt issuance will have to be absorbed fully by private investors again. This transition should not be underestimated. Since the onset of the pandemic, the Eurosystem has on balance bought more government bonds than Eurozone governments have issued. But today, the goals of managing inflation and containing spreads can no longer be achieved simultaneously by the twin policies of negative rates and QE.

From a credit risk perspective, a scenario in which the costs of living and refinancing debt increase, while the economy slows down and private and public debt are high, can cause significant risks.

These challenges are clearly major. But the EU is better prepared than ten years ago.

Prudential policy: EU banks are well capitalised and major efforts have been made to reduce bad legacy debt. As a result, the banking system is well positioned to absorb shocks. Yet Europe's banks would be in an even better place if Banking Union, including common deposit insurance, were finalised. This would help to weaken the dreaded sovereign-bank nexus and would promote an integrated banking market.

Fiscal Policy: The EU crossed a political Rubicon when it agreed on limited common debt issuance during the pandemic, but this is no permanent tool that can be automatically re-used to help fiscally weaker countries in the coming years. Yet the blueprint is now there to work from, if desired. Mutualising legacy debt does not seem politically feasible, but the EU could consider mutually financing economic stimulus that underpins EU strategic goals, most notably the drive towards net zero carbon emissions by 2050. Continued joint issuance would also bolster the international role of the Euro.

To weather an economic storm, the EU must show its political unity upfront.

Monetary Policy: The Eurosystem finds itself in the challenging position of having to fight inflation while the economy is already weakening. Moreover, it wants to contain spreads within the Eurozone to safeguard transmission of monetary policy, but cannot and should not prevent markets from pricing different risks. The Eurosystem's new "Transmission Protection Instrument" is an attempt to walk this fine line. In any case, a clear lesson from the Eurozone crisis is that the Eurosystem cannot be tasked with solving problems outside its remit. It is upon EU governments to prevent a crisis atmosphere when the waters get choppy.

Despite these hopeful points, it is undeniable that fiscal space is in short supply in the EU. Monetary policy is never the best answer to that problem, especially as inflation returns. In a weak economy possibly confronted with energy shortages, countries need to make hard choices in their fiscal policies, which can be alleviated by maximising coordination amongst the different layers of European fiscal firepower. To weather an economic storm, the EU must show its political unity upfront.

VULNERABILTIES FROM NON-BANK FINANCIAL INTERMEDIATION

MARTIN MOLONEY

Secretary General - International Organization of Securities Commissions (IOSCO)

Making open ended funds less vulnerable

Open-ended funds are vehicles for investors to join together to share the costs of investment management, administration and transactions costs. Once a number invest together, the mutual differences in the timing of their liquidity needs creates an odd, positive effect: the fund is more liquid than any one of them would be alone. This is good.

This fact has been the basis for one of the longest standing marketing devices for collective investment: daily redemption. This feature attracts additional investors so that a fund becomes a mixture not just of long-term investors with differing liquidity demands, but also mixed in with other more short term investors attracted by the daily liquidity.

It helps to manage all this if the instruments invested in are traded on liquid. The primary reason why daily redemption could be offered might originally have been the multitude of timing preferences for investment and withdrawal; but if that doesn't prove enough to facilitate the promise of daily redemption, then assets that can be sold quickly on liquid markets are an additional defence to ensure that the redemption demand can still be met.

Some public markets are almost as liquid as the daily redemption promise, which means there is no liquidity mismatch. But some markets are not that liquid. Then there are some markets that seem robustly liquid but suddenly become significantly less liquid.

Daily redemption is not an absolute promise, but it is a widespread expectation. That expectation combined with variable liquidity in assets makes daily redemption a vulnerability built into the structure of markets. Regulation rightly requires fund managers to manage the situation so that they can expect to meet the redemption demand under reasonably foreseeable circumstances.

Trying to understand if the vulnerability is getting worse or better, the main problem is bond markets. Even the most liquid bond markets are significantly less robustly liquid than most equity markets. When markets get stressed-- especially when the leveraged traders withdraw-- we don't want the open-ended funds also selling assets because of that daily redemption promise. That will make the stress even worse.

Better manage liquidity mismatch, allocate redemption costs, improve bond trading and better data.

But they do; not only do they sell assets when redemption demand is high, but when stresses emerge, they also sell assets in the expectation that redemption demand (and other liquidity requirements) might get high. Like regulators, market participants never exactly know as to when a dash for cash is coming. They plan for it at the last minute and that makes it more likely.

Every period of stress provides additional evidence as to whether more needs to be done by regulators. We have seen two recent exogenous shocks to markets that help inform us as to how this vulnerability works out. March-April 2020 (COVID) saw significant OEF asset sales as part of a chain of effects that became part of a destabilising dash for cash. February-March 2022 (Ukraine Invasion) saw some OEF asset sales, but no dash for cash. The difference in outcome seems easy to understand; the exogenous shocks were very different. But the detailed facts across multiple asset markets in different jurisdictions are hard to map. There is no global database. We do risk focusing policy excessively on the most transparent, regulated sector. But the alternatives are even more unpalatable given the damage financial instability can do.

What more should regulators do to help? There are some assets whose liquidity is very hard to manage if combined with daily redemption. The most dangerous are those that seem liquid, but prove vulnerable.

It will also probably help if we impose the costs of redemption on the redeeming investors. This would create would be some additional incentive for them to remain invested a little longer. But if this is going to be required, there should be strong guidance as to how.

In addition, it's worth asking what we can do with bond market structures to make them more robustly liquid. It doesn't work to expect broker- dealers to act as shock absorbers. That is risky in itself. But can we ensure that everyone with the capital to trade in periods of high volatility or falling prices has the chance to do so?

We certainly need better information to analyse such periods of market stress. In this regard it is notable that European UCITS don't have an informative common regulatory reporting mechanism. This is the biggest gap in IOSCO's database for OEF leverage, for example. The ESRB recommended better UCITs reporting in 2018; it would be a great help to see it happen.

Reduce or better manage the liquidity mismatch, impose redemption costs on early redeemers, improve bond market structures and get better data on what is really happening. These are all things we can do at proportionate impacts that will help. In the struggle to deal with the liquidity risk in OEFs, there is no silver bullet. But there doesn't need to be. This is about managing the liquidity risk in OEFs, not eliminating it.

JÉRÔME REBOUL

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Tackling the vulnerabilities that stem from NBFI: one size does not fit all

The NBFI sector, in particular investment funds, plays an increasing role in financing economies while the banking sectors shrank relatively since the post-GFC reforms. The banking and NBFI sectors provide to some extent a similar economic function but with a key difference: banks systematically perform transformation, while NBFI balance sheets mainly involve investors who bear the economic risks of the assets. As a consequence, they do not raise the same risks: typically, the risks involved in the banking sector are related to the fact that potential losses have to be absorbed to fulfil the promise made to deposit holders or other creditors, while losses are simply passed on to investors the NBFI sector. For that reason, they are not equally subject to liquidity risks; provided that losses can be passed on to investors, illiquidity is only a problem in NBFI to the extent that it would not be physically possible to sell the assets.

The main procyclical effect that stems from investment funds is an excessive use of leverage. In stressed market conditions, highly leveraged funds, as is the case for any leveraged entities, may be obliged to sell assets at a steep discount, e.g. for deleveraging purpose or to meet margin calls at last resort. The pressure on asset prices due to "fire sales" might, in turn, ignite fire sales from other leveraged funds. The contagion risk may be acute if the overall investors' confidence is affected.

The banking and NBFI sectors provide to some extent a similar economic function but with a key difference: banks systematically perform transformation, while NBFI balance sheets mainly involve investors who bear the economic risks of the assets.

Liquidity mismatch in funds is sometimes (mis-)perceived as a systemic risk the same way as leverage because of the first mover advantage ("FMA") it could create and ensuing preemptive runs that would accelerate the stress. Apart for MMFs that offer a stable NAV feature, the so-called "FMA" should not have a significant impact on investors' redemptions in times of stress provided that the price of liquidity is adequately reflected in redemption terms. To recall, an FMA occurs when investors who redeem their shares first do so on more favorable terms than investors in the same fund who redeem late (which excludes the case where investors redeem in anticipation of further market deterioration). Typically, there is an FMA if investors can redeem their shares at a NAV above the market value of the fund's portfolio or if they do not bear the cost of liquidity when assets are disposed to meet their redemption. In times of high volatility, it is hardly plausible that investors can expect that the gains or avoidance of losses due to the FMA as defined above might surpass the opportunity cost of remaining invested.

Contrary to depositors whose funds are guaranteed by banks' balance sheets, all funds' investors share indistinctively all the risks. Investors shall ensure they are in capacity to absorb losses when they occur so that they won't need to redeem their shares in stressed market conditions; i.e. they should carefully invest depending on their risk appetite and time horizon. Fund managers have fiduciary duties toward their investors that include equity of treatment: no investor shall be able to redeem their shares at more favorable conditions than others, which implies that the NAV shall reflect the market value of the portfolio and that the cost of redemptions shall not be borne by investors who remain passively invested. To ensure equity of treatment, it is necessary that funds include (and use appropriately) liquidity management tools, such as swing pricing, that permit to pass on the cost of liquidity to redeeming investors.

Markets regulators are conscious that their mandate includes the prevention of the build-up of systemic risks, but we shall keep in mind that crisis is inherent to financial markets and it is also up to economic agents to be resilient when they occur. A systemic crisis is a financial crisis that has triggered a self-amplifying mechanism that prevents the market to find a new equilibrium price. In our view, funds may raise systemic concerns primarily because of an excessive use of leverage rather than liquidity mismatch. Recent economic history shows us that the difficulties of one or a small number of entities using excessive leverage may have an outsized impact on the broader markets (e.g. LTCM, Archegos). To tackle this issue, European markets regulators already have a toolkit, derived from Article 25 of AIFMD, which (i) requires NCAs to identify funds that use excessive leverage and (ii) allows NCAs to remediate it by capping the leverage at fund level if deemed necessary. Liquidity mismatch may not be a major concern in this regard, but it remains our duty to tackle the issue from an investor protection perspective.

The AIFMD review is an opportunity to encourage a range of tools in funds, but additional guidance could also prove helpful in order to harmonize their use at EU level.

SARAH PRITCHARD

Executive Director, Wholesale Markets - Financial Conduct Authority (FCA)

The main vulnerabilities of MMFs and the UK approach

In March 2020, the effect of the COVID pandemic and public health measures on economic activity exposed underlying vulnerabilities in the financial system. While the shock itself did not originate in the financial system, evidence suggests that certain structural features of Money Market Funds (MMFs) amplified and reinforced the initial liquidity shock. While central bank actions helped reduce the liquidity strains on MMFs, the underlying vulnerabilities in MMFs remain and could crystallise again in the future, including under less extreme circumstances than those in March 2020.

The UK has sought to play an active role at the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) on strengthening the resilience of MMFs. The FCA has been working closely with the Bank of England (BoE) and HM Treasury (HMT). We are committed to assessing and addressing MMF vulnerabilities in the UK. In May, we published a joint Discussion Paper (DP) on MMF reform with the BoE, endorsed by HMT. This was based on the framework set out by the FSB MMF reports and discussed the various policy options. The DP's 'discussion period' has recently closed. We are considering the responses, as well as the input from discussions with European and international counterparts.

MMFs are subject to two broad vulnerabilities. They can be susceptible to sudden and disruptive redemptions and they may face challenges in selling assets, particularly under stressed conditions. This is mainly because: a) liquidity transformation can contribute to a first-mover advantage for redeeming investors, especially in stress, whether the stress is driven by credit or liquidity concerns or both; b) MMF investors' cash needs may be hard to predict, and c) for some MMFs regulatory thresholds may incentivise investors to pre-emptively redeem to avoid the consequences of a fund crossing those thresholds. These features can cause investor detriment and potentially financial stability risks if they drive escalating redemptions and exacerbate negative market moves in underlying money markets. Large scale outflows from a single MMF could raise fears that it and other MMFs might need to suspend dealing, triggering further large outflows from MMFs.

We are committed to addressing MMF vulnerabilities [...] and strongly support international engagement.

If multiple MMFs used by UK investors had suspended in March 2020, there could have been a significant threat to wider UK financial stability and ultimately to the real economy. MMFs are used as a cash management product by both financial and non-financial institutions such as corporates and local authorities, who readily need access to their cash for their own financial commitments. MMF suspension might impact users' ability to access liquid assets to meet margin calls, pay creditors and wages.

The UK authorities are seeking to strengthen the resilience of MMFs and the financial system, by reducing the need for future extraordinary central bank interventions of the kind that occurred in March 2020. UK authorities support the provision of sustainable and robust cash management financial services that meet users' needs including at times of financial stress.

Our DP discusses the full range of options at the disposal of regulators and policy makers and asks open questions on those options. While no policy decisions have yet been made, the DP indicates we are considering whether to consult on increasing minimum liquid asset requirements, removing ties between liquidity thresholds and decisions on gates and fees (and other changes to make MMFs' liquid buffers more usable), rules related to MMF managers passing material costs of liquidity on redeeming investors, and removing stable NAV for LVNAV funds. It also states that while we are still considering liability side options, other options may be preferable, and we are unlikely to pursue policies 'to absorb losses' such as capital buffers and sponsor support. Together with the BoE and HMT we are considering the feedback received to determine whether to consult formally on one or more reform proposals.

The work on addressing risks from MMF vulnerabilities is an international priority. We believe continuous close collaboration between securities regulators and central banks is crucial and we strongly support continued international engagement given the nature of cross-border activity. In our approach, we are not only mindful of the specifics of sterling markets and UK investor needs but also of the approach being taken in other jurisdictions, particularly in the EU, where most sterling MMFs are domiciled.

The UK will continue to welcome funds domiciled in other jurisdictions to market to UK investors, in line with the UK regulatory framework. HMT will assess whether the law and practice of the relevant country or territory for MMFs have equivalent effect to the requirements of UK regulations. This underscores the need to work closely with our international counterparts to ensure that our reform programmes achieve high common standards of resilience.

DERVILLE ROWLAND

Deputy Governor Consumer and Investor Protection - Central Bank of Ireland

Money Market Funds – The need for reform

Money Market Funds are an important part of the financial system acting as a source of short-term funding for issuers and a cash management tool for investors. Ireland is the largest European domicile for Money Market Funds, accounting for approximately 40% of total European domiciled assets.

Since its entry into force in 2018, the Money Market Funds Regulation, through the creation of a product-specific regime, has helped to improve overall liquidity in the sector and led to greater transparency for supervisors and investors in Europe and beyond.

The onset of the Covid-19 pandemic in early 2020 marked a period of acute stress across global financial markets. For Money Market Funds, this took the form of large redemption flows from investors on the liability side and liquidity shortages on the asset side that combined to place particular fund types under pressure, namely private debt Money Market Funds across a number of currencies and both variable and constant NAV products, with LVNAV US Dollar and VNAV Euro funds experiencing significant stresses. Conversely, European and US public debt funds saw substantial inflows during the same period.

Since the pandemic, there has been a particular focus on liquidity mismatches across open-ended funds and implementing appropriate measures to ensure that funds have the necessary tools in place to manage their liquidity.

While acknowledging that Money Market Funds were able to meet redemption requests throughout the period, this was in large part down to the significant market interventions of central banks. The stressed market conditions did expose vulnerabilities in the sector resulting from the 'dash for cash' which have since formed the basis for a substantial body of work by the FSB, ESMA and ESRB to better understand the structural vulnerabilities evidenced during this period and to suggest enhancements to the regulatory framework.

For those reasons, the Central Bank of Ireland has actively supported the development of targeted amendments to the MMF Regulation that we believe will improve overall Money Market Fund resilience while ensuring the continued provision of the economic functions they provide, minimising the need for future central bank interventions.

The CBI has actively supported the development of targeted amendments to the MMF Regulation.

We are particularly supportive of those measures aimed at reducing the likelihood of large redemptions having a destabilising effect, such as mandatory minimum public debt holdings and increased liquidity requirements, as well as moves to improve the availability and encourage the timely use of liquidity management tools that impose on redeeming (and subscribing) investors the cost of their redemptions.

We further support the consensus view to decouple thresholds for daily and weekly liquidity from any rigid imposition of gates and fees, which may have acted, contrary to expectations, to exacerbate rather than mitigate stress.

We also believe that enhanced reporting requirements and disclosures will further improve funds' crisis preparedness. Whilst we are open to assessing the role that the stable NAV may have played in exacerbating certain crisis dynamics, we do not think it was central to the events of March 2020 and therefore should not be a priority area for action in any reform of the MMF Regulation.

At the same time, market conditions in early 2020 also highlighted potential issues with the functioning of short-term funding markets under stress. This raises questions about the overall resilience of the market and its ability to withstand exogenous shocks. Whilst further research to better understand wider market dynamics under stressed conditions may be warranted, it is crucial given the important role played by Money Market Funds that the framework within which they operate remains robust and Money Market Funds are in a position to be as resilient as possible to future shocks.

We look forward to the Commission's publication of the feedback statement to the consultation it carried out earlier this year and its proposed next steps with respect to the MMF Regulation, which we believe should happen as a matter of urgency.

We believe this will be an important step in building upon the important work completed to date and ensuring the continued growth and future resilience of this important sector in supporting European capital markets. We are keen to see the funds sector fulfil its potential as a means of investment and funding in the European economy. This means ensuring that sector remains resilient; that it functions strongly in line with the principles of fairness and primacy of investors' interests, and that overall it is in line with the effective and sustainable functioning of the European economy.

ANDY BLOCKER
Global Head of Public Policy - Invesco

Money market fund reform: a broader perspective is needed

Money market funds (MMFs) are first and foremost investment products that seek to provide investors with an income or return on principal, as well as preservation of principal, with many MMFs offering daily liquidity. They are highly transparent and provide investors with cost-effective, diversified and risk managed exposure to short-term money markets by investing in high quality, short-maturity debt securities issued by governments, banks and non-financial institutions.

MMFs therefore play an important role in the functioning of the wider economy, representing a valuable source of non-bank funding to both public and private stakeholders. According to the ECB, at the end of Q1 2022, MMFs in the euro area were managing approximately €1.37 trillion on behalf of investors worldwide.

The utility of MMFs, both as an investment proposition and as a source of funding to the wider economy, is clear and it is important that MMFs, as well as short-term money markets more broadly, function effectively, in particular during periods of economic or underlying market stress.

It is therefore appropriate to consider the resilience of the sector in the context of COVID-related market events in early 2020.

It is our strong view that MMFs proved to be resilient despite deteriorating economic and underlying market conditions and continued to carry out their core economic functions. No MMFs had to suspend dealing, use redemption gates, apply liquidity fees nor utilise any other liquidity management tools that could impact investors' ability to redeem. Moreover, we note that no stable NAV MMFs breached their respective regulatory thresholds.

The broad resilience of the MMF sector can be attributed in part to the prudent liquidity management of fund managers, as well as the broadly robust regulatory and supervisory framework governing MMFs in Europe which has been in application since 2018.

Notwithstanding the above, it is important that, where shortcomings in the MMF framework are identified, action is taken to further enhance the resilience of the MMF structure. For example, regarding low volatility NAV MMFs, policymakers' various analyses have concluded that regulatory provisions linking weekly maturing assets and net daily redemption thresholds to the potential application of liquidity fees or redemption gates should be removed.

Policymakers must enhance the transparency and functioning of underlying short-term money markets.

We strongly support this conclusion as de-linking these provisions will reduce structural procyclicality by removing the incentive for investors to redeem their shares as MMFs' weekly maturing assets trend towards the 30% threshold. Enhancing the resilience of the LVNAV MMF structure in this way should be the absolute priority of policymakers given approx. 46% of total euro area MMF assets are managed via LVNAV MMFs, according to ESMA.

We do not support some of the other reform options being considered in respect of LVNAV MMFs, such as removing the ability to provide a stable share price or introducing new minimum or maximum thresholds for public or private assets, respectively.

Pursuing reforms that would remove one of the key product features that investors value, or that would re-introduce an incentive for investors to redeem their shares as a specific asset class trends towards a given threshold, is simply not justified by the evidence presented in policymakers' various analyses.

Neither are reforms such as requiring all MMFs to implement a swing pricing mechanism, given MMFs can already apply targeted liquidity fees to reflect the cost of liquidity, or to establish minimum balance at risk policies which would effectively undermine the MMF investment proposition and serve only to push investors away from MMFs.

Indeed, in considering the resilience of the sector in the context of COVID-related market events in early 2020, policymakers must take a broader perspective.

It is imperative to consider wider reforms that would enhance the transparency and functioning of underlying short-term money markets and that would accompany, not lag, targeted amendments to certain MMF structures. Such wider reforms could include:

- enhancing transparency requirements applying to issuers of qualifying money market instruments
- recalibrating prudential rules for credit institutions intermediating in short-term money markets in order to allow them to carry out that core function more effectively during periods of underlying market stress
- permitting CCPs to invest in certain qualifying MMF shares
- establishing a European sovereign reverse repo program, akin to the US Federal Reserve Overnight Reverse Repo Facility, with which a broad range of money market participants could engage

In considering such wider reforms, policymakers can more effectively ensure that short-term money markets and participants therein, including MMFs, are more resilient to and function more effectively during periods of economic or underlying market stress, and we stand ready to further contribute to policymakers' work in this regard as such initiatives are taken forward.

DENNIS GEPP

SVP, Managing Director and Chief Investment Officer - Cash - Federated Hermes (UK) LLP

The European money market funds regulatory framework is fit for purpose

EU money market funds (MMFs) are one of the most regulated investment products in existence. They are completely transparent and invest in high quality, short-term, liquid assets which are critical to funding the EU real economy and serve as a foundation for the CMU. EU MMFs provide a market-based yield for all investors, in a transparent, liquid, and highly diversified investment product, even more critical as we enter a period of rising interest rates. The EU MMF Regulation (MMFR) of 14 June 2017 has proven to be highly successful and ensured that MMFs were in the best position possible entering the March 2020 Liquidity Crisis.

It is imperative to remember that despite certain bank-centric creative narratives proffered, the Liquidity Crisis was neither caused nor exacerbated by MMFs. The Liquidity Crisis was the result of a global economic shock to the system, resulting from the decisions of governments around the world to shut down their economies to prevent the spread of Covid-19. These events were extraordinary, served as a real-life stress test, and highlighted key areas for improvements across the short-term funding markets (STFMs), and a few areas for enhancements to EU MMFs.

March 2020 illustrated that active portfolio management of MMFs, combined with minimum daily and weekly liquidity requirements with an overlying Know Your Customer obligation set forth in the EU MMFR, ensured that entering the Liquidity Crisis, MMFs were well positioned to manoeuvre through an incredibly stressful period of illiquidity. While each of VNAV, LVNAV and Public-Debt CNAV MMFs were subject to stress – something which should be expected when the entire financial market is frozen, each successfully operated throughout the Liquidity Crisis.

Notwithstanding the lack of any direct ECB support for EU MMFs and Bank of England support for UK MMFs, as IOSCO emphasises in its Thematic Note "Money Market Funds during the March-April Episode" published in November 2020, "Despite the strains faced by non-public debt MMFs in March and based on the responses to the IOSCO Financial Stability Engagement Group (FSEG) survey, it appears that all redemptions have been honoured, no MMFs have suspended redemptions, imposed fees and/or gates, or converted from LVNAV to VNAV." In short, EU MMFs proved resilient and performed as intended throughout the Liquidity Crisis.

There is simply no evidence-based analysis to support the removal of LVNAV MMFs in the EU.

There is no evidence to suggest that any single form of EU MMF product performed better or worse than others. All performed admirably given the circumstances and met all of their obligations to investors. Certain of the recent regulatory papers have questioned whether LVNAV MMFs should continue to exist. We believe, and EU investors and issuers believe, that LVNAV MMFs are incredibly important investment products. LVNAV MMFs are a regulatory success story, a demonstrated compromise between the historical use of CNAV Prime products and VNAV Prime products. There is simply no evidence-based analysis to support the removal of LVNAV MMFs in the EU.

While EU MMFs have benefitted from the adoption of the EU MMFR, there remain a few areas where improvements can be made to enhance the safety and stability of EU MMFs moving forward. Firstly, the current linking of potential liquidity fees and gate imposition to liquidity levels serves as an improper regulatory incentive to redeem in times of stress and should be removed. This delinking has been identified by EU policymakers as a top priority.

Additionally, while we support the use of liquidity management tools, the determination to apply such tools must be made subject to election by a MMF's board, in exercising its fiduciary duty. We believe the most appropriate liquidity management tool is the use of a targeted liquidity fee, guided by enhanced policies and appropriate escalation procedures, ensuring timely MMF board's consideration of the potential imposition in times of stress.

While certain enhancements to EU MMFs are appropriate, our focus, if we want to prevent a repeat of the Liquidity Crisis, must be on improving the functioning of the short-term funding markets. In March 2020, as investors worldwide searched for liquidity to avoid the unknown, STFMs froze when they were most needed. This must be addressed, and should be addressed alongside, not after, any reform of MMFs.

The existing regulatory framework of MMFR, including the use of LVNAV, Public Debt constant NAV (CNAV), and variable NAV (VNAV) remains appropriate and critical for the continued development of CMU and the funding of the real economy in a post-Covid environment. Having a successful MMF market is the first steps in CMU as MMFs put short-term capital to work to benefit EU investors and issuers.

ANN PRENDERGAST

Senior Managing Director and Head - State Street Global Advisors Europe Limited

Lessons from the 2020 market turmoil for MMF reform

The March/April 2020 market turmoil was a real test for the financial ecosystem including Money Market Funds. The near-total shutdown of global economic activity in response to the COVID pandemic resulted in an exceptional and unprecedented demand for liquidity, with particularly acute pressure being felt in short-term funding markets. In that context, MMF flows were driven by investors' prioritization of access to liquidity rather than as a result of concerns regarding the underlying credit quality of investments in MMFs.

Since then, MMFs have (again) been under regulatory scrutiny. While the regulatory framework introduced by the EU Money Market Fund Regulation has been effective and has enhanced the overall resilience of MMFs, the market events of March/April 2020 have highlighted some areas where the regulation had not operated as intended. Targeted and proportionate reforms are hence justified.

However, when considering possible reforms, MMFs' role and importance for the overall financial ecosystem need to be taken into account. It is also relevant against the background of progressing the EU Capital Markets Union. MMFs play an important role in the financial services system and the wider economic ecosystem. They are a low cost, efficient, scalable, and transparent cash management investment tool for investors and an important source of funding for both public and private sector issuers.

Therefore, reforms to the MMF frameworks should be guided by the following principles:

- The outcome of the reform process should ensure the ongoing viability of MMFs and not deprive investors of a valuable investment vehicle nor issuers of a crucial source of funding.
- Given that the March/April 2020 turmoil was a market-wide liquidity event, reforms should be focused on addressing liquidity risk. This includes ensuring the usability of the inherent liquidity within an MMF.
- To be truly effective, reforms should not be targeted at MMFs alone but also consider underlying structural issues, in both the short-term funding market and fixed-income markets more broadly.

There are several policy options that follow these principles while achieving the objective of enhancing the MMF regulatory framework.

The outcome of the reform process should ensure the ongoing viability of MMFs.

Most importantly, the link between MMF minimum liquidity requirements, namely the 30% Weekly Liquid Asset (WLA) threshold, and the potential imposition of liquidity fees and redemption gates needs to be removed. By doing so, MMFs would be able to make use of their available liquidity during times of market stress and most directly address the challenges faced by MMFs during the period of market volatility.

Furthermore, based on the experience in 2020, MMFs should have a broad range of Liquidity Management Tools (LMTs) at their disposal as well as flexibility regarding the use of LMTs. The choice, calibration and activation of such tools should be left to the discretion of the fund manager. However, swing pricing for operational and structural reasons is not a suitable LMT for MMFs.

In contrast, international and European policymakers are considering other policy options that would undermine or remove the viability of the MMFs, esp. of Low Volatility NAV (LVNAV) MMFs. In particular, not allowing LVNAV MMFs to use amortized cost accounting would lead to creating a different type of Variable NAV MMF with higher liquidity requirements but with little to no additional benefit to investors. As a result, this would lead to a significant number of investors leaving the product and possibly MMFs overall which would be particularly concerning given the lack of MMF alternatives.

Similarly, the introduction of prescriptive private or public debt quotas for MMFs would only introduce additional challenges and risks instead of making MMFs more resilient.

Importantly, MMF reform should be complemented by improvements to the underlying markets, esp. increased transparency and use of technology and automation. Also, short-term funding markets remain highly intermediated and dependent on banks for secondary market liquidity. As seen in early 2020, MMF managers were unable to utilize secondary market liquidity as broker-dealers were either unable or unwilling to engage in discretionary market-making to preserve balance sheet capacity. This may have been an unintended consequence of post-GFC prudential reforms and should be further considered. Other measures to consider include harmonizing practices and conventions in CP/CD markets as well as making eligibility criteria for asset purchase programs more consistent.

This combination of targeted MMFs reform and enhancements to the underlying markets will achieve the combined goals of strengthening MMF resilience and ensuring their viability and availability. As Europe is rightly focused on deepening its Capital Markets Union, it is important that MMFs continue to play their important role both as vehicle for cash and liquidity management as well as a source of funding for the economy.

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SUSTAINABILITY RISK IN THE EU BANKING SECTOR

NEIL ESHO
Secretary General - Basel Committee on Banking Supervision (BCBS)

Addressing climate-related financial risks in the banking sector

Mitigating climate-related financial risks continues to be a key priority for banks, bank supervisors, and the Basel Committee.

The Committee's broad approach to mitigating climate-related financial risk has followed the same approach as for other more traditional risks. It began its work with the objective of better understanding the risk features of climate change and potential implications for individual banks and the broader banking system. To provide a strong methodological basis for its work, the Committee published two analytical reports in April 2021 on climate-related risk drivers and their transmission channels, and climate-related financial risks - measurement methodologies. Taken together, the high-level conclusion from those reports is that climate risk drivers can translate into traditional risk categories used by financial institutions and which are essential elements of the Basel Framework (eg credit, market, liquidity, operational, and reputational risks). The reports also illustrated how physical and transition climate risk drivers affect bank's financial risks via micro- and macro transmission channels, while also emphasising the diversity and limitations of measurement methodologies.

Building off the analytical work, the Committee is pursuing a holistic approach and looking at the best combination of policy tools covering supervision, disclosure, and regulation.

On 15 June 2022, the Committee published principles for the effective management and supervision of climate-related financial risks. These principles address a broad range of topics including corporate governance, internal controls, risk assessment, management and reporting and scenario analysis, among others. The aim of the principles is to provide a common baseline for internationally active banks and improve both banks' risk management and supervisors' practices. But, being principles, they also retain sufficient flexibility given the degree of heterogeneity and evolving practices.

The BCBS is working on a combination of policy tools to mitigate climate-related financial risks.

A number of jurisdictions have further developed the capacity of banks and supervisors to assess climate-related financial risk through scenario analysis - a tool that helps challenge assumptions made for the purpose of risk analysis by considering extreme but plausible scenarios. While still in its infancy, scenario analysis is also an important learning tool that can serve to highlight the areas where further work is needed to improve the measurement and management of climate-related financial risk. These challenges relate to scenario design, data gaps, measurement methodologies and overall risk management capabilities. Further development of capabilities in this area by both banks and supervisors offers a promising way forward to better understand potential loss exposures faced by banks, and the potential benefits of risk-mitigating actions.

With regard to work on disclosure, the Committee is very supportive of efforts to develop global standards to improve the consistency, comparability and reliability of sustainability reporting, including those of the International Sustainability Standards Board (ISSB). In parallel, the Committee is exploring use of the Pillar 3 framework to promote a common disclosure baseline for internationally active banks. As part of this work, we are considering issues such as: the availability of sufficiently granular data for both banks and their counterparties and metrics to be used from a risk management perspective. We are also collaborating closely with the ISSB to identify potential synergies between its proposals and the needs of prudential supervisors.

Work is also proceeding on the regulatory front. The Committee recently conducted a gap analysis of the existing Basel framework to identify where climate-related financial risks may not be adequately addressed in the Pillar 1 framework. This analysis highlighted the challenges associated with the measurement and mitigation of climate-related financial risks, including the time horizon of such risks relative to traditional risk categories; the inability to rely on historical data to quantify risks; current data gaps; and the high degree of uncertainty regarding the outlook. However, these significant challenges are not unique to Pillar 1 regulatory approaches, but nor are they insurmountable. Work is therefore ongoing to consider the role of Pillar 1 measures to address climate-related financial risks.

While the Committee will continue to assess and consider potential Pillar 1 regulatory measures, it will be guided by its broader goal of developing an appropriate combination of measures across regulatory, supervisory and disclosure elements to mitigate climate-related financial risks.

KERSTIN AF JOCHNICK

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Climate risks for banks - the supervisory perspective

Climate change poses an increasing risk for banks and the European financial system as a whole. From a prudential perspective, supervisors should be concerned about the extent to which banks' exposures to physical and transition risks stemming from climate-related and environmental risks (C&E risks) may affect the safety and soundness of individual entities. Such risks, which could potentially affect banks regardless of their size, complexity or business model, could also act as drivers of "traditional" risk categories such as credit, market and operational risk.

In recent years, ECB Banking Supervision has taken concrete steps to include C&E risks in its ongoing supervision. In 2020 we published a guide[1] outlining our expectations for banks' management and disclosure of such risks. In 2021 we asked banks to conduct a self-assessment in the light of the supervisory expectations outlined in the guide and to draw up implementation plans to advance their management of C&E risks. We have since conducted annual reviews to check progress on these action plans[2] as well as on banks' transparent disclosure of their C&E risk profiles.

In 2022 we conducted a climate risk stress test to more fully understand how exposed euro area banks are to C&E risks, the results of which were published in July. We are also preparing a thematic review on C&E risks to assess where banks stand in terms of their alignment with the ECB's supervisory expectations in this domain, which will be published later this year. [3]

The common message which emerges from these various initiatives on the supervisory front is that while banks are making progress in their management of C&E risks, this trend is not uniform and laggards remain in all areas. The preliminary results from our thematic review suggest that, according to their own assessment, an increasing number of banks report that they are taking actions to foster alignment with our supervisory expectations. This is an improvement on the 90% of banks which considered that their practices were only partly or not at all aligned with our expectations in 2021. However, our results also indicate that while a growing number of banks have deemed themselves to be materially exposed to C&E risks in the short to medium term, there are some that have still not performed a materiality assessment.

Our goal is to fully integrate climate-related and environmental risks in the regular supervisory cycle and treat them in the same way as any other material risks that banks face.

Concerning banks' disclosure of their C&E risks, the gap analysis in the 2022 ECB report[4] indicated that they have made clear progress in various areas compared with 2021, for example as regards governance and risk management. However, the report also highlighted that most banks still need to make significant efforts to transparently disclose their exposures to C&E risks and further improve their disclosure practices.

With regard to the stress test on climate risk, the results[5] showed that around 60% of banks do not have robust climate risk stress-testing frameworks, with many lacking accurate data and insights into their clients' transition plans. Similarly, the results showed that most banks do not include climate risk in their credit risk models and just 20% consider climate risk as a variable when granting loans.

At the same time, the experience from our broad engagement with banks concerning their management of C&E risks in recent years suggests that they are cognisant of the challenge at hand. Some have already adopted state-of-the-art governance and risk management practices and, in more than 80% of cases, they intend to complete the actions set out in their plans before the end of 2023. We thus see it as reasonable that banks can be fully compliant with all our expectations by the end of 2024 at the latest.

Our goal is to fully integrate C&E risks in the regular supervisory cycle and treat them in the same way as any other material risks that banks face, eventually influencing their Pillar 2 requirements.

[1] ECB Banking Supervision (2020), "Guide on climate-related and environmental risks", November.
[2] ECB Banking Supervision (2021), "The state of climate and environmental risk management in the banking sector", November.
[3] ECB Banking Supervision (2022), "Thematic review on climate-related and environmental risks, 2022", presentation by the SSM Climate Risk Coordination Group, 18 February.
[4] ECB Banking Supervision (2022), "Supervisory assessment of institutions' climate-related and environmental risks disclosures", March.
[5] ECB Banking Supervision (2022), "2022 climate risk stress test", July.

TOMOKO AMAYA

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JFSA's approach to climate-related financial risk management

Financial institutions are inevitably exposed to climate-related financial risks. While the typical time horizon of financial institutions' risk management and capital planning is two to three years, climate-related financial risks are likely to materialize over a much longer time horizon, and some may materialize over a few decades or more. This suggests that financial institutions need to take more dynamic approaches in risk management considering the mid- to long-term impact of their managerial decisions, changes in their business strategy as well as changes in clients' business models. Having the capacity to absorb the loss from the existing portfolio is not enough. Sustainability of earnings is essential for resilient business in the long run.

In particular, the resilience of banks' business very much depends on how their corporate clients respond to climate change related risks and opportunities. Clients' delayed response means loss of business and increase in credit risk for banks, whereas clients' successful transition brings increased business opportunity and decreased credit risk to banks. Therefore, it is important for financial institutions to actively engage with their corporate clients and support them in addressing the challenges posed by climate change. Risk management and client engagement are both sides of one coin.

Based on this idea, the FSA published the "Supervisory Guidance on Climate-related Risk Management and Client Engagement (Guidance)" on July 12. The guidance is non-binding and provide viewpoints of supervisory dialogues between the FSA and financial institutions.

For example, with regards to "strategies and governance," the FSA urges financial institutions to fully understand the risks and opportunities of climate change both for their clients and themselves, and to develop strategies for supporting their corporate clients in addressing the challenges posed by climate change, thus enhancing the robustness of their own business and contributing to the transition to net-zero.

Viewpoints also include "identification and assessment of risks and opportunities both for own business and clients," "support for clients' transition and other response to climate change," "management of climate-related financial risks," and "provision of information to stakeholders."

Risk management and client engagement are both sides of one coin.

In addition, the Guidance presents approaches and cases of engagement with clients especially for the use of regional banks as reference. Financial institutions are encouraged to accumulate their knowledge of climate change and understand the effect on clients of the evolution in technologies, industries and natural environments caused by climate change. They are also encouraged to provide support to clients, such as provision of consulting and solution-delivery services, provision of funds for growth, and provision of area-wide support with enhanced collaboration among stakeholders.

Let me present one of the cases in the Guidance.

Corporate clients, especially SMEs, often do not recognize the potential impact of the transition to net-zero, including the impact of decarbonization on the local economy and the impact of supply chain restructuring on their own business. Therefore, one regional bank proactively offers support to its corporate clients based on its own analysis.

The bank first narrowed down the target industries to the automobile, steel, and chemical industries based on their view on the local economic structure and analyzed the potential impact that climate change may have on the current advantages of the region as a center for those industries. The bank further assessed the impact on clients sector by sector. For example, risks increase for one client as it is affected by the shift to EVs, while business opportunities increase for another, which is engaged in the maintenance and repair of plants.

Then, the bank developed an action plan listing solutions for their clients and the regional economy to benefit from potential opportunities. Based on the plan, the bank has been having discussions with clients to identify their needs and offering solutions, such as provision of funds and human resource matching services.

Financial institutions' initiatives of proactive engagement with customers have already begun. Furthermore, for industrial sectors involving multi-layered supply chains, such as the automobile industry, a successful transition requires communication and collaboration among all entities from top tier makers to small and medium size suppliers, from big banks to small cooperative financial institutions. In order to facilitate such communication, a local office of the FSA, in collaboration with a local office of a relevant ministry, organized a meeting of representatives from an automobile maker, top tier suppliers and financial institutions, from big banks to small ones.

The FSA urges financial institutions to engage with their clients and also facilitates such engagement.

JOSÉ MANUEL CAMPA

Chairperson - European Banking Authority (EBA)

Sustainability risks: work in progress

The growing importance of Environmental, Social and Governance (ESG) risks for the EU banking sector calls for assertive actions by all stakeholders, including financial institutions and supervisory authorities. In view of the potential for ESG risk factors to affect all traditional categories of financial risks to which institutions are exposed, ranging from credit risk to market risk through concentration and reputational risks, a holistic approach to managing these risks is warranted. We need to enhance the measurement, disclosure, risk management and supervision of these risks. We also need to assess the prudential treatment of such exposures.

Firstly, institutions need to enhance the measurement and disclosure of ESG risks. Starting from 2023 credit institutions will be required to implement clear disclosure of ESG risks on the basis of disclosures standards specified by the EBA[1]. The proposed granular templates and instructions should help institutions measure and report some of these risks and facilitate access to meaningful and comparable information, allowing stakeholders to assess institutions' ESG performance and risk profile. In this regard, while institutions should enhance their data collection and aggregation processes as soon as possible to meet their disclosure (but also risk management) obligations, they should also gradually benefit from more reliable information from their clients and counterparts, thanks to the EU and international efforts to develop an ambitious ESG disclosure framework.

In the EU, the Corporate Sustainability Reporting Directive and the EU Taxonomy are expected to improve significantly the data provided by non-financial corporates, which will among other things allow institutions to calculate and report their green asset ratios. At the international level, the work undertaken by the International Sustainability Standards Board to develop a global baseline of sustainability-related disclosures should also contribute to better availability of data provided by banks' non-EU counterparts. In this context, the EU emerging standards can help establish best practices and drive progress at international level on sustainability risks disclosures.

We need to enhance the measurement, disclosure, risk management and supervision of ESG risks.

Secondly, institutions need to further embed ESG risks into their business strategies, risk management frameworks and internal governance arrangements. The explicit integration of ESG risks into various EBA Guidelines – on loan origination and monitoring[2], internal governance[3], remuneration policies[4], and supervisory review[5] – indicates the overarching nature of ESG considerations. More guidance will follow on risk management, potentially covering requirements around institutions' transition plans and stress-testing practices.

The recent publications of the Bank of England and ECB climate stress tests results confirm the need for banks and supervisors to continue building their capabilities to identify and manage these forward-looking risks. These exercises constitute key tools to improve banks' climate risk modelling, pushing them to engage with their counterparties to understand better their climate exposures and helping them, and supervisors, sizing the risks. Internally, banks should continue to enhance their climate stress testing capacities. Ultimately, banks are expected to incorporate considerations on ESG risks into their regular business and risk management.

Last but not least, environmental risk drivers should be properly captured into the prudential regime. This should be grounded in a solid risk-based approach, as prudential regulation should remain geared towards ensuring the safety and soundness of institutions. The EBA's discussion paper[6], which explores the relevance of targeted amendments to the existing prudential requirements to capture these risks more accurately, represents the first step in the assessment of the appropriate prudential treatment of exposures subject to environmental risks and impacts. Here again, a holistic regulatory approach is needed as on-going developments under the Pillar 2 framework, macroprudential capital buffers and accounting rules should be taken into account to design the best prudential response to environmental risks.

The management of ESG risks continues to be work in progress. Progress has been made but more is needed. EBA will continue its efforts to provide a robust framework for identifying, disclosing and addressing ESG risks by institutions and supervisors. It will also monitor these risks in the EU banking sector, including through dedicated and regular stress testing exercises.

[1] See EBA Implementing Technical Standards
[2] [3] [4] [5] See EBA Guidelines
[6] See EBA Discussion Paper

STEFANO CAPPIELLO

Director General of Regulation and Supervision of the Financial System - Ministry of Economy and Finance, Italy

Climate and environmental risks: mind the (data) gap

Climate change is a reality that becomes every day more tangible, and thus are climate and environmental (C&E) risks for banks. The regulatory and supervisory initiatives in the field are hence absolutely urgent, starting from the Banking Package 2021, where the Commission proposes to reinforce the ESG disclosure requirements and introduces new provisions on identification, management, stress testing and supervisory review of these risks. Meanwhile, banks have been increasingly called upon to meet supervisory expectations with respect to disclosures, capital planning and governance (ECB Guide; Bank of Italy Expectations), to prudently increase the level of awareness and preparedness. Recently, the ECB thematic review's preliminary findings has shown that most banks have started to adapt their practices to incorporate C&E risks into their daily business. However, the results of the first climate stress test attest how much work still needs to be done.

The transition towards a greener and more sustainable economy could represent not only a critical point but also as an opportunity, amounting on average to $2.3tn of new investments per year globally. Under the 2021 Italian Presidency, the G20 set forth several strategies to finally achieve climate neutrality by 2050, and identified an ambitious policy mix made of investments in sustainable infrastructure and innovative technologies, investments that promote decarbonisation and the circular economy. Notably, the Commission has estimated that €650 bn per year of investments are needed until 2030 to meet the so-called twin transitions (a greener and more digitalised EU economy), of which at least €520 billion per year should be devoted only to the green transition. This aggregate exceeds by far public investment programmes and private investments will therefore be essential over the coming years to meet the environmental challenge. Banks will play a pivotal role in channelling these resources and shaping the transition towards a greener economy. This will require them to incorporate climate risks – and their long-term nature – within their lending and investment choices, enrich the offer of sustainable financial instruments, and increase the availability, reliability and comparability of climate-related data.

Complete, verifiable, comparable data are key for banks to play their role in the green transition.

To ensure the proper management of C&E risks and, at the same, the efficient allocation of private financial resources, one of the most compelling challenges hinges on data availability and comparability, and the need to work out data gaps and inconsistencies and avoid "adverse selection" problems. Regulators and supervisors require banks to carry out analysis and provide data. However, borrowers themselves are not fully aware yet of what information are relevant, and need to be produced for the purpose of getting access to banking and markets' finance. This, in turn, can negatively affect the banking sector in playing its crucial role of assessing and financing companies in the transition to a greener economy. Therefore, extensive standardised disclosure standards on sustainable activities, like the recent Corporate Sustainability Reporting Directive (CSRD) aims to introduce, will be crucial.

Even more so, to ensure a *complete, verifiable, and comparable* data set, it would be necessary to go beyond the scope of the CSRD and set minimum disclosure standards also for SMEs, either through industry-led initiatives or by regulatory measures. This would serve to steer SMEs in their preparedness to meet banks' requests for ESG material information, while being careful at the same time to curb compliance costs at a manageable level, considering the balance sheet of SMEs. For this purpose, the establishment of an EU single access point (ESAP) within the Capital Markets Union, for companies' financial and sustainable investment-related information goes in the right direction, offering investors and lenders easily accessible, comparable and digitally usable information. It is advisable to drive the 'upward convergence' even further, by providing guidance to economic operators on financial sector's and banks' expectations for them to commit to net zero and publish supporting transition plans in line with best practice.

The shift towards a greener, more sustainable economy will happen when economic operators and market players fully embrace it. However, for this to happen we need a collective effort, where policy makers, regulators, supervisors, banks, borrowers, and market forces work together to set the right preconditions – among which data are crucial – for the whole financial and productive ecosystem to work efficiently and effectively towards this goal.

DIONY LEBOT

Deputy Chief Executive Officer - Société Générale

European banks are catalysts for their clients' transition

At Société Générale, we welcome the EU's sustainable policies and goal to reduce 55% of CO_2 emissions by 2030 and achieve neutrality by 2050. We support the transition to a low-carbon and resource-efficient economy, in line with the Sustainable Development Goals and the Paris Agreement. Our engagement led us to be a founding signatory of the Net Zero Banking Alliance, a commitment that reinforces others, such as the Equator Principle, the Katowice Commitment, and the Principles for Responsible Banking.

We voluntarily participated in several exercises of European and national bodies, starting from 2016 when we collaborated with the ACPR to conceive robust methodologies around climate-risk. In continuity, the rolling out of the ECB's guidelines and recent large-scale climate stress test provided a common and consistent framework to get ready.

More is yet to come for EU banks. In 2023 we will publish the ESG indicators requested by the EBA for Pillar 3 disclosures. There are also questions on whether the prudential framework review (CRR) would include ESG in the risk management framework, including SREP, ICAAP and strategic risk of non-alignment to EU regulations. Simultaneously, the BCBS has issued recommendations on ESG risks, although globally standardized prudential treatment rules are not defined yet.

This calendar puts EU banks at a cornerstone to meet EU ambitions. We fully support these policies but expect them to be completed by additional measures to support our efforts. The legislative overhaul (Fit for 55) recently voted by the EU, the update of National Energy and Climate Plans and the involvement of public and private sectors (NextGenerationEU) are all key to achieve sustainability. Our view is that financial regulation should play a role in helping the finance sector address these challenges and meet associated funding needs, which will be colossal.

The EU has first to secure sufficient financing, especially at a time when interest rates and energy prices are rising. Investment needs, €520bn p.a. to 2030 for decarbonization and other environment goals, require that additional prudential constraints on banks' balance sheets are reasonable and that the Capital Markets Union becomes concrete.

Europe is at the forefront of climate risk regulations, with an ambitious agenda to deliver.

Second, policies should not overlook transitioning economies and sectors, which cannot be qualified as "green" yet but have robust trajectories and commitments to becoming greener. This is especially true for emerging economies and the most carbonated sectors with the will to transform. Our belief is that a too penalizing approach could hinder this transition. A balanced regulation should remain risk-based, grounded on granular indicators as standardized as possible. Rather than the definition of fixed weightings by activity, climate-risk should become a key element of the counterparty analysis to allow a fair representation of risk in the short, medium, and long term.

Further, strictly regulating banks on their ESG framework carries the risk of fragmenting the market between green EU banks strongly constrained, vs. capital markets escaping strict regulations. Measures announced on the ECB's CSPP purchases, and the collateral framework go in the right direction to ensure that climate does not remain a question for banks only. We should also ensure that transition remains discussed globally, as: (i) there might initially be a diversification problem (about 5% of the economy is taxonomy-aligned), (ii) other financial actors could replace EU banks' funding.

If not, an issue would be that international flows could divert from EU banks, at a time when the EU needs competitive banks to transform its economy. Indeed, banks are the dominant source of EU funding, notably for SMEs and the greening of the residential housing stock.

Finally, we should keep in mind that finance cannot green the economy alone. The ecological transition will depend on many sectors of the economy acting together. We are proud that the banking industry is committed and acts as a catalyst for its clients' transition but being early comes with a drawback: we are faced with operational and timing constraints when the rest of the ecosystem is not ready yet. Christine Lagarde rightly indicated, "the ECB does not act in a vacuum, but rather in parallel with many other policymakers". Similarly, banks are constrained by the political agenda.

A good example of our operational constraints is data access. Data collection and processing depend on counterparties' production and disclosure of ESG data, but less than 50% of firms publish TCFD-aligned climate-related metrics. Yet, EU banks are expected to disclose information before companies' obligation to produce relevant data (CSRD) applies, between 2025 and 2029, and many companies will remain out of scope (not-listed SMEs and not-listed foreign companies).

Banks must apply unharmonized proxies and use data providers, which will not help comparability between banks and carries the risk of raising greenwashing concerns.

LAURENCE DUBOIS

Partner, Industry Leader FSI - Deloitte

European banks: the challenge around climate risk data

Since 2019, the European Central Bank (ECB) has identified climate risk as a key driver on the SSM Risk Map and climate risk is part of the SSM supervision priorities for the 2022-2024 period.

There are so far three main supervisory 'tools' for monitoring European banks' risks exposures to climate risk.

The first one is the "Guide on climate-related and environmental risk", issued in May 2020.It explains how the ECB expects banks to prudently manage and disclose those risks. European banks are expected to implement this guide in their day-to-day risk management practices and the ECB is following up with banks through the concrete review of banks' practices and action plans. A thematic review on banks' climate-related and environmental risk management practices is expected in 2022.

The second tool is the Climate risk stress test which the ECB carried in 2022; this exercise is based on a methodology and scenarios defined by the ECB and results for the 2022 exercise were published in 2022.

Finally, significant European banks are requested to progressively disclose, starting from 2023, qualitative and quantitative information on their portfolios' exposures to both physical and transition risks, as well as mitigating actions to lower those risks. This includes the Green Asset Ratio (GAR) with exposures towards Corporates in the scope of the NFRD/CSRD[1] regulation financing taxonomy aligned activities consistent with Paris Agreement goals and a Banking Book Taxonomy Alignment ratio (BTAR) including exposures toward non NFRD/CSRD corporates not assessed in the GAR.

This comprehensive approach as well as the potential need for business specific KPIs require banks to provide a significant volume of climate related data on their exposures. Data is key for disclosure requirements but also for managing risks and commitments taken by banks toward a low carbon economy.

European Banks are making considerable efforts to adapt their risk management processes and collect relevant data. However, they are currently making extensive use of proxies or external providers of data instead of data directly available in the counterparties' disclosure documentation as requested by the banking regulator and EU (Green Asset Ratio). Banks are heavily dependent on their counterparties to collect this data and while it has been difficult to make use of counterparties' disclosures to date (due to a lack of standardisation of non-financial reporting) this is set to change.

Data is key for disclosure requirements but also for managing risks and climate commitments

A first step will be achieved by the end of this year, when corporates within the scope of the NFRD regulation[2] will, for the first time, issue "alignment KPIs", according to the EU Taxonomy Regulation.

A second step will be achieved with the CSRD that will replace the NFRD. The CSRD will extend the scope of corporates that have to issue standardised non-financial reporting: all large companies[3] with two of the three criteria, all companies listed in EU regulated markets except micro-enterprises, some non-EU groups.

In practice, it means data quality is likely to improve as banks will have access to direct standardised information from their counterparties, audited by a third party. But it is likely to be a very long journey. CSRD will come into force very progressively: for PIEs on 1 January 2024, for large undertakings on 1 January 2025, for listed SMEs on 1 January 2026, and other companies in the scope as from 1 January 2028. Data related to corporates not in the scope of the CSRD and to retailed exposures (such as energy performance certificates for housing collaterals) will have to be collected on a bilateral basis

Banks will look to manage this transition period by investing in a better understanding of methodologies and model input on data from third parties, working with the whole industry to define consistent approaches to measure key climate-related indicators and organise specific data collection processes to fill the gap between the information that will be available through the CSRD standardised non-financial reporting and the scope of counterparties in their portfolios.

Providing qualitative information would be good practice, to help stakeholders understand the uncertainties around data. Indeed, the ECB expects banks "to assess the quality of any data sourced and the plausibility of methodologies and to provide transparency on methodologies, criteria and assumptions", both in their internal reporting and in their public disclosures. This is likely to present a significant challenge given the volume of information required but this is the price to pay to bring more transparency to the market and enhance confidence from various stakeholders in non-financial reporting.

[1] NFRD Non Financial Reporting Directiveto be replaced by the CSRD -Corporate Sustainability Reporting Directive

[2] two of the three criteria: more than 250 employees - total balance sheet above 20 M€ -turnover above 40 M€

[3] Large undertakings as defined in the Accounting Directive and transposed in each country

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SUSTAINABILITY RISKS AND CHALLENGES IN INSURANCE

ALBERTO CORINTI

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

Main progresses expected from the Solvency II review on sustainability risks

In the context of the many works related to sustainability in insurance, the integration of sustainability considerations in Solvency II is certainly crucial. On the one side, the prudential regulatory framework should allow a satisfactory mitigation of the sustainability risks borne by the insurers (outside-in risks) and, on the other side, regulation itself could be a catalyst of the integration of sustainability considerations in the insurers' business model, and therefore a booster for insurers' positive impact on sustainability issues (inside out risks).

Even though at the moment the focus is almost exclusively on environmental risks, EIOPA, in the last few years, has produced a number of works in this area, starting from the (positive) assessment of the capability of the overall framework to integrate sustainability risks and then covering all the three pillars.

The on-going review of Solvency II will provide, among other things, the opportunity to make any concrete adjustment to the Pillar I legal framework, based on the analysis done. The Commission's proposal includes two mandates for EIOPA: one on the periodic review of the calibration of NAT CAT capital charge and the other on the assessment of a possible dedicated prudential treatment of assets aligned with environmental objectives. EIOPA, on its own initiative, has also undertook an assessment of the need for a differential treatment of insurance liabilities related to contracts that include climate-related adaptation measures.

Balancing quantitative evidence with grounded qualitative considerations will likely be critical

It is too early to discuss the expected results of these works. Certainly, EIOPA is facing challenges that could influence their outcome. Supervisors have always stated that capital requirements should be risk based and supported by clear evidence. Both criteria are difficult to apply in this case. The measurement of riskiness is challenged by the expected instability over time of sustainability risks; such instability limits the relevance of past evidence. At the same time, historical data are difficult to collect with enough accuracy, mainly due to the still incomplete implementation of the EU Taxonomy and the consequent lack of standardized reporting practices by companies.

More specifically, the work on NAT CAT consists in a new and – looking ahead – more frequent calibration of the parameters for this risk module, with the aim to consider the expected increase of the damages due to the climate change. Here the main challenge is to calibrate the parameters to capture the expected future dynamic of the frequency and intensity of the damages.

The analysis on assets faces the same type of problem, likely with increased complexity. Here there is the need to measure the expected risks (i.e. spread, equity and property risks) of the "green" (or alternatively "brown") assets in the context of a very dynamic evolution of the market factors that can influence their value. For example, the financial characteristics of the markets where sustainable assets are traded could reasonably be expected to differ from the markets of other type of assets but, at the moment, it is probably difficult, if not impossible, to find clear evidence of that, as these markets could not yet be sufficiently defined and mature. In addition, the identification of the "green" assets itself is complex, due to the still persistent incompleteness and uncertainty of the taxonomy application.

The work on insurance liabilities aims at identifying the riskiness (i.e. the level of premium and reserve risk) of the subset of insurance contracts that include consideration of prevention measures in the definition of the contract performances. Here there is also the challenge to identify these contracts. A specific request has been addressed to the industry for this purpose.

Overall, the outcome of these works will be affected by the availability of data with sufficient quality to be used in the analysis as well as by the ability to properly extrapolate past data to predict a rapidly evolving future. The latter task will certainly leverage on advanced, forward looking model technics but, in my view, it will not be able to avoid supporting quantitative analysis with reasonable qualitative considerations, without abandoning the evidence-based approach.

Prudential regulation should remain risk based. However, balancing quantitative evidence with grounded qualitative considerations will likely be critical to design a prudential framework that supports sustainability risk protection, but also is conducive to the achievement of wider sustainability objectives. This also implies reviewing these considerations over time, in line with the evolutionary features of sustainability issues. As many other workstreams in the field of sustainability, also its integration in capital requirements is not a short term exercise.

ROMAIN PASEROT

Deputy Secretary General - International Association of Insurance Supervisors (IAIS)

Embedding climate resilience into global insurance supervision

Climate change is a global challenge which must be tackled internationally. Moreover, from an insurance perspective, it poses risks to both sides of insurers' balance sheets, making it a doubly important focus of the IAIS' work.

A consistent global approach to addressing climate-related risk in the insurance sector is essential. The IAIS has been working on these issues for several years and supports its members as they assess and manage risks from climate change. Currently, the IAIS's work is focused on four pillars:

Risk analysis

It is essential to clearly understanding the risks to which the insurance sector is exposed. The IAIS' risk assessment framework, the annual Global Monitoring Exercise (GME), is crucial aid this understanding. The GME includes data from around 60 of the world's largest insurance groups and from supervisors in about 30 jurisdictions, covering over 90% of global gross written premiums. This allows us to have risk assessment discussions that are grounded in evidence. The outcomes of the GME are published each year in our Global Insurance Market Report (GIMAR).

Last year we published the first global analysis of the climate-related risks posed to insurers' assets as a special chapter of our GIMAR. This provided a detailed analysis of the impact of different climate scenarios on insurers' solvency.

This year we added climate data elements to the GME, collected from supervisors, that will cover both the insurance sector's assets and liabilities. These elements will become a regular feature of our annual assessment of insurance sector risks and provide a global baseline of climate risk data for the insurance sector. This year's GIMAR will include an update on our climate-risk analysis based on this year's data.

Standard setting

We regard climate change as a driver of existing risks and therefore see the importance of integrating climate-related risks into existing processes and practices. While we have concluded that the Insurance Core Principles (ICPs), the global standard for insurance supervision, are sufficiently principles-based to cover climate risks, we will make some changes to ICP guidance to make it even more explicit that insurance supervisors should require insurers to incorporate climate-related risks into their day-to-day operations. In particular, supervisors should ensure that insurers' enterprise-wide risk management and governance, together with public disclosures incorporate climate risk.

> **A consistent global approach to tackling climate-related risk in the insurance sector is essential.**

Supervisory practices

We are supporting our members to address practical challenges in responding to climate risk – in particular, guidance on good supervisory practices. We published initial guidance on this in 2018, which also fed into the Network for Greening the Financial System's supervisory handbook.

However, because our collective understanding of rapidly changing climate-related risk is still evolving, next year, we will consult on new supporting material to help IAIS Members understand and supervise these risks. We will publish two consultations and plan to engage with stakeholders extensively. The first consultation in Q1 next year will look broadly at this issue, with a subsequent consultation in the second half of next year diving into more detail in particular areas, including market conduct issues and integration within enterprise-wide risk management.

Within the emerging field of climate scenario analysis, we are delivering capacity-building workshops. This provides a platform for peer learning so our Members can share their experience of developments with this important risk assessment tool.

Disclosure

At this stage, we have a watching brief on any changes to insurer disclosures. We are supportive of the work being taken forward by the International Sustainability Standards Board (ISSB) to develop climate disclosure standards. Once the ISSB's next steps are clear, we will consider whether there is any insurance-specific additional disclosure that is needed from a supervisory perspective. However, here we will be mindful that the ISSB already includes sector-specific guidance and that there will be a high bar for any additional disclosure.

Next steps

Next year, we expect to undertake further work to assess risks from emerging protection gaps in the insurance sector as part of our mandate to foster policyholder protection. This work is likely to have a particular focus on gaps in protection from climate-related risks, given emerging evidence of repricing and exclusions in the face of increasing natural catastrophe risk. Working as a community of supervisors, together with insurers, we can take the necessary action to maintain the resilience of the insurance sector in the face of increased climate risk.

ANDREW MAIS

Commissioner, Connecticut Insurance Department - National Association of Insurance Commissioners (NAIC)

Evolving with climate change – Responding to risk

Climate change is one of the biggest issues for the insurance sector, and as supervisors, we must evolve with it to ensure we are capturing the risks and protecting our communities.

Recently, there have been many high-profile situations in the U.S. where climate change has affected the insurance market. Communities in the western U.S. facing drought and high heat have borne dangerous wildfires. In those areas, wildfire policies have become increasingly expensive, if they are offered at all, which places communities at risk as the coverage gap grows. Likewise, increased storms and flooding in the southeastern U.S. have created increasingly hard markets for homeowners, as insurers raise rates or remove services in affected areas.

U.S. state insurance supervisors see these effects and are enacting changes to address the current and future risks. Some actions, such as moratoriums on policy cancelation, are immediate, offering short-term solutions. Others are more subtle and will provide transparency and stability over time.

In April 2022, U.S. state insurance supervisors adopted a revised Climate Risk Disclosure Survey to provide a baseline supervisory tool to assess how climate-related risks may affect the insurance industry and to enhance transparency about how insurers are managing risks and opportunities. The new survey is aligned with the FSB's Taskforce on Climate-related Financial Disclosure, thus providing greater uniformity for insurers and comparability of the data. Disclosures are collected from nearly 80% of the market based on direct premium written in the U.S.

Also, U.S. state insurance supervisors recommended adding wildfires to their Risk-Based Capital (RBC) framework for catastrophe risk exposure, which will require companies to report their wildfire risk annually. While the data will be collected for informational purposes only, this helps ensure insurers are adequately reserving the capital necessary to remain solvent when wildfires occur. We are looking at other perils for inclusion in the RBC framework, including severe convective storm and flood. Changes to regulatory financial resources for examiners and analysts are being considered also, giving them tools and insights to better address climate risk in their interaction with insurers.

Climate change will continue to evolve, and supervisors must continue to evolve with it.

In addition to monitoring industry, educating consumers about risk and incentivizing them to reduce it is key so they can become more resilient to weather events. Last year, the NAIC created a list of pre-event mitigation measures that policyholders can take to reduce their risk of property loss. Combining that with state-specific information, the NAIC is planning to create a web-based resource with relevant materials and information regarding mitigation later this year.

Connecticut's insurance department is producing a regular climate progress report and is currently drafting guidance for its domestic insurers regarding managing climate-related financial risks. We are also taking action to build resilience to sea-level rise and inland flooding by promoting the increased uptake of flood insurance given the state's amount of high-value real estate in exposed areas and the low percentage of property covered by flood insurance.

These initiatives will be helpful, but supervisors also must seek to innovate to have the right tools for our job and for our communities to have the right products and resources to stay protected. The NAIC is developing a Catastrophe Modeling Center of Excellence to provide state regulators with access to tools and information, as well as provide education and training opportunities and fund necessary research into mitigation and resiliency projects. Through our independent research division, the Center for Insurance Policy and Research, we will be looking at climate-related factors affecting physical infrastructure.

We are exploring new industry concepts, including how parametric products and microinsurance might be able to resolve issues with coverage gaps created by natural disasters. These products are finding an increasing role in established markets, especially in areas not traditionally served by insurance.

Also, we must continue to identify how public-private partnerships for risk mitigation and risk transfer can be used to reduce coverage gaps and increase the availability and affordability of coverage. For example, ongoing projects in the U.S. are addressing flood mitigation along our nation's rivers and coastal regions. Such efforts can help focus resilience measures on vulnerable communities.

Climate change will continue to evolve, and supervisors must continue to evolve with it. By refining traditional tools, and using innovation to develop new ones, we can address evolving risks and ensure our work remains relevant and responsive to the needs of policyholders and the insurance sector.

FAUSTO PARENTE

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

Addressing the protection gap: challenges and opportunities for (re)insurers

The new EU strategy on adaptation to climate change[1] highlights the fact that affordability and insurability of natural catastrophes insurance coverage is likely to become an increasing concern. Research shows that in the past only a quarter of the total losses caused by extreme weather and climate-related events across Europe were insured (EEA, 2022[2]) indicating a large insurance protection gap in Europe. Improved climate projections provide further evidence that future climate change over the coming decades will increase climate-related extremes (e.g. heavy precipitation, droughts, flood...) and thus the related protection gap, if no measures are taken.

It is therefore key to understand the insurance protection gap and identify where it comes from. EIOPA's therefore developed a pilot dashboard which shows the insurance protection gaps for many natural catastrophes in Europe[3]. The dashboard aims to represent the drivers of such climate-related gap in order to identify measures that will enhance society's resilience in the event of natural catastrophes. At the same time, the pilot dashboard should also help increasing the awareness and promote a science-based approach.

Protection gaps cannot be addressed by increasing insurance penetration alone. It goes without saying that the best solution is to reduce the causes of climate change. More specifically many non-life products have short-term duration of contracts which allow them to re-price annually, which also means that they may be able to adjust the price if the risk changes. However, in light of the increasing frequency/intensity of some events, annual repricing may lead to insurance becoming unaffordable and might disincentivise consumers from taking up insurance thus increasing further the insurance protection gap[4].

Pro-active measures on buildings vulnerability, localisation of exposure and optimised insurance coverage will be important elements of a resilient society. (Re)insurers, as society's risk managers, can contribute to reducing climate change risks. Some insurers are already doing so in multiple ways, for example by providing advices on adaptation measures to policyholders. In its concept of impact underwriting, EIOPA aims to capture the options for implementing climate change adaptation and/or mitigation through pricing and underwriting.

(Re)insurers, as society's risk managers, can contribute to reducing climate change risks.

Another important aspect to close the protection gap is addressing demand side issues for the uptake of insurance products. As consumers might not fully understand the coverage they buy, expectation gaps may arise. These expectation gaps can be detrimental to consumers and impact their trust in the insurance sector. EIOPA has issued a Supervisory Statement to promote contract simplicity but also to ensure a more customer-centric approach to the treatment of exclusions following large-scale events.[5] Beyond exclusion-related issues, affordability is bound to be a significant barrier. Consumers tend to underestimate the losses and/or probability of a disaster, and therefore they might find the benefits of insurance cover unattractive relative to the premium/cost of the policy. Hence, it is also important to raise awareness about the risks some consumers may face.

Finally, it is important to note that (re) insurers as underwriters and investors can be particularly impacted by climate change. EIOPA has therefore assessed the materiality of the insurance sector exposure to physical climate in its recently published report[6]. The study reveals that in-sample insurers have been historically well placed for handling the ensuing claims. However, insurers expect all property-related lines of business to be impacted by physical climate change risk and that premiums are likely to increase.

Climate change is a growing risk for the insurance sector but also creates vast opportunities for insurers to be part of the solution to address climate change risks. In particular, they can play a valuable role in keeping cover affordable for policyholders. Indeed, with data, innovation and incentives, insurers are helping businesses and people prepare for the future risks.

[1] EU Adaptation Strategy — Climate-ADAPT (europa.eu)
[2] Economic losses from climate-related extremes in Europe (europa.eu)
[3] The pilot dashboard on insurance protection gap for natural catastrophes | Eiopa (europa.eu)
[4] EIOPA Report on non-life underwriting and pricing in light of climate change | Eiopa (europa.eu)
[5] Consultation on the supervisory statement on exclusions in insurance products related to risks arising from systemic events | Eiopa (europa.eu)
[6] Discussion paper on physical climate change risks | Eiopa (europa.eu)

RENAUD GUIDÉE
Chief Risk Officer - AXA Group

The Net-Zero Insurance Alliance will deliver a real-world impact on climate change

The Lutine Bell at Lloyd's of London's historic underwriting room is traditionally struck once when a ship goes missing. In our fight against climate change, now is the time to raise the alarm bell and act decisively. With the Net-Zero Insurance Alliance (NZIA), there is an opportunity to ring the Lutine Bell twice – the sign of a ship recovered. We still have a chance to get climate change back in control. To achieve that ambition, we must have all hands on deck and we need to get many levers aligned. These include increased cross-industry collaboration, defining transparent ways of measurement and validated reduction goals, as well as enabling consistent policy and regulation.

A little over a year ago, insurers and reinsurers joined forces to open a new chapter in the fight against climate change, with the launch of the NZIA under the auspices of the United Nations. The NZIA will deliver real-world impact, by using insurance and reinsurance underwriting as a tool to help corporates transition their business model to net-zero. Each NZIA member company has committed to reduce the emissions associated with their insurance and reinsurance portfolios to reach net zero by 2050.

The eight founding members – AXA, Allianz, Aviva, Generali, Munich Re, SCOR, Swiss Re and Zurich – have subsequently been joined by 20 others, including The Lloyd's Corporation, bringing together property & casualty risk carriers, life & health insurers, reinsurers, and insurance marketplaces, from all continents. Going forward, the NZIA aims to also include brokers to reflect the important role they play in advising commercial clients and building the risk capacity to support insured economic activities.

While NZIA members will resort to a range of decarbonization levers to shape their own transition pathway and achieve their goals – ranging from client engagement to risk capacity and advice, to support the new developments and technologies necessary for the net zero transition and sustainable claims management – it is foundational to build a common framework of metrics underpinning the commitment taken to measuring and disclosing emissions. What is not measured cannot be managed, let alone improved.

The NZIA spans all continents and aims at being as global as climate change. All insurance portfolios must be decarbonized.

At the time of the launch of the NZIA, work on ways to measure the carbon footprint or carbon intensity of underwriting portfolios was still in its infancy. The insurance community came forward to lend their expertise to the creation of the first-ever standard for associating insured emissions to insurers, as part of the collaboration of the NZIA with the Partnership for Carbon Accounting Financials. The progress report for the standard, released for public consultation in July 2022, details a body of work that no single insurer could have accomplished on a timeline of less than nine months. Collaboration of this scale will be needed for the development of the target-setting protocol of the NZIA. Transparency and accountability are two of the cornerstones of the NZIA, which is why each member company will report on progress against their own targets on an annual basis.

But industry collaboration of this sort is not without challenges. Just as the economies of the world needed to all come together to commit to the Paris Agreement, the whole insurance ecosystem must be involved and actively contribute to the decarbonization of insurance underwriting portfolios to ensure a 1.5°C world. The NZIA should be joined by more insurers to bring their experience and expertise for achievement of the alliance objectives.

Reaching net-zero by 2050 requires a collective effort and needs to be translated in sound and credible transition plans. Not unlike other stakeholders in the financial sector, insurers and reinsurers are dependent on the data disclosed by their insured clients. In this respect, among the key actors who must play their part by supporting and promoting net-zero insurance, are the policymakers and regulators.

Corporate disclosure of robust data and credible targets together with transition plans informing on core business transformation are essential to achieve the overarching goal set by the Paris Agreement. It will demonstrate that companies follow a credible transition pathway and allow for a holistic assessment from both an investment and underwriting perspective. Access to reliable, comparable and transparent data is a prerequisite to perform such assessment.

Of equal importance is the need for a consistent and harmonized data reporting framework amongst various jurisdictions. Companies operating in multiple geographies will have to comply with different sets of regulation.

Corporates need policymakers and regulators to establish consistent legislative standards which define how transition should be assessed and measured, to avoid energy being wasted on reconciling frameworks having different designs despite a shared ultimate purpose – serving the objective of winning the fight against climate change.

GERARDO DI FILIPPO

Head of Group Risk Management Processes and Operations - Generali

High-quality data is key to manage sustainability risks

Sustainability has put a new pair of lenses at the way we look at our business and consequently has revealed the presence of new risks. Although sustainability-related risks are managed by insurers through Solvency II as other types of risks, sustainability-related risks have three features that would suggest the enhancement of the framework. Those are:

- Double materiality, i.e., materiality of sustainability factors should be assessed considering both impacts to insurers caused by external environment and the impacts caused by insurers to the external environment: this latter being new for risk managers;
- Long time horizon, i.e., Impacts that sustainability factors have over a long time period, materializing with a slow progression with inevitable uncertainties growing over time;
- Interconnection, i.e. the occurrence of sustainability risks impacts and is influenced simultaneously by many other risk categories (sustainability and not).

The consideration of the double-materiality feature both into the risk assessment and the business model has been relatively simple, e.g., the creation of new insurance products dedicated to increase the resilience of SMEs or the issuance of green bonds or even through the decarbonization of the insurance and investment portfolio with significant Net Zero targets to be pursued over time.

The assessment of climate-change related risks over a long time-horizon can already be captured; for instance, the climate scenario for physical risk contemplates impacts up to 2100, although it still requires accurate monitoring. Indeed, in many cases, the consequences of certain actions taken today are still unknown, due to the inertial effect embedded in the evolution of sustainability factors. Furthermore, tipping points can lead to rapid accelerations of an analyzed phenomena. This is particularly true for climate change where irreversible effects are expected over time.

The interconnection feature remains the most complex to understand and consequently manage, despite its importance as a source of a new potential accumulation of risks. When considering climate-change related scenarios, a number of social and economic variables must be considered with all their interdependencies, from economic growth, demographic variables, financial market trends, etc.

We need less data points, but higher quality data!

To properly manage such new risks, a key enabler is the availability of new and high-quality data: currently, the information available for a proper assessment is still relatively limited and fragmented. It is worth to note that both internal and external data from information providers should be improved, as confirmed by the increasing ESG data and rating market.

Regarding climate-related risks, which indeed is at a more mature stage, the data availability is more consolidated. However, for other types of nascent risks, there is a significant data gap, which could lead to misleading risk assessment and incomplete risk reporting.

Risk assessment based on a consistent data sets, such as for climate, can be instrumental in the decision-making process. The outcomes of sustainability risks assessments help in the setting up limits to maintain such risks within the Risk Appetite Framework as well as to provide guidance to understand the future dynamic of market growth, indicating for which sectors / geographies / perils there will be more need for product adaptation.

The absence of data, hence of a proper risk assessment, might also have a knock-on effect on the quality of reporting.

A common challenge that it will be faced by the financial industry is the increasing reporting demand from regulators and other stakeholders. If the lack of data may lead to incomplete reporting, on the other hand, there may be an increasing risk of greenwashing, potentially causing an intensification of litigation risks.

Going forward, it is paramount that standard-setters, policymakers, regulators, industry, and data providers work together as a whole on the following:

- Identifying the relevant data points and the right level of quality of data;
- Avoiding over-prescriptiveness in the data production and data reporting;
- Asking for less data points but better quality of data;
- Agree on a phased-in, incremental approach over time.

The financial sector needs to converge at the same pace towards more meaningful, relevant disclosures regarding sustainability-related risks. Not only given the interconnectedness of our industries, but also to demonstrate our ability to manage and mitigate these risks, and hence instilling more trust from stakeholders in our industry's ability to meet the pressing urgency of the climate change.

Furthermore, insurers can play a relevant social role through their protection role, but also by supporting societies based on accurate knowledge of risks. By informing societies on future vulnerabilities, they can foster resilience.

AML CHALLENGES WITH AMLA AND UKRAINE WAR SANCTIONS

MARCUS PLEYER

Deputy Director General, International Financial Markets, Digitization, Anti-Money Laundering & Counter Terrorist Financing - Federal Ministry of Finance, Germany

Private-sector information-sharing as a mean to more targeted AML efforts

Money laundering and terrorism financing (ML/TF) are cross-border phenomena that can only be addressed with cross-border cooperation. Cross-border cooperation, in turn, is only possible if all stakeholders involved in the fight against ML/TF can participate in each other's findings on where money laundering risks lie. More extensive forms of information sharing – e.g. pooling transaction data – could help prevent the exploitation of information gaps and legal loopholes by criminals who may, for example, use multiple financial institutions in the EU, each of which has only a limited and partial view of transactions. To put it bluntly: We need to see the whole picture, not just parts of it. With this in mind, the Council has already conducted its negotiations on the Regulation to establish the European watchdog AMLA and in this regard provided supervisory authorities with access to a European database held by the AMLA with relevant information on obliged entities and actions already taken by other supervisory authorities. The next step would be to align the substantive law contained in the Anti-Money Laundering Regulation and Anti-Money Laundering Directive with this insight to also allow for better information sharing in the private sector.

The Commission's initial proposal in this regard allows only for the very limited possibility of outsourcing and strictly prohibits disclosure of supicious transaction reports ("tipping off"), which in turn could pose significant obstacles with regard to information-sharing and the shared use of digital tools. Our aim should be to overcome these obstacles and at the same time not lose sight of the fact that there are other legal interests to take into account, primarily data protection. In this regard, we should take advantage of new technologies to contribute to a more resilient, effective and future-proof framework.

We need to strike the right balance between information-sharing and privacy considerations.

There is a need to provide legal clarity regarding which kind of data processing and data sharing will be possible and which safeguards will be put in place. This would support obliged entities in their efforts towards a more intelligence-led approach to informationsharing. A European approach is indeed needed in this regard, since models and innovative technologies that have been applied or considered in some member states to date raise a number of questions on privacy rights and data protection.

Our further work at EU level should build on the lessons learned from the FATF report with the title "Partnering In The Fight Against Financial Crime: Data Protection, Technology, And Private Sector Information Sharing", which was initiated under my presidency and published in July 2022. The report contains several case studies from the UK, Singapore, Estonia, the Netherlands, the US and Germany, on how entities and authorities have endeavoured to balance anti-money laundering and counter terrorist financing (AML/CFT) interests and data protection objectives to advance private-sector informationsharing for AML/CFT.

The report identifies a number of challenges, but also gives practical advice regarding the role of the public sector, the application of privacy-enhancing technologies and the benefits of a Data Protection Impact Assessment (DPIA). This FATF report was drafted in close cooperation with data protection authorities, corrobarating the fact that data protection and the fight against ML/TF are both important public goods that are not inevitably in conflict with each other.

We should take away two lessons from the report:

1. We need to strike the right balance between information-sharing and privacy considerations for citizens. To this end, we should make effective use of privacy-enhancing technologies, which have already made significant strides in recent years. In this regard, it is essential to exchange best practices and practical experiences about how privacy-enhancing technologies can mitigate concerns or even increase data protection.

2. We can only strike this balance with the joint effort of AML experts from obliged entities as well as from authorities, data protection authorities at the national and European level and tech experts. We need to develop a common understanding of the benefits of the use of innovative technologies in the fight against ML/TF and of the legal framework which would be required to enable financial institutions to work together more effectively.

In the forthcoming negotiations in the Council, we should use the FATF report to stimulate the debate on private-sector information-sharing in line with data protection requirements. We will need to work on information-sharing even more intensively over the coming years, driven by a better understanding of what is possible, what patterns can be detected and what safeguards are necessary and technically possible.

JESPER BERG
Director General -
Danish FSA (Finanstilsynet)

AML Supervision under the AMLA – only cooperation will work

If things go as planned the new European AML/CTF authority, AMLA, will begin its supervision in 2026.

A pan-European supervisory authority will not have the proximity to the banks and the markets as have the national competent authorities, and it will have to build its organization from scratch.

The AMLA will have the largest banks in Europe under its supervision. These banks are very large also in an international context. Very few, if any, other AML authority in the world will have such a population under its supervision.

At the same time, it is important to recall that the AMLA will only be a supporting actor in a value chain, where the lead roles are played by the banks and the police. The AMLA's role is to supervise that the banks do their work. It is the banks and the police, who have to catch the criminals. The AMLA will start with the disadvantage that it is further away from, where things take place on the ground.

In order to succeed, the AMLA will have to facilitate cooperation between authorities as regards both supervision and exchange of information and in the use of new technology and information systems, e.g. joint facilities. The AMLA will not be successful unless it establishes a spirit of cooperation with the other authorities.

There is plenty of possible conflicts. It will be easy to earn political applause by being critical towards national competent authorities. Similarly, both prudential supervisors, including the SSM, and AML/CTF supervisors address governance issues with the potential for different positions. It will be utterly unproductive, if the AMLA goes down this road.

The AMLA will not only have to recruit highly technically skilled people, but also people with cooperative skills. Indeed, it needs to establish a corporate culture, where cooperation is a core value. This will not be easy, not least because the AMLA has been founded as part of a narrative that other authorities have failed.

The AMLA will have to live up to the highest standards in the world – particularly the standards issued by the Financial Action Task Force (FATF) and, of course, the future common rule book in the EU. Some EU policymakers have tried to create a conflict between the EU and FATF. This should be avoided.

The future European AML/CTF authority will have to facilitate cooperation between authorities.

During the build-up, the AMLA shall also draw up a plethora of rules in the form of Regulatory Technical Standards. These shall be updated regularly. However, we need to avoid adding complexity to an already excessive complex single rulebook.

It will not be possible to have the AMLA fully up and running from day one. Or year one, for that matter. Most of the AML authorities in Europe have been working hard on this for several years and the target is moving.

It is of paramount importance that the efforts against money laundering, terrorist financing and thereby other forms of crime is not set back during this transition period nor after the period.

This requires that there is a continuous clear division of tasks between the AMLA and the national competent authorities. No supervisory task must be left without an owner. I am convinced that the national competent authorities will continue their tasks with the same vigor as now and we will even enhance our efforts as for example can be seen in the new Danish national strategy for AML and CTF.

There shall, of course, be a point in time where the responsibilities are handed over from the national authorities to the AMLA. I believe that in practice the transferal of tasks and responsibilities can only gradually be transferred to the AMLA because the time it will take to build up the new authority and the sheer size of the task. There should therefore be established a clear road map for the process.

The management of the AMLA will have to be very transparent on the roles and responsibilities. The management will also have to reach out to each and every national competent authority in order to precisely establish divisions of responsibilities and the gradual handing over of supervisory responsibilities for the specific banks. There is a risk that the proposed governance structure creates to big a distance from the AMLA to the national authorities.

The national competent authorities know the big banks very well because they have been in charge of AML supervision for many years and many of them also have responsibility for the prudential supervision. The AMLA will not have an all-round and in-depth knowledge of institutions in the same way as the national authorities. Therefore, it is important that the AMLA also in this area reach out to national authorities in order to gain a thorough knowledge of the banks with which the AMLA is to be engaged.

The AMLA has the possibility to add value, in particular if it embraces technology. With technology and public private partnerships, we can lift the banks' work on know your customers and transaction processing. We need to work smarter in order to focus our efforts on the important issues. Electronic IDs, databases on politically exposed persons and registers of beneficial owners offer great possibilities.

The bottom line is that the transition from supervision by the national competent authorities to a European supervision should not hamper the ALM/CTF supervision.

If we do not safeguard this, we will risk that the overall supervision will suffer from the establishment of the AMLA.

ANTE ŽIGMAN

President of the Board - Croatian Financial Services Supervisory Agency (HANFA)

AMLA as a new reliable and powerful partner in addressing AML/CFT challenges

Recent history and current unfortunate circumstances have shown us that the current EU AML/CFT framework needs a strong and significant boost to enable us to combat money laundering in all its many forms, and to ensure the consistent enforcement of war sanctions. The new EU AML package has tremendous potential to provide us with a more efficient framework of powers and tasks, and can provide us with new opportunities to achieve our common goals, if we use them wisely.

The negotiations on the AML package between the co-legislators are on going, and we all have great expectations from this process. The result should enable the current national supervisory authorities and FIUs to react effectively and to enforce a sound risk-based system that will not allow illegal practices to fall through the cracks, both nationally and EU-wide. The result should also boost direct cooperation between supervisory authorities and FIUs, strengthened by the new dedicated Anti-money laundering Authority (AMLA). So far, there has been no EU AML/CFT "umbrella" agency that would have the authority, responsibilities and tasks that are now to be provided for AMLA. Now that we have the opportunity to establish such a powerful coordination point, it is important to avoid any beginner mistakes that we can already foresee, by drawing on the experience and practice we already have from other ESAs.

Lessons learned are a good foundation for further development and improvement, and any potential shortcomings that we detect and solve now, will reduce "growing pains" for AMLA, while it takes on its systemically important role. While this role needs to be ambitious and demanding, we also need to ensure that AMLA's objectives and tasks can be efficiently applied in practice, and that these tasks are accompanied by sufficient resources.

AMLA should become our reliable and powerful partner in our common effort to address AML challenges.

How can we achieve this?

The first prerequisite is making sure that AMLA has highly specialised expertise, operational knowledge, professional experience and quality professional management. This is important to keep in mind while the legislative package is being negotiated, and even more so after AMLA becomes operational. The role of General Board should be carefully addressed in order to enable the necessary participation and influence of national supervisors and FIUs in the decision-making process that will affect the entire AML/CFT area. National supervisory and FIUs are AMLA's partners that have the expertise and experience that AMLA will need, particularly in its beginning stages.

AMLA should become our reliable and powerful partner in our common effort to address AML challenges.

The second prerequisite is the establishment of a functional central AML/CFT database, which should have all necessary and up-to-date information, enabling both national authorities and AMLA to react more promptly and to exchange targeted data more efficiently. It is important to pay special attention to the functionalities that we expect and need from this kind of database. What level of interoperability and interconnectivity do we need to establish in order to be more efficient? What is the right level of access, and can we use AI solutions in order to maximise the benefits, without overloading NCAs or AMLA? Digital development and interconnectivity can speed up supervisory tasks and a central AML/CFT database can have a crucial role in this process.

The final and equally important component is designing a digital strategy to combat AML/CFT risks. New technology will place increased demands on supervisors and on AMLA in terms of specialist skills and infrastructure. Simply put, supervisors will need to recruit from the same talent pool as fintechs and BigTech; and will need to avail of the same technological infrastructure. Some of these skills and infrastructure can be replicated in-house. Most of it may be either too specialist, expensive or complex to be replicable, requiring supervisors and AMLA to become "users", outsourcing components of the process to third parties. The trade-off between "make" or "buy" will be increasingly present in dealing with AML/CFT risks specific to fintech, and the right balance will determine ultimately the supervisory costs and the success of EU in combating these risks and its success as a fintech hub.

A successful ALM framework for the digital age necessarily implies an upgrade of supervisory resources; and likely a significant reliance on outsourcing of supervisory skills and functions.

There are still open questions for careful consideration and discussion. We have the opportunity and the responsibility to strengthen our AML/CFT actions in the best possible way. But we also need to align the desired targets with AMLA`s planned capacities through prioritisation of tasks and a phased approach.

ANA FERNÁNDEZ MANRIQUE

Global Head of Regulation and Internal Control - Banco Bilbao Vizcaya Argentaria (BBVA)

A new European framework to face emerging and evolving AML risks

Over the past three decades, since the EU issued its first AML directive in 1991, the EU institutions have been working on improving its framework to fight money laundering and terrorist financing in line with evolving FATF guidelines. Despite these improvements, the existing framework still suffers from some shortcomings, and further action is required in five main fields. First, the uneven national transposition of the AML directives. Second, the need for better and common supervision at EU level of the more vulnerable sectors. Third, the urgency to improve the coordination of national Financial Intelligence Units (FIUs), in order to enhance investigations and prosecution. Fourth, the application of the rules to the crypto sector. Finally, there are opportunities and challenges of new technologies for AML/CFT, innovative skills, methods and processes.

Completing the AML framework with these pending elements is crucial to protect the integrity of the EU and international financial systems. Thus, the Commission AML package constitutes a welcomed step forward, particularly the Single Rule Book, intended to address the fragmentation and regulatory asymmetry caused by the different transposition of the directives. Other positive elements are the inclusion of the crypto sector in the scope, the setting up of an EU AML Authority (AMLA) and the fostering of coordination and support between national Financial Intelligence Units (FIUs). However, challenges may arise in the implementation of these measures, and in particular regarding AMLA.

With respect to AMLA, there are several issues to be considered. First, a strong and credible European AML authority should have a broad scope, the new supervisory powers and related competences should be clear and well calibrated and it should also cover the non-financial sector in order to preserve the level-playing field and to make the fight against AML more effective. In general terms, the trend moving from technical compliance to a more risk-based and risk prioritization framework is crucial.

Second, for the success of the framework a fluid exchange of information and coordination between AML supervisors (national & AMLA) would be crucial. The methodology for deciding which entities should be supervised directly at EU level should be clear and predictable, with a streamlined selection process based on harmonized and risk-based criteria. Additionally, the expected gradual increase in the number of entities subject to direct supervision by AMLA should be done following objective criteria as well as an in depth cost/benefit analysis.

A strong and credible European AML authority should have a broad scope.

Third, the future AMLA database should be a central data hub designed to facilitate the sharing of information among all the authorities involved, including prudential supervisors, while minimizing the reporting burden and facilitating the control activities of obligated banks. However, the intrusion into individuals' privacy should be avoided ensuring that full compliance with data protection rules is compatible with an efficient use of data when justified.

Finally, the structure of the Single Supervisory Mechanism could be seen as an example for AMLA. The creation of joint supervisory teams could help create a common European supervisory culture.

In AML, like in many other fields, there is much to gain from making good use of technology. As proposed in the FATF Recommendations on opportunities and challenges of new technologies, innovative skills, methods and processes as well as new ways to use existing technology-based processes can help regulators, supervisors and regulated entities. Elements such as machine learning, data analytics, artificial intelligence or digital identity can facilitate data collection, processing and analysis and help actors identify and manage risks more effectively and faster, even closer to real time.

AML supervision has shown its shortcomings over the past few years, with scandals arising in different Member States due to banks with inadequate AML frameworks. Those cases have shown the benefits of having pan-European structures and have made evident the need to complete and reinforce the AML framework. The new AML package is an opportunity to further harmonise the EU framework and to foster supervisory collaboration, thereby strengthening the prevention of money laundering and terrorist financing risks. It is the responsibility of policy makers, supported by the private sector, to complete a strong EU AML framework, making good use of the lessons learned along the past few years.

TYLER HAND

Chief Compliance Officer - Western Union

Anti-money laundering: making the new EU framework a reality

The European Commission has published an ambitious package to reform the anti-money laundering (AML) and combating the financing of terrorism (CFT) framework in the EU. The approach recognizes that AML challenges are transnational and trans-sectoral in nature and require a common and integrated response at European level.

Western Union supports the move from a Directive to a Regulation, as well as the consolidation of AML supervision at the EU-level through the Anti-Money Laundering Authority (AMLA). We also welcome proposals that empower the Authority to directly supervise certain selected obliged entities through joint supervisory teams. If applied effectively, this could create real efficiency gains for payment services providers operating in multiple Member States.

At present, the envisaged process for direct supervision under the AMLA presumes that a company is either of high risk or has demonstrated failings in its AML procedures. Western Union believes that the scope of the legislation should be extended and that it should allow companies to opt into the direct supervision of AMLA at their own accord. This would contribute to more efficient AML supervision at the European level, without the negative reputational connotations otherwise potentially associated with the designation process.

Another improvement is the European Commission's intention to harmonize the templates for reporting suspicious transactions (STRs). AMLA is empowered to draft the Regulatory Technical Standards (RTS) which should open the way for a risk-based approach which would allow payment services providers to apply their own sophisticated risk mitigation techniques such as a unified template on an operational basis both for filing of STR's but also harmonizing the information that industry collects to create controls across the region.

The establishment of AMLA will moreover foster supervisory convergence and best practices within the EU, in particular by improving supervisory information and intelligence sharing.

Western Union believes that AMLA should establish a platform that would act as a one-stop-shop for the exchange of information within the EU on a need-to-know basis between (i) national Financial Intelligence Units (FIUs) and (ii) ALMA.

AML challenges are transnational and trans-sectoral in nature and require a common and integrated response at European level.

A European one-stop-shop platform would furthermore help develop and nurture a feedback culture from FIUs and AMLA to obliged entities on their submitted STRs. This would allow companies to continuously improve their AML processes and the development of even better risk mitigation techniques.

Moreover, Western Union supports the development of public-private partnerships (PPPs). The public and private sector play a critical joint role in combating financial crime. The ability to detect and fight financial crime has significantly improved in recent years. We see potential for further improvements by adopting better and broader data-sharing arrangements, including with law enforcement agencies, and applying an intelligence-led approach to the reporting mechanism.

Such data sharing arrangements based on an intelligence-led approach should be compatible with high levels of data protection. They should allow the relevant parties to share only that data which is necessary and proportionate for the purposes of fighting illicit activity, while maintaining safeguards and protection for fundamental rights. PPPs should allow payment services providers and the participating public authorities to share actionable information arising from any critical threat assessments both within the EU and at an international level, where appropriate. For this reason, Western Union would welcome more clarity on the application of data privacy rules in relation to AML. AML enforcement works best where public authorities can share information among themselves, but there is also a flow of information between companies and between the public and private sectors.

Finally, we would like to turn to the subject of international cooperation. Financial crime is global in nature. Western Union believes that the Financial Action Task Force (FATF) has been instrumental in fostering global cooperation and a common understanding of AML risks, common standards and the promotion of best practice. We welcome the EU's active participation in the work of the FATF and the consistent alignment of the EU's AML regime with these international standards.

IGOR VIDA
Chief Executive Officer,
Chairman of the Board -
Raiffeisebank a.s.
(Czech Republic)

Business outlook on AML/CFT by a Czech commercial bank

What are the biggest AML/CFT challenges in the banking sector? Lately, one of the most significant challenges is the increasing number of new and further modified legal requirements from regulators. These are not only imposed by the European Union but are subsequently transposed to national regulators' requirements in each member country. In the last few years, there has been a significant increase in the number of amendments to laws, regulations, decrees, and methodological guidelines related to AML/CFT. Therefore, the need for extensive administrative changes has had a significant impact. In particular, activities related to changing and creating new processes, methodologies and forms. It has also created a demand to allocate more human resources to carry out more and more controls. Moreover, it relates to a need to implement new technical/IT solutions.

A significant challenge is to be able to interpret the impact of the new provisions of laws and decrees on time and in correct manner. Thus, to be able to correctly understand all impacts on processes to other employees and other departments within the same organization. Especially to employees in direct contact with clients, who have to perform and comply with them during standard and hence very often enhanced AML controls.

Unfortunately, it has been common practice recently that the interpretation of some provisions is not clear until the effective date and the regulator itself (especially in the case of multinational regulations) is not sure of the exact interpretation. Banks then must decide themselves on the implementation of the "correct" interpretation and already count on the fact that shortly there may be a change in interpretation, which will subsequently mean a change in the setup of the new process/methodology and IT solution.

Recent experience has shown that effective combating of AML/CFT has and will have increased human resource requirements and extensive financial budget for any obliged institution which wants to be able to not only react to legislative requirements but also to react to current threats on time. Thus, in addition to analysing the legal obligations, each institution must also perform an AML risk analysis of its products and its client mix. Then evaluate what appropriate solution to choose. In this seemingly never-ending battle, it turns out that being an established obligor with many years of experience and a robust system is not always a win. For example, newly established obliged entities do not carry historical practices and, in some cases, obsolete IT solutions. They are therefore able to respond much more quickly to the new challenges that obliged persons face from national and, especially, multinational regulators.

A recent example is the accelerated implementation of sanction measures taken in response to Russia's aggression in Ukraine. Obliged parties, in this case primarily banks and other payment service providers, were forced to implement several sanctions measures almost immediately, some of which required the allocation of significant resources, in terms of human resources and new IT solutions. What happened in practice is that within a very short period after the implementation of an automated solution responding to a given sanction measure, the interpretation of that measure is unclear and is interpreted differently by the local regulator, the European Commission, and even individual obliged entities. This fact led to new and further questions mostly to the local regulator, which has proceeded to change its interpretation of the sanctioning measure. It resulted in the new interpretation putting the obliged entity back to the previous set-up of systems and processes. Therefore, the first incorrect interpretation meant an unnecessary use of funds for system changes, but mainly for human resources and restrictions on clients and their transactions.

In addition, further limiting clients and transactions will always generate complaints to which the obliged party must respond. In Czech we have a profound saying that I would recommend obligated persons to apply when regulatory changes are quickly approved - "measure twice, cut once".

A few words on AMLA (the new EU AML Authority) from a local bank perspective and what are our expectations. This new authority/body will be created under the 6th AML Directive. Its task will be to coordinate the individual FIUs, manage a central AML/CFT database and have direct supervision of "selected entities" according to defined criteria (e.g., operating in multiple countries, with high inherent risk, etc.). The AMLA will carry out indirect supervision in the financial market area. It will likely mean an increase in administration for individual obliged entities. We hope that AMLA will help to unify the various FIUs and thus achieve a more rapid exchange of information between FIUs and therefore faster detection of money laundering cases.

At the same time, it could help obliged entities to obtain information about foreign clients through the local FIU and thus prevent the possible adoption of risky clients sooner. But on the other hand, we must expect an increased number of queries compared to the current volume of interaction with the local FIU. In conclusion, therefore, from what has been mentioned – we expect AMLA to be an asset for an effective combating with AML/CFT, however, connected with further costs increase.

A key factor for an obliged entity to be successful in the combating against AML/CFT is connecting the experts in this area with the selection of the right IT solution. The reason we mention IT so often is mainly because of the need to use highly automated solutions to enable obliged organizations to keep up with the ever-faster client-facing tools and services. At the same time, money-laundering criminals are reacting to the evolution of society, adapting their methods and therefore tools that are only a few years old no longer meet current trends. Unfortunately, there is no clear end to the AML/CFT fight, the issue will have to be addressed not only by developed countries but ideally with global support. So, it is certainly not advisable to stop innovating and think that we are done after deploying all the measures that are currently known.

It is important to retain experts and to have an IT solution that is flexible enough to be constantly adapted to new requirements. An equally crucial factor is education and training of employees, clients, and the general public. However, let's keep in mind that even the best system can be evaded by human ignorance. We wish us all to find a successful direction in the combating against AML/CFT threats.

SYLVIE MATHERAT
Senior Advisor - Mazars

Improving the effectiveness of the fight against money laundering in Europe

Money laundering and terrorist financing are now major concerns for public authorities and a constant preoccupation for financial institutions which must implement sophisticated means to avoid being used as channels of transmission without their knowledge. The situation in Ukraine and the development of a regime of sanctions against certain Russian companies and personalities has further increased the topicality of these issues.

In order for Europe to fight effectively against these scourges, certain prerequisites are necessary; in this respect, the proposals made by the European Commission last summer are a step in the right direction. Nevertheless, these proposals must be translated into reality in a sufficiently operational manner so that international financial institutions can implement them effectively. What is involved?

1) **A harmonized European regime:** It is essential that the rules in force in the different European countries be identical for two main reasons. On the one hand, fraudsters must not see their projects facilitated by loopholes in certain countries that would allow them to slip through the net, and on the other hand, international financial institutions must be able to rely on common rules by major geographical areas to integrate them into their internal control systems. Too much diversity of rules makes these internal control systems more difficult to parameterize and manage and exposes them to risks of error/less efficiency. On this point, the announcement of the European Commission to legislate by regulations that are directly applicable and not by directives subject to the vagaries of national transposition is an excellent initiative.

More harmonization, more cooperation for more efficiency.

2) **A unified control of these rules within Europe:** It is essential that these rules be applied in the same way in all European countries, once again to avoid national distortions that would make certain countries (or certain financial institutions) more or less conducive to the spread of these crimes. In this context, the proposal to create a new European authority which will have to set up a unique system of supervision, ensure coordination between national authorities but above all will have a direct power of control over the establishments considered as the most risky, is also good news. The concrete and effective application will undoubtedly take time, but the example of prudential control with the single supervisor (ECB) is encouraging. However, one should not underestimate the costs and energy required to create an efficient authority. On this point, the problem of how to finance this authority is fundamental: a new, under-dimensioned institution would be both inefficient and would carry serious risks, both reputational and financial, for Europe. The current proposal seems to be perfectible in order to achieve the desired objectives.

3) **Facilitated cooperation and exchange of information :** In the fight against money laundering, operational efficiency is confronted with a dilemma: how to ensure compatibility between the necessary search for information that may involve personal data across borders and data protection rules that prevent the storage, retention and dissemination of these same data? Financial institutions, which are at the heart of the fight against these scourges, face great difficulties in exchanging the necessary information, even sometimes within the same banking group. It is essential to clarify the rules applicable in this area and to facilitate, for these specific needs, the exchange of information. This is obviously also true between public authorities.

4) **Greater maturity in the face of these risks:** The risks of money laundering and terrorist financing are not ordinary risks and are not treated as such within financial institutions. While a tolerance threshold exists for classic financial risks (credit, market, liquidity risks) and is included as such in the internal risk appetite systems, the threshold for money laundering is zero. This rule is understandable but it results in very significant costs, in systems that are not always efficient (see the number of false positives in internal control systems) and in attitudes that are not very mature, both on the part of financial institutions and public authorities. Financial institutions can thus choose to systematically refuse certain types of clients, certain activities (correspondent banking for example), make a considerable volume of suspicious transaction reports with the sole aim of protecting themselves against criticism or subsequent procedures, while certain public authorities tend to give priority to form (sending suspicious transaction reports within a given timeframe) over substance (sending reports after investigations at the level of the institution, even if they are out of time). A more effective fight against money laundering and terrorist financing also requires a greater maturity of all with regard to these risks.

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BANKING AND INSURANCE REGULATION PRIORITIES

ISSUES AT STAKE

European banks entered the Covid-19 pandemic and the Ukraine war with stronger capital positions, higher liquidity buffers and better asset quality than the 2008 financial crisis. So, this time European banks have been part of the solution. However, the Banking Union is failing to provide the expected degree of financial integration. The EU banking crisis management framework also needs reviewing to ensure that the banking system can face future episodes of stress. In addition, European banks suffer from a persistent low level of profitability caused by excess capacity, low interest rates, domestic ring-fencing policies and insufficient efficiency that need tackling for preserving their capacity to support the financing of the EU economy.

Further challenges include the competition from non-banks and tech companies, significant digitalisation costs and the implementation of additional Basel III standards. How the European banking sector may preserve its current diversity, which is beneficial for the financing of the EU economy, with on-going evolutions in the EU regulatory framework is a further question to be considered.

Policy changes are also needed for supporting the role that insurers play in the long-term financing of the economy. In this perspective, the European Commission has launched a review of Solvency II aiming to adapt it to new risks such as cyber risks, climate and environment-related ones, and to the new opportunities offered by digitalization, AI and the EU green deal, while preserving the soundness of the European insurance sector.

Q&A

JEAN LEMIERRE

Chairman - BNP Paribas

Leveraging European banks' lending capacity in times of transformation and uncertainty

In February 2022, as the Eurofi community gathered in Paris, Europe was expected to embrace a strong economic recovery following the pandemic crisis, supported by unprecedented fiscal and monetary support, and in particular a vigorous pan-European boost to investments made possible by the Next Generation EU program.

But instead, the world pivoted from this mindset of confidence to the shock of a war on European soil, with its tragic human consequences and a series of consequences on energy prices, inflation, supply chain issues, with potential severe social consequences in our European democracies and in many developing countries.

This shock also accelerated the normalization of monetary policy, which had been already in the cards after years of an ultra-accommodative stance. The US FED led the way, and the US economy is expected to slow down. The ECB has been more cautious in its response, but the Eurozone, and Europe as a whole, is more affected by the war and will also experience lower economic growth.

In this context, banks are confronted with two challenges: the need to play fully their role of supporting their clients in the more difficult environment to come, with inflationary and energy pressures, and at the same time the necessity to finance Europe's main priorities of structural reforms, such as the green and digital transitions, the reindustrialization needed to achieve the imperative of European Strategic Autonomy, and the defense investments necessary to guarantee our security.

All in all, this means around 1 trillion of additional investments per year to finance.

But paradoxically, while banks are prepared to increase their financing of the EU economy, relying on sound risk management practices, and subject to strict oversight, the regulatory and supervisory authorities may create a contradictory wind.

These injunctions are seen in particular in the number of pressures on raising capital requirements:

- Pressure by prudential authorities toward a "full" implementation of Basel, which would lead to a significant increase in RWA;
- Discussions about potential capital add-ons to cover climate-related risks;
- Continued MREL goldplating;
- Debates about countercyclical buffer in some member states.

We know that public funds will finance a limited part of these needs and that European banks balance sheets will not be sufficient to finance an additional one trillion of investments per year.

In the last ten years, banks have double their capital and built strong liquidity positions. They showed during the Covid crisis that they were part of the solution. They have today the capacity to go through very severe stress tests with double the capital after stress compared to the minimum Pillar 1 requirement.

This shows that a severe toughening of the regulation is not at all necessary. Moreover, under the present geopolitical and economic context, a balanced approach towards banks capital is indeed needed.

But to finance the massive additional private and public investments for digital and green transition, reindustrialization and defense, a strong development of

market finances is also necessary and, in particular, a strong development of the EU securitization market which lags far behind the US securitization market (€3000 billion of agency securitization volumes versus less than €200 billion retained and placed securitization volume in Europe in 2020) and far behind its pre-crisis level in 2008 (more than 700 billion).

As a matter of fact, we know that public funds will finance a limited part of these needs and that European banks balance sheets will not be sufficient to finance an additional one trillion of investments per year. This is the crux of the matter.

So, to summarize, there are three absolute imperatives in my view:

- The first one, because most of the financing will continue to come from banks, is to avoid any untimely reduction of the banks' financing capacities.

- The second one is to succeed in the development of EU's securitization market, to free up banks 'balance sheet. To do so, we need a European political will as the measures which should be implemented have already been defined by the Commission High Level Forum.

- The last one is related to the way in which these measures are implemented: collective cooperation by all actors, in a true partnership among policy makers, public authorities and the private sector will be essential to face these challenges with a shared roadmap.

Acting together in an orderly and efficient process should also be required to accomplish the hard work ahead. And notably, sufficient time should be allowed for completing the high-quality technical work necessary for the green transition.

After the talk, we need to do the walk.

BASEL III IMPLEMENTATION

PABLO HERNÁNDEZ DE COS
Governor, Banco de España & Chair,
Basel Committee on Banking Supervision (BCBS)

Climate, crypto and carrying through Basel III

The dual shocks of the war in Ukraine and resurgent inflation have darkened the outlook. Growth is losing its momentum. The transition from pandemic to endemic is proving tortuous and wracked with uncertainty.

Against this backdrop, elevated financial vulnerabilities will continue to test the resilience of the global banking system – with challenges coming from increased debt levels, stretched real estate valuations and proliferating links with non-bank financial intermediation.

What's more, structural trends continue to brew, with important implications for banks. In particular, climate-related financial risks and the digitalisation of finance loom increasingly large in the risk priorities of banks and supervisors over the medium term.

While there is no shortage of work for the Basel Committee, I would highlight three "Cs" that are of particular relevance right now: climate, crypto and carrying through the implementation of Basel III.

Climate change will result in physical and transition risks that could undermine the safety and soundness of individual banks, as is now generally accepted, to say nothing of the broader financial stability implications.

Banks worldwide are potentially exposed to such risks regardless of their size, complexity or business model. The scale of such risks is potentially tremendous: a recent study estimates that G20 financial institutions have exposures worth almost $22 trillion to carbon-intensive sectors, of which on-balance sheet bank lending accounts for 60%.

The transition to net zero is likely to be a bumpy one, as recent geopolitical events have shown. So it is crucial to ensure that banks are resilient to climate-related financial risks as we navigate the uncertain path towards net zero.

To that end, the Committee is pursuing a comprehensive programme to mitigate climate-related financial risks to the banking system. A series of analytical reports have assessed the transmission channels of such risks to the banking system and measurement methodologies. And, to follow these up, we recently published a set of high-level principles that seek to improve risk management and supervisory practices. We are now assessing whether additional global measures are needed, spanning supervision, regulation and/or disclosure.

Another area of focus is cryptoassets. Despite the frenzied activity in such markets over the past few years, banks' exposures to cryptoassets are still relatively limited; at their peak last year, cryptoassets represented only about 1% of total global financial assets.

Yet we know that such markets have the potential to scale up rapidly, posing risks to individual banks and financial stability. This calls for a forward-looking approach to regulation and supervision to ensure that we meet our mandate both today and in the future as technology and markets evolve.

This is why we are in the process of finalising a prudential treatment for banks' crypto exposures. The Committee will be guided by three principles in this area:(i) simplicity and caution in the design and calibration;(ii) treating assets with the same risk profile and activity in a similar manner; and (iii) setting global minimum standards for jurisdictions to build on.

Collaboration on both climate risks and cryptoassets is key. For this reason, the Committee is closely liaising with other global standard setters and forums. It will also continue to actively seek the views of a wide range of interested stakeholders.

But the benefits of global agreements will not materialise if the Committee's agreed standards, endorsed by the G20, are not implemented in a full, timely and consistent manner. This takes me to my third "C": carrying through the implementation of all aspects of the Basel III framework. I take heart in seeing that all member jurisdictions have recently reaffirmed that they expect to implement the outstanding standards as soon as possible. It is now crucial to translate this willingness into action. Otherwise, the regulatory fault lines from the Great Financial Crisis will remain unfixed.

Finally, the Committee recently published a set of high-level considerations on proportionality. These aim to support authorities that seek to apply proportionality in their regulatory and supervisory frameworks in a way that will not compromise financial stability. They provide another lever for implementing Basel III.

ALEXANDRA JOUR-SCHROEDER
Deputy Director-General, DG for Financial Stability,
Financial Services and Capital Markets Union - European Commission

The Banking Package: a prudential framework fit for purpose

In October 2021, the European Commission adopted a package of legislative amendments to the Capital Requirement Regulation and Directive ('CRR3' / 'CRD6'). The package is currently being negotiated by the co-legislators, i.e. the European Parliament (EP) and the Council. The rapporteur in the EP tabled his draft report on the package at the end of May. In the Council, the French presidency tabled a first draft compromise text in June and discussions are now continuing under the Czech Presidency. It is expected that consolidated positions of the EP and the Council will be reached by year-end, with an agreement between the co-legislators in the first half of 2023.

The package strikes a delicate balance between several objectives. Most notably, it implements the Basel III international standards faithfully, without leading to a significant increase in capital requirements, on average. The Commission´s proposal adapts the Basel standards to tailor them to the specificities of the EU banking sector and economy, inter alia:

- It is proposed to keep the adjustments that have already been adopted by the co-legislators in the last banking packages, such as the small and medium enterprises (SME) supporting factor and the exemptions from the credit valuation adjustment (CVA) framework.
- The proposal does not treat EU banks' equity holdings as speculative investments, in cases where they are of a long-term and strategic nature.
- The proposal also sets out specific transitional arrangements for banks using the internal ratings-based approach for their exposures to low-risk mortgages on residential property and to non-rated corporate borrowers. These transitional arrangements are supplemented by European Banking Authority's (EBA) reports and carefully designed so as not to become permanent treatments.
- Lastly, the Commission proposes pushing back the implementation date by two years, i.e. to 2025. This takes into account our legislative process, implementation efforts, and not constraining banks in their ability to support the economic recovery in the coming years.

The nature and calibration of these provisions is still being discussed both in the Council and Parliament.

Another key issue is the implementation of the output floor and whether it should be applied at the level of a consolidated EU banking group, or separately for each local banking subsidiary. An application at consolidated level would be fully consistent with both the international Basel III standards and the logic of the Banking Union, as it reflects the benefits of risk diversification within a group. The proposal incorporates a distribution mechanism to ensure that capital requirements that result from the output floor calculation are allocated fairly across various subsidiaries of the group according to their risk profile.

Overall, and to put things into perspective, we estimate that the average impact of our proposals would be lower than a 10% increase in capital requirements at the end of the long transitional period. Also, significantly, the impact of the proposal would be below +3% when the new requirements start to apply in 2025.

We want a robust, competitive and sustainable banking system. The banking proposal will help to deliver on this goal.

Among the non-Basel III-related aspects, the Banking Package will pave the way for the integration of environmental, social and governance (ESG) risks into the EU prudential framework. With regard to the supervisory framework, the Package also contains a number of improvements, for instance to further harmonise the following: the rules on fit & proper assessment, the assessment of certain prudentially relevant transactions, as well as the powers related to sanctions and penalties. Lastly, we are putting forward a comprehensive framework for the regulation and supervision of third-country bank branches in the EU, including specific provisions on systemic branches.

To conclude, we are finishing the job we started over a decade ago. We first increased the quality and the amount of capital, then we introduced liquidity and leverage requirements as well as a framework for large exposures. Now it is about measuring risk and ensuring that banks using models are adequately framed. We want to ensure that in the EU there is a robust, competitive, and sustainable banking system. The banking proposal will help to deliver on this goal.

JONÁS FERNÁNDEZ ÁLVAREZ

MEP, Committee on Economic and Monetary Affairs - European Parliament

Towards Basel-compliant EU banking legislation

After a delay to the pre-established calendar, explained in part by the impact of the COVID-19 pandemic, last October the European Commission presented its proposal for the banking package that essentially looks to implement the Basel recommendations in the European regulatory framework. During the first semester of this process, both the European Parliament and the Council of the EU have made a start on their work.

In my opinion, the European Union must implement the Basel recommendations in an accurate and timely fashion, although some delays already seem unavoidable. In any case, no one should call into question the need to faithfully implement the Basel standards, given that many of the European specificities cited to introduce local deviations were considered at the Basel negotiating table. Europe can not play two different hands while negotiating in international fora.

We cannot have one stance to bring our particularities into line with international standards and then a second stance once in Brussels, to surpass the agreements reached. Indeed, the G20 mandate states that the new recommendations should not lead to excessive capital increases in the banking system, and this is the case based on the numbers produced by the EBA. But that mandate should not be dictated by the impact on individual banks, some of which will need to work with more capital. This is the objective of the reform.

The Commission's proposal, despite everything, includes new, mostly temporary, deviations from the Basel standards. These deviations, materialized in transitional arrangements, not only do not imply an immediate capital increase but rather allow for a reduction of capital in certain cases, at a time when our banking system must prepare for a long transition, threatened by developments in the Russian war on Ukraine. This is why, contrary to the strictly temporary shock that came from the pandemic, there is no space at present for reducing capital. Instead, we should be safeguarding banking stability in preparation for the coming period of uncertainties.

Therefore, my initial report on the Capital Requirements Regulation (CRR) has focused on eliminating or minimising the impact of the new deviations proposed by the Commission. Furthermore, I recently proposed new economic and political incentives to implement a full Banking Union. To this end, I decided to address some of the uncertainties of host countries in the framework for the implementation of the output floor. I have added amendments to ensure that its calibration at an exclusively consolidated level is conditional on the development of European deposit insurance and to also facilitate the application of capital and liquidity waivers as the Banking Union moves forward.

Moreover, in my initial report, I have reduced the scope of application for some transitional regimes in the implementation of the output floor within the internal models. As stated, we should not ease capital requirements at this time. Additionally, there can be no doubt that such transitional arrangements are indeed temporary.

Furthermore, this summer we have once again seen the risks linked to global warming. These climate risks must be internalized in our credit risk calculation models. In this area, I have proposed adjusting the infrastructure supporting factor to apply to projects that comply with EU taxonomy and limiting the preferential temporary treatment of low-risk mortgages to those that also mitigate climate risks. Other possible options will very likely come to light during the negotiations. We will have to consider, given that the elements of transparency and market discipline in Pillar 3 will not be sufficient.

I am confident that the EU will strengthen the resilience of our banking system.

Finally, it is essential to improve the governance systems of banks through the fit-and-proper framework chapter of the directive proposed by the Commission. In Spain, we have suffered in the past from the effects of inefficient governance models, and the reform promoted by the Commission to improve them should serve as a guide for implementing such control mechanisms throughout the European Union.

Parliamentary negotiations are underway to reach a broad agreement and open the debate with the Council of the EU. I am confident that the EU will honour its international commitments and strengthen the resilience of our banking system. That will be my endeavour over the coming months.

ALBAN AUCOIN
Head of Public Affairs - Crédit Agricole S.A.

A misleading international convergence

According to the most recent progress report on adopting the Basel regulatory framework published by the Basel committee in October 2021, most countries including the EU, US and UK have not started the implementation of the final Basel III Accord. Some of these countries have published a draft regulation, with a few having adopted and implemented it.

However, the main issue is the level playing field. Adopting an international recommendation does not mean it has the same content or impact in all jurisdictions. For instance, the US only applies Basel III to the largest banks, and the standard approach does not include operational risks nor the Credit Valuation Adjustment – which roughly represent a 30% reduction from Basel. Moreover, economic structures matter. Many features of the Basel framework are designed on the US economic model and penalise Europe, which has, for instance, a much smaller capital market and then a majority of unrated corporates.

International convergence of prudential regulations is desirable to avoid distortion of competition. However, if international standards do not take into account the specificities of the different jurisdictions, they may actually lead to distortion of competition. For instance, the output floor significantly reduces the risk sensitivity on mortgage loans in internal models. This penalises European banks, which have lower risks thanks to the double recourse on debtors and real estate, when American banks only have a recourse on the assets. When Americans speaks with one voice, European countries are divided between them to take into account European specificities in international fora and in their own transposition of the Basel III Accord.

In addition, Europeans usually gold-plate international standards, so that the convergence is often theoretical. For instance, MREL requirements are higher than TLAC, and both the Systemic risk buffer and Pillar 2 requirements add another layers to the already thick capital buffers.

According to the European Commission, Europe will require EUR 500 bn per year in additional investment to meet its 2030 environment targets. The digitalisation, and the economic and strategic autonomy of Europe also require huge investment. As European capital markets are small, most of the external financing of these much-needed investments will rely on European banks.

However, further increasing banks capital requirements limits their financial capacity and the finalisation of Basel III will reduce this capacity by roughly 20%. The impact study for this reform, published by the Basel committee last February, shows a 300 bp reduction in the CET1 ratio of large banks in Europe. Clearly, the overarching principle of the 2017 Basel accord of no significant increase in capital requirements is not being respected. The Commission's proposal to implement this reform includes temporary alleviations, but, fully loaded, the overall impact will be around the figure calculated by the Basel committee. Copenhagen Economics, an independent think tank, evaluated that this significant increase in capital requirements would reduce the financing capacity of European banks by roughly EUR 3000 bn.

Higher capital requirements would indeed have a deleveraging effect, which is the very purpose of capital requirements (see also the measures taken by the SSM during the pandemic, based on a leverage between capital requirements and financing capacity). The experience of the two last decades is very clear: Basel III and following prudential regulations had a significant deleveraging effect, as shown by the ECB data, and the loans to non-financial corporations are still lower than they were in 2009. When saying that banks will adapt their business model to absorb the new capital requirements, supervisors simply imply that banks are going to reduce their outstanding loans!

Banks are intermediaries: all these capital costs will ultimately be passed on to consumers.

As calculated by Copenhagen Economics, the cost of borrowing in Europe is also going to increase, by EUR 25-30 bn. For the EU, average, corporate customers will be the most affected with an estimated increase in borrowing costs of some 0.25% points. Banks are intermediaries: all these capital costs will ultimately be passed on to consumers.

HIROTAKA HIDESHIMA

Counsellor on Global Srategy to President and the Board of Directors - The Norinchukin Bank

Is there room to improve the international rule-making process?

How are countries progressing on Basel III implementation?

According to the "Progress report on adoption of the Basel regulatory framework" published by the BCBS on 14 October 2021, Canada, Singapore and Japan were the only jurisdictions that had published draft rules for all of the final pieces of Basel III (covering the revised standardised and IRB approaches to credit risk, the revised CVA framework, the revised market risk framework, the revised operational risk framework, and the output floor) , as of end-September 2021. As well known, the European Commission published draft rules on 27 October 2021, just after the publication of this BCBS report. (Australia and South Korea did not have the draft rules for the revised CVA framework and market risk published, but did for the other elements.)

There has been no official consistency assessment of these rules with the Basel standards to date. However, track record suggests that countries like Australia, Canada, and Singapore tend to at least fully apply the Basel standards, if not more stringently.

International vs domestic?

Following the debate on Basel III implementation in such arenas as Eurofi, a couple of thoughts come to mind. The first is that it would have been ideal if these debates took place ahead of the finalisation of Basel III. The second is that things may have been easier if there was a differentiated treatment within the EU between large, internationally active banks and those that are not.

First, on the latter point. It is well understood that the question of whether or not to have a differentiated approach for small domestic banks in Europe has been raised in the past, and that a decision to not do so has already been made. It should also be noted that, given the implications for the competitive equality among different banking groups, this is a decision that needs to be made by each jurisdiction, with which outsiders should not interfere.

Nevertheless, it may be worthwhile recollecting that some things have changes after this decision. One is that some jurisdictions, like the US, have expanded the range of differentiated treatments, and some others, like the UK, are considering newly introducing differentiated treatments. Another change is that there has been an introduction of differentiated treatment within the Basel framework with the introduction of the G-SIBs notion. There are now more stringent treatment for G-SIBs compared to non-G-SIBs, even though both groups are internationally active and subject to the Basel standards. The rationale for the increased stringency for G-SIBs is their higher systemic importance. Then, it should be possible to argue that less systemic banks may be subject to less stringent standards.

Although we make these observations, the decision should be left with the relevant jurisdictions as mentioned above.

Improved process?

Regarding the issue of the timing of the relevant debate, our impression is that the stakeholders' views do not seem to be fully taken into account in the current international rule-making process, at least in some jurisdictions. The ideal scenario is for all relevant stakeholders to respond to the public consultation by the BCBS and to make all the points during that stage. However, the reality is that not all the relevant stakeholders take this process as seriously as one would hope. An example within a bank could be that it is only the regulatory affairs team that reads the Basel documents seriously, and the staff of the front and middle offices only react when the domestic consultation starts.

One suggestion to better reflect the stakeholders' views in the international rule-making process.

If this is the case, one idea might be to conduct the domestic consultation ahead of the international agreement to finalise a Basel standard rather than the other way around which is the current case. By doing so, representatives at the BCBS will be able to take account of all the views of the relevant stakeholders and thus the international agreement can better reflect those views. In addition, the implementation timetable may become more realistic.

One drawback could be that the process after the domestic consultation leading to the international agreement may become more difficult. We could ask ourselves the following question: do we prefer an easier process with a lower probability of adherence, or a more difficult process with a higher probability of adherence and improved legitimacy?

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BANKING UNION AFTER THE EUROGROUP JUNE DECISIONS

JOSÉ MANUEL CAMPA

Chairperson - European Banking Authority (EBA)

Next steps in the development of the Banking Union

The way banks are supervised and managed in failure has improved considerably over the last decade. The Bank Recovery and Resolution Directive (BRRD), and the Deposit Guarantee Schemes Directive (DGSD) have established a powerful framework in the EU for dealing with failing or failed banks. A dedicated framework for bank resolution was established and all jurisdictions in the EU now have authorities dedicated to managing bank failures of any size. The authorities' actions, together with additional powers for supervisory authorities to intervene early in stressed banks, transform the landscape for handling idiosyncratic and systemic failures. The framework also includes the creation of the Banking Union, and completion of two of its envisaged three pillars – the Single Supervisory Mechanism and the Single Resolution Board.

However, it is also important to acknowledge that the process is not complete in particular with regards to ensuring full resolvability and achieving full MREL in particular for mid-sized banks.[1] The recent crisis events have represented an important testing moment and we must use this time to push for completion of those reforms.

Strengthening the crisis management and deposit insurance framework (CMDI) in alignment with the objectives of the European Commission review is, in my view, an important next step towards completing the Banking Union. It matters because improving the CMDI is a precondition for further integration of the banking market and for avoiding national ring-fencing when problems arise. More specifically, I would like to highlight four areas where changes are needed.

A stronger crisis management and deposit insurance framework is the next step for the Banking Union.

Firstly, in relation to the largest banks in the EU, there is a need to achieve high level of resolvability to ensure that when such banks encounter difficulties, it is possible to manage their failure effectively. To support this objective, the EBA has published guidelines on resolvability and transferability that should be complied with by all EU banks by 1 January 2024. EBA is also working on guidelines for testing resolvability that aim to frame how resolution authorities should gain assurance of institutions' capabilities to support the execution of the preferred resolution strategy. In this context, we also see a need to increase the overall transparency of the resolution framework to improve its credibility via greater predictability and a broader understanding by a wider audience.

Secondly, there is a need to harmonise insolvency regimes across the EU, starting with a clearer and uniform approach to the public interest assessment which determines whether a failing bank will be resolved, using the resolution tools, or liquidated. More harmonization here would introduce more predictability and ensure trust between home and host authorities. That is of particular relevance to mid-sized banks and banks with cross-border presence.

Thirdly, there is a need to introduce more flexibility to deploy resolution funds, and funds raised by deposit guarantee schemes more effectively. Currently, the hurdles to use such funds in resolution are so high that these funds are hardly ever used for this purpose. More flexibility in that respect would provide the authorities with the possibility to apply the most efficient tool and avoid value destruction in bank failures.

Finally, there is a need to further strengthen and harmonise deposit protection rules. While the agreement on the third pillar of the Banking Union – the European Deposit Insurance Scheme – remains elusive, we should continue strengthening the framework to ensure that where depositor payouts are needed, they are done as efficiently as possible. This matters because maintaining depositors' trust in the deposit guarantee is essential for financial stability. The EBA has supported the European Commission in the review of the current DGSD and made more than a hundred recommendations on how to improve the current framework, including clearer and better information for depositors, improved transparency concerning DGS funding, and clearer and more harmonised rules on complex or specific cases, such as failures where there are money-laundering concerns.

The Banking Union remains a work-in-progress. Enhancing its regulatory framework is a necessary step. At the same time, we should continue to foster effective integration of cross-border activities and the single market by enhancing supervisory cooperation and collaboration in properly assessing cross-border risks within the EU.

[1] *https://www.eba.europa.eu/eba-sees-progress-mrel-shortfall-reduction-largest-institutions-while-smaller-institutions-are*

MARGARITA DELGADO

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Completing the Banking Union: an even more urgent task in times of uncertainty

Banking Union is an essential element to safeguard financial stability and sustainable growth in the euro area. The euro area sovereign debt crisis of 2012 highlighted the extensive contagion channels between the financial system and sovereign issuers, their amplification effects and how easy it was for them to spill over national borders. The answer at that time was pivotal for the future of Economic and Monetary Union (EMU): a Banking Union was essential and, more recently, albeit still incomplete, it has been crucial to underpin the resilience of the euro area during the pandemic.

Consequently, completing Banking Union is an indispensable priority, particularly in the present context of high economic uncertainty that translates into heightened risks to financial stability. Furthermore, a complete Banking Union will allow us to fully reap the benefits of EMU membership, by guaranteeing the level playing field and a competitive and robust European banking system. The present status of the Banking Union is clearly not our desired destination. Rather, there is much work ahead. The costs of inaction damage the credibility of the project and should definitely be avoided. Certainty about the timeline is also key for decision-making by the different stakeholders.

Against this background, reaching an agreement on the way forward for Banking Union in June was very important. The Eurogroup (EG) has provided a welcome and practical response to this challenge by proposing to focus on an area where there are well-identified gaps to fill: strengthening the framework for the management of failing banks in the EU. Reducing the heterogeneity of liquidation procedures across Member States and broadening the uses of the different national deposit guarantee schemes for resolution and liquidation, as well as making them more consistent, are especially welcome adjustments to improve the resolution of medium-sized and small banks. We also need to facilitate the access to the Single Resolution Fund when it is needed without modifying the previous political agreements.

The costs of inaction damage the credibility of the project and should definitely be avoided.

Nonetheless, this way forward should not draw our attention away from a fully mutualised EDIS – the third pillar of the Banking Union as originally proposed – which should be the final goal. The EDIS is pivotal to ensuring a true Banking Union: first, it equalises the level of depositor confidence across the single market; second, it helps to delink depositor protection from depositor location, thus reducing the link between banks and sovereigns; third, it reinforces the level playing field for banks; and lastly, it strengthens depositor protection against local shocks. In the current situation, with both the SSM and the SRM already in operation, a common safety net for depositors at the European level is the logical complement to shared responsibility for banking supervision and resolution.

To further complete the Banking Union, we need to address banking market fragmentation. Market integration is key to reaping the full benefits of the single market for the banking sector and for the financing of the EU economy. Well-established common supervision and resolution frameworks are essential to build trust among the different stakeholders. Additionally, a mutualised EDIS will be the key element to overcome the current situation.

The issue of weakening the sovereign bank nexus and fostering the diversification of banks' sovereign bond holdings is a complex and particularly sensitive one. In my view, all the parties should make an effort to compromise on this matter. A fully mutualised EDIS, a Capital Markets Union and the inclusion of other missing elements in the EU financial architecture (such as a European safe asset) would enable the treatment of sovereign debt holdings under Pillar 1 to be addressed.

Nonetheless, in the present macroeconomic scenario, we need to be particularly careful to avoid episodes of financial instability. A message conveying progress towards a fully working Banking Union at the European level would help to mitigate the risks of instability.

In short, there are three key messages I would like to underline:

- Completing the Banking Union is essential. A fully mutualised EDIS is the main element outstanding to achieve this aim.
- Strengthening the resolution frameworks and further harmonising the use of national deposit guarantee schemes and bank insolvency procedures is a welcome and helpful immediate step forward.
- All sides should compromise on the missing elements of the Banking Union. This would ease the way for the diversification of banks' sovereign debt portfolios. Nonetheless, in light of the current macroeconomic uncertainties, we need to be careful to avoid introducing measures that could trigger financial instability in the euro area.

STEVEN COSTERS

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Completing the Banking Union : an issue of equal progress and level of ambition

Remaining committed to completing the Banking Union and reaching an agreement on the third pillar, a European Deposit Insurance Scheme and its 4 building blocks (crisis management, depositor protection, single market for banking services and diversification of sovereign holdings) is important not only to make the European banking sector stronger, more competitive and more resilient but also for the further deepening of the Economic and Monetary Union and for the economic and financial situation of EU Member States as a whole. Furthermore, it will give more confidence to businesses and citizens in the European financial system.

We must not forget however, that the discussion on the third pillar and the development of a corresponding work plan with different workstreams has always been and remains very complicated as many areas are involved and Member States expressed many different views. The impact of Covid and the war in Ukraine on the current economic and financial situation of Member States, leading to more fragmentation throughout the EU also played a role.

Looking at the 4 building blocks, next to a discussion on the need to reduce fragmentation and the need to create a pan-European competitive banking sector, the discussion is also about risk sharing versus risk reduction, burden sharing, financial stability, consumer protection, harmonization of legislation, a level playing field for all types of banks... This shows clearly that the 4 building blocks are closely interlinked on top of the variety of areas covered and the different views.

When it comes to the 'limited' results achieved at the June Eurogroup, the most important reason was undoubtedly the level of ambition between the different building blocks, this also includes speed and equal progress. Having the same level of ambition in all 4 building blocks is the precondition for making progress on the third pillar. From the beginning of the discussion on the work plan it was clear that getting to the same level of ambition in all 4 blocks would be very difficult, in particular because of the very strict and tough positions taken by Member States in areas like depositor protection and diversification of sovereign holdings . As a consequence showing high ambition in areas like the single market for banking services would have created unbalance as for many Member States a holistic approach, including the same level of ambition and same level of progress remains an important condition to reach an agreement.

Not a given that consolidation and waivers will lead to more competitive banks and investment.

Coming back to the issue of fragmentation and the importance of creating a competitive pan- European banking sector, it is important to note that the level of cross-border integration cannot solely be linked to the lack of consolidation or to prudential rules (e.g. liquidity and capital waivers). While there is no empirical evidence this would lead to fragmentation, it was stated many times during the discussion on the third pillar of the Banking Union that non-prudential factors, like taxation, company law, consumer protection, employment laws, do play an important role for cross-border integration and profitability and efficiency of cross-border banks. Another important factor is confidence and mutual trust in the system.

The memory of the 2008-2009 financial crisis is still too fresh and for this reason many Member States need a high degree of national supervision or the necessary safeguards, through legally binding acts, that the financial stability of subsidiaries of cross-border banking groups is guaranteed and in case of problems group support will be given. This is what the home-host discussion is really about. The issue of fragmentation is more complex than many people think and it is not a given that consolidation and waivers will lead to more competitive banks and investment into the real economy.

As already said, the discussion on the third pillar of the Banking Union is a complicated and complex discussion. For the moment, there is no other way forward than, as the Eurogroup stated last June, to start the discussion on the Commission's proposals concerning CMDI (Crisis Management Deposit Insurance). Let us hope that we can agree to the proposals on CMDI within the given timeframe.

Finding an agreement on the CMDI proposals will not be easy as discussions will concentrate on the enhanced use of the DGSs (alternative measures next to payout and resolution, possibly preventive measures), the inclusion of medium-sized and small banks in the resolution tools and MREL build-up, the role of IPS in the CMDI framework and harmonization of insolvency laws. This is only the first step in the process of agreeing on the third pillar.

By the time of agreeing of the CMDI proposals, Member States should have taken the necessary action to come to a more sustainable economic and financial position, with less divergences and fragmentation. This will be imperative to start discussions on the other 3 building blocks.

HARALD WAIGLEIN
Director General - Ministry of Finance, Austria

Are we open to find different ways to improve efficiency in the banking sector?

There is widespread consensus, that improving the efficiency and therefore the competiveness of the European banking sector is crucial to manage the financial needs of the double transition, complementing thereby the benefits of CMU. Nevertheless, measures to improve the efficiency of cross border banking groups have remained rather limited so far. Obstacles are still in place that hinder the free float of capital and liquidity within cross border banking groups, preventing thereby their optimal allocation but also the economic benefits from economies of scales. It is to be expected that ring fencing measures to protect the host-country's stability will persist as long as suggested safeguards are not perceived as credible. The lack of credibility is costly, not only for the banking group itself but also for the authorities involved and indirectly for the real economy.

The inability of the Eurogroup in June to overcome discrepancies and find an agreement on the four workstreams for strengthening the Banking Union cannot be considered as helpful for building up trust, and we all agree that trust between public authorities is the crucial but missing element here in completing the Banking Union. Trust is needed to abolish ring fencing practises, trust is needed to overcome fears of moral hazard or free riding – but trust cannot be effectively prescribed, neither legally nor politically. Obviously, the time is not ripe for a further major step of integration. Maybe it was better to make a break right now than to create expectations and fail in operationalization, which might have damaging effects on the Banking Union as well.

Despite all, the agreement to move forward in CMDI is a step to be welcomed. But most likely it will not ease the problems of the European Banking sector in terms of low profitability and competiveness. After EDIS has been postponed for a longer period, there are no convincing ideas buzzing around that would offer sufficient reassurance to the Hosts, so ring fencing measures will remain in place.

Alternatives should be looked for to increase international competiveness of European banks.

Maybe at this point of time it could be helpful to start looking more intensively for other ways since the previous one was blocked. Maybe we even need to look from a different perspective. It's the banks that make the choices about their business structure, but are we ready to support them in their choice or do we put indirectly or implicitly stumbling blocks in the way? Despite all the difficulties and the time consuming and expensive process branchification might be an alternative, especially since the chances to achieve a free flow of capital and liquidity across the entire group in the nearer future have diminished drastically after the Eurogroup in June. Operating with branches rather than with subsidiaries might therefore become more attractive and more efficient, taking advantage from simplified governance structure as well as. Nordea and the UBS head office in Frankfurt are good examples.

So, how relevant are other factors that have prevented the conversion from subsidiaries into branches so far, such as legal issues and the soft pressure not to branchify? The most obvious consequences would be for deposit protection which would fall on the home country's national deposit guarantee schemes. But can a DGS in the current setting deal with large cross-border branches in a credible way? Who can provide support to the DGS in case of needs? Would we profit from EDIS here as well, especially when in times of rising spreads the issue of a credible (public) backstop might become more relevant again? What are the implications for the protection of deposits for stand-alone banks in the so called former host-country? In the end, might branchification be a new but different stimulus for EDIS?

Without any doubts large scale branchification leads to a lot more questions, also in other areas. Some answers and ideas are already in the air, such as amending DGSD to allow for larger transfer of contribution between DGSs to adjust the size of the funds to the higher target level without delay. Anti-money laundering is also often cited as an area where diverging national rules pose practical problems for cross border business, but here stronger harmonisation is envisaged by the current AML-package which might reduce the respective burden.

In any case it could be worth identifying the problems in relation to branchification in more details and trying to find answers and solutions to them. We might end up discarding the idea, but it might turn out to be a feasible approach as well. Whatever the case may be, it is most important to leave no stone unturned to raise efficiency in the banking sector and improve the financing of the real sector.

CHRISTIAN CASTRO
Head of Public Affairs - CaixaBank

EDIS and the 'sovereigns concentration conundrum'

The prelude to discussions in the June Eurogroup on the Banking Union and recent tensions in markets leading to swings in euro-area sovereign spreads, have reignited the debate on how to effectively complete the Banking Union and address market fragmentation in the EU.

Two focal points in such a debate were: first, how to advance towards a European Deposit Insurance Scheme (EDIS); and second: how to incentivise diversification of banks' sovereign debt holdings in the EU. As logically expected, the latter has contributed to revive some old debates on the prudential treatment of banks' sovereign holdings.

Unfortunately, results in the Eurogroup were rather limited. This, once again, suggests a need to explore new approaches and policy tools, taking advantage of evidence and experience accumulated during all these years of discussions.

In this regard, motivation and arguments supporting a fully-fledged EDIS are known. It involves institutional and economics reasons to complete the EU Banking Union. An EDIS can be seen as the missing third Pillar to sustain the Banking Union temple or – as recently suggested by Mr Enria – as the missing branch in a tree without which the EU Single Market and the Banking Union cannot be sufficiently "single" nor "unified" as they meant to be. The unity point is particularly relevant because the lack of an EDIS also works as a source of fragmentation for depositors, banks and, ultimately, for sovereign debt markets. To note, the price for an EDIS cannot be undue constraints to domestic sovereign debt holdings.

In fact, regarding the diversification of banks' sovereign debt holdings, it is useful to review five key empirical features of the observed domestic concentration.

First thing to have in mind is that banks' domestic sovereign debt holdings are a relatively small fraction of their balance sheets once liquidity needs considered. Just as an illustration: by end 2020, euro-area banks' domestic sovereign debt securities reached circa 4% of total assets. By the same date, the net outflows considered for the denominator of the Liquidity Coverage Ratio (LCR) were around 11% of total assets. That means that, if all these domestic sovereign securities were the only source of High-Quality-Liquid-Assets (the LCR numerator) available, they would be less than half of the HQLA needed to reach a 100% minimum level for an overall LCR. So, the alleged 'sovereigns concentration conundrum' is not that big, and diversification tools should not constrain liquidity management.

We need to explore new approaches and policy tools, drawing on evidence and accumulated experience.

Second, banks' sovereign holdings are not static. They tend to move countercyclically, playing a potential loss-absorbing role during stress periods. This cyclicality can be explained by shifts in risk-return opportunities in balance sheets along the financial cycle. So, diversification should not become a source of undue procyclicality.

Third, the so-called 'bank-sovereign' nexus is mainly explained by macroeconomic factors such as GDP growth, industrial production, unemployment rates or, simply, country of location. That helps to understand why correlation of CDS premia between sovereign and banks tend to be not that different of CDS correlations between sovereigns and non-financial corporates. So, the logic of the 'diabolic loop between sovereign and banks' does not seem an argument to motivate diversification.

Fourth, concentration in domestic sovereign debt holdings – 'home bias' – is also observed in banks holdings of corporate debt and equity. Such a home bias also seems to move cyclically. So, diversification should be mindful of underlying structural economic factors.

Five, scarcity of 'safe-assets' or 'high-quality' sovereign bonds makes sovereign debt portfolios to be intrinsically concentrated when compared with other types of assets such as those in corporates or retail portfolios. So, diversification of sovereigns has its own natural limitations.

But the question remains: what is truly new and what can be done?

What is not new is that, as a result of the characteristics of banks' sovereign holdings, including their low-frequency high-impact risk features, prudential policy tools are not the right ones to incentivise diversification. They are likely to do more harm than good. If nonetheless, for a given reason, they have to be used, it should be ensured that their design and calibration minimise negative consequences for banks and economies.

One new thing, and a major breakthrough, is the issuance of bonds by the EU. This is the right type of policy tool to address the root causes of the 'sovereigns concentration conundrum' while considering the distinctive features of sovereign debt. To develop new tools to face new kinds of shocks as the ones we are experiencing, is a step in the right direction.

Finally, it may be worth to continue exploring ways to integrate sovereign debt diversification into the design of an EDIS – for example, as an element to determine contributions to the fund.

FRANCESCO CECCATO

Chief Executive Officer - Barclays Europe

As Banking Union progress slows, the importance of Capital Markets Union grows

As we gather in the beautiful surroundings of Prague, there are worrying storm clouds on the economic horizon for the euro area. At the time of writing, Barclays expects a mild recession in Q4 22 and Q1 23 as inflation-induced real income losses more than offset the support provided from low unemployment and high household savings.

It is therefore crucial that we get the policy infrastructure right to help banks and other financial services institutions support European corporates, helping them mitigate the worst of any impacts and return us to economic growth. In our view, this means a renewed focus on two main focus areas for policymakers: Banking Union and Capital Markets Union. Whilst there has been commendable progress on both, we must be more honest about the remaining challenges.

We were encouraged by the Action Plan the Eurogroup were considering and given it was not agreed in full, we think the Commission should look holistically at what it can do to make progress when it brings proposals forward later this year. All solutions should be considered here, and a new approach to the asset side, i.e. the harmonisation of lending products, is to be encouraged, rather than a singular focus on the liability side (principally deposits). Areas we would highlight include:

- OSII buffer: we need to ensure less heterogeneity in macro-prudential tools such as the O-SII buffer and this should be addressed in the macro-prudential review.
- Cross-border lending: more progress needs to be made in this space. There is a Eurogroup goal of facilitating a more integrated single market for banking services which needs to be advanced.
- We should also focus on the need to remove certain local jurisdictional differences. The fact that the MREL calibration for small and medium banks is typically decided by national resolution authorities, and thereby subject to different approaches to bail-in, can give rise to further level playing field issues.
- As previously noted in this publication, European Banking Union suffers from the continuing absence of an EDIS solution, which clearly lacks a unity of purpose given the availability of alternatives to fix the issue. That being said, the asset-side challenges are multiple and would need to be programmatically addressed by a concerted European effort.

It is crucial we get the policy infrastructure right to support European corporates.

On CMU, stronger, deeper and more liquid capital markets are achievable if we have a more honest, conflict-resolving approach to unification and realise that the capital market needs the kind of political support that EMU and Schengen benefited from. The opportunity is too great to be ignore. A recent New Financial report* measured EU member states against each other and identified an ambitious but achievable growth opportunity: pools of long-term capital could more than double, injecting around €14 trillion into the EU economy. To realise this opportunity, we must accept the fact that on average, bank lending represents 75% of corporate borrowing in the EU compared to approximately 25% in the US. Capital markets must therefore be capable of financing a greater proportion of the European economy.

A clear lesson from the many years of attempting to create a genuine pan-European capital market is that there remains too much national self-interest. Perhaps we are deluding ourselves that the EU can follow the US, where different parts of the country specialise in different sectors (West Coast for venture capital, Chicago for derivatives and commodities and NY for equity/bond trading). We urgently need a unified ecosystem if we are to unleash the power of the European capital markets, otherwise the EU will be left behind the US, UK and Asia.

The areas which should be given more focus include tax harmonisation; European bond issuance and the need for one area where this can be adjudicated; harmonised insolvency law; securitisation; reform of European primary markets; plus the various corporate governance issues and disparities across the Union. As progress on Banking Union falters, the importance of dialling up our ambition on these issues rises - we increase the efficiency of our cross-border banks and we diversify our economy's funding sources.

Recent geopolitical events tend to make us think initially about our domestic security – be that on energy, security or finance. In that context, no-one can disagree with the concept of strategic autonomy. However, it is crucial that we do not unintentionally limit access to finance for European corporates, as doing so will only restrict their ability to manage forthcoming headwinds. It is important that we widen and diversify the range of financing options available therefore strengthening the European economy, protecting jobs and facilitating growth.

Barclays Europe look forward to playing a constructive role in these challenges as we strive collectively to ensure a safe, strong and prosperous European economy.

A new vision for capital markets. New Financial February 2022.

CHRISTIAN EDELMANN

Managing Partner Europe - Oliver Wyman (UK)

Closing the value gap in European banking

The June Eurogroup gathering in Luxembourg promised to offer more clarity on integrating European banking and capital markets. Instead, it was widely seen as a disappointment.

While the work continues, the lack of progress shouldn't have come as a surprise. In times of geopolitical tensions, priorities change.

The war in Ukraine is feeding an already inflationary environment and an economy struggling to recover from Covid-related supply chain disruptions. As a result, concerns over fiscal stability in (Southern) Europe are growing, and the European Central Bank again is challenged to stretch its mandate to manage the widening of sovereign bond spreads.

How bad are things for banks in Europe? At first sight, the global financial services sector is in relatively good shape today and has been growing for the past several years. It has also shown remarkable resilience during the peak of the Covid crisis.

But growth and value creation have been skewed decidedly toward new players. In 2012, incumbent firms accounted for 90% of the total value of the financial services industry; today their share is just 65%, according to recent Oliver Wyman research (The Tectonic Shift Between Risk, Data, and Technology). Financial infrastructure and technology companies, or FITs, have begun to replace them, now accounting for 35% of the industry's value. While the top incumbent firms have increased their shareholder value by about $1.3 trillion over the past decade, according to Oliver Wyman research, the non-incumbents have increased their value by $3 trillion.

The vast majority of the FITs growth is taking place in the US and China, where the biggest technology firms there are piling into financial services. Europe lacks true "tech giants" and hence has seen more limited value creation thus far. As online wallets, digital tokens and the metaverse will eventually gain further ground, Europe is again at risk of standing on the sidelines.

The situation is especially bad for European incumbent banks. The market value of the top 20 banks in Europe at the end of 2007 was 58% greater than the top 20 US players; now it is 43% less. Annual profits of some of the largest US banks now exceed the market capitalization of a number of those banks in the top 20 back in 2007.

With the banking union not delivering the hoped-for panacea, what should European banks now do to address the value gap?

In the end, it will be up to European banks themselves to reverse the widening gap with US firms.

First, banks should not wait for the perfectly conducive environment for M&A, but rather should actively work with all involved regulators to achieve better synergies in cross-border M&A (Europe's banks can't ignore the M&A rush in fight with the US giants - Financial News (fn-london.com)). They should challenge domestic ring-fencing practices in the Eurozone — in particular, by pushing for cross-border liquidity waivers, which national regulators can grant. Along those lines, banks should push domestic resolution authorities to not add MREL (minimum requirement for own funds and eligible liabilities) requirements to local subsidiaries of banking groups on top of the MREL requirements made by the Single Resolution Board.

Longer-term, European banks need to challenge their core business models. Yes, we have seen various rounds of restructuring and digitization at all European banks since the global financial crisis. But at their heart they are set up across traditional client-oriented silos (such as retail or wholesale banks or wealth management divisions), with the majority of their revenue streams reliant on risk intermediation. While rising rates now help these businesses, this is not enough to change the fortune of European banks.

These incremental revenues can create additional ammunition to finance a transition into the future — that is, to venture more deeply into technology, particularly data. Value technology services (such as payment, banking/insurance-as-a-service models or digital assets) are getting earnings multiples of 20 to 30, while connected data services (such as wallet services, connected ecosystem services for mobility, employment, education, commerce, or climate risk data) enjoy multiples of 30 to 40. Traditional risk intermediation businesses, by contrast, have multiples of just 10 to 20.

Transitioning to the future will require more than an innovation lab — companies must undergo sweeping organizational change, turning these platforms into primary or at least equal reporting lines, with future leaders being groomed in these leadership positions.

In the end, it will be up to European banks themselves to reverse the widening gap with US firms. Those that show they can change are likely to find eager support among investors, regulators and prudential authorities across Europe.

PIER CARLO PADOAN

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Banking Union: the way forward?

There is no doubt the completion of the banking union depends on some complex and controversial issues. Even so, the failure of Member States to agree a way forward is disappointing. Not only was there no agreement on EDIS, there was no progress on the actions to achieve a true single market. This is a problem for cross border banks and the further integration of the EU banking sector.

A true Banking Union is key to ensure European banks can efficiently fund the European economy; continue their transition to green energy; embrace a digital future; develop private sector risk sharing; and reinforce financial stability in the Eurozone. It is equally important for the competitiveness of European banks, not only vis a vis foreign banks that have single, much deeper and more efficient domestic markets, but also with respect to new players.

Support of a more efficient flow of liquidity and capital between subsidiaries of the same banking group is critical. Cross-border groups should manage their liquidity and capital at a consolidated level, rather than for each individual subsidiary.

For the time being, one pragmatic solution lies in how supervisors of Europe-based banking groups apply pillar 2 requirements. They could take into consideration the risk profile of each subsidiary and its capital levels, rather than automatically mirroring requirements at a consolidated level. This approach would also not require legislative changes.

Another quick win would be a review of the policy governing the liquidity waivers. The SSM should amend the ECB policy which grants liquidity waivers for cross border groups to make it more flexible and easier to access for banks.

Finally, the revised methodology to calculate whether a bank is a GSII lacks rationale. If it rightly acknowledged that exposures within the euro zone should be treated as domestic exposures and therefore should not be a relevant indicator for the cross jurisdictional activity of a bank, it is not clear why a bank cannot be removed from the list of GSIIs by applying this methodology.

These changes would better reflect the reality of the Eurozone banking sector and remove an important obstacle to the free flow of capital and liquidity within cross border banking groups.

But to solve many of the current ring-fencing practices legislative changes are needed (either at EU or national level or at both). In the Union the vote of a majority of the Member States would be required.

It's critical to find pragmatic solutions to support a more efficient flow of liquidity and capital.

So far, every attempt to introduce cross border prudential requirements waivers or reduce discretions in terms of infra-group large exposures has failed. Countries whose banking sectors are dominated by the subsidiaries of foreign banks (host countries) fear that a crisis in the parent company could result in a liquidity drain and thus impact the host country's real economy.

The existing intra-group support actions within Group Recovery Plans of Single Entry Point resolution groups should provide sufficient reassurance that a parent company would support a subsidiary in case of crisis. The reputational cost of not doing so should alone give enough comfort to host countries.

However, this is not the case. We need solutions to reassure host countries that they would not be responsible for saving the subsidiaries located in their countries.

While the political debate has shifted away from arguing that the only possible solution would be the establishment of a fully-fledged European Deposit Guarantee Scheme (EDIS), there are several proposals which have been recently debated by regulators: i) a mandatory waterfall payment scheme; ii) the introduction of legally enforceable unconditional parent - subsidiary guarantees and iii) the transformation of legal entities into branches.

Branchification is the best solution, allowing capital and liquidity to be moved across borders without significant constraints. Legal obstacles to branchify subsidiaries dedicated to retail activities and the reticence of host jurisdictions could be overcome by moral suasion by the SSM.

Two years ago, the German Finance Minister proposed allowing capital and liquidity to freely flow intragroup in normal times while creating a waterfall payment scheme that clearly sets out in law how available funds should be distributed to the subsidiaries in host countries in times of crises. This should be revisited.

As for the bank crisis management and deposit insurance (CMDI) framework, there is a case for the harmonisation of the creditor hierarchyas well as the harmonization of the Least Cost Test. This last change would enhance the chances of using Deposit Guarantee Schemes (DGS) funds in early intervention and resolution to avoid atomistic liquidations of banks and reduce the costs for the national DGS itself.

To the same end, the State aid framework should clarify that private DGS' resources used in preventive and alternative interventions, when executed outside a public mandate, are not to be conceived as State aids.

COMPETITIVENESS OF THE EU BANKING SECTOR

SYLVIE GOULARD

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The profitability challenge of the European banking sector

Since the Great Financial Crisis, the EU banking sector has been going through considerable changes. One of those has been the sizeable increase in capital and liquidity reserves, which have made banking institutions stronger and safer as illustrated during the COVID crisis, where they were able to service the real economy in times of stress. However, the profitability of EU banks has stalled at a depleted level, especially in comparison to US banks which consistently generate larger returns on equity.

The reasons behind this gap are manifold and before delving into the details, it is necessary to mention that if banking institutions on both sides of the Atlantic share the same economic mission, they do not share identical market and institutional settings, which reflect into different business models. Helped by a deep and integrated capital market, that provides with 71% of corporate funding (vs 35% in the Euro area)[1], US banks follow an originate-to-distribute design, where less risky assets are sold on the markets while the riskiest are kept on the balance sheet to generate revenue. By contrast, EU banks retain most of the assets they originate on their balance sheet. Moreover, this originate-to-distribute model benefits from a large investor pool given the capitalization retirement system, whereas EU banks operate mostly in countries with defined benefits schemes. Those differences in dynamism, risk profile and market depth are not a problem in themselves as the revenue generation divergence fades off when adjusted for risk, but it explains a part of the profitability gap when coupled with the larger cost base of EU banks.

Another structural cause behind the EU banking sector' low profitability indeed lies in its fragmentation and overcapacity: the top 5 EU banking groups concentrate 23% of the continent's total assets, while that figure is 43% for the US top 5[2]. Despite the progress made on the Banking Union and having a few large banks being active across European borders and internationally, most EU banks remain active in their only domestic markets and cannot benefit from large economies of scale. Capital markets also remain confined within borders and are not deep enough to allow EU banks to compete on global markets or to manage their balance sheet more dynamically.

While more resilient since 2008, EU banks still have to find their way to stronger profitability.

Cyclical causes add to these structural features. The first one relates to the gap in economic dynamism between the US and EU economies: banking profits strongly correlate with economic growth and US GDP figures quickly rebounded after the GFC while the Eurozone crisis hamstrung prevented a quick economic rebound in the EU. Second, while the accommodative monetary policy followed by the ECB since 2014 had positive impacts on banks (i.e. lower cost of risk, marked-to-market gains or economic growth), it has depleted their net interest margins, which represent around half of their source of revenues. On the contrary US banks never faced negatives nominal interest rates and rather have benefited from rates' increases between 2014 and 2018 (even if they returned to 0% during the pandemic).

The profitability issues constitute a risk for the European financial stability and sovereignty. Indeed, banking profits are key for the capital trajectory, being a key generator of capital reserves, and banks failing to generate a return above their cost of capital might struggle to tap the markets when in need of capital. This is especially true at a time where a significant amount of financing is needed for the adaptation of the European economy landscape to, among other, the ecological transition and digitalization. Having efficient local corporate and investment banking services such as debt & capital issuance or structures finance is also important considering the risk of overseas banks shutting down their European activities in case of market turmoil and thus threatening corporate access to vital resources.

To mitigate the risk posed by weak EU banks' profits, several levers are usable. As fragmentation and the lack of economies of scale stand as a key cause, the removal of obstacles to cross border activities and mergers should be a priority for public policy. This includes the finalization of the Banking Union through the creation of a European wide deposit insurance framework and, where possible, the closure of national discretions and home bias. Moreover, given its complementarity with the Banking Union and its spillovers on banking profitability, the new impetus given to the Capital Markets Union by the 2020 European commission's action plan is a welcome development.

Once consolidation initiated, EU banks will be able to close the profitability gap arising from their high-cost base through cost reduction and digitalization programs they are engaged into.

[1] https://www.institutmontaigne.org/en/publications/reinventing-european-banking-sector#

[2] https://publications.banque-france.fr/sites/default/files/medias/documents/821129_bdf235-2_en_consolidation_vfinale.pdf

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Mind the gap: the competitiveness of European banking

Creating a more globally competitive economy has, rightly, been one of the long-standing political priorities of the EU, in recognition that enhanced competitiveness drives gains in productivity and growth, thereby improving the lives of citizens across the Union. The development of more efficient financial markets and competitive institutions is one part of that equation, helping to ensure the smooth flow of finance from investors to businesses seeking capital and contributing to a more dynamic economic environment. In this regard Europe however continues to be a laggard compared to other large banking markets. The reasons for this competitiveness gap can be attributed to both cyclical and structural factors.

Considering cyclical factors first, relatively weak economic growth has proved to be a hindrance for the competitiveness of banks in Europe, manifesting in lower profitability. Over the past decade average annual GDP growth was 0.9% in the euro area, compared with 2.1% in the US[1]. This led to stronger organic business growth opportunities for banks in the US, indirectly supported by borrowers' improved creditworthiness and lower impairments. Conversely European financial institutions suffered from the double-dip recession caused by the 2010-12 sovereign debt crisis.

The divergence of monetary policy over this period has also played its part. While the ECB and Federal Reserve both pursued expansionary monetary policies after the 2008-09 global financial crisis, the US started hiking rates from 2015. The ECB's main policy rate has remained close to zero since 2016, combined with negative deposit facility rates. While this has supported banks' funding costs, and indirectly helped to address non-performing loan ratios, low rates in the euro area have led to a significant contraction in the net interest margins of banks – which is critical to profitability.

Perhaps more interesting from a financial services policy-maker's perspective is the impact of structural factors on bank competitiveness. While aggregate non-performing loan ratios have declined in Europe, the US moved faster and more effectively to clean up its banking system in the wake of the global financial crisis. The lack of a coordinated European approach to government-backed 'bad banks' proved to be a particular missed opportunity.

Achieving a single market would allow Europe to seize the chance to finance the transition to net zero.

A fragmented domestic banking market continues to hold back European banks from realising economies of scale, resulting in higher average cost-to-income ratios and insufficient scale to compete effectively. An incomplete Banking Union means there are still barriers to cross-border consolidation in the form of capital or liquidity ring-fencing. National supervisors, for example, retain the power to stop banks branching into their territory and can require capital add-ons, such as systemic risk or counter-cyclical buffers, which make cross-border activity a less appealing prospect.

Despite laudable recent harmonisation efforts, the economic rationale for retail banking integration in Europe faces natural barriers from different legal and tax frameworks, in addition to obvious language issues, which hinders much cross-border activity and meaningful synergies. Chronic over-capacity, despite reductions in the number of high-street branches as banks have responded to consumers' preference for online services, has exacerbated the problem with little appetite from national authorities to countenance market exits by failing banks. Retail banking in Europe has, in other words, remained stubbornly national in nature.

Finally, Europe is held back by relatively shallow capital markets, thereby missing out on the benefits of greater liquidity. Various Capital Markets Union initiatives have helped to make in-roads, but there has been insufficient progress on increasing the use of securitisation. As such, European financial institutions tend to keep less profitable assets, such as mortgages, on their balance sheet rather than distribute such assets through credit transfers. The latter is a common feature of the US market, where banks can leverage both the depth of the capital markets as well as the implicit government guarantee mechanisms from US federal agencies, which are largely unparalleled in Europe.

Facing into these twin challenges, cyclical and structural, Europe has a choice. It can continue to allow the fragmentation – which, it should be acknowledged, has its benefits in the shape of retail banks exclusively focused on and attuned to local communities and their needs – or it can double-down on existing efforts (like the Banking Union) to address the causes of market fragmentation.

Achieving a single, coherent market would allow Europe to seize fully the opportunity presented by its early leadership on financing the transition to net zero and to channel international investments into the European economy. That, surely, is a prize worth grasping?

[1] World Bank, 2012-2021 https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2020&locations=XC-US&start=2010

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Mind the gap! Ways of active transition for the EU banking market

Arising from the financial crisis in 2008 the supervisory focus was clearly set on strengthening the crisis resilience of the EU banking market. This is probably best seen through the creation of the Banking Union, encompassing the Single Supervisory Mechanism and the Single Resolution Mechanism. In addition, European supervisors managed to steadily increase the capitalisation in the Euro Area to up to 19.5% in Q4-2021 for significant institutions; well above for example the US banking market with 15.2% in Q4-2021. However, in other areas, EU banks are still lacking behind its US and Asian peers. This concerns in particular the stake of European banks in the corporate investment banking area.

On a global level, but also in Europe itself this segment is dominated by US banks, which outperform their European peers in terms of pricing, technology and economies of scale. This discrepancy is sometimes referred to as one reason for the differences in profitability observable between US and EU banks. While the cost income ratio in the Euro Area averages 66%, US and Asian competitors with a CIR of 61.8% and 40.9% respectively are on average more profitable. This holds true even though personnel expenses are on average higher in the US than in the EU. Here, one may ask several questions: First, what drives these differences and second is there a need for "European champions" in the investment banking area?

Focusing on the first one, here the crucial differences in capital markets and banking sectors between the EU and the US come into play. US companies rely much more on capital market financing than EU companies, which naturally drives up the demand for investment banking services. In addition, securitisation in the US is by far more important in terms of volume than in the EU, not least because of Fannie Mae and Freddie Mac, two government-sponsored enterprises dominating the US securitisation market. EU banks in turn focus more on traditional lending business and finance themselves via deposits. These fundamental market differences are, however, only part of the answer. Another crucial aspect is a European banking sector still fragmented along national borders.

In light of pressures towards cost efficiency, an evolving risk landscape and competition pressure from global competitors, it could be argued that there is not enough consolidation taking place in the EU banking market. One reason to this is a still incomplete Banking Union, where the common deposit guarantee scheme constitutes the last missing corner stone.

European investment banking is needed to fund the transition to a green and digital economy.

Another crucial aspect is a rule book, which is not as single as it seems. Due to the national implementation of EU Directives, national discretion in the application of common rules is still widely possible, hampering thus the formation of a true single market. Fraqgmentation in European banking market is promoted not least by obstacles that do not come directly from banking regulation. All these factors put together put EU banks in a disadvantageous position towards their US peers when it comes to competitiveness, especially in the investment banking business.

Let me now turn to the second question, i.e. do we actually need European champions for investment banking services? Let me answer this question with a full-hearted yes. Climate change and the transition to a green economy as one of the many challenges Europe is currently confronted with requires an enormous amount of long term investment. These funds will need to be mobilised globally and channelled to those projects (like for example dedicated green tech industrial complexes) bringing the most value added to both the environment and investors. If this intermediary role is not filled by EU banks, Europe will become completely depended of foreign funds provided by foreign banks to finance its transition.

The final and crucial question thus would be how do we foster the role of EU banks in investment banking? First, further harmonisation of financial regulation, and most prominently the completion of the Banking Union, is needed in order to support European cross-border banking as well as M&A's, leading in turn to increased efficiency. Further to that, banks require a digitalisation strategy, permitting them to address existing cost inefficiencies, scale up their business and support the adaptability of their business model in light of changing customer and investor behaviour. Finally, further initiatives to boost European capital markets are needed in order to allow for more market-based finance.

All in all there is still considerable way ahead of us until the European banking sector can compete with its US and Asian counterparts on equal terms. I am, however, confident that a transition towards a truly integrated European banking sector is doable; Europe definitely needs one to cope with the challenges of the future.

NICOLETTA MASCHER

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Diverse, green, and agile: an investment-friendly banking landscape for Europe

Performance metrics show the euro area banking sector does not compare favourably with other major jurisdictions. Profitability is the weakest spot with return on equity being close to half that of US and Chinese competitors. The cause of such disparity is not easily traceable; efficiency metrics are a case in point. Rationalisation of business structures and digitalisation of processes have already brought about significant efficiency gains; however, operating expenses remain relatively high, as the production cycle cannot generate adequate return on assets.

The industry size and concentration indices do not fully explain the underperformance of euro area banks either. While bank assets are nearly three times GDP figures in China, they are approximately twice the size of the euro area economy and close to the level of economic output in the US. Some national markets in the euro area are more concentrated than in the US or China, but there are considerable disparities across big countries.

The question is whether performance and concentration are the right metrics for competitiveness. A finer analysis should look at the value banks can offer to customers and the constraints they face (e.g., regulatory).

One clear disadvantage is weak market integration. The global financial crisis has scarred cross-border activities. While peers in other jurisdictions rebuilt their cross-border positions a few years after the crisis, euro area banks permanently reduced their international activities.

Despite efforts towards establishing banking union, the European banking sector remains segmented along national lines. Regulatory requirements for liquidity and capital at solo level limit banks' possibilities to optimise resource allocation, preventing banks from exploiting economies of scale and the benefits of risk diversification.

Euro area banks are well placed to support the twin transition.

Banks could also better compete in a more integrated European capital market with wider opportunities to serve a diversified demand. In such an investment-friendly market environment, banks could better serve the needs of firms with little or no alternatives to bank financing, while other corporates could tap into a wider range of funding sources and a larger investor base. To this end, a deeper market for securitisations can help. While US banks continue to actively manage balance sheets via securitisations, asset portfolio choices for European banks are quite limited. Deepening this market with the right incentives and safeguards would open opportunities to improve efficiency and free up capital for lending.

Euro area banks are well placed to support the twin transition

There is one aspect where Europe has recently advanced faster: the green transition. European banks have been actively incorporating climate-related risk considerations into their mandates, thanks in part to strong supervision. In contrast, US banks seems to have taken a more passive stance. Europe's more conscious approach may deepen differences in the short term, while ensuring a longer-term advantage for European banks over foreign banks and their growing EU branches.

To accelerate progress, European banks can also scale up their digitalisation efforts and adapt business models more decisively to serve a growing new type of demand. Compared with the US, euro area banks have invested less than half into information technology in 2020. Euro area banks must anyhow speed up digital transformation to achieve sustainable cost efficiency in the long term.

For Europe to be able to effectively compete with peers, playing fields need to be levelled. To achieve this, the completion of banking union and progress on capital markets union are essential conditions. However, the full removal of obstacles to optimal resource allocation will only be possible once the European safety net is complete and capital markets are integrated. The introduction of the ESM backstop to the Single Resolution Fund and the establishment of the European Deposit Insurance Scheme are essential steps to that end. The revival of securitisation activity, by streamlining the related regulations and harmonising national insolvency laws, would help banks in a more effective capital management.

Europe probably does not need many global megabanks. Although they seem to perform better by standard measurements, the fact that orderly resolution for global banks remains an unsolved issue casts doubt on the superiority of their financial stability. Moreover, there is a clear need for healthy competition and diversity in the banking sector to protect customers and serve domestic needs, something quite versatile in Europe.

IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK

EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board - European Central Bank (ECB)

Facilitating orderly market exit in the EU crisis management framework

There has been a consensus for some time now at the Member State level that the next practical step towards integration of the European banking market should aim to improve the crisis management framework. At the ECB, we are convinced that useful progress can be made towards making the present European framework more efficient and furthering its basic approach so as to protect public funds without any need for additional contributions from the banking industry. The amounts earmarked for the crisis management framework in Europe are already comparable to those in the United States, so reaping the benefits from increased use of such funds has the potential to reduce crisis costs and, ultimately, the burden for both public and private contributors.

The key will be to focus on measures that make it possible to manage an orderly exit from the market for troubled banks of all sizes through both resolution and liquidation, without economic disruption or indirect forms of bailout by public authorities. By avoiding fire sales of assets, orderly exit reduces the burden that the industry has to bear. It also allows for a healthier banking market; preventing continued activity by "zombie banks" benefits all market participants.

For resolution, this could be done by facilitating access to the Single Resolution Fund (SRF). The ECB supports the IMF recommendation of a possible financial stability exemption. A similar argument can be made for situations where the resolution authority decides that a failed bank needs to exit the market. In such cases, we think consideration should be given to the idea of allowing deposit guarantee scheme (DGS) funding to be used to unlock access to the SRF by helping to finance a possible shortfall below the intervention threshold.

European harmonisation can make the crisis management framework more efficient.

In liquidation too, we favour allowing broader scope for DGS interventions when the objective is to allow an orderly exit from the market. We see strong merit in harmonised European principles allowing DGSs in all Member States to contribute to preventive, alternative and exit measures. For preventive interventions, it will be important to ensure a level playing field between DGS and institutional protection scheme (IPS) interventions, in particular in the way we recognise their contribution to lessening the costs of interventions after the fact. We recommend clarifying and harmonising the least-cost test as a way of promoting alternative exit funding measures once a bank has passed the stage of failing or likely to fail (FOLTF).

We therefore favour a common EU basis for calculating this test, taking into account a broader concept of the costs of a pay-out scenario. We also support limited harmonisation of national creditor hierarchies in liquidation, as these are key to determining the least cost. Instead of a limited DGS super-preference, in our view a more general depositor preference should be introduced. This would support the level playing field across the whole of the European Union and facilitate resolution by reducing the complexity of the "no creditor worse off" test. Both these elements would also enhance DGSs' capacity to contribute to the funding of resolution strategies.

As the rationale of all these proposals is to facilitate exit from the banking market, it is of course essential that the competent authority can ensure exit in all cases. The resolution authority can do this. The supervisor should be able to do so as well, even in situations where the trigger for national insolvency proceedings may not be met. While the role and powers of the supervisor in these situations could also be a field for further harmonisation of national legislation, market exit by a credit institution can be ensured by withdrawing its licence. This is why the ECB very much welcomes the amendment in the Commission's CRD VI proposal allowing the supervisor to withdraw a licence in all cases where banks are FOLTF and encourages legislators to support it.

In the interests of efficiency, the supervisor needs to retain discretion in assessing the timing and conditions of withdrawal, in particular so this can be combined appropriately with possible support measures from the DGS. Automatic withdrawal would make much it more difficult to arrange an orderly exit, as the supervisor would be obliged to take a decision that puts an end to its authority and powers over the institution.

At the ECB, we are convinced that the best way to make practical progress towards the integration of the European banking market is harmonisation which allows a combination of flexibility on means with clarity on the objective of market exit.

DOMINIQUE LABOUREIX

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

Let's work resolutely on resolution

The adoption of the European resolution framework in 2014 was an essential landmark providing for a unique harmonized crisis management model for the EU banking sector. While resolution authorities are vested with strong powers and multiple tools to address banks' failures, experience from past years also highlighted these powers and tools were not entirely used for some failures in Europe involving mid-sized banks, initially considered as too small for resolution. As a result, these failures have been handled outside the resolution framework, through non-harmonized national paths that proved not always aligned with the resolution core principles, in particular because of the recourse to public funds.

This situation raises important consistency issues: the same banks that did not go into resolution, because of the absence of a "public interest", eventually benefited from external support in national liquidation proceedings, justified by financial stability objectives. These liquidation cases have highlighted different definitions of "public interest" hampering the initial objective of the crisis management framework: to reduce moral hazard by implementing the principle of letting shareholders and creditors absorb losses, and recapitalise when necessary.

Moving forward, there is a need for important adjustments both to the resolution and to the liquidation frameworks.

On the one hand, the harmonized resolution mechanism should apply to a larger scope of banks – including smaller ones. Broadening the scope of the public interest assessment might require some targeted adjustments for some specific institutions, such as the ones funded exclusively by deposits. Resolution authorities have indeed logically focussed their initial efforts on resolution planning for larger banks, in particular by developing bail-in strategies. In the light of past crisis cases, "closed bank" transfer strategies should be further operationalized, and the use of DGS in resolution could be expanded to facilitate the funding of such strategies. However it is clear that adequate MREL capacities remain the most efficient way to enhance depositors' protection and a successful market exit in the event of a failure.

On the other hand, crisis management avenues at a national level that rely on national liquidation frameworks need to be further harmonized to ensure more consistency. Also for one reason relevant for resolution: the key principle "No creditor worse off" in resolution is assessed against liquidation rules.

A response to fragmented crisis management: resolution for more banks.

First, national creditor hierarchies could be further aligned, in particular as regards deposits, in order to increase level playing field among deposit-taking banks and to facilitate resolution in a cross-border context. These targeted changes to creditor hierarchies should also allow for a broader use of DGS in resolution, by easing the least-cost test, thus contributing to make resolution work for a wider scope of banks.

Second, it should not be possible to use external funding (DGS alternative measures, State aids) in liquidation to protect creditors who would otherwise have shared the burden in resolution. External funding in liquidation should be circumscribed to the protection of deposits only, with burden sharing requirements similar to the ones in resolution. The revised framework should avoid situations in which failing banks with a negative interest to resolution receive State aid in the context of national insolvency proceedings, based on grounds already assessed during the PIA. A negative PIA for resolution is a strong indicator to limit State aid in liquidation.

Last, it would be good preserve room for an orderly winding-up, taking the form of run-off management, provided that strong safeguards are associated with this process (in particular sufficient burden sharing requirements and an effective market exit), to avoid so called "limbo situations". Such an orderly phase-out proceeding could be included in the resolution toolbox, in line with what the Commission has recently proposed for the resolution of insurance undertakings.

As a consequence, also taking note of the conclusions from the Eurogroup June meeting, one can legitimately wonder if the priority, both at European level and in the context of the UNIDROIT project, is to create new instruments such as administrative liquidation regimes that would unnecessarily duplicate the resolution framework.

Instead, **an immediate step to take is to work on strengthening the only existing common framework, namely the resolution framework, so as to ensure it can be applied consistently to more banks.** The current review process is the perfect occasion to reshape and strengthen some of the building blocks of the CMDI, such as the public interest assessment or the funding arrangements, together with some features of liquidation proceedings, before new steps can be taken in the consolidation of the Banking Union.

GIUSEPPE SIANI

Head of the Directorate General for Financial Supervision and Regulation - Banca d'Italia

Towards a more efficient and effective crisis management framework in the EU

Ten years after the launch of the Banking Union, its architecture still remains unaccomplished with respect not only to the EU single deposit insurance scheme, but also to some features of the crisis management framework. Despite the progress achieved by the Single Resolution Board (SRB) in enhancing the resolvability of larger banks, some shortcomings hinder both the effectiveness and the efficiency of the framework.

- As to the effectiveness, the main goals of the framework are not fully achieved yet. The objective of ensuring a level playing field is frustrated by the fact that in the euro area a resolution strategy only applies to 200 out of about 3000 banks, the rest being subject to a vast and diverse array of national insolvency procedures. The goal of ensuring a smooth exit from the market may be hampered by the fact that in some jurisdictions failing financial intermediaries are liquidated under the same procedures applicable to non-financial corporations. The goal of avoiding bailouts is contradicted by the frequent use of public resources by Member States that have no viable alternatives to avoid financial turbulence.
- As to the efficiency, the resources collected by the two industry funds established by the EU framework are potentially not trivial[1], but remain idle due to legal constraints embedded in the EU directives that limit their use. The single resolution fund (SRF) may be used only in resolution and provided that at least 8% of liabilities have been bailed-in: the SRF is thus unusable when the prescribed minimum bail-in would trigger contagion effects or exacerbate financial turbulence, like in a system-wide crisis or in case of distressed banks with large deposit base. In most Member States deposit guarantee schemes (DGS) may only be tapped to repay covered depositors during value-destroying piecemeal liquidations, but not to fund the transfer of the failed bank's assets and liabilities to viable third parties. Even in jurisdictions that foresee this possibility, the DGS super-senior ranking in the creditors hierarchy still makes the repayment of covered depositors the less costly – hence, the only viable – option.

Industry funds should play a greater role to support failed banks' smooth exit from the market.

To improve the framework, small and medium sized banks (for which currently resolution is not in the public interest) should be able to exit the market without repercussions on financial stability while preserving their franchise value. To achieve this goal, a greater role should be played by transfer strategies, financially supported by industry funds. In particular, to unlock the resources in national DGSs, the current creditors hierarchy should be amended to introduce a general depositor preference (where all depositors would rank pari passu). This would allow the EU to incorporate some of the key features of the approach successfully applied by the FDIC for almost a century in the USA (and by the domestic DGS in Italy).

One of the most debated question is whether small and medium sized banks should be subject to a fully-fledged MREL requirement, along the lines of large institutions, and have adequate internal loss-absorbing capacity to be resolved without external support. In the USA, the answer is a clear-cut "no": as flatly put by a FDIC senior manager, "the Deposit Insurance Fund has been our MREL"[2]. Indeed, requiring these banks to build up MREL buffers would put their business model at danger, as they are typically funded by retail clients and depositors: therefore, a proportionate approach would be key to preserve some bio-diversity in the EU banking system.

Moreover, the lack of a (or a reduced) MREL requirement for small and mid-sized banks would not necessarily foster moral hazard, since their creditors are usually unsophisticated agents that are not in the position to effectively monitor their bank counterparty. Moral hazard concerns could be efficiently addressed by a risk-based contribution system, whereby each intermediary would contribute to industry funds in function of the probability that it may need their support.

The envisaged approach would add one critical instrument to the toolkit already available to both the SRB and national authorities without amending their competence at this stage. In the longer run this approach could also pave the way to EDIS, the ultimate goal of the Banking Union, possibly merging with the SRF. Indeed, implementing a framework that can successfully deal with the crises of all types of banks might reassure all Member States that mutualized resources are used in the most effective and efficient way.

[1] The SRF and national DGSs collect an amount equal to 1,8% of the covered deposits (euro 144 billion by the end of 2023).

[2] Arthur J. Murton, "The FDIC approach over time to the crisis management of small and medium-sized banks" in "The crisis management framework for banks in the EU. How can we deal with the crisis of small and medium-sized banks?", workshop organized by Banca d'Italia on 15 January 2021 (available at www.bancaditalia.it).

JUAN POSWICK
Head of Recovery and Resolution - BNP Paribas

Towards a more harmonized bank crisis management framework?

A truly harmonised and integrated framework for managing bank crises is essential for preserving trust and financial stability. Over time, it would also help reducing the excessive fragmentation of the banking sector in the EU.

The broad principles agreed by the Eurogroup in June 2022 are generally welcome. It should however be underlined that a true harmonisation of key principles such as Public Interest Assessment (PIA) or Least Cost Test (LCT) will only be achieved if their implementation stands under the direct responsibility of EU authorities. Leaving it at national level can only lead to diverging courses.

The opening of resolution to viable medium size banks with a positive PIA assessed at EU level makes sense too. Immediately thereafter though comes the question of how to fund that resolution for medium size bank and the idea that DGSs might play a role in it. The question is a bit surprising and the proposed solution even more.

As recently reminded by Mrs König at the joint ECB-SRB conference of end June, resolution must be funded through MREL. There is no reason to depart from that basic principle and it is the duty of resolution authorities to set appropriate MREL targets to all the banks potentially subject to resolution. It has been empirically demonstrated that even very small banks were able to issue Eligible Liabilities (EL). So why would medium size banks not be able to do the same?

It is understood that some banks are well capitalised essentially with CET1 instruments. If that is sufficient to meet MREL requirements, why adding further constraints? They should only be bound to keep their CET1 at the required MREL level or, were it to decline, to replace it with newly issued CET1 or EL. In the case of decline below the required MREL level without replacement, the M-MDA mechanism should apply first. If the situation deteriorated further there should be a mechanism allowing authorities to trigger recovery actions or to declare the bank in question Failing or Likely to Fail, even if the CET1 level is still well above the minimum prudential requirement of 4.5% of RWAs. In other words, banks potentially subject to resolution that stick to CET1 only for their MREL requirements must accept higher than standard CET1 requirements. In this way, an other key principle underlined by Mrs König, Same Business - Same Risk - Same Rule, would be respected.

Resolution must be funded through MREL. There is no reason to depart from that basic principle.

As several medium sized EU banks that would potentially be subject to resolution have apparently not yet built up appropriate MREL levels or have not even been notified MREL targets commensurate to resolution requirements, a transition period of a few years should be foreseen.

Using DGSs to fill funding gaps and allow resolution of medium sized banks goes against their very purpose. These are schemes primarily conceived as safety nets for covered deposits. They are also funded by the industry, i.e. mainly by the largest and soundest banks in a given country. Consequently, any relatively intensive use of them in resolution would constitute a burden for the sound part of the sector to resolve failing competitors that would not have built up sufficient MREL. In fact, that would be a form of bail-out by the sector. This would not only raise serious questions of level playing field but could also threaten financial stability. In that sense, mutualised resources should be managed as parsimoniously as taxpayer money and LCT should strictly and consistently apply.

The idea that DGSs might be used to fill the gap and reach the minimum burden-sharing of 8% of Total Laibilities and Own Funds necessary to access the SRF would double up the issues, bringing them at Banking Union level in addition to national one.

If any, possible flexibility to use DGSs in resolution should be limited to the above-mentioned transition period of a few years (e.g. 4 years maximum) and only for banks that would not have been notified MREL targets before the change in policy. The maximum relative intervention per concerned bank should gradually decrease to the end of the transition period. There should also be a limit per DGS relative to its size.

On the other hand, the use of DGS to facilitate market exit of failing banks not subject to resolution is a logical one. It should well remain subject to LCT while market exit should clearly entail a true reduction of offer (branch closures, brand disappearance, ...), not the extension of the offer of an acquirer.

Finally, changing the creditor hierarchy to ease the LCT and extend the potential use of DGS would be a step in the wrong direction. Besides already mentioned issues, it would entail moral hazard for creditors, potential liquidity risks through increased volatility for banks and open the door to further deviations from the basic principles of the SRM.

KARL-PETER SCHACKMANN-FALLIS

Executive Member of the Board - Deutscher Sparkassen- und Giroverband (DSGV)

IPS provide financial stability to the Banking Union

Being small or medium-sized less significant institutions (LSIs) in their vast majority, over 99% of the German Sparkassen do not qualify for resolution. It is also highly unlikely that one of them becomes insolvent – not the least because of the well functioning institutional protection scheme (IPS) they adhere to. Its support measures work in a preventive manner before any of its member institutions are declared failing or likely to fail (FOLTF). While the IPS falls under the regulations of the DGSD it could provide depositor compensation, but this is merely a formal last resort.

Consequently, we very much welcome the Eurogroup Statement dd 16 June as it recognises the stabilising role of IPSs. More precisely, it captures their specific relation to the CMDI Framework by stating that its review needs to preserve "a functioning framework for IPS to implement preventive measures".

In addition, Europe's Finance Ministers used the statement to provide further meaningful guidance on how to advance on the Review of the CMDI framework, a topic with high potential for controversy. Now, it will be on the European Commission to come forward with a suitable and balanced proposal. For this, it can build on prior work undertaken in the last two years. However, in the light of the Eurogroup Statement, a careful re-evaluation of that work will be essential. The Commission will have to proceed with prudence, as only a balanced proposal will be able to enable a consensus on the review by the end of this legislature. Far-reaching changes to the framework will be detrimental to that task.

The question of expanding the scope of the resolution regime to mid-sized banks is one of the crucial issues. Clarity on whether a failing institution is undergoing resolution or being sent into national insolvency is paramount. Increased transparency on the criteria for the Public Interest Assessment would be welcome in that regard.

The crisis management framework benefits from taking into account EU's banking sector's diversity.

However, with a larger scope, the question of the necessary funding of resolution cases is on the table. Medium-sized banks that are mainly deposit-funded might face a disadvantage compared to capital market-funded banks when holding sufficient MREL. As this is linked to the possibility to access the Single Resolution Fund, there are considerations for using deposit guarantee schemes (DGSs) to finance the resolution of mid-sized banks instead. However, there are certain risks involved:

- The Eurogroup clearly decided against pursuing a European deposit insurance scheme (EDIS). It is clear that concentrating competencies on deposit insurance at European level would not be in accordance with this decision. Therefore, if a national DGS is to be used to fund a mid-sized bank in resolution, then it needs to be one of its member institutions and the framework for this intervention will have to be carefully calibrated.
- The DGSD already provides for the flexible use of DGSs. With Alternative measures and the possibility of preventive measures as used by IPSs, DGSs can be used for measures other than the pay-out of secured deposits. These measures have proven their value as they help to ensure the continuation of a bank's business relations to its customers. Against this background, we do not see merits in or the feasibility of a harmonised least cost-test, which would just hamper their functioning.
- Further widening the access to and the use of DGS funds for resolution comes with the high risk of undermining depositors' trust – even more so, if unwarranted changes to the creditor hierarchy increase the likeliness of such events.

It is high time that the European Commission puts forward less controversial issues than EDIS that are more important for financial and capital markets integration and promise faster results. Considering how contentious the discussions on the Banking Union are, the European Commission would be well advised with regard to the CMDI review to properly take into account the diversity of the EU's banking system. For LSIs, the upcoming review could look at ways for a targeted harmonisation of national insolvency rules for banks. Additionally, the review should ensure that the existing flexibility of the framework is maintained and encourage the national DGSs and IPSs to make use of these measures. In this context, the warranted recalibration of state aid rules could ensure that measures in accordance with the DGSD are not limited or prohibited. Finally, there are many technical issues to be addressed based on the lessons learned in the last years, for example on triggering FOLTF or the use of early intervention measures.

The review should be used to find ways to further improve the functioning of the resolution and deposit protection systems. This has to happen in an evolutionary way that is not hampering the functioning of existing structures. The underlying rationale must be to ensure that the Banking Union can further increase the stability of our financial system.

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PUBLIC AND PRIVATE SECTOR VIEWS

TAKING ADVANTAGE OF BANK DIVERSITY IN EUROPE

GIUSEPPE SIANI

Head of the Directorate General for Financial Supervision and Regulation - Banca d'Italia

Towards financial bio-diversity and new business model sustainability

In the last decade, European banks have been dealing with demanding business challenges, coping with the prolonged low interest rate environment and struggling with legacies from the past, such as overbanking and non-performing loans, as well as with significant technology developments and revised consumer attitude.

The financial system is currently facing a new fundamental sustainability step where digitalization and ESG issues represent crucial drivers for structural changes. In particular, banks currently rely on a set of business capabilities that provide for the differentiation to compete in the market place and that help develop their business along with technological advances, such as smartphone technologies, internet and application programming interfaces (APIs), artificial intelligence, big data and distributed ledger technologies. Financial firms combine these business drivers to pursue competitive edge in providing their services. Moreover, they may make recourse to market operators and external providers, often outside the scope of prudential supervision, by lowering entry barriers in business model developments.

The current development has clearly attracted both Fintechs, typically small and focused on specific services and Big techs, usually operating through platforms and moving from the non-financial sector to the financial one. Therefore, incumbent banks face competition across different business lines and in turn have to review their business models.

Structural changes due to digitalization and climate push EU banks to reshape their business models.

The ESG plays a crucial differentiation role too; several banks have started to consider adjusting their business models to incorporate ESG factors into their strategies, governance and risk management, and acknowledge that these factors can affect their financial performances. Their current key challenge lies with data issues, ie. their availability, reliability and comparability; effective data governance is therefore crucial to assess the "greenness" of investments and favoring the desired efficient market allocation.

Against this background, the European banking system has reacted in different ways. Some institutions are trying to perform traditional banking business in a more efficient way, setting up an agile cost structure through investments for innovation, deep digitalization of processes (e.g. credit scoring and algorithms), outsourcing of internal controls and IT systems. In the latter respect, an effective risk management is crucial to deal with the threats posed by data sharing, location (essential for cloud solutions) and integrity, as well as the concentration of critical functions in few external providers.

In other cases, traditional banks have disposed unprofitable and capital intensive businesses, thus increasing bio-diversity of the financial system. In fact, new players – such as investments funds specialized in credit portfolios and/or turnaround, NPL managers – have started to consider the opportunity to extract value from these activities. Moreover, new business models have been developed, by both reengineering internal processes with larger use of technology and relying on new skills and competences, thus proposing new mix of activities and alternative distribution channels.

A number of successful business cases has also showed that size may not represent the unique success factor any longer; small and medium intermediaries, with a more flexible cost structure and higher ability to react to market changes, seem to manage to get competitive advantages. As a matter of fact, reaching a minimum scale does not represent a hurdle to invest in new technologies (sunk costs may no longer be an obstacle), thanks to new business opportunities offered by both the use of external platforms and the potential access to data and information embedded in the banks' proprietary data.

The increasing differentiation among business models in the financial industry raises new challenges to supervision too, given that a one-size-fits-all approach that is based on one predetermined set triggers as proxies for financial distress may no longer be fit for purposes. The supervisory toolkit therefore needs to incorporate tailored methodologies without undermining the necessary horizontal benchmarking; the acquisition of new skills and expertise plays a central role too.

Last, but surely not least, the current business model differentiation increases the business role of outsourcers, thus raising the issue of the appropriate scope of prudential supervision beyond the traditional definition of financial intermediation, whatever their nature.

MARGARITA DELGADO
Deputy Governor - Banco de España

Banking business models in the EU: dealing with diversity

A business model describes the way a firm operates and how it creates value for its stakeholders. In the banking context, the definition of business models is usually based on a combination of structural banking features, such as the funding configuration or ownership arrangements and business lines (e.g. retail, CIB or asset management).

The EU banking ecosystem comprises 5,179 individual credit institutions with diverse characteristics, operating in a complex mix of 27 Member States with differences in national history, culture, financial markets and local regulatory frameworks.

Over the past decades, the EU banking system has undergone very significant institutional changes, such as the adoption of the euro or the creation of the Single Supervisory Mechanism (SSM) with more than 2,200 consolidated credit institutions under its remit. This is clearly an outstanding example of the coexistence of various business models under a single supervisory authority.

In order to assess banks consistently, the SSM uses a common methodology, with peer comparison as a key component. For this purpose, it has identified 12 different business models for significant institutions, considering three key features:

1. Main income source: from traditional lending to trading activities.
2. Customer and funding base: distinguishing between the retail deposit base and wholesale market-based funding.
3. Size and geographical focus: from a small market to a large international footprint.

There are meaningful differences among the resulting business models in terms of bank size (from €10 billion in average assets for *Small Market Lenders* to €1,500 billion for *G-SIBs and G-SIB Universal Banks*), profitability (from ROE of 3.9% for *Corporate & Wholesale Lenders* to 7.4% for *Universal Banks and Investment Banks*) and risk assessment (best SREP scores for *Asset Managers and Custodians* and worst for *Diversified Lenders*).

The plurality of business models poses challenges for banking regulation and supervision in the Banking Union. Combining homogeneity in banking rules with diversity in business models is a difficult task and leads to the risk of neglecting important intrinsic characteristics of the broad European banking sector.

Prudential authorities need to adopt a flexible approach to cater for a variety of business models.

Clearly at the SSM we have to find the right balance between horizontal standardisation and banks' singularities. Additionally, proportionality issues need to be taken into consideration in the application of a level playing field.

But the existence of different business models can also be beneficial and even necessary. It makes for a better fit for European economic needs and helps to better meet the demand of the different customer segments. Some credit institutions focus on specific areas or even on social objectives, whereas larger universal banks compete in global markets.

Diversity in business models is also a source of financial stability for the EU banking sector. It reduces systemic risk, makes the sector overall more resilient to economic turmoil and provides room for smaller, more keenly-focused participants, less affected by the moral hazard problem of too-big-to-fail institutions.

EU prudential authorities need to adopt a flexible approach to cater for a variety of business models.

We are striving for a complete European Banking Union, with a common regulatory and supervisory framework that will most certainly be beneficial for the functioning of a single market. But this objective has to be compatible with the need to adapt the framework to European economic and banking diversity.

As a general rule, the existing set of business models has to meet European market needs and provide adequate support to finance the economy. But business models – even though their profitability levels differ – also need to be sustainable.

Close scrutiny of how business models are evolving, combined with a flexible approach, is more justified than ever. Given the fast-changing environment, the digitalisation process, the appearance of new players in the financial industry, increasing environmental and demanding regulatory requirements and the new macroeconomic challenges, banks need to adapt their business models to ensure that they remain sustainable over time.

While it is for bank management to define the business models, supervisors need to assess their robustness, profitability and sustainability, to identify potential vulnerabilities at an early stage and address them within the supervisory framework, while remaining neutral regarding management decisions. It is a challenge for both parties to assess the changes and cater for the diversity required.

To conclude, the existence of a range of business models is beneficial for the European financial system and requires a flexible approach from the prudential authorities.

FRANÇOIS-LOUIS MICHAUD

Executive Director - European Banking Authority (EBA)

Banks, business models and beyond

Coming back to first principles when approaching bank business models

Fundamentally, the business model of a bank is simple: it is about granting credit and collecting deposits. While banks may look very similar to the public (or to their non-bank competitors!), they are in fact not all the same. This is especially the case in Europe, where the economy remains largely funded by a high number of banks which display many combinations of activities, resources, and organisations.

A good match between these three parameters will ensure that a bank strives in the short term (aka "business model viability") as well as in the long term ("sustainability"). This of course matters for its stakeholders and may warrant change over time due to endogenous or exogenous factors. This is also of direct interest for policymakers willing to ensure an adequate flow of funding to the economy through the cycle. For all these reasons banks business models need to be scrutinised individually and collectively, as recommended by EBA guidelines. [1]

The notion of bank business models is commonly used, but what constitutes a model and distinguishes it from another is not easy to define. Most approaches look at the past performance of certain combinations of activities, resources, and organisations (i.e. types of business models), and of shifts thereof. To assign banks to types of business models, academic studies tend to rely on quantitative approaches: applying clustering methodologies to banks' financial accounts and complementing this with judgmental overlays.[2] As an alternative, EBA staff proposed an initial qualitative categorisation of institutions based on supervisory judgment applied at solo level further validated using quantitative indicators.[3] This offers both more granularity in classifying banks and more flexibility for reflecting national specificities.

Along those lines, certain business models may look "more equal than others" depending on the perspective considered. As shown in EBA's 2021 Risk Assessment Report the average RoE of cross-border universal banks was 6.4% against 5.3% only for local universal banks between 2014 and 2021. On the other hand, during the pandemic, local universal banks experienced a lower profitability decline. Cross-border universal banks tend to benefit from higher net interest income (NII) and higher fee and trading income as a share of equity than competitors from other groups. They however display higher operating expenses due to lower economies of scale when operating across jurisdictions with different rules. Local universal banks tend to have higher impairment costs presumably due to a lesser geographical and product diversification.

The 2021 EU-wide EBA stress-test seemed to confirm these results. In the adverse scenario, geographically diverse banks had lower capital depletions than banks focused on domestic markets, and banks with higher NII had lower capital depletion than other banks.[4]

Academic studies also analyse the effect of business model migration on bank performance. Banks changing business models tend to increase their profitability, stability, and cost efficiency. Interestingly, it is not entirely clear-cut whether underperforming banks are inclined to switch models.[5]

All in all, lessons should be drawn from such analyses but caution is in order. Indeed, the future performance of a bank cannot simply be inferred from the past performance of any peer group. Moreover, bank business models should also be envisaged from the perspective of the important transformations which are currently underway in the banking sector.

A first such trend is that other financing sources than banks have gradually developed in the EU over the past decade. They may expand further as a Capital Markets Union progresses. Innovation in the areas of digital and information technology is a second game changer. "Bigtechs" increasingly leverage their client databases and IT systems to offer some the financial services which used to be provided by banks. Together with "fintechs", they are now key components of a banking value chain which so far had been fully integrated by banks. Lastly, the necessary ESG transition will directly affect banks' activities, resources, and organisations.

Even if these developments suggest a regime change, they do not necessarily mean that "this time is different." They may simply require looking at bank business models through the prism of first principles: what are banks supposed to provide, whatever the forms they may have taken over time?

Against that backdrop, a viable and sustainable bank business model should meet the three criteria which are at the core of financial intermediation: ensuring a "delegated monitoring" of lenders and borrowers, which requires having better information than the market; providing them liquidity through the cycle (transforming risks, durations, currencies...), which requires having sophisticated risk management and sustainable funding; and performing these critical functions efficiently, which requires reaping economies of scale and scope. The latter does not necessarily mean bigger balance sheet anymore.

[1] EBA (2014 and 2021), Guidelines on common procedures and methodologies for SREP

[2] Roengpitya et al (2017), Bank business models: popularity and performance, BIS Working papers; Ayadi (2019), Banking Business Models: Definition, Analytical Framework and Financial Stability Assessment.

[3] Cernov, M., and T. Urbano (2018), EBA Staff Papers.

[4] EBA (2021), 2021 EU-wide stress test – Results.

[5] BIS (2017); Ayadi et al. (2020), Bank Business Model Migrations: determinants and effects, British Journal of Management.

EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board - European Central Bank (ECB)

Preserving the diversity of European banking business models

A business model can be defined as the sum total of systems, mechanisms and methods through which a bank generates earnings and satisfies its owners, customers and other stakeholders. The key to sustainability is to maintain an adequate cost/income ratio and keep stakeholders satisfied with the services provided. As supervisors strongly committed to a neutral and objective approach to different business models, our starting point is measuring financial resilience. From this point of view, the main parameters defining bank business models are income mix, customer mix, funding mix, size and geographical exposure. We also take other criteria into account, most importantly strategic management, risk appetite and development strategies – of which digitalisation forms a very important element. Needless to say, specificities arising from legal form and ownership structure are considered too.

Market share in the banking system can be defined in various ways. The most common indicator is total assets in terms of loans to households and non-financial corporations, but this does not necessarily tell the full story of revenues generated. Some banks specialise in certain activities only, so for them the market needs to be defined more narrowly. For example, asset managers do not aspire to have a significant balance sheet, so their market share is more adequately captured by assets under management; likewise, investment banking services are typically measured in number and value of transactions rather than any balance sheet amount. Nevertheless, most of these measures of market share taken from supervisory statistics roughly coincide.

Global systemically important banks (G-SIBs) in the euro area make up nearly 50% of the total market of significant institutions directly supervised by the ECB; other universal and investment banks another 25%; diversified lenders are a bit less than 15% (even though this is the largest category by number); other bank business models (such as specialised lenders for customer finance or corporate/wholesale finance) tend to be around 5% each or below.

To preserve diversity, banks need to ensure the resilience of their banking models.

The degree of reliance varies – indeed it is one of the key differentiating factors among banks – but lending remains the main source of income at around 60%. This is why the latest reported statistics can be seen as relatively good; they show lending income benefiting from rising interest rates, credit demand resilient despite the macroeconomic situation and income statements not yet affected by the strong deterioration in the cost of risk. The pre-pandemic standards they are being compared against, however, are not very high.

The viability test for different business models is yet to come. The core issue is a bank's capacity to sustain its activity through the cycle, including absorbing risks in the event of a recession. As supervisors, we believe the appropriate level of profitability should be determined bank by bank and on average through the cycle, not just at a single point in time. Everything depends on a bank's business model and specific characteristics – the overall riskiness of the bank being the key driver when determining the appropriate level of profitability. This goes beyond simply risk on the asset side (credit risk, market risk); it also extends to liquidity risk, funding risk, interest rate risk in the banking book, operational risk and risks related to sound decision-making and strategic management and execution. The ability to retain profits through the cycle and raise capital in case of need have to be considered as well.

It is important to emphasise that supervisors do not look at the profitability of a credit institution in the abstract, but its contribution to the resilience of the banking system as a whole. This goes beyond a single-factor approach; the specificities of each case are taken into account. Even within peer groups of comparable banks, we still see very different levels of cost/income ratio, and also quite different investments in the future, in digital transformation for instance.

From the point of view of the supervisor, what is essential right now is for each bank, whatever its business model, to carefully assess the potential impact different macroeconomic scenarios could have on its customer base and prepare to respond proactively to difficulties that may emerge. Experience tells us it is best to react quickly. This includes adapting operations and services to the needs of the economy, supporting increased use of digital tools and investing to cope with emerging risks.

It is precisely because we value diversity of business models that we are sceptical about the notion that authorities are able to assess what the optimal degree of diversity is: this should be determined by the market alone.

The role of the authorities is to ensure that individual banks are able to manage the risks inherent to their business model in a way that is prudent – otherwise, they should exit the market.

JACQUES BEYSSADE

Secretary General - Groupe BPCE

Recognition of different business models: we need a big step forward!

Reflecting upon the different impacts of banking regulation and supervision on different business models would constitute without a doubt a big step forward for cooperative banks, as a step towards the recognition of their business model and their characteristics.

Indeed, it seems long ago when cooperatives have entailed debates on the opportunity to dismiss or not the main assumptions of their business model: economic democracy based on stakeholder representativeness ("one head one vote" and openness of membership), mutualism implying acting in the interests of members and with them, local roots, and long-term clients' relationships.

What was seen yesterday as disadvantages (risk aversion, composition of capital, untradeable cooperative shares...) were recognized as advantages during the crisis. Indeed, the reasons for their resilience are their cooperative structure (member ownership and benefit) and their comparative advantages in times of crisis (stronger attractiveness among investors because their shares are not sensitive to stock market fluctuations, statutory level of reserves ensuring a stability of value, non-dilutive nature of their capital in case of capital increase, good balance between long-term profitability and low risks).

This was evidenced when cooperative banks suffered far less than other banks and have demonstrated their ability to recapitalize during crises. Intending to drop the "one size fits all" regulatory approach is the right thing to do. But we would face the same old pitfall if benchmarks are the "new normal" to supervise banks. Let's highlight some key points.

Today, the SSM is in its role when it sends a general message about the insufficient profitability of some European banks and makes transversal analyses. But these analyses must take into account the variety of business models.

In terms of profitability for instance, our Group has a payout ratio of less than 10%, its capacity to put earnings into reserves is therefore not comparable to the listed groups and moreover the reserves are not distributable. Furthermore, the high level of equity, which is a choice of the group, also naturally explains the lower profitability. Hence, the right indicator should be the residual income after distribution of the payout to equity holders.

We would face the same old pitfall if benchmarks are the "new normal" to supervise banks.

Another example is visible in the analyses on the cost income ratio, which is very high for some European banks: the weight of real estate credit in the balance sheet should be taken into account as it mechanically explains a high-cost income ratio for those banks because the margin is low (and the risk too). The weight of the French Livret A also explains in particular a high cost of resources for some banks.

Moreover, the ECB's analyses of European averages also lead to comparisons of very different business models without entering in more in-depth analysis (see in particular the flat vs floating rates topic in real estate). Beyond that, the regulation itself could lead to numerous unintended consequences on the different business models if we don't consider the broad picture.

Let's take the example of the cumulative effect of the leverage ratio and the NSFR which is very significant: the first ratio tends, if it is applied individually and not globally, to favour risky activities, and the second one favours long-term activities. We are therefore potentially left with a non-diversified risky long-term business model. Since analysts and rating agencies focus on the same ratios, they reinforce the trend.

To ensure that supervision is respectful of the diversity of the business models, the transparency of different benchmarks is the cornerstone of supervision analysis. Each bank should be able to position itself vis-à-vis the benchmark and either comply or explain.

Second, we should ensure that supervision fully respect the different business models. A set of relevant diversification indicators should be defined and applied by the SSM in that purpose. We stand ready with the cooperative banks to work hand in hand with the SSM on this matter.

Notably, the capacity of serving customers and small companies at granular level in all the territories should be one of the main indicators. Maintaining banks activities in some French territories is a concern for public authorities. It is key that cooperative banks continue to play a development role in the economy, notably to encapsulate every stakeholder in the ecological transition.

On the contrary, the sale of NPL on the secondary market is a counterproductive action based on an irrelevant criterion for groups like ours that are focused on long-term relationships and have a role in supporting local communities.

As regard BPCE, it is essential to preserve the DNA of our Group: support its 36 million customers, whether they are individuals, professionals, associations, companies or local authorities, over the long term and at every stage of their lives, with the ambition of being useful to everyone.

JULIA SYMON
Head of Research and Advocacy - Finance Watch

Bank diversity in the European Union and banking regulation

A diverse and well-integrated banking sector, comprising banks of different sizes and business models, is demonstrably beneficial for both financial stability and corporate and retail customers. In this context, the role of banking regulation and supervision should be to provide for financial stability and protect EU citizens and society at large from excessive risk-taking in the banking sector – among others, by creating, and preserving a level playing field for banks of different sizes and business models.

Yet, as of today, the EU banking sector is very polarised. The top-5 banks in almost each member state hold more than half of all banking assets in that market (the EU average is 68%). The EU's 37 largest banks account for 71,4% of domestic banking total assets.

The EU finalisation of Basel III reforms - the Banking Package - holds among its stated objectives the prevention of competitive disadvantages and the reduction of compliance cost for the European banks. Yet, judging by the contents of the legislative proposal, the largest EU banks, G-SIIs and major O-SIIs, would be allowed to continue operating with lower levels of capital, on average, than their global peers and with a competitive advantage over smaller and mid-sized banks in the EU domestic market. EU citizens, and society at large, would remain exposed to the systemic risk emanating from a poorly capitalised banking sector and liable to underwriting the losses of underperforming banks.

Levelling the playing field

Truly levelling the playing field between banks of different business models and sizes requires a faithful implementation of the Basel reforms without the so-called 'EU-specific adjustments', which stand to benefit mostly large banks, as they account for over 80% of the total capital shortfall that would result from the undiluted implementation of Basel III in the EU per the EBA estimates. A large number of smaller and mid-sized EU banks would remain either largely unaffected or even benefit from the combined effect of (i) the modifications of the Standardised Approach introduced by Basel III, and (ii) the output floor, which caps the 'cost of capital' advantage of banks using the IRB approach.

Basel III as an opportunity to level the playing field and improve diversity in the banking sector.

Capital rules for unrated corporate exposures

Generally, under Basel III, SA-CR risk weights are reduced for highly-rated borrowers and increased for low-rated and unrated borrowers. In the EU Banking Package, the Commission proposed a transitional arrangement that would allow banks, under certain conditions, to apply a preferential risk weight of 65% to unrated corporate exposures for the purposes of calculating the output floor. This arrangement is motivated by the desire to prevent disruptions of bank lending to unrated corporates in the EU, as they are significantly more reliant on bank funding than their counterparts in other regions. It is separate from, and comes alongside the so-called 'SME supporting factor', which benefits all banks, whereas the transitional arrangement is targeted solely at IRB banks.

The Commission's reasoning is based on the assumption that the competitive environment is static and that banks will pass on increases in their own funding costs, if any, to their customers. In reality, the financial industry is anything but static and it would not be difficult at all to conceive of a different scenario where closing the gap in capital requirements between banks using the SA-CR and those using IRB, would restore a level playing field. IRB banks account for a majority of SME lending. With smaller and mid-sized banks competing in this segment on level terms, even a modest increase in competition would likely prevent incumbents from passing on the increase in their cost of capital to customers. In the broader context, this could reverse the trend towards concentration and promote a more diverse banking landscape that is more resilient and less exposed to systemic risk.

Beyond the Banking Package: a case for a structural reform

Beyond the reform currently on the table, the accounting for different bank business models calls for more fundamental reform, including the separation of deposit-taking and commercial banking activities from capital markets-related activities. Too-big-too-fail bank institutions do not only take deposits and provide credit, but also run highly leveraged and risky trading activities at their own cost and for their own benefit. The bank regulators' paradox is that large complex and interconnected banks need very little capital in the good times, but they can never have enough in an extreme crisis. Splitting different business segments would remove the benefit of implicit public support for banks' trading activities, increase financial stability and prevent systemic contagion between banks.

This contribution draws on sections of an earlier Finance Watch publication by Christian M. Stiefmueller, "Cracks in the pillars – Financial stability loses out in the EU's Basel III endgame", March 2022.

GUIDO MARIA NOLA

Chief Executive Officer - BancoPosta - Poste Italiane

Be disruptive, keep your roots – Embracing the everchanging nature of banking in the digital era

In 2022, Poste Italiane celebrated its 160th anniversary. In its long history, Poste adapted to secular changes in its main markets, Italy: from universal service and postal saving roles, to banking, insurance, and payment activities in the last two decades. Nowadays, it is playing an important role in the digitalization of Italian financial and non-financial services.

Even in the context of its continuous development, one would be hard pushed to find a period of faster change in the history of Poste when compared since its IPO in 2016.

First among them is the impact of the digital transformation-transition of our businesses, along with new threats, such as cybercrime or the birth of a new class of financial intermediaries (e.g.Fintech). Secondly, the role that Decentralised Finance is building for itself, along with the current, steady increase in the democratisation of financial services, bound to create more disruption.

In addition to the digital transition, the European financial system is facing unprecedented externalities: Covid 19, the war in Ukraine and extreme climate events, like the droughts in most of Europe. Our society as a whole and our companies are having to move suddenly from preparedness to adaptive strategies.

In this context, the role of regulatory bodies is even more relevant: as market players, we seek to achieve an even playing field for competition and protection for our customers from any excess. Our constant focus on governance, risk management, and internal controls remains central. Besides, the tackling of new requirements, such as the recent focus on sustainability (e.g. ESG), the fight against financial crime, and the need to find new channels of distribution of products, create completely new challenges (e.g. phishing and data stealth). Trusted intermediaries are the channels through which European citizens benefit from the financial innovation that technology can bring, advancing into new territories with the shielding of strong internal governance and conduct principles.

Shaping financial regulation in such complex times is a difficult task, not dissimilar from managing large financial institutions: it requires a fine balancing act between generating the expected outcomes and managing the impact of multiple disruptive forces pulling in different directions.

The best chance for financial system to ensure its own and its clients' sustainability is to embrace disruption, or disruptive innovation. This is key in our shared journey into an uncertain but fascinating future. Some ideas:

Proactive regulation should support adaptive governance – A popular concept among to environmental studies experts, "adaptive governance" is about managing complex ecosystems as webs of different ecosystems and it requires stake holders to develop a framework where all system players and interests are more widely understood and proactively managed. In a nutshell, it is about redefining the boundaries of the financial system and developing a wider, more comprehensive overview of its complexity.

Sandboxing and testing as a state of mind – We have appreciated recent efforts by ESMA, through Consob in Italy, the European Commission and the ECB, to develop sandboxing tools for the testing of financial innovation tools. One example has involved inviting Poste to test digital wallets by the European Commission. The sandboxing-validation approach, while fundamental for digital solutions, could also be widened to include more traditional financial products and governance frameworks. This measure will support the sharing of common best practices and shared terms and definitions.

Consider the new agents in the financial world #1: algorithms and machine learning – Our financial decisions and strategies are increasingly based on algorithm-based technologies. High frequency trading has been one of the first areas singled out by European institutions since a seminal study by ESMA in 2014. While special attention was originally paid to organisational requirements, the focus has shifted to more substantial challenges: algorithms and machine learning systems will become not only decision tools, but agents – even with legal consequences yet to be determined - as they will be able not only to follow coding rules but also to take their own decisions. This development can be a strong competitive driver, but it may also have distorting effects - especially where allocation of responsibility is relevant.

Consider the new agents in the financial world #2: nature and society as a whole – There is a substantial interest on the part of the European financial 'biosphere' in determining how to incorporate climate change in their work practices. See, for example, the work of the Commission around the Green and Social Taxonomies or the constant refining of our sustainability metrics. The lack of trust towards the financial system post-2008 requires to regard nature and society in its entirety as key agents in our decision-making processes. Increase attention to these agents will rebuild trust in the whole of the banking experience, from current accounts to investment management.

As we feel our way through externalities, it is time to refocus on the impact of finance on the world at large, be it our biosphere or our own society, from the general to the individual level. And this kind of disruption will serve well the purposes of regulation and conduct authorities too.

We thank the **Czech EU Council Presidency** and **the partner institutions** for their support to the organisation of this Forum

SOLVENCY II REVISION

MARKUS FERBER

MEP - Committee on Economic and Monetary Affairs, European Parliament

Solvency II: improving on the Gold Standard

The European Union is currently facing a multitude of challenges. Some of them are more acute such as handling the fallout of the Russian aggression in Ukraine, others such as the challenges related to the green and digital transition or dealing with the impact of unfavourable demographic trends are more of a slow-burn problem. On many of those challenges, insurance undertakings can be useful allies: due to their long-term business model, they are natural long-term investors that could deploy vast amounts of capital into illiquid assets. That could give a boost to the digital and green transitions. Furthermore, insurance companies offer the kind of long-term financial instruments such as life-insurance policies that can help people plan for a successful and dignified retirement. In light of the pressure public pension systems are under, this can be an important contribution helping to deal with the demographic developments.

In a nutshell: insurance companies can help address many of our most pressing policy problems. Of course, we need to set a regulatory framework that allows insurance companies to do just that. For that, Solvency II is the key policy tool. We should use the ongoing revision of Solvency II to make European insurance companies more agile and more competitive. The overarching objective though is to put insurance companies in a position to offer policies that are attractive and safe and to empower them to fulfil their role as long-term investors.

The current calibration of Solvency II is very conservative and there are still some buttons we can push in order to make European insurance companies more competitive without compromising on financial stability. There are two main avenues that we should look at to achieve those objectives.

Insurance companies can help address many of our most pressing policy problems.

The first one are the technical details of the calibration of certain key variables under the headline "long term guarantees" (such as the extrapolation of the interest-rate curve, the prudential treatment of equity and long-term investments or the adjustment of the risk margin). Many of those variables are currently dealt with as part of the delegated regulation and unfortunately the European Commission has suggested to keep it that way in its legislative proposal. This is not a desirable status quo though. To put it simply: those are the variables that make or break an insurance company. Little tweaks in those numbers can free up billions of Euros or they can tie up billions of Euros. Finding the right trade-off on those numbers is ultimately a political decision that we cannot simply delegate to insurance supervisors.

The second way to boost insurance companies' ability to promote long-term investments is by reducing operational complexity and operational burdens, particularly for those insurance companies that are smaller and have a low risk-profile. For those companies, a "longer leash" can be justified. The European legislator has already introduced such a regime for smaller and less complex banks in a recent revision of the Capital Requirements Directive. Such an approach can serve as a blueprint for the insurance world and the European Commission has indeed picked up on the idea by introducing a new category of low-risk insurance undertaking.

Insurance regulation is overdue for a healthy dose of proportionality. A "one-size fits all" approach is usually very convenient for the supervisory authority, but it is not for the supervised entities, particularly for the smaller ones. The Commission proposal is a decent starting point that should be further refined in the legislative process.

Of course, only because there is now a distinct class of insurance companies that is classified as low-risk does not mean that we are done with reducing regulatory burden. Many of the reporting requirements in Solvency II are quite burdensome and often of little use to a wider audience. Rather than slimming it down, the Commission proposal would even further extend those more problematic reporting requirements.

When revising the Solvency II framework, we should be mindful that we already have a good system in place that is considered by many as the international gold standard for insurance regulation. Therefore, what we need is not a grand overhaul of Solvency II, but a few targeted changes in order to make it fit for the challenges in the upcoming decades. We can improve Solvency II, make our insurance industry more competitive and have it contribute to key policy initiatives without compromising on financial stability. We should make the most of this chance.

PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Solvency II review: main aims, topics for negotiation and remaining challenges

Solvency II established a framework for supervision of Europe's insurance sector, underpinning the importance of a risk-based approach to assessing and mitigating risks. With the overarching objective of strengthening policyholder protection, the framework continues to work well. Nonetheless, it is important that the recent review concludes in a timely manner so that the regime remains fit for purpose, in particular given the current economic situation.

Overall, EIOPA is happy with the progress of the review, with all parties involved – the European Commission, the Council and the European Parliament – largely following the same objectives as those that EIOPA proposed: To target an evolution rather than a revolution and to recognize the economic situation and complete the regulatory toolbox with macro prudential tools and recovery and resolution measures.

Furthermore the Commission's proposal for a Insurance Recovery and Resolution Directive, is to be welcomed. The ultimate goal is always to prevent failure or – if this is not possible – faciliatate an orderly market exit. The Commission's proposal, which follows closely EIOPA's technical advice, focusses very much on the preventive approach, addresses all relevant building blocks of a recovery and resolution framework, and also focusses on cooperation and coordination among authorities.

Target an evolution rather than a revolution, recognize the economic situation and complete the regulatory toolbox.

One areas area that remains of some concern – and where current proposals have moved away from EIOPA's Opinion relates to proposed relaxations in the valuation of liabilities and capital requirements that have the potential to endanger the well-functioning of the regime, thereby generating an undue capital relief again at the cost of weakening the protection of policyholders. In this regard, the measures included in EIOPA's Opinion have been designed specifically with the long-term nature of the insurance business and consumer protection in mind:

- The review of the extrapolation is key to make the liabilities realistic, improve incentives to risk management and thus ensure that insurers will be able to pay future claims.
- The Risk Margin is a consumer protection measure to ensure undertakings can transfer their liabilities to another undertaking without impacting the insurer's future benefits. Revision of the risk margin can be introduced in order to recognize diversification over time thereby reducing size and volatility of the margin, especially for long-term liabilities. But the calibration should remain prudent, indeed a too high decrease the Risk Margin value would be unjustified and harming policyholder protection.
- The revisions to the Volatility Adjustment are introduced as a consistent set of measures, in order to enhance its efficiency as a countercyclical adjustment. In particular, there can be a more favourable but prudent treatment of insurers' long-term liabilities compared to those of shorter duration.

Further, there are technical arguments for the Solvency II Directive to address sustainability explicitly. The analysis on the prudential treatment of insurers' activities associated with sustainability factors requires a strong legal basis, as does the requirement for proper climate risk assessment by the undertakings in their ORSA. This is intended to reinforce the risk based and evidence-based nature of the analysis.

Besides the topics mentioned above, EIOPA stresses that the SII review is a good opportunity to address tdiversity on board of insurers. There are existing provisions for management boards of banks and there should be in the same manner for insurers.

EIOPA also considers the review of Solvency II an opportune moment to include a targeted amendment regarding individual disclosures in the context of EU-wide stress test exercises. To that end, in April 2022, EIOPA published an Opinion to the European Institutions to recommend a consistent and disciplined communication of individual stress test results to enhance market discipline, increase stress test participants' commitment and contribute to a level playing field among insurers and across the financial sector.

It is in everyone's interest that discussion progress well and that the new Directive enters into force as early as possible. This is to the benefit of both the sector and policyholders. The very technical nature of some elements of the review deserve precise scientific treatment including reliable impact assessments and EIOPA – as a technical supervisory body – stands ready to support the co-legislators during the process of Trilogues and finalization of the texts in good time.

STÉPHANIE YON-COURTIN

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

Is a more uncertain world uninsurable? Making the Solvency II framework fit for the future

Unpredictable is the key word to define the world we live in as we are witnessing multiple large-scale crisis, coming from climate change and environmental degradation; the rise of global pandemics, cyber-attacks, or the economic consequences of ramping inflation and interest rates.

The current review of the Solvency II Directive has no choice but to take into account this uncertain and challenging context. European regulators and supervisors have to ask themselves how to trigger the right incentives and amend the various pillars of the Solvency II framework for, on the one hand, financial stability of the insurance sector and on the other hand, the unlocking of its full potential, within the EU and abroad, to support the twin transitions, to a more digital and more sustainable economy.

This challenging equation mirrors the current challenges of the insurance sector, which despite a high level of capitalisation, was unable to cover policyholders against the many consequences of the Covid 19 pandemic.

The Solvency II framework has proven its value in ensuring the strength of the insurance sector after the financial crisis but needs to be updated to become fit for the future.

In practice, this means a threefold legislative framework:

- Risk-based, coherent and simplified when needed, with the right articulation between the principles included in the Directive and the technical provisions of the Delegated Regulation;
- Enabling, to foster cross-border activities while protecting policyholders through a proper supervision at European and national level; and
- Forward-looking, to take stock of past crisis as well as new risks coming from a more digital or climate-vulnerable world.

This review is definitely our chance to make the Solvency II framework fit for the future and keeping it as a leading insurance regulation at the global level by building on and strengthening its core principles.

As the outcome of a successful Solvency II review, we can expect the framework to reflect more accurately the risks of each insurance provider, based on a tailored analysis of their risk profile and the application of the proportionality principle. This should never compromise financial stability, a level playing field and consumer protection. It will also require a review of the technical provisions put in place to ensure a robust solvency of the insurance provider, taking into account the moving situation on interest rates, which requires to be ready to tweak and adapt the legal requirements as needed. Ensuring a proper funding of long term and sustainable objectives, through a fair and risk-based prudential treatment of equity investments, will be key.

We can also expect a better take on the cross border essence of insurance activities in a single market, to allow insurance activities and providers to be spread across markets and ensure equal access and protection for all European citizens. This means that European supervision and the role of EIOPA should be strengthened, although some competences might stay in the hands of national supervisors for the time being.

Last but not least, a legislative review is the perfect opportunity to update the Solvency II Directive against rising risks but also opportunities European insurers are facing. This is critical to address the protection gaps observed during the Covid pandemic or predictable in a world 2.7°C warmer in 2100 according to the IPCC 2021 report. These new risks should be cover like any other risks as part of a necessary and ambitious review of the Solvency II Directive. Insurers are not exempted from the need to take into account climate in their business and strategic decisions, should set up transition plans and put in place climate-related considerations in the selection of the members of their various internal governance bodies. Digital and cyber-related risks should not be forgotten and need to also become a key component of the insurers risk management processes, to strengthen their cyber resilience and progress on the coverage of cyber risks.

The Solvency II review, which is also accompanied by a new proposal for an insurance recovery and resolution framework, has therefore to strike the right balance between these equally important but sometimes conflicting priorities, for the benefit of policyholders and insurance providers, but more importantly, for the benefit of society as a whole. The current context and changing economic parameters should be an additional lens to consider to reach that objective, while building on the fundamental principles and specificities of the insurance business model and activities.

FRANK GRUND

Chief Executive Director Insurance and Pension Funds Supervision - Federal Financial Supervisory Authority, Germany (BaFin)

Solvency II reform: making a proven approach fit for the future

My opinion is clear: overall, Solvency II has proven itself since it entered into force at the beginning of 2016. The risk-sensitive regulatory framework, based on principles and market values, has been helpful in enabling the early identification and better assessment of risks. At the same time, however, it has also shown some need for improvement in a few areas, which is not surprising in legal texts of this calibre. It was for good reason that a review was planned for Solvency II.

Europe-wide coordination of course requires compromise

The reform of a complex European regulatory framework such as Solvency II will make it necessary to balance many different interests, since the situation in Europe is very heterogeneous.

In the discussions regarding the Solvency II reform, we have always engaged in very intensive dialogue with supervisors of other European countries. This has enabled all of us to get an understanding of the special features of the various national insurance markets – and it has given us the chance to participate in formulating EIOPA's reform recommendation in many aspects. In the end, the compromise recommendation submitted by EIOPA was one we at BaFin supported, though we still saw some need for improvement in some points.

The right approach: evolution, not revolution

When it comes to the quantitative requirements, the assessment of long-term guarantees and the associated risks takes on a key role. Here, it is important to adjust the economic perspective of Solvency II such that the framework takes the long-term character of these guarantees into account.

A reduction of supervisory requirements could damage the foundations of Solvency II.

In introducing Solvency II, the EU introduced the extrapolation of the interest rate term structure, the volatility adjustment and the transitional measures – instruments that serve to implement such adjustments. EIOPA subjected these instruments to a comprehensive examination in the Solvency II review. It confirmed the transitional measures and recommended targeted improvements for the extrapolation and the volatility adjustment, in line with the idea of "evolution, not revolution". The extrapolation involves a new procedure that is to entail a moderate increase in the amount of market information considered but continue to ensure an adequate level of stability. The volatility adjustment is expected to have a significantly larger impact while taking the insurer's risk profile better into account.

From a technical point of view, this is a move in the right direction. It will be essential, however, to ensure that the new regulations are also manageable for the industry. To this end, we need to strike a balance between old and new requirements.

Reducing supervisory requirements would send the wrong signal

The recommendations of the Council and the Commission have addressed this aspect and struck a significantly better balance by making adjustments to the EIOPA recommendations. This is a positive development. But while relief measures are already being implemented, it would not be wise to go too far by satisfying additional demands, as the uncertainties and risks inherent in future developments are starting to become visible in light of the pandemic and the current geopolitical situation. Climate change, too, is becoming more and more evident. In light of all this, a reduction of supervisory requirements would send out the wrong signal and could damage the foundations of Solvency II: the adequate identification of risks. Such a step would jeopardise the protection of the policyholders and the stability of the financial markets – which are key objectives of solvency supervision. Trust in the Solvency II framework could erode, on a national and an international level. Nevertheless, the framework should provide for risk-adequate relief measures for small, non-complex insurers. This would strengthen the principle of proportionality and promote a more uniform approach for dealing with undertakings whose risk profile calls for simpler solutions.

European legal framework – in international demand

Today, we see Solvency II also setting standards beyond Europe's borders. Several countries already have similar supervisory regimes that are based on market-consistent assessments, or are currently in the process of developing such regimes. Examples include China, Japan, South Korea and Mexico.

At the global level, the International Association of Insurance Supervisors is developing an Insurance Capital Standard (ICS) – based on principles that resemble those of Solvency II. The ICS is intended to serve as an indicator of capital adequacy for Internationally Active Insurance Groups. Its key objectives are to create a level playing field and make international convergence a reality; significant progress has already been made in this respect. A five-year monitoring period commenced in 2020; once this period is over, a decision will be taken concerning the ICS and the form it might take. In Europe, Solvency II is currently considered a suitable implementation of the ICS.

CLÉMENT MICHAUD
Chief Financial Officer - Crédit Agricole Assurances

Solvency II: finding the right settings for a more balanced review

Slowly, the institutional procedure for reviewing the Solvency II directive moves forward. On June 17th, the Council of the European Union has agreed on its position on updated rules for insurance companies. Nonetheless, the position remains largely based on the European Commission's proposal and does not integrate the fundamental issues that will make the review a balanced one or not in terms of capital charges, volatility and long-term investment. The Council has opted for a compromise which represents more of a status quo compared to the Commission's proposals; the core of the review remaining in level 2 negotiations.

On the other side, the European Parliament (the ECON committee in particular) shows willingness to enhance the Commission's proposal before the future trilogues. If the Parliament's position is quite far from being decided, the Ferber's report is a step in the right direction for supporting the role of insurers in Europe's current and future economy (for instance, thanks to the reduction of the lambda factor for calculating the risk margin and of the cost of capital to 4%). Indeed, MEPs have more room for manoeuver than member states when it comes to differ from the Commission's proposal and to adjust the review in favour of a less volatile solvency ratio, pro long-term investments and capital-neutral prudential regime.

The reduction of the volatility of the solvency ratio should be an overarching objective for the legislators. Excessive volatility drive insurers towards countermeasures such as taking fewer risks in their asset portfolios, for example by limiting their exposure to the equity market.

Because of the current pro-cyclic nature of Solvency II, the recent sharp increase of interest rates carries disproportionate prudential effects. Counter-cyclical tools are essential and the coming months will be decisive. On that matter, we welcome the Commission's proposals on the volatility adjustment (VA), which increase the effectiveness of the VA in mitigating artificial volatility, with the exception of a proposed change to the "Risk Correction", which undermine the effectiveness in reducing pro-cyclicality. Indeed, the VA is key for stabilising insurers' balance sheet. More generally, countercyclical measures should be as effective in increasing as in decreasing interest rate environments.

Favouring LTEI is a positive political gesture but also a recognition of the insurers' DNA.

Although the European Commission announced last year a 90bn€ release in capital charges on the short term, it estimates that capital requirements should return to a level which is similar to the status quo at the end of the transition period, in 2032,. However, national impact analyses in France indicate even an increase of capital requirements and a deterioration of the Solvency positions on the long term, which contradicts the Commission's declarations and the EU's ambition of a financial sector that serves even more the Europeans. Let us recall that the direct effect of strengthening the interest rate shock would be to increase significantly the overall capital charge. Then, we reaffirm our advocacy for a review that is, at worst, neutral in capital charge.

Most of the Solvency II review will be decided next year, during trilogues and discussions over level 2 measures. It is especially true for long-term equity investments (LTEI), although perfectly in line with the EU's aim to finance its environmental and digital transitions, but whose eligibility criteria are unworkable as they stand. Favouring LTEI is a positive political gesture but also a recognition of the insurers' DNA as business actors who manage long-term investments. In this regard, some Member States proposed a few months ago a risk-based solution that introduces a liquidity test to justify a reduction in capital charges. Much work remains on LTEI, otherwise the review will not live up to its ambitions.

A balanced review is of utmost important to enable insurers to invest more in infrastructure and the economy. In parallel, the entry into force of accounting norm IFRS 17 in January 2023 puts an end to the overlay period of IFRS 9. This will create more artificial volatility of insurers' results, which may lead to a massive reduction of their exposure to the equity market towards safer investments as early as the end of 2022. Furthermore, the increase of interest rates could drive parts of private savings from equity markets to bonds, safer but less contributing to the funding of EU's economy.

To conclude, we pledge for an evolution of the prudential standard with substantial changes to balance the newly designed interest rate shock, so that Solvency II becomes a framework that guarantees financial stability but also reduces volatility and enables insurers to take a greater share in funding EU's major challenges.

HUW EVANS

Partner, Financial Services - KPMG in the UK

Solvency II reform – EU against the UK or different routes to the same outcome?

Solvency II reform is not just one of the biggest reviews of the post-financial crisis regulatory regime, it is also an early test case for how far a post-Brexit UK financial services framework will end up differing from the EU when the reviews are happening at the same time. The evidence so far suggests that recognisably similar issues are being considered by both the EU and UK, alongside the significant tension between the overall resilience of the sector and the desire to increase productive investment.

As arguments continue between insurers, regulators, and policymakers in Brussels and London alike, it is easy to forget that six years on from its commencement, the Solvency II regime enjoys wide support as a regulatory framework. In the UK, the Government is not proposing fundamental change to the directive. This approach is supported by the UK insurance sector which has joined with its continental neighbours, through Insurance Europe, in arguing for some key improvements whilst retaining a risk-based capital framework that incorporates best practice in both risk and capital management.

Where tensions are showing in both the EU and UK, they are on topics that are no less important for being familiar:

- how best to remove barriers to investment in long-term productive assets that aid transition to a net-zero world and build the post COVID economic recovery;
- how to calculate the value of those long-term liabilities and the true investments risks; and
- how to streamline overly onerous regulatory procedures that damage global competitiveness?

The UK Government approach to these over-arching challenges has been to segment them. Thus, it has proposed reductions to the Risk Margin of up to 60-70% on a modified cost of capital basis, comparable to similar proposals from the EU. For the Matching Adjustment (MA), it has proposed widening asset eligibility and streamlining approval processes but agreed with the Prudential Regulation Authority (PRA) on the need for changes to the Fundamental Spread mechanism. Finally, the UK Government has backed PRA intentions to streamline reporting requirements and approval processes.

How far a post-Brexit UK financial services framework will end up differing from the EU.

The European Commission has likewise proposed a major reduction in the Risk Margin. However, it also proposes changes to the extrapolation methodology for the risk-free curve rate and the Volatility Adjustment as well as revised capital charges for interest rate risk and long-term equity risk. As the interest rate related changes will increase capital requirements substantially, the impact on aggregate capital requirements appears rather limited.

Taken with the parallel EU proposals on recovery and resolution which insurers argue 'cut and paste' inappropriate banking requirements, there is still a range of areas on which insurers need to convince European Parliament policymakers ahead of final decisions. At stake is the extent of the insurance sector's ability to help meet the EU's ambitions for the Green Deal, Capital Markets Union and post COVID recovery.

In the UK, the points of contention seem more narrowly focused. There is just about consensus between the PRA, UK Government and insurers on a reduction in the Risk Margin, but still disagreement on its impact on off-shoring of longevity risk and overall benefit to particular firms. There is also some agreement on process improvements that can be made to speed up internal model processes and improve decision-making on MA eligibility. However, the greatest disagreement remains on the MA itself and, in particular, how the Fundamental Spread (FS) mechanism works.

The original UK Government reform proposals did not moot any changes to the FS, but the PRA intervened to put the issue on the table last summer, asking large insurers to model major changes to the FS that many insurers believe more than offset any capital benefits from Risk Margin reform. Amid a backlash from insurers, the Government has now proposed a Credit Risk Premium (CRP) mechanism that would require relevant assets using the MA framework to carry extra capital for extra and unexpected default. Even at the lowest of the three levels proposed, insurers estimate this could add to their net capital position, remove incentives to invest in a wider range of assets and increase balance sheet exposure to market volatility.

In both the EU and UK, elected politicians will have to make the final judgements on the trade-offs and overall risk appetite. In both cases, the technical details and their application will matter more than the headline rhetoric. Regulators see a world of increasing risk while policymakers see the opportunity to use insurer capital more productively. Insurers want regulation that works in practice and better reflects their long-term business and investments.

Further compromises will be needed but there are no guarantees that all sides will emerge feeling satisfied with the outcomes.

GINO J.
DEL SESTO

Vice President and Head of Government Relations, Europe - MetLife

Cross-border Insurance in the Solvency II Review

Over the past few years there has been a growing discussion around cross-border insurance services within the EU. This is partly driven by certain failures of Freedom of Services (FoS) providers and partly by the perceived increased differences in supervisory practices after the implementation of the minimum-harmonization Insurance Distribution Directive. It is encouraging that, as part of the Solvency II review, there will be more formalized methods of communication among supervisors going forward as without it, the legitimacy of cross-border models may be undermined. This model works, as it already has for MetLife, and the proposed changes will settle the discussion so that cross-border businesses can develop and grow without the risk that the provision of insurance via FoS or Freedom of Establishment (FoE) will be hindered or obstructed by divergence or duplication of supervisory requirements.

EU institutions are keen to achieve increased availability of cross-border financial services. It is how the overall single market is meant to work. For insurance, this progress has been slower, not just because of divergent market characteristics, but because of a scepticism of cross-border business models. While there is still divergence in insurance markets around the EU, a coordinated structure of supervision can work, even with the differences. All stakeholders have an interest in ensuring that cross-border insurance provision is a legitimate model within the EU. An effective and coherent supervisory ecosystem can be created by clear and pro-active communication between the home supervisor, the host supervisor, and the insurance undertaking.

The model constructed for MetLife, which provides insurance services via FoE branches in ten EU countries from a subsidiary in an eleventh, has been very effective, with an active home supervisor regularly engaging with host supervisors and a robust annual College programme (with EIOPA often in attendance). This has been bolstered by direct communication between the company and the host supervisors and the participation of the home and branch staff in local market insurance discussions via industry and business associations. By keeping all three sides of the triangle (insurance undertaking, home supervisor, host supervisor) strong, this ecosystem can be developed in a way that ensures strong confidence with the cross-border provision of insurance services.

Reinforcement of transparency, supervisory cooperation, and pro-active company engagement with both supervisors will allow supervisors and companies to progress with their work without the concern that cross-border models pose additional risk.

EIOPA can offer guidance or consultation, where and when needed, on consistency of supervisory practices and on College activities. EIOPA can observe and promulgate best practices and case studies in supervision. Their expertise, analysis, and push for supervisory convergence can reinforce the ecosystem developed by host and home authorities. The effort of all stakeholders working together will help reduce risk and improve the perception of these cross-border business models.

As noted above, one expectation of the current Solvency II review was some agreement and conclusion that enhanced supervisory cooperation would be able to allay concern about the provision of cross-border insurance services. The system outlined above exists under the current framework and, while it is understandable that this can be strengthened in some ways, the information sharing part of the model should be purposeful for the specific business being supervised and not increase or duplicate the information already being collected as part of normal supervision.

Reinforcement of transparency, supervisory cooperation, and pro-active company engagement with both supervisors will allow supervisors and companies to progress with their work without the concern that cross-border models pose additional risk. And this, in turn, will help the EU progress its plans to grow and develop the cross-border retail financial services, including insurance.

NEXT EUROFI EVENTS

THE EUROFI HIGH LEVEL SEMINAR 2023

26, 27 & 28 APRIL 2023

STOCKHOLM

SWEDEN

THE EUROFI FINANCIAL FORUM 2023

13, 14 & 15 SEPTEMBER 2023

SANTIAGO DE COMPOSTELA

SPAIN

4

THE EU AND GLOBAL SUSTAINABILITY AGENDA FOR FINANCE

ISSUES AT STAKE

The EU Commission is unfolding a "Strategy for financing the transition to a sustainable economy" adopted on 6 July 2021. By extending the existing sustainable finance toolbox this strategy aims to increase the level of ambition of the EU in terms of share of private capital flows redirected to green investments. The objective is more generally to embed a culture of sustainable governance in the private sector. Given the magnitude of sustainability related changes, the EU banking and insurance sectors - and their supervisors – are defining how ESG considerations are going to be embedded not only in risk management arrangements, but also in governance, business model, product and services definition and strategy.

In order to reduce the sources of «green confusion» for investors and citizens, the Renewed Strategy encompasses the adoption of the EU taxonomy for sustainable activities and the Corporate Sustainability Reporting Directive (CSRD), which both raise significant implementation challenges, notably data ones. In parallel, the EU must help to overcome the fragmentation of sustainability reporting at the global level.

A definition of detailed transition pathways is also considered as essential to optimise the contribution of the financial sector, alleviate part of transition risk and reduce "green confusion".

Q&A

SABINE MAUDERER

Member of the Executive Board - Deutsche Bundesbank & Vice-Chair - Network for Greening the Financial System (NGFS)

Between climate change and biodiversity – New challenges for central banks

What is the opinion of the NGFS regarding the magnitude of the impact of nature-related risks on macroeconomics and financial stability?

The NGFS is expanding the scope of its work – from climate change and climate-related risks to nature-related risks stemming from the loss of biodiversity. The link between nature and human economic activity is highly complex with many interdependencies. Our economic and financial activities largely depend on, and are affected by, goods and services originating from the natural environment and, in turn, have a significant impact on nature and biodiversity. Since the proper functioning of ecosystems is essential for economic activity, failure to address biodiversity loss entails major economic and financial risk. We therefore need to halt biodiversity loss because it may impair the provision of nature-related resources such as food, raw materials and fresh water, to name just a few examples. The transition to a nature-positive economy that protects biodiversity will be key to ensuring the sustainability of a wide range of business models.

Similarly to climate-related risk, nature-related risk could materialise, for example, as credit risk, liquidity risk or operational risk, affecting households, firms and governments. Further research is needed into the impact of biodiversity loss on the work of central banks. Thus far, only very few central banks worldwide have conducted economic and financial stability assessments to understand the magnitude of nature-related financial risks. Some preliminary evidence is emerging for the link between biodiversity and price stability. For instance, measures to mitigate biodiversity loss, such as banning imports of timber from unsustainable forestry, could lead to price increases for natural resources and the economic activities that rely upon them. The NGFS has set up a task force and will ramp up its analytical capacities on this front. Going forward, central banks and financial supervisors will need to develop forward-looking approaches to understanding nature-related financial risks.

How has the "data gap" been addressed globally and in the EU so far?
What is the outlook for a perceptible improvement in transparency with regard to climate-related and nature-related risks, particularly in the financial sector?

High-quality climate-related data are crucial for aligning capital flows with low-carbon transition paths as well as managing climate risks. There is still room for improvement regarding both the quality and quantity of data. In 2020, the NGFS started work on bridging data gaps to tackle this issue. The first step is to identify discrepancies between data needs and data availability. Recently, the NGFS introduced a data directory that serves as a central catalogue of available climate-related data sources. The data directory – which is open to the public – supports financial sector stakeholders in finding important and relevant climate-related data sources and facilitates access to these data. In this way, we are helping to identify existing data gaps.

Currently, the data directory contains more than 700 links to relevant data sources. Moreover, regulatory ambition has increased in recent years, especially at the EU level. The Corporate Sustainability Reporting Directive (CSRD) and the Sustainable Finance Disclosure Regulation (SFDR), which require firms and financial institutions to disclose climate-related information, are expected to contribute to more and better climate-related data. The European Financial Reporting Advisory Group (EFRAG) has been tasked with developing draft EU sustainability reporting standards that are envisaged to become part of the CSRD. In addition, initiatives such as the newly established International Sustainability Standards Board (ISSB) will play an important role in harmonising data metrics for and building trust in climate-related data. Aligning disclosure standards globally must take priority in order to enhance market transparency. Close cooperation between the EFRAG and the ISSB will be essential in this context.

Likewise, harmonising national and regional classification frameworks, such as the European and Chinese taxonomies, could pave the way for a better understanding of sustainable activities. The Common Ground Taxonomy, which compares the green taxonomies of the EU and China, makes an important contribution toward this. In its report on enhancing market transparency in green and transition finance, the NGFS also emphasises the importance of clearly defining sustainable economic activities and products, as well as the need for consistent and comparable data based on internationally harmonised disclosure requirements. Transparency is key to closing data gaps.

What are transition pathways for financial institutions made for? Do these objectives lead to the same metrics and features in a transition plan? What would be the main features of comprehensive transition plans?

More and more firms and financial institutions around the world have committed themselves to reaching net-zero emissions, which is an encouraging development, but only half of the story. It is vital that corporations and financial institutions fulfil their net-zero commitments. Transition plans could be a useful instrument for ensuring that firms and financial institutions put their words into action. Laying out a path toward specific targets makes commitments more credible. By strengthening climate action, transition plans will help to reduce physical and transition risks stemming from climate change.

Currently, net-zero commitments vary widely in terms of their features, metrics and benchmarks, which means that work remains to be done on harmonising approaches, developing best practices, and making transition plans comparable. Credible transition plans should meet four criteria.

First, organisations should define clear and transparent targets, such as emissions-reduction targets that specify how they plan to mitigate climate risks.

Second, short-term and long-term milestones must set out a path for reaching these targets.

Third, actionable and deliverable steps must ensure that the targets remain feasible.

Fourth, appropriate governance structures must be put in place to monitor and steer the transition process. It is important that financial institutions build up capacities to adequately implement their transition plans to ensure that these plans are not merely an exercise in compliance.

A sound transition plan would have two effects. It would help organisations to operate in a sustainable way and remain profitable in the future, and it would boost market confidence and show investors that their commitments and actions are aligned. This, in turn, would help to mobilise investment and ensure that the funding actually contributes to decarbonising the economy. Transition plans are also relevant to the real economy. More and more investors will expect businesses to disclose how they plan to manage their transitions to net zero.

Government action will also be crucial in influencing corporate behaviour. The United Kingdom has taken promising first steps. Companies and financial institutions listed in the UK are expected to put forward transition plans from 2023. This initiative sends a strong signal to firms and financial institutions that they must deliver on their commitments.

What are the current priorities of the NGFS towards greening the financial system, improving its resilience to climate-related and environmental risks, and encouraging the funding needed to support the transition toward a sustainable economy?

The NGFS has quickly become a key player in sustainable finance. Going forward, we aim to expand and strengthen our role as a catalyst for greening the financial system, as set out in our new work programme. We will also expand our focus from climate change to nature-related perspectives. We are currently updating and enhancing our flagship product, the NGFS climate scenarios, which help market participants to gauge the economic and financial implications of different emissions and policy paths. Refining the NGFS scenarios will also strengthen our supervisory activities, as it will help to improve climate stress testing. Proper assessments of climate-related risks can provide guidance to banks on their journeys toward net zero. On the macro-modelling side, we aim to deepen our understanding of the impact of climate change on economic variables and, in turn, on monetary policy. We will also step up our efforts toward improving the availability of granular climate-related data.

As we make progress on climate-related issues, we will continue to explore relevant and emerging topics, such as biodiversity loss, and assess their implications for central banks and supervisors. In addition to our analytical work, we will ramp up our capacity building efforts to ensure that all our members, especially from developing and emerging economies, can benefit from the wealth of expertise within our network. In the same vein, we will enhance our outreach efforts and cooperation with relevant stakeholders, such as standard setters, policymakers, financial market participants, and academics.

All of this will reinforce the role of the NGFS as an analytical powerhouse and a key player in promoting sustainable finance globally.

Q&A

BERNARD MENSAH

President of International - Bank of America and Chief Executive Officer - Merrill Lynch International

Only a true public-private partnership can deliver the transition

In what ways should the public and private sectors collaborate on the transition to a low-carbon world?

To devise solutions to the problems we face today, while in parallel pre-empting challenges ahead, collaboration between private and public sectors is arguably more essential now than ever before. It is estimated that around $6 trillion in investment capital must be deployed to achieve a successful transition. Hitting that target will need the combined financial fire-power of both sectors.

There is a tangible opportunity for banks to use their balance sheets for this need. Fortunately, the European banking system has considerable resources to bring to bear and is well capitalised. Its common equity tier one capital of €1.3 trillion has doubled since the financial crisis. Over the same period, its loans have been flat and market risks are lower, while core deposits have tripled. All this funding can be put to good use in helping to achieve the Sustainable Development Goals. But it wouldn't be enough. Traditional financing will need to be supplemented by leveraging more ESG themed market products and services to help bring meaningful capital to sustainably focused projects.

Mobilising Europe's savings for the transition requires new approaches to both financial policy and regulation and innovation. The transition entails long-term investment in complex projects that by their nature are not well aligned with the current regulatory definition of "safe" investments. One approach is for governments to assume some of the risk, or enough of it such that banks can intermediate savings into the less risky, senior tranche of funding. Alternatively, we need to consider new approaches to financial regulation.

Analysts often cite the example of the Liquidity Coverage Ratio, given that one notable feature of the past three years is that banks have been hesitant to draw down their ratio in times of stress. Today's ratio in the euro area is 172%, up from 145% in 2020. Their hesitancy is on a fear of uncomfortable conversations with regulators should they fall below 100%, or even approach that threshold. This was not the intent of this regulatory intervention, which was originally specified at 100% in normal times, with the potential to run below that. More importantly, the effect of the Net Stable Funding Ratio is to limit banks' maturity transformation, but this is an inherent tension given that the net zero transition requires long dated financing. For a system with €8 trillion in demand deposits, three times that of a decade ago, an unwillingness to accelerate lending because of these rules could prove expensive for Europe in the transition path ahead.

Progress with Banking Union would also be a positive part of the picture. Despite efforts to progress this major initiative, there is still a long way to go. Banks are stuck with separate balance sheets in each country which adds complexity and traps capital and liquidity. The result has been little cross-border consolidation in the past decade which would help to realise balance sheet synergies.

Building relevant, workable solutions across geographies, economies and societies is a challenge. Getting this right relies on a constant pursuit and unwavering cross-sector commitment. Getting it wrong would represent failure, and a let-down to many who are relying on the financial sector to harness its resources efficiently to play its part.

Can bank balance sheets accelerate parts of the green transition?

The financial services sector has an important role to play in financing efforts to address the biggest challenges facing societies today. To this end, banks are now better capitalised and have better funding positions, putting us in a strong position to invest in the environmental transition and in a way that can be a catalyst for change.

At Bank of America, we have established a $1 trillion by 2030 goal to mobilise capital to accelerate the transition to a low-

carbon world. Since 2007, we have mobilised more than $350 billion toward climate and environmental action, including more than $150 billion in 2021. We are delivering best-in-class financing and advisory capabilities to advance critical environmental and social business activities.

We have the scale and tools to help our clients succeed and are focused on areas including adopting treasury solutions to tighten working capital for self-funding ESG initiatives and digital transformation projects.

Our recent commitment to the production and use of one billion gallons of Sustainable Aviation Fuel (SAF) by 2030 provides a good case study. We're working to build this market with every tool possible, including by paying a green premium to support the purchase of SAF. Importantly, in addition to procuring SAF for its operations, Bank of America is deploying and mobilising capital to scale and grow the SAF market and accelerate sustainable innovation.

We recognise that many of the new low-carbon technologies are not economical today. It is critical that we work as quickly as possible with participants across the public and private sectors to accelerate and expand technologies which will help to reduce the green premium. The key is to speed up the supply-demand flywheel to help scale production.

The banking industry will undoubtedly play a leading role, but collaboration is – as I must reiterate –essential. The European Commission estimates a need for €350 billion to meet the Union's Green Deal commitments – that's not a one-off, that's every year through 2030. It will not be easy, and it will require the full commitment of both the public and private sectors.

To what extent would reform of how securitisation is regulated provide the European economy with greater financing power?

To help maximise the contribution of the private sector, we need to make progress on the Capital Markets Union, opening up market-based finance to channel Europe's savings into investment capacity. Securitisation is an important element of that.

It is a funding and risk redistribution technique that channels financing to both bank and non-bank lenders, helps convert illiquid balance-sheet assets into liquid investments and generates investment opportunities relevant to a wide range of investors in multiple jurisdictions. It is considered a key tool in advancing the Capital Markets Union and can also play a role in advancing the Banking Union.

The development of the European securitisation market has stalled since the global financial crisis, despite strong credit performance of European securitisation during many economic and credit crises. In recent years, EU new issue placed volume has been around €100 billion – a far cry from the more than €270 billion issued annually before the crisis. One of the reasons behind the low competitiveness of EU banks in comparison to their US counterparts is the weaker development of the securitisation market in the EU relative to the US. The issuance of non-agency securitisation in the US represented just under 4% of GDP; by comparison, the issuance of EU placed securitisation bonds was barely 0.5% of GDP.

The potential for securitisation in the EU is substantial, which is why securitisation practitioners have been warning for a decade now that the EU's approach to regulating securitisation creates high barriers to entry for both issuers and investors alike. The regulations have multiple layers of in-built conservatism, including high capital requirements inconsistent with the risk involved, disproportionate disclosure and due diligence requirements, a lack of comparability of regulatory treatment across comparable capital markets instruments and gold-plating at both EU and national levels.

Similarly, capital requirements under the Solvency II regime do not allow the transfer of securitisation notes from the issuing banks to the highly qualified long-term investors such as insurers and pension funds, in contrast with the prevailing practices in the US and other jurisdictions. The potential high standard of securitisation pools disclosure requirements for sustainable securitisations, unlike the expected disclosure requirements for other capital market instruments, limits the use of securitisation to accelerate the sustainability transition of the EU economy.

To jump-start the EU securitisation market and allow it to fulfil its potential role, a new approach to its regulation is needed along the lines proposed by the High-Level Forum on the CMU. Without changes, it is unlikely that the EU securitisation market can recover, grow and support the recovery of the EU economy and its transition.

PROSPECTS AND CHALLENGES FACED BY THE GREEN TRANSITION

SYLVIE GOULARD
Second Deputy Governor -
Banque de France

The war in Ukraine is forcing Europe to make crucial green transition choices

Despite progress in the development of renewable energies in particular, greenhouse gas (GHG) emissions have barely declined. The latest reports from IPCC Working Groups 2 and 3, published in February and April 2022 respectively, anticipate that, given the policies currently implemented, GHG emissions will continue to increase beyond 2025, leading to an average warming of 3.2°C in 2100. A temperature increase of more than 3°C would have major economic and financial implications. Meeting the objectives of the Paris Agreement therefore requires strong actions now.

The war in Ukraine, the resulting sanctions taken against Russia, and the weaponization of commodity exports by Russia are sources of human suffering, but also risks for financial stability. In particular, energy prices currently observed correspond to an increase similar in magnitude to that simulated by the NGFS at the end of a transition. For instance, oil prices double by 2030 and gas prices triple in most NGFS scenarios. In the case of an orderly transition to Net Zero by 2050, this increase is gradual over the next 10-15 years. In the case of a delayed transition, this increase is concentrated at the end of the period. The current increase in fossil fuel prices is however more brutal, concentrated over 2-3 quarters. Such a development is, in itself, fraught with risks. Beyond the effect of the war on prices, the situation renders obsolete in the very short term (with a destruction of economic value and corresponding financial losses on the balance sheet of their owners) all the infrastructures allowing the import of these fossil fuels from Russia. In a sense we are already paying the price of the transition.

The war in Ukraine forces Europe to make crucial choices in the very short term. Europe can reduce its dependence on Russian oil and gas imports by seeking other sources of supply and by investing massively to adapt the continent's energy infrastructure (liquefied natural gas regasification terminals, adaptation of refineries to the characteristics of these new products) and/or extend the use of coal. Alternatively, Europe can seek to accelerate its transition to carbon neutrality by rapidly making the necessary investments in terms of energy savings, renewable energy production, storage and adaptation of distribution networks, in particular.

The search for new sources of fossil fuel supply would likely delay the transition, thereby contributing to an increase in physical risks in the medium and long term and/or risks of a disorderly and delayed transition in the short or medium term. In addition, new investments whose amortization period is not compatible with the respect of the objectives of the Paris Agreement imply an increase in the volume of assets likely to become stranded assets over time. The NGFS scenarios clearly illustrate the adverse economic and financial consequences of a delayed transition: GDP would be 5% lower by 2050 compared to an orderly transition. The economic and financial losses would be further aggravated in the absence of transition. This response to Ukraine's war-induced energy crisis would therefore contribute to increased financial risks related to climate change.

> The risks of a disorderly climate transition are increasing with the impact of the war in Ukraine.

The circumstances are in place for an acceleration of the transition to carbon neutrality, a preferable choice in terms of short, medium and long-term risks. Given the levels currently reached, the price of fossil fuels should limit the use of those energy sources in a proportion similar to the effect of the introduction of a carbon tax in the NGFS scenarios and encourage the deployment of carbon-free production capacities. As such, it represents an opportunity to accelerate the transition to a carbon-neutral economy. Caution is needed however, as the option of investing massively in the transition to a decarbonized economy is not entirely risk-free either, and could lead to an increase in the prices of energy and of minerals that are needed to develop renewables, which are also subject to geopolitical risks.

ELIZABETH MCCAUL
Member of the Supervisory Board –
European Central Bank (ECB)

Climate transition: risks and opportunities

Summer 2022 saw record-breaking heatwaves and forest fires across Europe. Climate change makes such extreme weather events more likely and increases the hot and dry conditions that fuel wildfires. These events, just like the floods seen in Europe last year, remind us of the need to take urgent action to transition towards a carbon-neutral economy. The war in Ukraine has also brought into sharp relief the need to accelerate the green transition and make Europe less reliant on Russian gas and oil, as confirmed by the Commission's REPowerEU Plan. [1]

The European Commission estimates that Europe will need around €520 billion in additional private and public investment per year until 2030 for the green transition.[2] Globally, the International Energy Agency estimates that investments in clean energy of around USD4 trillion annually will be required by 2030 to get the world on track to achieve net-zero by 2050, and that around 70% of that investment will need to be carried out by the private sector. Climate change is not just a risk for credit institutions, it is also a financing opportunity.

At the same time, financial markets are faced with pronounced economic and geopolitical uncertainty. Increasing transition investment might well be a challenge for indebted governments and private firms. The most recent euro area bank lending survey by the European Central Bank (ECB) showed a tightening of credit standards, a trend that banks expect to continue through the third quarter.

Fortunately, despite the macroeconomic uncertainty and difficult market environment, the demand for sustainable investments has remained relatively stable. Sustainable investments continue to grow globally, driven by an increased volume of environmental, social and corporate governance (ESG) funds and green bond issuances. While the bond market as a whole has suffered a significant slowdown in recent months, in the first half of 2022 green bond issuances were comparable to those in the first half of 2021, amounting to USD245 billion globally. During the COVID-19 market turmoil, investors in ESG funds were less sensitive to past negative performance. This suggests that ESG investors might constitute a relatively stable source of financing to support the transition. ECB research has indeed shown that investors are willing to pay a premium for green bonds.

The ECB's recent climate stress test showed that almost two-thirds of bank income from non-financial corporate customers stems from greenhouse gas-intensive industries. In many cases, banks' "financed emissions"[3] are coming from a small number of large counterparties, increasing bank exposure to transition risks, pointing out vulnerabilities in portfolios in terms of physical and transition risks (and missed transition opportunities). In view of the far from negligible income generated from financing carbon-intensive industries, banks must step up their long-term strategic planning.

In order to properly understand their exposure to climate risks, banks need to gain insight into their clients' transition plans. To be clear, we are not asking banks to divest from carbon-intensive activities. Rather, we are asking banks to fully grasp and manage transition risks in order to make their portfolios more resilient. This means that banks should evaluate what transition entails for their risk exposures to sectors that will continue to be reliant on carbon-intensive technologies for some time and reflect their evaluation in their overall risk management. Not all sectors will decarbonise overnight.

The stress test results also confirmed that timely action pays off. In an orderly transition scenario, where climate policies are introduced early and gradually become more stringent, banks face considerably lower potential losses compared with scenarios where transition policies are phased in late or not at all. This is also in line the ECB's economy-wide stress test last year, which showed that the advantages of early action outweigh the initial costs over the medium to longer term. Acting now is not only the right thing to do, it also makes economic sense.

Depth and breadth in capital markets are needed to complement bank lending and public investment in order to close the investment gap for the green transition. Research shows that economies with a higher share of equity funding tend to reduce their carbon footprint more rapidly. This is just one of the reasons why the ECB fully supports the European Commission's Capital Markets Union (CMU) Action Plan.[4]

Initiatives that improve the comparability and standardisation of sustainable finance products, or otherwise enhance the quality and availability of sustainability-related information, will be essential to create a genuinely green CMU and to address the risks of greenwashing.

[1] Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of the Regions - REPowerEU Plan (COM/2022/230 final).

[2] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions - The EU economy after COVID-19: implications for economic governance (COM(2021) 662 final).

[3] Financed emissions refers to greenhouse gases emitted by entities that receive financial services, loans or investments from financial institutions

[4] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions: A Capital Markets Union for people and businesses – new action plan (COM/2020/590 final).

MARIO NAVA

Director General, DG for Structural Reform Support - European Commission

Supporting Member States towards green and just transition

To what extent inflation strains the green transition?

Just when the economies started to bounce back after the COVID-19 restrictions were lifted, the Russian invasion in Ukraine created new negative shock for all economies across the globe.

Due to their geographical proximity and high dependency on Russian gas and oil supplies, the European Union (EU) is particularly severely impacted.

The latest statistics confirm the seriousness of the situation. In June 2022 reported inflation rate of the EU reached 9.6%. In 15 Member States, it reached a double-digit, between 10% – 22%. Amongst the most impacted are the Central and Eastern European Member States. Many of them already experienced complete disruptions of the supply of these commodities. It is thus no surprise that the energy component of the inflationary developments is the highest. In March 2022 the recorded rate was as much as 40%.

The deployment of renewable energies needs to be accelerated for the EU to become independent on energy. The tragic invasion of Ukraine by Russia has confirmed that the path towards the green transition embraced by the EU some years ago was, and still is, the right one. The European Commission, through the Technical Support Instrument (TSI), is stepping up efforts to help Member States achieving this objective in such difficult times.

What is the role of REPowerEU and DG REFORM in this context?

The REPowerEU Plan is the most prominent EU policy initiative that addresses the double urgency characterising EU's current energy system: (i) the dependency on Russian fossil fuels and (ii) the climate crisis. The implementation of the REPowerEU Plan requires joint EU and Member States action, including in the implementation of ambitious reforms and investments.

Reforms, in particular, are essential to tackle structural problems and to provide long-lasting solutions to energy production and supply in Member States. To address the urgent needs of Member States, and to complement the REPowerEU initiatives, the European Commission's Directorate General for Structural Reform Support (DG REFORM), is supporting through the TSI 17 Member States in phasing out their dependency on Russian fossil fuels and identifying investments and reforms (Support to REPowerEU) to accelerate the EU's green transition.

In addition, DG REFORM has identified several areas where Member States can ask for technical support for the year 2023 to further accelerate the Green Transition as well as boost Smart, Sustainable and Inclusive Growth:

(i) Support to Climate Adaptation,
(ii) Accelerating permitting for renewable energy (europa.eu),
(iii) Support to industrial ecosystems (europa.eu)
(iv) Integration of environmental dimensions in public finances (europa.eu).

How to describe and address the ESG risks in the EU in current circumstances?

This year's increased surge of wildfires across the EU and globally only re-confirms that the world has an enormous task ahead in containing global warming. Addressing climate change remains a priority for the EU and an important opportunity for the financial sector.

The path towards the green transition embraced by the EU some years ago was, and still is, the right one. The European Commission, through the Technical Support Instrument (TSI), is stepping up efforts to help Member States achieving this objective in such difficult times.

The growing demand for green investments and financial products give more importance to the proper management of possible effects of the environmental, social and governance (ESG) risks. Moreover, up until very recently, the environmental risks were featuring amongst the most urgent, given the increased occurrence, severity and geographical spread of natural disasters. The Russian invasion of Ukraine brought a new spin within the "S" and "G" dimensions. We witness unprecedented global businesses response through voluntary discontinuation of activities in Russia. Businesses attach clear value to "terms" like freedom, democracy, human rights.

To address the emerging ESG risks in the financial sector, Member States can ask the Commission for technical support via the TSI through the ESG risk management framework for the financial sector (europa.eu). The support will build on a long track record of accompanying Member States through these challenges. Since 2016, DG REFORM supported over 160 projects targeting clean energy, circular economy, just transition, green budgeting and taxation and sustainable finance.

ARNE STAAL

Chief Executive Officer - FTSE Russell & Group Head of Benchmarks and Indices - London Stock Exchange Group (LSEG)

Sustainability standards should not be a modern day Tower of Babel

7th century BC, somewhere in Mesopotamia. A group of builders who embarked on the uniquely technical and complex task of building the tallest tower ever suddenly find themselves speaking different languages. Although the goal was still the same, the lack of a common language led to the failure of the project.

As policymakers and standard-setters race to roll out sustainability reporting standards, this myth represents an important lesson: that a myriad of different languages can be the difference between success and failure, even if everyone is driving towards the same outcome.

The recent wildfires and record temperatures here in Europe serve as poignant reminder of the impact of climate change and what is at stake if we don't effectively act in a coordinated manner.

Private investors are central to the climate transition and to deliver on the European Green Deal's objectives, but to properly achieve their role, they need reliable and comparable sustainability-related data. Yet, access to basic sustainability data remains challenging and the picture is fragmented across global markets. Data gaps arising from incomplete disclosures mean the indicators used by various stakeholders often rely on diverging methodological choices and assumptions, leading to wildly inaccurate estimated figures. At FTSE Russell, we have found that have found that even in markets with well-developed sustainability reporting, only 73% of companies disclose scope 1 and 2 emissions, which has barely changed since 2018.

Furthermore, the interchangeable use of different terminologies creates a general confusion and lack of measurability of the various contributions to the transition. As such, FTSE Russell's clients, namely large global asset owners, will indistinctly refer to the "race to net zero" or to "the Paris agreement", or to a general "decarbonisation path". Those terms will ultimately reflect a common collective intention, but they will be declined in different objectives that will be difficult to compare.

The greater the difference in approaches and terminology among policy makers, the more challenging the climate transition will be, especially as the world is facing complex geopolitical dynamics and de-globalisation trends.

In that regard, LSEG welcomes the vital political agreement reached on the Corporate Sustainability Reporting Directive (CSRD) as a key building block towards achieving these goals.

As a next step, LSEG is advocating for a common approach to specific metrics or concepts among the European Financial Reporting Advisory Group (EFRAG), the Securities and Exchange Commission (SEC) and the International Sustainability Standards Board (ISSB). As an example, we believe that the opposition of single materiality versus double materiality is artificial. Both concepts should indeed be seen as part of a dynamic continuum – a company's material impacts on external factors (the environment or the society) will ultimately lead to financial impacts, and can therefore constitute a financial risk to be accounted in an actual period of reference. Agreeing on a simple and well-defined set of key metrics to measure climate impacts and transition plans is also needed as a matter of priority.

LSEG is advocating for a common approach to specific metrics among the EFRAG, the SEC and the ISSB.

Finally, sustainability is not, and should not, only be about climate change. To ensure a balanced transition, it is important that other environmental and social areas be accounted for. In that respect, nuance matters: too narrow a focus on climate change could indeed create new risks and destabilize entire ecosystems. For example, the extraction of rare minerals mining for electric vehicles and hydro-electric dams are two climate positive activities that can significantly degrade surrounding ecosystems and displace local people. This is recognised by asset owners who are increasingly asking for innovative sustainable benchmarks, such as UN Sustainable Development Goal (SDG) aligned benchmarks, with this broader lens.

The task is no small feat. Modern day financial accounting took a hundred years to develop and in comparison, we are making giant steps to measure sustainability impacts. It is however critical that we get the foundations right and achieve a common reference framework. Indeed, to paraphrase the Tower of Babel myth, if one people speaks the same language, then nothing will be impossible to them.

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

Developing an internationally consistent approach to climate change transition

We can all agree that carbon neutrality is a universal priority, while pathways towards it differ by countries and regions, neither moving in tandem nor yet speaking the same language. However, the flow of capital moves on a cross border basis. Companies operate globally and must consider the impact of their activities across different jurisdictions, while also accelerating enormous investment to make their business more sustainable.

Both European and Japanese energy companies have been mutually entering into renewable energy markets, but they may face a challenge to fund the transition, due to insufficient liquidity or impairment of traditional cash-cow assets. The pace of transition should be managed to balance the drive towards sustainability with maintaining the resilience of fundamental economic activities.

The energy price surge and the shock from supply chain disruptions have created severe and rapid inflationary pressures and subsequent interest rate rises may negatively impact credit markets. Bond issuance in EMEA decreased by approximately 40% year-on-year in the second quarter of 2022. Even while steering their business through these circumstances, companies must maintain sustainability initiatives. It is essential to monitor whether funds continue to flow into the green transition both globally and locally.

Banks and investors need to properly assess the "transitionability" of companies as greater challenges are coming up in driving sustainability initiatives. Although pathways will differ for each business, a standardised process would increase the transparency of transition plans. A uniform taxonomy would allow them to understand the transition status, but should get better result if it focuses on reflecting their mid-to-long term transition efforts. Thereby companies should be able to implement their respective transition plans in a more consistent way to achieve a just transition.

Policymakers have been discussing regulatory requirements for sustainability disclosure, due diligence and ESG rating standards, however, those discussions are still underway and the lack of a consistent approach risks causing fragmentation across jurisdictions. ESG rating agencies and data providers are striving to develop ESG assessment methodologies and definitions to evaluate a corporation and these are increasingly referred to by banks and investors.

While such analyses are helpful, there is currently no broadly-accepted standard approach and dataset. Some cases appear to only show a snapshot of the status of a corporation, rather than focusing on its path towards sustainability. Therefore, a common language set by any future regulations should create a consistent approach to assessing transitionability from both companies and investors perspectives.

We may come across fragmented trends across countries or regions due to an increased focus on energy security. RePowerEU evidences the EU's flexibility and strong commitment in achieving the EU Green Deal, but countries approaches may differ depending on economic, industry and energy interests. Corporations and investors need a clear and universal regulatory standard to avoid fragmented and unbalanced capital flows for the transition.

Prioritise an internationally agreed standard to ensure global consistency.

One solution would be to prioritise an internationally agreed standard to ensure global consistency and a level playing field. While national discretion may be allowed on top of that where needed, policymakers should focus on setting a global standard as a minimum requirement. We welcome that the BCBS concluded the principles for the effective management and supervision of climate-related financial risks, aiming to create a common baseline across jurisdictions, although this is still at an early stage and various challenges remain. We urge policymakers to collaborate in rulemaking to reduce global fragmentation, especially where rules have an extraterritorial effect, which would facilitate sufficient funding for achieving the targets set and a just transition.

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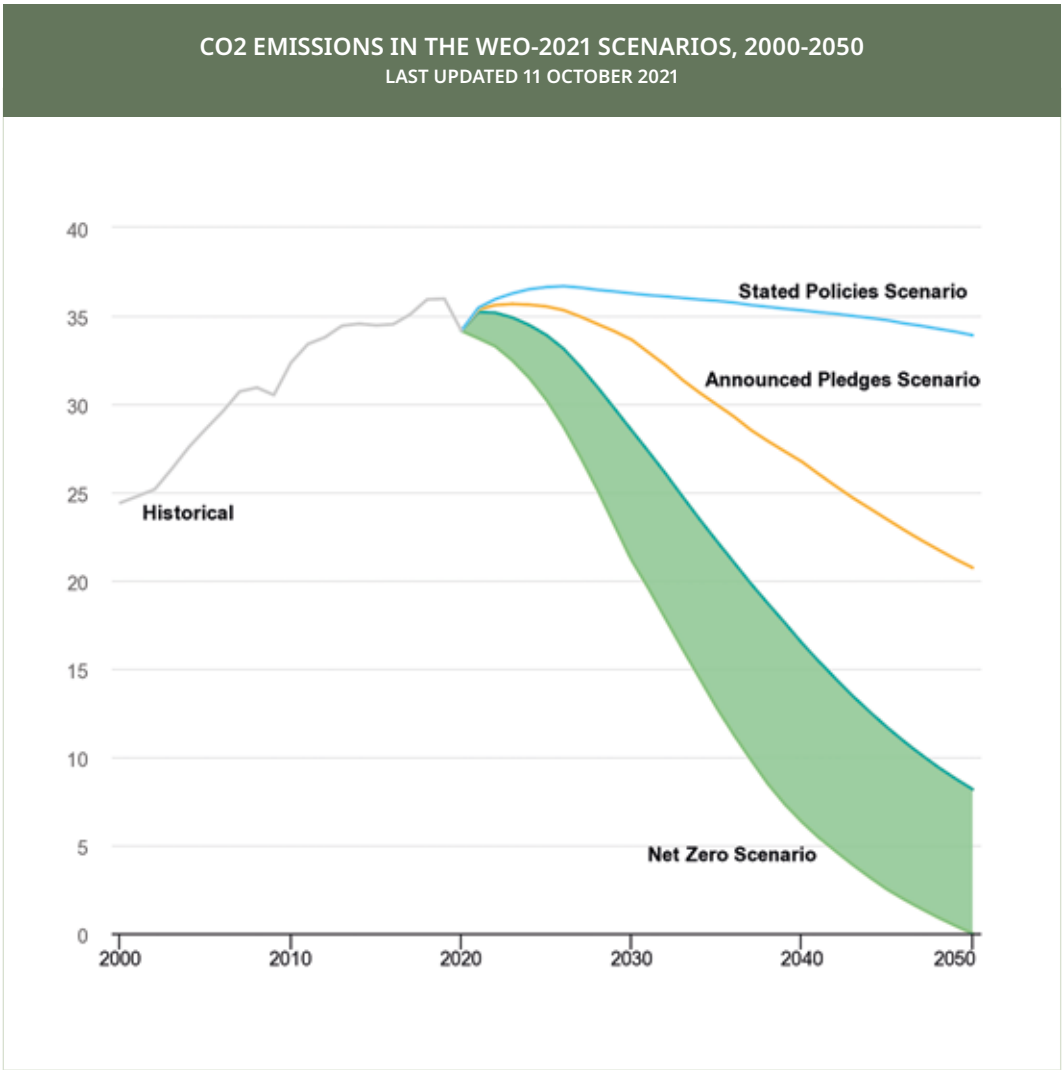
TRANSITION PATHWAYS: DEFINITION AND ADOPTION CHALLENGES

SYLVIE GOULARD
Second Deputy Governor - Banque de France

Transition is urgent

This chart from the World Energy Outlook 2021 (WEO 2021) of the International Energy Agency (IEA) shows that transition must take place rapidly.
And should be financed. The sooner, the better.

If we continue to procrastinate, it will be more costly.



Source : Scenario trajectories and temperature outcomes – World Energy Outlook 2021 – Analysis - IEA

SACHA SADAN
Director of ESG - Financial Conduct Authority (FCA)

From long-term targets to decarbonising the economy

The FCA is committed to supporting the financial sector to enable an economy-wide transition to net zero. Achieving an orderly transition depends on the combined efforts of government, industry, regulators, and individuals. The first stage of any organisation's transition journey is defining ambition and long-term targets. Last year, COP26 catalysed unprecedented long-term net zero commitments from the private sector, including over 5,000 businesses and 450 financial firms.

Commitments are nice but immediate actions are needed. The Network for Greening the Financial System (NGFS) work to build analytically robust transition scenarios has been vital here, as has that of Glasgow Financial Alliance for Net Zero (GFANZ), Transition Pathway Initiative (TPI) and others on sectoral transition pathways. However, building a robust transition strategy is still far from straightforward. A complex web of assumptions, relating to future developments in policy, technology, and science, need to inform any transition strategy. Firms are also having to respond to a seemingly constant flow of global socio-economic shocks: nobody foresaw the global pandemic, war in Europe and a cost-of-living crisis. This underlines the importance of focusing on short-term actions, targets, and milestones, for which existing management will ultimately oversee and be accountable.

But we must take care when shifting from setting long-term targets to developing strategies. Firms' transition strategies should include – but stretch beyond – plans to meet their net zero target. There are three key reasons for this.

First, a focus on decarbonisation of assets and portfolios risks unintended consequences. Firms could divest carbon-intensive investments, selling them to private, unaccountable owners with little incentive to transition investment towards net zero. We must not mistake the greening of portfolios for the greening of the economy. Transition strategies need to focus on active stewardship towards decarbonisation, including through financing responsible phase-out of emissions-intensive assets.

Firms' transition strategies should include -but stretch beyond- plans to meet their net zero target.

Second, the emissions profile of a company is not always a robust proxy for financial risk. Let me illustrate with two examples. On the one hand, a software provider might have a low emissions profile, but rely on offering a product that supports oil exploration. On the other, a mining company might have a high emissions profile, but focus on mining lithium to create batteries that power electric vehicles. In both cases a focus on entity-level carbon emissions misses the bigger picture.

Third, the climate transition is a unique, long-term systemic risk. Firms can act today to use their sphere of influence to shape the actions of their workers, policymakers, customers, and communities to accelerate an orderly transition, build strategic resilience and ultimately strengthen long-term corporate value. It is here that low-emitting sectors like the services sector, which makes up approximately 80% of UK GDP, can most effectively contribute to the transition.

So where does the FCA fit in? Last year, we released our ESG Strategy, including new work to support a market-led transition to net zero. Our primary focus is on promoting transparency so investors, clients and consumers can assess transition plans and make effective decisions in response. Last December we set out initial expectations on disclosure of transition plans by listed companies, asset managers and regulated asset owners in accordance with TCFD guidance. But this is not about tick-box compliance. Disclosure should also drive behaviour change in how preparers develop their transition strategies.

The UK Government has now convened a Transition Plan Taskforce (TPT) to develop a gold standard framework for transition plans. My team and I are active participants and will draw on the outputs to develop our regulatory expectations and align internationally. We will also road-test the TPT's outputs with industry, to identify challenges for preparers and assess whether outputs support investor decision-making and stewardship. Another focus is on promoting complementarity between the Taskforce's work and related international initiatives. This includes guidance developed by GFANZ and the ISSB's climate-related disclosure standard. On ISSB, our domestic work on transition plans could demonstrate how the ISSB's vision for a building blocks approach to sustainability reporting can work in practice. We remain a strong supporter of the ISSB's work to create a global baseline of sustainability disclosures, as expressed in our recent response to their exposure drafts.

Last year saw the financial sector step up by setting net zero targets. Our focus – as policymakers, standard-setters, and industry – is now on building a suite of tools that enable firms to develop and disclose robust transition plans, actions, and strategies. These tools need an unwavering focus on driving decarbonisation of the economy. That is the North Star we must all follow.

ANTJE STOBBE
Head of Stewardship - Allianz Global Investors

MARIE RUPP
Senior Sustainability Analyst - Allianz Global Investors

Financial institutions' climate transition plans: transparency is vital

Climate transition plans of financial institutions (FI) reflect the highly complex nature and the broad and multi-faceted exposure of FIs to a wide range of economic activities. Consequently, communications on transition strategy cannot be made simplistically in a few bullet points and performance goals. Moreover, such communication from FIs is often dispersed over many different documents, made public at different points in time and for a range of purposes.

Financial institutions could further improve their climate transition communications by being more comprehensive on all relevant parameters for each specific target: scope, time frame, accountability metric and starting level. Currently, such parameters are not provided in a systematic way with key information often left out. All information about the company-wide climate transition plan should be available in one place, easily accessible and up to date on all active key climate action metrics. Improvements are also needed in terms of clarity and visibility: understanding a FI's transition plan can be like putting together the pieces of a jigsaw. A clear mapping of current and scheduled climate actions – according to a clear roadmap – against whole company activities would be most helpful.

Without transparency and universally available data, certain issues would risk remaining unaddressed and unmanaged. Well-coordinated rules across the entire data value chain are needed to ultimately attain these goals because FIs need to rely on the climate data of their customers, investees, lenders, creditors etc. for incorporating into their own disclosures. To date, the biggest obstacles to FIs' action on climate change are limited availability and access to such data, followed by data quality, reliability, and comparability. Regulation should also address the format in which data are made available: more standardized digital formats should facilitate the collection and comparability of data on a much larger scale than is presently feasible.

No regulatory requirements have been imposed to date apart from disclosure, but the power of transparency is not to be underestimated. Well-designed reporting rules implicitly carry multiple related requirements: data systems must be in place, and data collection must be embedded in the various business processes.
Reporting may also be a catalyst for positive (side)effects: awareness about climate-impact and related risks will be raised across many functions and levels within the organisation as well as outside (including customers). This will contribute to shifting business models and corporate culture towards sustainability, enabling the right priorities of actions to be set and identifying challenges in execution.

Transparency also allows engagement with other stakeholders. Constructive dialogue is crucial to push an organisation to the next level.

It is not always possible to compare FIs' transition pathways to the national pathways of the different countries in which they operate. Countries' climate transition plans must reflect local fiscal, regulatory and political positioning on climate. Local FIs' activities are linked to the national pathways, however for international FI's there is no direct link to a single country.

Net zero-aligned firms are committed to transitioning investment and business portfolios to net zero (NZ). As such, NZ initiatives have a complementary role to regulatory rules, closing gaps to achieve a common approach and defining self-imposed requirements. NZ initiative signatories emulate good practices while regulators can observe in an applied setting what is possible, what works, and which challenges exist, ahead of introducing industry-wide regulation.

To make overall transition plans mandatory for FIs may be counterproductive. This is because such plans are generally very broad, staggered, and long-term, which means a mandatory approach to implementation could well cause delays until a full plan is ready and in place. However, mandatory steps on relevant specific aspects, with the potential to trigger other elements (such as mandatory reporting), could be necessary to drive the transition.

For example, the focus on climate-related risks could justify mandatory stress testing. Stress tests carried out by the ECB show that banks should sharpen their focus on climate risk. Regulators could also focus on other areas for mandatory requirements, such as the share of investments in climate solutions or the exposure to activities classified as significantly harmful, as suggested in the draft proposal for the taxonomy extension by the Platform on Sustainable Finance.

MELISSA OCAMPO

Head of Sustainability Strategy in EMEA - SMBC Bank International plc (SMBC)

Supporting a just and urgent transition through regulatory collaboration

Considering the recent extreme weather events on multiple continents and the threat to economic and political security posed by soaring energy costs and supply challenges, the case for an urgent and just low-carbon transition has never been clearer. Fortunately, there is broad alignment between banks and regulators; both have a strong incentive to reduce the multiple risks posed by a disorderly transition and to create an environment conducive to directing capital toward activities with the greatest likelihood of helping our society to undergo this fundamental transformation. To benefit from these aligned incentives, we must collaborate closely to find mutually effective solutions.

SMBC Group has set an ambition to be a leader in the low carbon transition. Building on our strong roots as a leading project financier, we are aiming to grow our already market-leading stake in renewable energy projects. SMBC is also building our credentials in new energies, supporting innovative EU projects such as the world's largest green hydrogen power plant, part of a unique baseload solar project in French Guiana called CEOG Hydrogen. SMBC believes green hydrogen will play an important role in energy storage and in unlocking heavy industry decarbonisation.

Through actions such as SMBC Group's recently announced strategic alliance with Marathon Capital, a leader in ESG advisory, and hiring our own in-house decarbonisation advisors, we will support our clients in the EU with their transition through both cutting edge expertise and financing. SMBC is already working with EU clients in diverse industries to understand their transition plans as we work toward achieving Net Zero financed emissions by 2050.

In client conversations, SMBC observe a range of practices, from very advanced firms that have clear, science-based targets, robust governance, and detailed plans to those organisations that are earlier on their transition journeys, due to several factors, such as a lack of availability of technical options or the need to support local economic development in non-OECD countries. SMBC recognises the need to be able to flexibly support a variety of client needs. From a regulatory perspective, we believe that this uneven transition maturity across regions and sectors should be a key consideration when considering the scope of disclosure requirements.

Common principles will be key to ensuring comparability and more time spent on decarbonization.

Recent detailed guidance and focus from regulators is a welcome development, to ensure consistency and comparability across sectors. Along with our industry peers, SMBC is reviewing the European Financial Reporting Advisory Group's recent draft EU Sustainability Reporting Standards (ESRS) to understand expectations and impacts to our business and our clients, alongside the Corporate Sustainability Reporting Directive (CSRD). We welcome the leading role that the EU is taking to develop sustainability reporting standards, and considering the need for more sustainability data across the board from both financial institutions and corporates, it is right that policymakers show urgency in developing these frameworks

Of course, given SMBC's global footprint, ESRS and CSRD are among several recent proposals related to Sustainability disclosure that we are reviewing, which includes the International Sustainability Standards Board's reporting standards. Considering the priority regulators are giving this important topic, harmonisation of standards to drive consistent and compatible frameworks internationally will be welcome.

We are supportive of efforts by the ISSB to develop a global baseline for sustainability reporting standards, and would encourage others in the industry and regulators to engage in this process to foster closer alignment on these standards both within the EU and globally. Especially for banks in the EU with a parent in Asia, having standards that begin to coalesce around a common set of principles and reporting approaches will be key to ensuring comparability as well as more time spent on client decarbonisation and less on interpreting competing standards.

SMBC believes that comparability of performance is important in building trust, so that investors have confidence in the green credentials of the banking industry in the context of both the urgent climate emergency and energy crisis that we face. SMBC has an ambition to be a leading green financing provider in the EU, so we are conscious of supporting transactions that are consistent with that vision and build the trust of our clients.

There is much work to be done, and SMBC EU is keen to actively support this work. As new technology and data becomes available, transition pathways will have to adapt. SMBC also welcomes the availability of more green projects in the near future, given that there is presently more green capital than demand, and we look forward to participating in nimble cooperation with regulators & peer lenders to manage the risks and opportunities presented by the low-carbon transition.

SINTHUJA YOGARAJAH

ESG Integration, Responsibility Platform - Federated Hermes Limited

Transition pathways: the critical role of stewardship in the journey to Net Zero

Although climate change action needs to be significantly increased on a global basis to achieve the goals of the Paris Agreement, the years since its entry into force have already sparked action with more and more countries, regions, cities and companies are establishing net zero targets.

At Federated Hermes Limited, we believe that the investment management industry – working with asset owner clients– could and should be a potent force alongside governments in making a climate-resilient world a reality. The financial industry sits in a unique position, where its actions could continue to compound the climate issues we collectively face, and in doing so undermine its fiduciary obligations to clients, or it could instead use intelligent and considered stewardship of capital to effect genuine and positive change in fulfilment of these obligations.

We have a responsibility as an industry, and indeed as a business, to make the right choices and play our part in delivering the goal of the Paris Agreement: an outcome that is fundamentally in the long-term financial interests of our clients.

Unchecked, we believe that climate change represents a systemic risk to financial markets, the global economy and our ability to create sustainable wealth for our clients and their investors. Of particular concern to us is the possibility that even if transition risk is managed within our portfolios of investments, unmanaged physical risk could still destroy value through business operations or supply chain interruption caused by factors outside the control of our investee companies. This also presents an unprecedented growth opportunity with low carbon sectors expected to grow by several multiples leading to value pools of $9-12 trillion of yearly revenues by 2030 (McKinsey, 2022).

We believe that financial markets are only as sustainable and 'Paris-aligned' as the real economy they serve, and that recently strengthened government pledges on climate action must be complemented with sufficiently strengthened real world policy measures and corporate action, alongside the actions of individuals, communities, philanthropic and civil society organisations to accelerate change. Based on current government policies, overshooting 1.5C is "almost inevitable," and we could still see a temperature rise of 2.7° to 3° C according to the latest IPCC Report. As a result, we believe governments should mandate transition plans to support stewardship and engagement efforts of investors and improve the quality and comparability of what is currently reported on a voluntary basis. New measurement approaches to assess real economy impact will also be required.

Financial markets are only as 'Paris-aligned' as the real economy they serve.

We recognise that companies, regardless of sector, industry and the location they are in, need to understand and plan to manage the potential physical risks to their operations and supply chains that arise from a changing climate. Companies also need to undertake climate transition risk assessments. These are needed to understand what operational and business risks – and also opportunities – may arise from a progressively tightening climate policy environment capable of shifting global markets onto a sustainable footing that is aligned with what scientific experts in the IPCC say is needed to stay within the 1.5°C temperature limit. It is also critical that social considerations are factored into their climate change mitigation plans (including impacts on workers, communities, supply chains and consumers) to ensure a just transition. For example, social and economic considerations present tensions, trade-offs, or constraints that must be considered and addressed in a holistic response that works for both planet and people?

The pathways ahead for investee companies are varied and uncertain, especially in the multiple jurisdictions where climate policies are absent or in early stages of development and where technology just doesn't exist to allow certain industries to move away from their current practices. Investment in the shift to a low-carbon world is about six times lower than it needs to be. Hence, it is key that we continue to invest in the transition and as a global economy help fund the development of new clean technology.

We know that success in the endeavour to achieve a net zero carbon global economy by 2050 will require a far-reaching transformation where coordinated efforts between investors, corporates and governments will be integral.

ANGUS GRAHAM
Sustainability Chief Financial Officer - UBS

The financial sector needs to partner with its clients to deliver net zero

Momentum behind net zero is rapidly reaching critical mass. The financial sector has a powerful influence on the global economy. This is why partnering with clients, providing them with the choice they need to meet their sustainability objectives to help them mobilise their capital toward a more sustainable world and thereby facilitate an orderly transition towards net zero is so vital.

UBS fully recognises the crucial role finance must play. We are organising ourselves to finance the transition, scaling up private capital flows towards a 'net-zero', low carbon economy. Addressing climate change also presents an important opportunity for the financial sector to play a key part in building modern infrastructure for the post-industrial age.

Sustainability means thinking and acting with the long term in mind. We have an obligation to our clients, shareholders, and employees to apply a long-term lens, and we also have a responsibility to those communities in which we operate across the world.

This is why we have put sustainability at the heart of our own business too, with a climate roadmap that takes us from commitment to action, setting out key milestones to deliver on our net zero commitments by 2050, including reducing absolute financed emissions associated with UBS loans to fossil fuel companies by 71% by 2030 and engaging with our main vendors about moving toward net zero emissions by 2035.

The credibility of net zero transition plans - turning commitments into action - can only be assured if we have harmonised science-based metrics and targets which measure where we are, where we need to be, across supply chains, and ensure consistent and collective efforts to prevent global heating from exceeding more than 1.5 degrees above pre-industrial levels.

A global and standardised approach towards measuring and reporting financed emissions will also provide financial sector firms with insights into their portfolios' carbon footprints and the extent to which they are aligned with global net zero climate goals.

It's essential to provide clients with the choice they need to meet their sustainability objectives.

Active ownership by investors can also contribute to the long-term sustainability and success of companies and the markets in which they operate. Effective stewardship, informed at least in part by portfolio alignment assessments, can foster healthy dialogue and enhance performance on a variety of environmental, social and governance issues by monitoring and, where necessary, influencing corporate conduct on matters that affect the long-term value of investee companies. We believe that by working directly with companies on realising sustainability improvements through stewardship and driving positive corporate changes it will lead to better informed investment decisions that help to deliver transition, while positively impacting the company's business performance and generating benefits for the environment and society as a whole.

The alternative - divestment - is not a panacea, at least in the short term. Doing so risks pushing carbon-intensive industries towards alternative sources of capital that may be outside the regulatory purview.

If the world today is sustainable and carbon intensive or green and brown, then we need to turn the brown part green by engaging with it not divesting it. Divesting from entire sectors or simply passing carbon-intensive assets from public markets to private markets will not make the world greener.

It is important to recognise that transition requires time. Changing from one state or condition to another needs to be appropriately sequenced, however this not indefinite. With a clear timeline and end point divestment may be considered a last resort if companies fail to improve.

The cost-of-living crisis in Europe, and its global reverberations, further highlights the importance of a 'just transition' towards a climate-neutral economy, leaving no one behind. In particular, the energy crisis, driven by the war in Ukraine, has underlined the need, now more than ever, to accelerate plans to transition towards renewable energy while at the same time delivering energy security.

All of this needs public support and so, in addition to the pivotal role of finance, the real economy is also central to our collective efforts to reduce the impact of climate change. Governments individually and collectively, also have a significant role to play in designing economy-wide policy frameworks that incentivise companies to re-engineer their production processes while providing the certainty which finance needs to make the necessary investments.

CLARIFYING THE SUSTAINABLE INVESTMENT UNIVERSE

CARLO COMPORTI
Commissioner - Commissione Nazionale per le Società e la Borsa

Labels, a means of increasing trust in sustainable finance

Over the past decade the growth of so-called green, sustainable, ESG investment products has increased tremendously and so has the debate around the development of labels for financial products. Like ratings, labels aim to assess how ESG issues are integrated into investment decisions in order to convey a message on the sustainability of a financial product; nevertheless, there are some differences between ratings and labels, which make the latter a more interesting alternative for non-professional investors.

Labels are easy to understand, as they define minimum requirements for sustainable products and largely use the "pass or fail system". Once the label has been credited, they do not distinguish between labelled-products. Ratings, on the other hand, have a grading scale and not every investor know how to best use the specific rating given to a specific financial product. Additionally, information provided by labels is somewhat different from that provided by ratings, labels are normally focused on the "investment process" and reward a well-defined investment process that considers ESG criteria, whereas ratings are normally focused on the "portfolio" and evaluate all the holdings in the portfolio with the goal of providing investors with a comprehensive assessment of its environmental, social, and governance attributes. These differences have contributed to the development of sustainable labels for financial products, mostly in Europe where nine sustainable labels are currently in use, with France, Belgium and Luxembourg having extensively contributed. As of December 2021, more than 1700 funds on the European markets (which totals almost 60,000 funds) have been awarded with one or more of these labels. Labelled funds represent more than € 1,3 trillion of AUM (+90% compared to previous year).

Undoubtedly, labels can play a role in reducing the information asymmetry between providers of financial products (i.e. asset management companies) and buyers of these products (i.e. investors). Labels aim to help buyers selecting products that match their own investment goals and sustainability preferences. This is important if we consider that sustainability characteristics of an investment are extremely complex as they are based on a large variety of terminologies, metrics and practices. In its Action Plan for sustainable finance, the European Commission recognizes the merits of a label-system explaining that "labelling schemes can be particularly useful for retail investors who would like to express their investment preferences on sustainable activities". The Action Plan precisely enumerated a number of priority actions to support sustainability transition, one of which is the creation of labels for green financial products.

Whilst the Proposal for Regulation of the EU Green bond is at final stage of negotiation, the Commission is currently working on the EU Ecolabel for Retail Financial Products and on its alignment with the Taxonomy Regulation. The intent is to provide retail investors with a reliable and widely recognised label for financial products, alleviating some of the concerns about the lack of standardization of private labels.

The key point is that while industry has moved forward and has already developed a number of labels for financial products, these are highly heterogeneous. Existing labels differ significantly in their specifications: some are thematic (focusing on environment or climate), others are broader and integrate all ESG factors. Some are very strict, others set only minimum proportion of a portfolio total asset under management to be invested in sustainable activities.

While most labels use a "pass or fail" system to assess whether an investment is eligible, the threshold applied for the "pass-or-fail" vary significantly from one label to another. As a consequence, existing labels have little common ground as to what constitutes a sustainable investment product. If the intent was to help investors understanding the degree at which an investment funds sustainable activities, the result is that each label has its own criteria to assess whether an investment is sustainable or not.

Now, the big question is: do labels really help investors? Does this variety achieve the desired end of helping investor or does it encumber the market with uncertain signals? Academic research show that instead of simplifying the choice of agents, the multiplication of labels tends to increase the noise in the market and deteriorate confidence. The asymmetry of information increases as the number of labels grows and investors may lose confidence in sustainable labels and ultimately turn away from sustainable products. This topic is at the heart of discussion of regulatory community as the challenge for regulators is to ensure that investors are provided with reliable and comparable information on the sustainability characteristics of products. Labels are largely considered among the key elements of product-level disclosure.

In its Recommendation on sustainability-related practices published in November 2021, IOSCO recommends regulators to consider new requirements or guidances to improve product-level disclosure on sustainability. In particular, IOSCO recommends regulators to cover the labelling of the product providing clear parameters around use of sustainability-related label as this would promote the comparability of labelled financial products. In its Sustainability Finance Roadmap, the leaders of G20 made a call for International coordination on approaches to identify, label and verify sustainable investments. Along the same lines, ESMA in its roadmap highlights as priority action its work on labels for financial products. Clearly, regulators are very conscious that mis-labelling is one of multiple facets of green washing and mindful of the importance to watch on it. The challenge ahead is to design an effective regulatory framework for labels which could strike the right balance between the strictness of the criteria (so as to give label its credibility) and ensure a sufficient large pool of eligible investment opportunities.

Work is in progress and current discussion is mainly about scope and eligibility criteria of the label, verification and assessment of the criteria, time and content of information for the investors. I think the path is there. Time to take action is now.

PAUL TANG

MEP, Committee on Economic and Monetary Affairs - European Parliament

Labels are omnipresent

From electrical appliances to food, our consumption is often rewarded with a green A-label, or punished with a red F or, god forbid, a G-label. And for a good reason. Without needing to dive into behavioural economics, we know that labels work. Who doesn't want to be rewarded with an A when buying something? Indeed, data from the European Commission confirms that energy labels for electrical appliances will save us some 230 million tonnes of oil equivalent by 2030.

An area lacking in the EU's labelling-drive is finance. With work on an Ecolabel for financial products put on the back burner, focus has been on transparency and disclosure requirements. Being accustomed to analysing significant datasets, the reasoning goes, disclosures are more appropriate for the financial sector than simplistic labelling regimes.

Additionally, the multifaceted impact investments have on our economy mean any labelling regime will be a drastic simplification of the ESG impact of a fund. As such, they may remove from financial market participants the responsibility to look at the broader picture and instead shield behind a label when marketing products to end investors.

Yet, a stamp of approval on a fund is exactly what end investors want. In the need to balance these two aspects – the need for detailed transparency and the user-friendliness of labels – the EU has veered then to the one, then to the other extreme.

The singular focus on transparency has exposed the Sustainable Finance Disclosure Regulation (SFDR) to abuse. This because instead of looking at what is being disclosed, the simple fact of whether a fund discloses according to article 8 or article 9 is seen as an indication of its green credentials. This had led to calls for limiting the types of funds that can use these disclosure regimes. While clarification is certainly needed as to what counts as the 'sustainable investments' that products using the article 9 regime can invest in, policymakers should be careful not to put limits to climate-related disclosures.

The more disclosures on sustainability strategies the better, so especially article 8 should continue to be a 'catch-all' regime for funds wanting to show how they take sustainability characteristics into account. Instead of using the SFDR itself as a labelling regime, the disclosed information should be used to give retail investors easy to understand and trustworthy information on the green credentials of their investments. This could go via labels, but also via limits on the use of ESG-related terms in fund marketing materials. Funds shouldn't, for example, market themselves as 'green' or 'sustainable' while investing in economic activities that significantly harm our environment.

Simplistic labelling regimes should therefore only be part of the regulatory efforts in sustainable finance.

While the unitary focus on transparency has created difficulties for the SFDR, the exclusive focus on labelling may limit the impact of the European Green Bond Standard (EuGBS) Regulation. The exponential growth of the green bond market in recent years has led to bonds with dubious green credentials entering the market. NN Investments estimates that a full 15% of green bonds constitute greenwashing. Creating a gold-standard label in this market may put pressure on market-based standards to improve. But then again, it may not. If investors don't have sufficient data to compare the green credentials of EuGBs with those of other green bonds, competition between them may be limited. What is more, by focussing on the EuGBS, the Commission proposal fails to close a remaining data-gap. The SFDR mandates fund managers to disclose the sustainability performance of their fund, but will, after the Corporate Sustainability Reporting Directive enters into force, only have access to company-level data. Data on the characteristics of the assets underlying Use of Proceeds bonds will not be available.

An equally big risk is that by focussing only on how a EuGBS is spent and not on the issuer, the label becomes a tool for greenwashing. If companies refinance their green assets through a EuGB and use the return to invest more in polluting activities, the 'additionality' of the EuGBS is more pollution. Issuers would pretend to be green while being brown, a schoolbook example of greenwashing. Mandating trustworthy transition plans for companies issuing EuGBs would counter this, while harnessing the power of the EuGBS to help any company transition to a more sustainable business model.

The impact of investments on our planet is more complex than that of electrical appliances. Simplistic labelling regimes should therefore only be part of the regulatory efforts in sustainable finance. Making information easy to understand for end investors should be coupled with disclosure regimes that allow for the myriad of sustainability impacts to be measured and monitored.

Whether it comes to financial products or the bond market, good regulation will combine both elements. But to get there, more work is still to be done.

BIRGIT PUCK

Managing Director Securities Supervision - Austrian Financial Market Authority

Sustainability labels needed to prevent greenwashing

The market for sustainable funds has been growing strongly in both absolute and relative terms, in particular due to increased net cash flows in this segment. Consequently, the market for sustainable funds has evolved from a well-established niche market into the mainstream. Due to the high demand for sustainable financial products, an increasing number of funds promote themselves as "sustainable" or "green". This trend is observable not only for the Austrian market, but also for EU markets.

Given this market trend towards sustainability, potential greenwashing is a top priority for collective investor protection from a supervisor's perspective. There is even a risk that brown or CO_2-intensive investment products are somehow labeled as "green", although no material sustainability criteria are met. It is a paramount supervisory concern that financial products declared as "green" are actually and comparably "green".

As supervisors, we currently face challenges due to the non-harmonization of material (minimum) standards with regard to "sustainable" or "green" financial products, which are problematic for cross-border prevention of greenwashing.

EU legislation has taken fundamental steps by putting into force the Taxonomy Regulation (TR) and the Sustainable Finance Disclosure Regulation (SFDR). New rules require the inclusion of a description concerning the promotion of environmental or social characteristics and sustainable investments in pre-contractual information disclosures for financial products. Such harmonized regulation of disclosures on sustainability is fundamental in order to enable consumers and investors to make informed investment decisions, as the demand for green sustainable investments has been constantly rising.

The SFDR introduces product categories for the purpose of specific disclosure requirements. So-called "light-green financial products" (Article 8 SFDR) promote, among other characteristics, environmental or social characteristics while the objective of "dark green financial products" (Article 9 SFDR) is sustainable investment. Even though the categories for financial products provided by SFDR have not been envisaged as "labels", market participants effectively use them in this way. Furthermore, market participants in Europe are experiencing legal uncertainty with regard to the different "shades of green" as their understanding differs between national markets and jurisdictions.

A labelling approach is needed for financial products to prevent greenwashing.

If we compare the Austrian fund market to other European markets, the significance of different stances towards light and dark green financial products becomes apparent. They may lead to market distortions and fragmentations within the EU financial market and might give wrong signals to investors. Therefore, the market needs further guidance concerning classification on the application of European rules.

Moreover, there are several national eco-labels for financial products and funds already in place and an EU eco-label in development. For example, the Austrian eco-label on sustainable investment products promoted by the Austrian Federal Ministry for Climate Action is widely used, having been established in 2004, making it one of the oldest national eco-labels for funds in Europe. While eco-labels provide some standardization and are prominent in their national markets, they are only voluntary, vary in their requirements and are not within the remit of the financial supervisors.

These issues highlight market fragmentation due to insufficiently harmonized sustainability labelling. By setting clear standards, a label for sustainable financial products should be simple, transparent and easy to understand for investors. Harmonization should occur across different financial products (with the same criteria applying for funds, insurance-based investment products or pension products, etc.) and should not prevent market participants from setting even higher standards.

Ultimately, a label for sustainable financial products should be defined by EU regulation with specific mandatory criteria, as has already been the case for other specific fund classes such as money market funds, EuVECAs or EuSEFs. In the meantime, however, regulatory guidance is necessary to foster sound market development of sustainable financial products. This could be achieved by ESMA Guidelines on (minimum) standards for sustainable financial products such as funds.

In my perspective as a supervisor, a labelling approach appears to be a necessary tool to prevent greenwashing. I strongly believe that the harmonized application of "sustainable" financial products is the only way to achieve a level playing field in a sustainable European financial single market.

BENOÎT DE JUVIGNY

Secretary General - Autorité des Marchés Financiers (AMF)

Clarifying the sustainable investment universe, what is needed labels, ratings...

Today, needless to say that sustainable finance is booming. Regulatory activity has been extremely rich, and taking our European Union (EU) example, has led to an ambitious and complex framework that unfortunately lacks consistency and remains much to complex. Good progress has been achieved on the issuer side, where the political agreement on the Corporate Sustainability Reporting Directive (CSRD) is excellent news. However, investors and stakeholders will remain in need of reliable ESG data, and assessment based on robust and transparent methodologies.

Hence the need and temptation to rely on labels, ratings and data products, and the quick growth of providers to answer these demands. But are those compasses fit for purposes, and is the needle pointing towards the real North? Our responsibility as supervisor is to ensure the credibility of the ecosystem and the development of a green economy of trust. Avoiding greenwashing is key. And there are still key milestones to accomplish and to progress in bringing more credibility to the system, including in the regulatory area.

In the investment space, the Sustainable Finance Disclosure Regulation (SFDR) categories of article 8 or 9 are mistakenly used and promoted as labels, despite being designed only for disclosure purposes. Three competing definitions of sustainability investing coexist and are concurrently used in newly revised Markets in Financial Instruments Directive (MiFID) sustainability preferences. Regulators themselves find it hard to keep up with these concepts. It cannot be expected that investors will be able to do so. Therefore, we urgently need to simplify and clarify the landscape. The most direct route could be to create new categories with minimum requirements inside article 8 and article 9 SFDR categories. Indeed, labels targeted at retail investors are thriving in Europe since the Austrian Umweltzeichen one in 2004. Some have been quite successful such as the French ISR, or the Belgian Febelfin ones. However, the great diversity in geographical scope and contents, and the market fragmentation induced, has led to confusion for the investors.

Our responsibility as supervisor is to ensure the credibility of the ESG ecosystem.

Our AMF 2021 study on retail investors' preferences[1] demonstrated that 71% of the respondents do not know the French ISR or Greenfin labels and around 56% do not trust those labels. It is therefore time to join forces and promote truly European labels, potentially based on SFDR categories. Too narrow, they would only constitute niche products. Too large they would be a catch-all and potential vehicles for greenwashing. The alternative route that could be used as a first step would be to enforce common marketing rules.

Second, it is urgent to regulate both ESG rating providers and ESG data product providers. We have called for that for a while since our 2020 joint paper with our Dutch counterpart and the world of regulators is brewing with initiatives at international levels (IOSCO 2021 Report), and in several key jurisdictions, both in the EU but also UK, Japan or India. All these initiatives meet on the need for transparency on the objectives or the products (risk or impact), methodologies used, ESG preferences rated, underlying data sources and estimates, conflicts of interest management, proper governance... All very classical. Indeed, without such transparency, financial actors are bound to rely on "black boxes" not being able to identify providers that best suit their own ESG needs and adequately understand the products they use.

It is time to regulate ESG rating providers and data providers, this future regulation must cover the entire range of services from ESG data to ratings and services and not be limited to "ESG ratings" where no single definition exists as issues identified are common to all these products. But the diversity of approaches and innovation in this market is an asset and I am convinced we should not standardise methodologies in order to support innovation and market development to ensure financial actors' needs are met.

Last but not least, who better than European Securities and Markets Authority (ESMA) could ensure a harmonised consistent and European supervision?

As a conclusion, Christopher Columbus discovered the Americas by chance, let us not try the same method for our ESG journey, and make sure our compass can be relied upon to show the right path to sustainability.

[1] https://www.amf-france.org/en/news-publications/news-releases/amf-news-releases/sustainable-finance-76-french-people-environmental-impact-investments-important-issue

NATALIE WESTERBARKEY

Director & Head of EU Public Policy - Fidelity International

Common EU ESG labels - Can we get there quicker?

ESG labels in Europe have played a key role in guiding investors and represent a useful third-party validation of ESG credentials of investment funds beyond their self-declaration. Asset managers are increasingly seeking this type of external validation to mitigate the risk of green washing. Labels are welcomed by investors as it provides them assurance that ESG standards are being met by each fund. Investors trust labels to bring clarification to the sustainable investment universe, with some choosing only those funds with ESG labels. As a result, labels help increase and ease the distribution of ESG funds, so their growing importance is welcomed - in principle.

The positive impact of labels, however, does not come without challenges

The fact that label providers across EU member states tend to take different approaches, requiring differing sets of criteria for funds to qualify as ESG funds, is a major challenge. Some countries have more than one label provider, which adds to the confusion. In some cases, there is even a direct contradiction between countries' approach to sustainability. For example, nuclear and gas energy is considered to be sustainable in France, but not by the majority in Germany.

Secondly, the labels are not always aligned with ESG compliance requirements at an EU level. Some labels take an exclusion-based approach and require nuclear energy to be excluded, which is no longer in line with the most recent classification by the EU taxonomy. In addition, in many cases they require prospectus-type language to be included. This leads to diverging requirements across different jurisdictions and can even imply requirements beyond SFDR, the Sustainable Finance Disclosure Regulation. Consequently, it means greater complexity for asset managers, who as a result need to develop operational procedures around this.

The key goal however is to find an approach that works for investors

A self-regulatory approach by label providers has so far proven to be confusing for investors. Hence, label providers need to align their label criteria and approach with evolving EU ESG legislation. This would be in line with the ESG legislation applicable to asset managers and financial service providers generally. The alignment of a labelling approach and criteria with EU-level ESG laws are essential so to ensure simplicity and consistencies of a sustainable finance approach from the point of view of investors.

> Label providers need to align their label criteria and approach with evolving EU ESG legislation.

Even if EU member states choose to deviate from EU-level ESG laws, the label providers across Europe should be guided by regional principles with an EU-level label. If there is investor demand in local markets, they may add a label specific to that particular jurisdiction in addition to the EU-level label. This would allow investors to identify specific local market differences and make informed investment choices based on individual views.

EU legislative developments such as the EU Taxonomy and the SFDR are designed to generate increased disclosure, which will make ESG labelling inconsistencies more obvious. This should require label providers to continuously update the design of their label criteria to remain consistent with the taxonomy.

Such approach will also have a positive signalling effect beyond Europe for international investors. It would address the commonly perceived challenge within the EU to find agreement and act united. Whilst the democratic debate is important to shape its evolving common EU values, it is nevertheless equally important to arrive to a practicable solution - soon. Especially as we find ourselves in a climate emergency, with limited time to reduce global warming, protect biodiversity and prevent reaching irreversible tipping points.

Yes, it is debatable whether nuclear and gas can be considered sustainable: nuclear waste is considered harmful and non-degradable, and gas is a fossil fuel. However, nuclear energy emits almost no CO_2 and gas, as a transition source of energy, is still less harmful to the planet than oil and coal. Where gas is used as a replacement for more carbon intensive technologies, it is - at least comparatively - the more sustainable energy source.

The same principle applies to so-called renewable energies like wind and solar energy, which face challenges around carbon-intensive production and use of rare materials extracted under environmental downside effects.

We have yet to develop a truly sustainable and scalable energy source; hydrogen energy shows promise. In the meantime, we are best guided by relative sustainability criteria among the energy source choices we currently have. With the help of consistent labels across the EU, that are aligned with EU legislation, we have the greatest chance to get to the best possible result within the very short timeframe left to get it right.

CHRISTINA PAPACONSTANTINOU
Deputy Governor - Bank of Greece

The need for a robust framework for scaling up sustainable finance

In the current context of geopolitical tensions and the energy crisis, there is a profound urgency for accelerating efforts towards the transition to a carbon neutral economy. This transition requires the mobilisation of significant amounts of financial resources towards sustainable activities.

One of the main gaps for mainstreaming sustainable finance is the lack of common definitions, standards and labels for sustainable activities and financial products. An example is the absence of requirements for environmental, social and governance (ESG) ratings providers to disclose their methodologies and the low correlation of ESG ratings across providers.

Significant steps are being taken in the EU to address this gap, such as the introduction of the Sustainable Finance Disclosure Regulation (SFDR), the ongoing development of the EU Taxonomy of sustainable activities and the EU Regulation for a green bond standard. However, the comparability of the sustainable financial products offered across and within markets is limited. In particular, the legislative framework for sustainable finance is still under development and there is sometimes inconsistent application of the existing regulation. Market participants apply different frameworks and practices when labelling their offerings and regulators may take different actions at the national level to protect market participants.

Additional effort is necessary to create the conditions for scaling up sustainable finance. More specifically, markets need to be supported by the appropriate regulatory and supervisory framework in order to be transparent and credible, limiting the risk of greenwashing. A commonly applied mandatory framework could improve comparability and transparency of financial markets, protecting market participants, enhancing investor confidence and enabling the mobilisation of funds towards activities supporting sustainable transition. A labelling framework should include clearly defined and sufficiently detailed criteria for assessing sustainable financial products. These criteria could be science-based and applicable to a wide range of products and activities. In addition, a labelling framework could evaluate the transition pathway of the activities which are being financed, when these are not classified as sustainable at the time of the assessment.

The lack of common labels and standards is a major gap for mainstreaming sustainable finance.

Green and sustainable bond markets are dynamic and rapidly growing. The EU can already be considered a leader in green capital markets. EU green bond markets have a higher degree of integration and investors' preference for cross-border holdings (limited "home bias"), which may also be attributed to the lack of local supply of green bonds. Investment funds that meet ESG criteria appear to be more stable compared with other types of collective investment undertakings, as investments are less likely to be withdrawn after a negative performance.

However, more needs to be done in order to increase the depth of green and sustainable capital markets. The lack of transparency and of implemented taxonomies of sustainable activities, as well as the absence of regulation and supervision of sustainable markets and ESG ratings may increase the risk of greenwashing. This risk may be exacerbated by the urgent need to increase finance towards activities aligned with transition pathways.

In order to meet the ambitious targets for the energy transition we need to mobilise a significant amount of financial resources. The contribution of the financial system, both banking and non-banking, is of paramount importance. Financial institutions need to fulfil their role and support the financing of the real economy. In the context of the sustainable agenda this could become an area for the financial institutions to compete and grow.

Although the main responsibilities remain with the governments, central banks can undertake an active role in sustainable growth, within the remits of their mandates. The Governing Council of the ECB agreed last summer on a comprehensive action plan, to further incorporate climate change considerations into its policy framework, with further progress made towards this objective in July 2022, while also addressing climate-related and environmental risks in its supervisory work since 2019.

At the Bank of Greece, we started looking into sustainability issues in 2009 and we are among the first central banks to do so. Within our mandate, we have been supporting national and international efforts towards meeting sustainable growth targets and creating the appropriate conditions for scaling up sustainable finance. We plan to continue our work on this area and, together with other stakeholders, make this transition an opportunity for sustainable growth, towards a more fair and inclusive society.

JESSICA GROUND
Global Head of ESG - Capital Group

Bringing the focus on accessing relevant, reliable and comparable ESG data

We are already 5 years in the implementation of EU's framework on financing sustainable growth. What started with the European Commission's action plan in 2018 has been a tremendous effort from all sides – policy makers and market participants – to work towards setting and implementing an ambitious regulatory regime with investors at the centre of it. With the main building blocks now in place or close to finalisation (the Sustainable Finance Disclosure Regulation (SFDR), the Taxonomy Regulation, the Corporate Sustainability Reporting Directive (CSRD)), the experience drawn from the first implementation phase since March 2021 and in preparation for the second phase as of January 2023, this is the right moment to pause and assess. While there is undeniable commitment and remarkable progress in delivering on the requirements, it remains crucial to keep sight of the main goal: ensuring investors have transparent, relevant and credible data to direct their investment, should they wish, towards financing more sustainable economic activities.

This is a crucial "test" we need to apply prior to launching changes or new regulatory initiatives. The most useful lessons drawn by the industry so far are:

- The SFDR aims at enabling transparency in relation to sustainability-related claims and enhance investment products' comparability. However, this data ultimately comes from issuers, and many key elements are missing. Reporting under CSRD is only expected by 2025, meaning asset managers are struggling to meet their own requirements and provide information to investors that is accurate, non-misleading or avoid following estimations that differ among different actors in the market.
- The Taxonomy regulation is set to create a common language and understanding of the sustainable economic activities' universe. However, the complexity of the project together with delays and controversies as to defining its different objectives has rendered it an extremely difficult tool for asset managers to use and investors to understand.
- The MiFID rules on sustainability preferences created confusion on how they can apply in practice; in an effort to standardise compliance the industry ended up with overly detailed and lengthy boxes to tick. It is not clear how this collection of information will help end investors integrate their sustainability preferences into their decisions.

We need a framework that ensures transparency on the construction of ESG data and ratings.

Capital Group's ESG Global Study this year[1], surveying over 1,100 professional investors from 19 markets around the world, identified the main challenges in terms of accessing ESG investments:

1) While ESG adoption continues to grow, accessing relevant, reliable and comparable ESG data remains a key challenge for investors; hence fears of misselling and greenwashing are on the rise despite all of the regulation in this area.
2) Our survey revealed the challenges posed by inconsistent ratings lacking clarity as to their methodologies.
3) Investors seek a more holistic approach and recognise that social considerations are being overlooked, while the E of ESG continues to dominate investor allocations.

All findings and lessons drawn so far highlight the need for reliable and comprehensive ESG data accompanied by transparent methodologies employed by data providers. At Capital Group we seek to integrate ESG into our research process in a bottom-up fundamental manner using raw data over scores wherever possible. However, we still rely on third party providers to gather ESG data, in particular for some of the new areas like Taxonomy compliance and Principle Adverse Impact (PAI) reporting. We can assume the level of reliance is heavier for smaller-sized asset managers with less globalised expertise and resources.

Based on the main feedback to the European Commission's recent consultation, while the ESG data and ratings market is growing, there are persisting inefficiencies concerning its function. The lack of transparency and significant biases with the methodologies applied, as well as potential conflicts of interests are the main challenges reported. We need a framework that ensures transparency on the construction of ESG data and ratings. This should be focused on establishing clarity as to the methodologies used by third party providers, the sources of their data, the frequency of reviews, the controls applied etc. The objective isn't to diminish the divergence of ESG scores but to make them understandable, track and explain the reasons for divergence, and to easily assess accuracy of the ESG data.

We believe this need for relevant, comparable and reliable ESG data is the main priority the EU and regulators globally need to tackle moving forward. For the EU this would mean more effective disclosures under SFDR, improving usability of Taxonomy and shifting the focus on meaningful and more holistic information for investors.

[1] https://www.capitalgroup.com/institutional/about-us/esg/esg-global-study.html?cid=sm_og_tw_8660939299&sprinklrid=7238646222&linkId=172757235

THE **EUROFI** FINANCIAL FORUM **2022**

PRAGUE | 7, 8 & 9 SEPTEMBER

SFDR / CSRD / TAXONOMY USABILITY CHALLENGES AND IMPACTS

PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Fine-tuning needed to ensure investors contribute to the European Green Deal

There is no question that urgent action is required to address climate change and that environmental protection should be integrated into economic growth strategies. In the financial sector, insurance and pension funds have the longest investment time horizons and hence the greatest stake in sustainability. It is also necessary to ensure that retail investors can invest and save sustainably, and participate in the transition to a greener economy.

EIOPA believes that the policy framework put in place is sensible to achieve these goals. The Corporate Sustainability Reporting Directive (CSRD) establishes reporting requirements for issuers, the Sustainable Finance Disclosure Regulation (SFDR) establishes disclosure requirements for financial market participants. In addition, the Insurance Distribution Directive (IDD) requires advisers to integrate sustainability preferences as part of the suitability assessment and there are other initiatives at play, such as EU Ecolabel and Green Bonds. The EU Taxonomy provides common definitions for those economic activities that can be considered environmentally sustainable – the basic language to communicate information on sustainability.

Yet sustainable investing – and reporting – is a complex and sometimes challenging path to navigate.

Insurers, insurance intermediaries and pension funds are required to disclose principal adverse impacts of their investments under the SFDR. They are also required to provide details of the objectives of the products and pension schemes that they make available.

Data is one of the critical factors. In particular, corporate data is crucial to ensure that insurers, pension funds and other financial market participants can screen their investments and report on social and environmental indicators, including the principle adverse impact indicators. However, one difficulty for the insurance sector is that the deadlines for disclosure for insurers precede the deadlines for reporting of company-reported data. EIOPA considers it essential insurers already start with disclosing responsibly, despite the challenges in doing so in the absence of the CSDR being in force.

This pragmatic approach allows insurers to make a serious best effort, while supervisors monitor this effort and the progress made in the first year of the SFDR, while recognising the existing limitations.

Besides insurers, retail investors also face challenges. Most sustainability-related products currently being sold fall under Article 8 of the SFDR – 'a Fund which promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.' This is a broad definition and consumers may not always be aware that this category covers products with a low sustainability ambition. For consumers seeking a product with a high level of ambition, they might not find anything suitable within the current market offer.

And while there is a need for more information, there is also the potential for information overload. Will consumers really read the soon-to-be seven pages of information on sustainability that comes on top of the basic disclosure on the product? The volume of information is one element, but there is also the complexity. Will consumers understand the technical terms? When seeking advice, will they be able to answer questions from advisors on sustainability preferences?

EIOPA is working to address these issues. For example, when it comes to preferences, EIOPA recently published guidance on integrating the customer's sustainability preferences in the suitability assessment under the IDD. The guidance includes how to help customers better understand the concept of 'sustainability preferences' and their investment choices; how to collect information on sustainability preferences; and how to match customer preferences with products, based on product disclosures under the SFDR.

With regard to the Corporate Sustainability Reporting Directive (CSRD), EIOPA welcomes the political agreement reached by the co-legislators. Companies need to know to what extent they are responsible for climate change and other sustainability impacts, as well as identify the costs for them that result from sustainability changes. Overall, increased transparency in sustainability reporting from companies is needed to more effectively promote investor protection and combat greenwashing. Increased transparency will also help to detect ESG-related risks which may undermine financial stability and to support the EU's ambition to enact an effective transition towards a more sustainable economic and financial system.

EIOPA recognises the challenges that financial market participants and retail investors face with sustainable investing and reporting. But greening the economy is non-negotiable and EIOPA will make every effort to support the insurance and occupational pensions sectors in achieving this goal.

MONTSERRAT MARTINEZ PARERA

Vice Chair - Spanish Securities and Exchange Commission (CNMV)

Sustainability reporting: moving forward, but not plain sailing

Several years have gone by since the conversation about sustainable finance started. Throughout this time, Europe has strongly supported the transition to a more sustainable economy and has been at the forefront of efforts to build a financial system that supports sustainable growth.

Looking back, it is impressive how much we have advanced in the development of a new sustainable finance regulation. One of the main drivers of this change has been the establishment of a transparency framework based on disclosures at product and entity level in the financial sector.

Firstly, the EU-wide classification system introduced by the Taxonomy Regulation has provided clarity for investors on environmentally sustainable economic activities. Additionally, the Sustainable Finance Disclosure Regulation (SFDR) has implied a great change for asset managers and asset owners setting disclosure obligations of an entity's investment decisions and requirements on how to present the characteristics of products. Lastly, the Corporate Sustainability Reporting Directive (CSRD) will be a game changer in enhancing comparability and increasing transparency on sustainability corporate performance.

However, despite all the effort made so far, the challenges ahead are still huge, partly due to the intensity and velocity of this regulatory wave. These changes will take time to digest. I would like to underline three of these challenges: risk of greenwashing, a lack of criteria for market participants and regulators, and possible inconsistencies across regulatory requirements.

First, greenwashing. One of the main objectives of the new sustainable finance regulation is precisely to crack down on so-called greenwashing. Regulators should play an essential role in identifying, preventing, and remediating greenwashing but they can not do this alone. Greenwashing is a complex and multifaceted issue which takes many forms. There is a clear role here for the European authorities to develop a cross-cutting definition of greenwashing and consider further sector-specific adaptations if needed.

Secondly, despite efforts made, the lack of enough data and criteria has led to some misalignment in the interpretation of key regulation concepts and possible inconsistencies in their EU-wide application.

Adaptation to the intensity and velocity of this regulatory wave will take time.

For instance, SFDR was not intended to be used as a labelling regime, but it is becoming one, and some areas remain open to a wide spectrum of interpretation. More work needs to be done on specifying minimum sustainability criteria, mainly for Article 8 funds, to reduce the current confusion in the market.

Furthermore, reliable and comparable corporate reporting is still lacking. The first EU Sustainability Reporting Standards (ESRS) will not be due until early 2025 since companies will need time to adjust. Additionally, the proposed ESRS bring their own challenges, such as the possible information overload and the need to ensure convergence with international initiatives without compromising the EU's sustainability ambitions.

Finally, another key challenge of this evolving regulatory framework is that it could lead to inconsistencies across regulatory requirements. The sustainable finance rulebook is complex, and it is important that all market participants understand how various texts are interlinked. I will just mention two examples: do no significant harm (DNSH) definition and differences between sustainable investment and activities in SFDR and the Taxonomy.

But, does this mean that we have to slow down the implementation and development of regulation?

Some may argue that legislators are going too far, too fast. It is true that some of the regulation may have too much detail, but I do not think the answer is to slow down, at least not regarding transparency and reporting. It is precisely the lack of a completed regulatory framework that increases the risks of greenwashing and the problems of lack of comparability, both between products and companies, as well as between jurisdictions. That is why it is more important than ever to increase efforts to ensure rules are comparable and consistently applied across jurisdictions.

To that end, regulators should apply the necessary flexibility so that market participants can adapt to the new requirements and navigate this new domain. But this is not enough. First, legislators should also understand the challenges that companies are facing and take this into account while completing the framework. Secondly, we all should increase coordination and cooperation. ESMA has a prominent role to play in ensuring supervisory convergence and offering guidance in achieving the desired level of transparency and comparability of financial products across EU jurisdictions.

KAROLIN SCHRIEVER

Executive Member of the Board - Deutscher Sparkassen- und Giroverband (DSGV)

Proportionality needs to be considered much more in sustainability reporting

What gets measured, gets managed – that's probably a short way to summarize the thinking behind the EU's sustainable finance agenda. Consequently, the EU taxonomy was the starting point of the EU Commission's activities. It provides a common language of what can be regarded as sustainable. The next step was to increase transparency by disclosing the sustainability of financial products – via the Sustainable Finance Disclosure Regulation (SFDR). In order to know whether the assets behind the respective products are sustainable, companies must provide detailed information about the sustainability of their activities. This is where non-financial reporting according to the new Corporate Sustainability Reporting Directive (CSRD) comes into play.

The aim of the system is to increase transparency, so that investors can make better-informed investment decisions.

It seems though that when designing this system nobody had the "think small first" principle in mind. And it may be true that the framework was not targeted to SMEs or small and locally active financial institutions from the outset. But the focus of sustainable finance is no longer primarily on financial market investors, large listed companies and the capital markets. Today, the scope is much broader. This creates ongoing challenges in implementing the framework – especially for smaller banks and smaller companies.

The new reporting requirements are extremely comprehensive. For the first two environmental goals of the taxonomy regulation alone, more than 100 economical activities need to be checked and reporting templates with more than 1,500 data fields have to be filled in on a loan-by-loan basis. And this is just the beginning. For instance, the first set of the European Sustainability Reporting Standards (ESRS) currently developed by European Financial Reporting Advisory Group (EFRAG) foresees 137 mandatory disclosures and numerous data points. The amount of data that will created is just overwhelming for data users – which may find such a mass of data virtually impossible to evaluate – as well as providers. Especially for smaller financial institution and companies it means a big challenge.

A simple rule of thumb applies when it comes to the amount of effort caused by the data requirements: the smaller the bank or company, the bigger the burden.

Sustainability reporting should not lead to an unlevel playing field.

It was correct to spare SMEs from requirements that are already very burdensome for large enterprises. But this causes a SME conundrum: There is a lack of sustainability data for basically 99 % of enterprises in the EU and that will most likely not change any time soon. Further down the road, this will lead to several structural problems, especially for the financial institutions responsible for financing those SMEs. One example is the Green Asset Ratio (GAR). Supposedly a simple and catchy metric which banks will have to publish from 2024, suggesting objectivity. But loans supporting the transition of SMEs will not be reflected in the GAR, even if they are compliant with the taxonomy.

Moreover, the GAR in no way reflects regional characteristics, i.e. the operations of smaller, locally active institutions that are significantly affected by the economic environment within their radius of activity. Many banks are eager to support their corporate clients in their efforts to become more sustainable, but their efforts are not incentivised by the GAR. On the contrary, they may even harm them because they might appear less green.

What has to be done? Close attention must be paid to those aspects when developing the ESRS. The standards need to be as lean as possible and easy to apply. The focus should be on meaningful information. When it comes to the development of the future voluntary reporting standard for SMEs, it needs to be designed in a way allowing for full participation of SMEs in the transition to a sustainable economy. At the same time, it needs to provide the data necessary for financial institutions to fulfil their reporting requirements. Usability must be at the centre of the design of the ESRS. Already in the run-up it must be considered whether the data requested are available at all. Obtaining non available data must be considered under a cost-vs.-usefulness approach. Additionally, more time for implementation is needed and a timely provision of taxonomy-relevant data for corporate lending via the European Single Access Point (ESAP).

In summary, sustainability reporting needs to consider proportionality much more than it is the case now. Otherwise, reporting requirements will create an unlevel playing field to the detriment of SMEs and their financial partners. The CSRD has taken this into account to some extent, but it is only a first step in the right direction. More must follow.

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COEXISTENCE OF SUSTAINABILITY REPORTING STANDARDS

SÉBASTIEN RASPILLER

Head of Service for the Financial Sector - Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

The European Union can be proud of its sustainability standard-setting framework

Sustainability reporting standards are of special importance in the fight against climate change and towards the goal of building a capitalism of stakeholders. They are not an end in themselves, but a tool enabling corporates and their stakeholders to act. They should bring the necessary information to financial institutions allowing them to finance the transformation of our economy, as well as to corporates and governments to plan this sustainability transition, and to regulators and civil society to hold economic and financial players accountable for their actions, or lack of action. Sustainability data need to be reliable, comparable and decision-useful in order to be an incentive for change. It is a question of knowing better in order to act better.

France has introduced ground-breaking regulatory requirements in terms of sustainability reporting some 20 years ago. The EU has followed in 2014 with the Non-Financial Reporting Directive. Despite incremental improvements, the information still lacked standardization to be truly comparable and usable by stakeholders. This is why the Corporate Sustainability Reporting Directive – finalized under the French Presidency of the Council of the EU – is such an important step forward. It provides for the most ambitious and complete set of standards in the world – covering both the impacts a corporate has on the environment and on society and the risks linked to sustainability that it faces, and covering the whole spectrum of ESG. It will make it mandatory for more than 50 000 European corporates to report according to these standards, and to digitalize the information for it to be included in a European Single Access Point – gathering corporate financial and sustainability data in a freely accessible platform.

To provide for a proper understanding of the impact a corporate has on its environment is key.

Several jurisdictions are starting to implement or to consider adopting regulatory requirements in terms of sustainability reporting – but few support disclosure on the impact of corporates. However, the impact of our economic activity is precisely the information which should be guiding our transformation – not the individual climate-related financial risk a company is facing. Achieving the Paris Agreement implies deeply questioning and transforming our strategies and corporates business models to make them climate neutral. It is a distinct objective to the one of ensuring financial stability and managing climate risk – however important this other challenge is. Initiatives have emerged at the international level to bring more standardization to the market, claiming that it will help solve the climate challenge. Then, there is an absolute necessity to provide for a proper understanding of the impact a corporate has on its environment.

Multilateralism should provide leadership to improve coordination and convergence on sustainability standard-setting, based on the basic principle of allowing the real transformation of our economy towards the achievement of our common climate and sustainability goals. But to allow for acceptance and ownership, international standards or principles should build on what jurisdictions are working on. Otherwise, they would run the risk of not being fully owned by stakeholders or even not implemented.

There is still a long way to go for sustainability data to be standardized even for climate at the international level. Given the urgency of the challenge, climate should be our priority for multilateral discussions, alongside exploring other environmental topics like biodiversity, even though the EU has chosen for itself a more comprehensive framework covering all environmental, social and governance matters because of its social model and traditions. The best being the enemy of the good however, it appears more efficient to focus international discussions on well identified priorities like climate and biodiversity, instead of achieving no consensus at all. The Taskforce on Nature-related Financial Disclosure is for example a significant step in the right direction, at a time where all jurisdictions are fumbling around to determine which metrics should be used to appropriately reflect impact on biodiversity and biodiversity-related risks. Unlike climate matters, this topic is not mature enough yet to have been covered thoroughly at the national level, hence providing a fertile ground for international work.

On the other hand, any work at the international level on social matters should be particularly mindful to respect national social contracts and political traditions, especially the heritage reflected in national constitutions.

SUE LLOYD

Vice-Chair - International Sustainability Standards Board (ISSB)

The global baseline – part of a bigger picture

The establishment of the International Sustainability Standards Board (ISSB) was announced by the IFRS Foundation (Foundation) in November 2021, at the COP26 climate conference, in response to demand from market participants and requests from the G7 and G20 that the IFRS Foundation assist in addressing the complex and fragmented landscape of corporate sustainability reporting. Finance Ministers and Central Bank Governors from over 40 jurisdictions on six continents officially welcomed the Foundation's goal to create a comprehensive global baseline of sustainability disclosures focused on meeting the needs of capital markets.

In the past six months a lot has been achieved, but the ISSB did not come from nothing and does not operate in a vacuum.

The ISSB was given a running start by consolidating with the VRF (which houses the SASB Standards and the Integrated Reporting Framework), as well as the Climate Disclosure Standards Board (CDSB). This consolidation means that we benefit from the existing materials of the VRF and CDSB and their people and processes and enables us to accelerate our work to remove complexity from the reporting landscape, streamline reporting and make the resulting information prepared by companies more useful to investors for their capital allocation decisions.

The ISSB's first two proposed standards have been published – a draft climate standard and a general requirements standard, complete with industry-based requirements, fully embedding the TCFD framework and building on the SASB's industry-based standards. Our consultation closed at the end of July and we are now working through the feedback we received on our proposed standards.

This consolidation of efforts has allowed us to achieve a significant amount in a seemingly short space of time, by building on the work of others while enabling our stakeholders to provide their comments through our inclusive consultation process.

Ultimately, our objective is to provide standards that produce comparable, high-quality information about the effects of sustainability-related risks and opportunities for the capital markets across the world. In building this comprehensive global baseline, we are seeking to create a common language for sustainability information for the capital markets. We are conscious of the bigger landscape in which we operate and that we can create better standards if we collaborate.

As countries around the world look to make changes to reposition their economies to a sustainable and resilient system, we will continue to engage with jurisdictional authorities and market participants, including EFRAG, the US SEC and other jurisdictional initiatives. Through this dialogue, we are seeking to reduce differences between the ISSB's proposals and jurisdictional proposals as well as working together to establish the ISSB's global baseline. This engagement also includes working closely with the International Organization of Securities Commissions (IOSCO) as it evaluates whether to endorse standards issued by the ISSB.

This global collaboration is important in delivering our building blocks approach. It is our goal that IFRS Sustainability Standards provide a global baseline of disclosures that facilitate comparability in global capital markets while also enabling particular jurisdictional information needs and/or to any incremental information needs of stakeholders beyond investors to be met. Using a building block approach incremental disclosures can be required that build upon the global baseline.

Furthermore, we are establishing the necessary advisory and consultative bodies that will serve as a platform for enhanced collaboration with other international organisations, jurisdictional authorities and representatives of other stakeholders. These arrangements provide an essential mechanism to allow stakeholders to help shape IFRS Sustainability Disclosure Standards and to facilitate compatibility with broader jurisdictional requirements.

As the comment period on our Exposure Drafts comes to a close, we can now benefit from a great depth of analysis and input on our draft standards. At the last count over 30,000 people from a wide cross-section of stakeholders have engaged in our outreach activities. The insights we have obtained from this outreach, along with the results of the comment letters and survey results we received on the Exposure Drafts will prove invaluable as we begin our deliberations to finalise our proposals.

One important message that we are already aware of through our outreach activities, has been the concept of proportionality. It is clear, that we must ensure our standards are fit for global application, not just for large companies and developed markets, but for smaller companies and emerging economies. We are committed to creating standards that are truly global and suitable for all jurisdictions to implement. In short, we want the global baseline to be truly global.

Although we have made strong progress to date, we are still rounding the first bend of this journey and a significant amount of work still needs to be done to ensure our standards can support the efforts of the global community in meeting the challenge of transitioning to a sustainable global economy. Much will need to be done, including in partnership with others, to finalise and then successfully implement the ISSB's standards around the world.

The ISSB is one part of a larger ecosystem. We benefit from the insights and initiatives happening globally, and we are working collaboratively to play our part in developing standards to bring high-quality, comparable sustainability-related financial information to facilitate decision-making in the capital markets.

MARCEL HAAG

Director, Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union - European Commission

CSRD : a cornerstone of the EU's sustainability agenda

On 21 June, the European Parliament and the Council reached political agreement on a cornerstone of the EU's sustainability agenda and the European Green Deal: the Corporate Sustainability Reporting Directive (CSRD).The co-legislators confirmed the main elements of the Commission's CSRD of April 2021:a wider coverage of companies than is currently the case under the NFRD, the introduction of an assurance requirement, the digitalisation of sustainability information and the introduction of mandatory EU sustainability reporting standards. The European Financial Reporting Advisory Group (EFRAG) will develop the draft standards and the Commission will adopt the final standards as Delegated Acts. The CSRD and accompanying standards will ensure that corporates disclose the sustainability information necessary to underpin the rest of our sustainable finance agenda.

In April 2022, EFRAG's newly established Sustainability Reporting Board released for public consultation a first set of thirteen draft European Sustainability Reporting Standards (ESRS) covering all environmental, social and governance aspects. The next step will be for EFRAG to analyse the responses to the public consultation and to make any revisions that it considers necessary according to its due process, before submitting final drafts to the Commission in November 2022. EFRAG's due process will ensure that the final draft ESRSs strike the right balance between the information needs of users and the burden for preparers.

EU standards must be coherent with the EU's political objectives and with the existing legal framework for sustainable finance which means that EU standards will address all ESG issues from the beginning. The final drafts must meet the mandate set by the CSRD which confirms that the Commission will adopt a first set of ESRS by June 2023,with a second set of standards, including sectors-specific standards and standards for listed SMEs, to be adopted in 2024.

CSRD and accompanying standards will ensure stronger sustainability reporting rules for companies.

Listed small and medium-sized enterprises (SMEs) are included in the scope of the CSRD because they risk being excluded from investment portfolios if they do not provide the same quality of information as large listed companies. To ensure proportionality, listed SMEs have a lighter reporting regime, including the option to use simpler, proportionate standards and a possibility to opt-out from the reporting during the first two years. The CSRD does not propose any mandatory requirements on non-listed SMEs, which is the overwhelming majority of SMEs but they would be able to use the standards for listed SMEs on a voluntary basis. This should help them deal with the increase in demand for information from company clients, the financial sector and others.

At international level, there are several standard setters dealing with climate and sustainability reporting. The International Sustainability Standards Board (ISSB) has issued two Exposure Drafts by March 2022 on climate and general sustainability-related disclosure standards. The US Securities and Exchange Commission (SEC) has also released a proposal to enhance climate-related disclosures for companies.

ESRS will cover all sustainability aspects under a double materiality perspective. This means they address how sustainability issues create risks and opportunities for the company and provide also an objective account of the company's own impacts on people and the environment. ESRS aim to serve the needs of investors and other stakeholders such as civil society organisations, trade unions or citizens. In contrast, the ISSB standards and the SEC proposal cover climate related-aspects only–no other environmental issues such as water or biodiversity and no social or human rights issues. In addition, they only look at financial materiality relevant for investors, the so-called enterprise value creation but not explicitly at company impacts.

It is difficult in practice to split sustainability information reported under financial materiality and impact materiality as many impacts of companies become financially material, in particular in climate disclosures. ESRS, by addressing both financial and impact materiality in the same set of standards, provide a single, coherent sustainability reporting solution for companies and for users of information.

The CSRD does not foresee the adoption of ISSB standards in the way that International Financial Reporting Standards are adopted by the EU. Rather, EU standards will integrate the content of ISSB standards to the extent that it is consistent with the EU's legal framework and the ambitions of the European Green Deal. The Commission together with EFRAG is participating in the ISSB jurisdictional working group and has started bilateral discussions with the ISSB to achieve as much interoperability as possible between ESRS and ISSB standards.

JULIA HAAKE
Managing Director for Market Strategy – Moody's

Sustainability Reporting challenge: Companies and investor demand

Investors require high quality ESG data to assist asset allocation, decision-making and reporting requirements. Anticipated reporting standards will help to support these demands, provided challenges are addressed.

As reporting standards from the EFRAG and the ISSB make their way through the drafting process, towards adoption and into eventual practice, potential challenges are becoming clearer. Investors are seeking high quality ESG data to assist asset allocation, decision-making and reporting requirements. As an ESG solutions provider with experience in reviewing and evaluating disclosures to support investors decision-making, Moody's ESG Solutions see three main challenges ahead of the respective sustainability reporting standards initiatives to address.

Implementing the new reporting standards will take (too much) time

Standards that jurisdictions mandate resulting in consistent and comparable disclosures across economies will be a boon to increasing transparency, reducing greenwashing and driving capital to high performers. The EFRAG exposure drafts standards are a level up from requirements of its predecessor, the Non-Financial Reporting Directive. The ambition shown is commensurate with the multiple and complex challenges at hand and in supporting ambitions of the Green New Deal for Europe and the Strategy for Financing the Transition to a sustainable economy.

Demands for ever more granular data across a range of ESG-related domains are growing. Investors want consistent and reliable information and data across economic activities that provide them with the comprehensive coverage helping them understand potential exposure to risks and opportunities across highly diversified portfolios. Investors are asking companies like us at Moody's ESG Solutions for this data now. This cross-economy information need is urgent. At present the new requirements will apply to companies already in scope of the Non-financial Reporting Directive in January 2024 and those not in scope of the NFRD in January 2025.

Faster adoption by companies in scope will lead to reporting practice scaling and skilling up, which will take a number of reporting cycles, and meeting investors' demands at the earliest opportunity. We already see many investors looking to bridge data gaps with modelled solutions, where disclosures are not available. This can lead to further fragmentation in the sustainability reporting market.

Coordinated standards are needed in delivering the high quality ESG data investors need.

Risk and impact considerations are needed for a complete picture of ESG performance

Both standards have adopted different materiality approaches. The European Sustainability Reporting Standards employ a double materiality approach, while the ISSB uses enterprise value as underlying materiality concept.

At present, it is unclear whether efforts to enhance interoperability will be enough to ensure that the different materiality approaches will not lead to a bifurcation of material issues identification, management and reporting by companies. While there are efforts to improve coordination between both standards (notably the jurisdictional working group and ongoing bilateral engagement activities), a fragmented result on this key topic will fail to serve investors.

Difference in approaches to materiality taken by the two standards may also hamper further deepening of understanding of the interconnectedness and interdependence of material ESG factors across businesses and stakeholders domains. At the same time, it will be important that the complementary role of GRI reporting (focused on impact and globally the most widely used sustainability reporting framework) is well integrated, alongside future ISSB and EFRAG standards, so that both elements of material issues are covered by reporters to provide investors with useful, more complete information.

Delivering high quality ESG data for increasingly complex issues is a growing challenge

Some data is still a challenge for companies to report at the level required by investors. Consider scope 3 climate emissions data: despite recognition that for many companies, scope 3 accounts for the majority of their emissions, disclosure rates are still very low. Other topics such as biodiversity suffer from poor adoption of management and measurement practices leading to insufficient disclosure levels compared to other more established environmental topics. Will the standards be part of the solution to solving these urgent questions? Or, will investors feel that different approaches, for example using unstructured data, or using new voluntary frameworks such as the Taskforce for Nature-related Financial Disclosures that are currently under development, can provide a better way to understand ESG exposure and impacts? Stronger links between the standards and wider efforts to support areas where data are lacking and management and disclosure are limited, can build a systems-wide approach to delivering the high quality ESG data investors need.

MASAMICHI KONO

Senior Advisor, MUFG Bank, Ltd, Member of the Global Advisory Board, Mitsubishi UFJ Financial Group & Trustee, IFRS Foundation

Building a credible road to decarbonization

We are living in extraordinary times; fighting a persistent pandemic and coping with an energy security crisis in the short term, while facing an increasingly severe climate crisis in the medium to longer-term. When it comes to climate change, society's sense of urgency is fast rising, and the net zero ambitions and strategies of the private sector have been elevated to new hights. This is a positive development despite the deepening and continuing crises; the world must move fast if it is to tackle climate change and achieving the sustainable development goals (SDGs).

126 governments, including Japan, and numerous individual companies globally have announced their ambitions to commit to a net zero world. And while it is important for all stakeholders to state their ambitions, it is critical to articulate how the public and private sectors are going to achieve these ambitious goals, and make sure that the plans that are being announced are credible and effectively implanted to enable a just transition.

Decarbonisation pathways of the hard to abate sectors vary across countries and regions and individual circumstances of the stakeholders involved. Finance is key in enabling the transition, and the role of transition finance is particularly important in determining whether we are on track and whether the path is credible.

For financial institutions to properly allocate their funds in support of decarbonization, disclosure of relevant data and information by preparer firms is key. Over 3000+ private institutions from 92 countries with a combined market capitalization of USD 27.2 trillion are already committed to TCFD disclosure and their disclosure content and capacities will be significantly enhanced once they start reporting on climate and other sustainability subjects under the new ISSB standards, based on the four TCFD pillars.

In Japan, the TCFD consortium was established in 2019, and as of June 2022, it has 650 members, the highest number of any country. The Japanese Bankers Association has strongly encouraged global standard setters to use TCFD as the basis for a global ESG reporting standard and the JBA has been fully supportive of the ISSB's work to establish the global standard for sustainability disclosures which is based on TCFD framework.

Let us do our best to enhance transparency, consistency and comparability of disclosed data.

In order to understand what the overall transition pathway will look like, we need to rely on consistent and comparable data. Not only will this data help to understand whether we are on rack, but it will also help financial institutions and regulators as well as central banks assess and mitigate the risks to this pathway, while simultaneously seizing the opportunities to promote innovation and potentially accelerate the transition.

Mandatory ESG disclosure standards at national or regional level can cause divergence, making it more difficult to remain aligned with evolving global standards, developed by the ISSB. Therefore, it remains important that third country banks can rely on global standards for their EU-based entities.

We know that national or regional frameworks are at risk of diverging from the global baseline, which can be caused by several factors, including the ongoing political divides and geopolitical developments in the world.

While disclosure of consistent and comparable data and information is key, we should not lose sight of the need to work on our individual forward-looking transition strategies and plans as part of the overall disclosure framework. The credibility of our own transition plans is intrinsically linked to those of the clients we serve. Financial institutions must be able to provide useful advice and support to their clients' transition plans.

The financial sector is making an unprecedented shift to support the transition to a low carbon economy. We may need to accept a certain level of flexibility in the speed of the individual economies to transition. However, what we should not accept is imposing regional divergence and fragmentation that creates unnecessary burden on those institutions that need to help the transition.

Let us do our best to enhance transparency, consistency and comparability of disclosed data and information to enable the global financial system work as a part of the solution, not a drag on the transition to net-zero. Let us call on regulators and supervisors to strengthen global coordination, and thereby help create the necessary conditions for the private sector to be the driver of the just transition.

RAMI FEGHALI
Partner - PricewaterhouseCoopers Advisory

Sustainability reporting should be as simple as possible

Sustainability reporting is a complex reporting, potentially much more complex than financial reporting.

Unlike financial reporting, sustainability reporting has multiple dimensions, each with its own specificity, technicality, and unit of measure. These dimensions are interdependent and non-fungible which makes materiality assessment more difficult. It is possible to assess and aggregate individual items in income statements and balance sheets, but it is impossible to compare or add water consumption and carbon emissions unless natural capital accounting is used. Granularity also matters, sustainability issues are often "local" by nature: they are rooted in a production unit, in a specific location or somewhere in the value chain.

Granular information is relevant but can lead to a large amount of disclosure and raise confidentiality issues. Finally, the rules are constantly evolving, as public authorities progressively impose constraints on the economy to be compatible with a sustainable state. Legislation is being developed in both the real economy and the financial sector, and one would expect sustainable reporting to show progress or compliance with these regulations.

Complexity is inherent in sustainability reporting, but it is critical that we mitigate it as much as possible. We are at the beginning of a deep and comprehensive transformation and in this context, execution is just as important as setting the right targets. We need simple, clear and precise requirements for economic actors to act with certainty.

In this regard, there is room for improvement in many of the proposals for sustainable reporting put forward by the three main bodies, the SEC, ISSB and EFRAG.

The first area of improvement is international convergence where additional clarification and practical guidance could facilitate implementation. Concepts and principles should be the same for both global and jurisdictional standards and when there are different policy choices, a reconciliation of approaches should be provided. For example, the delineation between financial materiality and double materiality is not clear, and additional guidelines and examples would be useful in this regard. Some similar metrics can also be defined differently in each jurisdiction reflecting different technical practices or regulatory requirements. The provision of comparisons and equivalences on these metrics, could facilitate the work of preparers and the interpretation of results, this can be the case for example for energy performance certificates or Scope 3 approaches.

Complexity is inherent in sustainability reporting, but iwe reduce it as much as possible.

The second area of improvement is limiting the number of disclosures and their level of granularity. All dimensions are important and by limiting the number of indicators and information we risk providing an incomplete picture, but we should still try to restrict the number of disclosures to those that are most mature and important and allow for a progressive approach on other complementary indicators. The priority indicators should be those that are already required by other regulations (e.g., in the CSRD context, the taxonomy and SFDR/ Principal Adverse Indicators) and the most mature climate related disclosures. This approach would also allow for potential future changes in regulation and practices (such as the finalization of the work of the TNFD). It would also make it easier for SMEs to implement disclosures, as even exempt SMEs could be required to comply with the full standards because they are part of a large company's value chain.

The third area of improvement is providing more precision and prescription on disclosures. This would facilitate implementation, enable comparisons and aggregation which is necessary for financial institutions, and ensure auditability. There are many examples of disclosures where additional precision and prescription would be useful, such as the materiality assessment process, the climate scenarios used for certain climate-related disclosures, or the presumption of material disclosure by sector.

A fourth area for improvement is disclosure of measurement uncertainty. Many of the reported metrics will rely on estimates and assumptions, and some forward-looking metrics will have inherent uncertainties and limitations. Categorization and disclosure of the level of uncertainty in these metrics, similarly to fair value leveling in IFRS, would be an effective way to provide transparency on data quality and would be safer for both preparers and users.

The SEC, ISSB and EFRAG have, in a very short period of time, proposed relevant disclosure standards, which are much needed in our transition journey. This is a great achievement. We should now focus now on the implementation challenges with the objective of making implementation as easy as possible without compromising relevance.

5

CMU NEXT STEPS AND CHALLENGES

ISSUES AT STAKE

Implementing CMU and developing EU capital markets remains a key objective in the current challenging environment in order to support the economic recovery and the green and digital transition objectives of the EU.

Four legislative proposals were published at the end of 2021 aiming to facilitate access to corporate information (European Single Access Point), enhance the competitiveness and resilience of the EU asset management sector (ELTIF and AIFMD reviews) and enhance the liquidity and transparency of EU securities and derivative markets (MiFIR review), in addition to changes to insurance and banking prudential requirements regarding long term investments. Further proposals are planned for 2022 for improving retail investor participation, addressing fiscal issues (withholding tax procedures and debt/equity bias), streamlining listing requirements, further harmonizing insolvency rules and strengthening the clearing capacity in the EU.

While significant progress is being made in the enhancement of the EU capital markets framework with these measures, the CMU initiative faces a number of challenges. Firstly, implementation challenges, due to the breadth of the project and the pace of change in the sector, which is not easily compatible with the protracted European legislative process. Secondly, challenges related to the post-Covid macro-economic and monetary context that tends to favour debt financing and liquidity hoarding over long-term investment. Thirdly the challenge of finding the right balance between the objective of achieving more strategic autonomy in capital market activities in a post-Brexit context and the competitiveness of European capital markets. Finally continued fragmentation of supervision in the EU despite efforts made to foster supervisory convergence.

Q&A

STEPHAN LEITHNER

Member of the Executive Board - Deutsche Börse AG & Chairman - Clearstream Supervisory Boards

EU Capital Markets as a cornerstone of an open strategic autonomy

How important is the further development of capital markets for the post-Covid recovery and supporting the green and digital transitions? What is the role of stock exchanges and market infrastructures in this regard?

The impact of the COVID-19 pandemic, the challenges from the dual transition as well as Russia's attack on Ukraine mark nothing less than a turning point for Europe. What we need now is political guidance and a clear compass on what to preserve and promote, what to revise and change – and how to discern between strategic objectives. I believe there are two crucial political pillars to focus on. Firstly, it is about regaining as well as defending our sovereignty and autonomy in a new world order that is only now starting to unfold and take shape. Secondly, stability and competitiveness must go hand in hand in these challenging times of rising inflation, hiking interest rates and sky-rocketing energy prices.

The EU is facing a transformational process with enormous financing needs that neither governments nor banks can provide. Hence, a deep and efficient capital market is key to global competitiveness. This requires forward looking and smart financial regulation. The completion of the CMU is not optional anymore.

In this context, I strongly welcome Commissioner McGuinness' intention to "strengthen EU financial market infrastructures". EU FMIs have not only proven to responsibly live up to regulators' expectation as the key anchor of financial stability in times of uncertainty. They act as the backbone of the EU's capital markets and are a key vehicle to boosting growth. While I fully support the broader thinking around strategic autonomy and the CMU agenda, it is important to translate the objective of making EU FMIs stronger into concrete regulatory realities. While we see a great impetus in relation to EU CCPs and the EU's clearing strategy, the MiFID II/ MiFIR realities require a clear political steer to boost global competitiveness, notably for exchanges.

What are the consequences of the current under-development of capital markets in the EU and the objectives that should be pursued going forward?

Strong capital markets play a key role in economies as one of the most powerful drivers of growth and wealth creation – ensuring that citizens, pension funds and our broader society can participate in the value creation we all drive. Their importance is growing by the day as more innovative growth companies are needed in Europe. However, despite more than 20 years of significant political and regulatory efforts, EU's capital markets continue to be underdeveloped and fall behind if benchmarked at global level. We are struggling to be an attractive place for growth financing and IPOs.

The lack of a deep European institutional market has led to a structural discount in valuations while simultaneously triggering an unjustified investment outflow due to an insufficient understanding of European realities by global investors. However, the EU needs to build on its own strengths. Next to an emerging wealth management industry and a more sustainable flow of long-term retail investments, the 50-year-old Eurobond market must be promoted to attracted global issuers and investors. Moreover, competitive financial services technology innovation in financing and securities as well as the leadership on sustainable finance need to be fostered. In this context it is critical that the EU gets some of its key legislative acts right, the CMU Action Plan 2.0, the MiFID II/ MiFIR framework, or also the upcoming EU Listing Act. This becomes even more important in light of the UK's approach to boosting its capital markets post-Brexit, where we observe a strong regulatory competition.

The decision on the location of the ISSB in Frankfurt has sent an important signal proving ESG as one of our many strengths in a global context. However, we also need a more profound industrial strategy that boosts the EU's exchanges and the listing ecosystem to be able to compete at global level.

What is the extent of the fragmentation of EU capital markets and what are the consequences of this? Should more be done to foster a further integration of EU capital markets?

EU capital markets continue to suffer from serious fragmentation – which is significantly more pronounced than in other key jurisdictions. This would have equally been the case in the absence of Brexit, given the MiFID II/ MiFIR realities. As per the official ESMA statistics, the EU trading landscape sees about 500 trading and execution venues across all asset classes, with the degree of fragmentation being particularly pronounced on the equity side.

This compares to slightly more than a 100 venues in the US, despite the fact that the US market is multiple times bigger. As such, it occurs that those jurisdictions which house the strongest capital markets globally, have taken a very different political and regulatory approach. The philosophy focuses on global competition and ensuring champions in this regard.

The EU, by contrast, seems to focus more on intra-EU competition and with that occurs to be missing the global trend. This is also visible in other sectors. For the EU's capital markets, we clearly note that their size and performance does not reflect the size and role of the EU economy. However, there are many positive developments in Member States such as the Netherlands, Sweden or Germany – where policy makers have understood the importance of driving the capital markets agenda forward also with national initiatives.

Through this, Brussels will hopefully receive more support for some of the measures that were difficult to push and hopefully trigger a reflection process on how the EU has to steer on some of the key frameworks going forward.

If we continue with the policy making approach as if the geopolitical realities would not have changed, we will not be able to remain competitive and should not be surprised if we fall further behind. This, in turn, should lead us to realise that our ability to promote and defend our societal values will be weakened.

Does the November 2021 CMU package provide the actions needed for making a decisive progress in the development and integration of EU capital markets? What are the priorities and what more may be needed?

The European Commission's focus on ensuring that "investors have better access to company and trading data" is certainly welcome. Reliable, high-quality information forms the backbone of informed investment decisions and we have to ensure that global investors have an easier acces in this regard. The ESAP initiative will in particular boost the visibility of SMEs, the backbone of the EU's economy, which is key to boosting growth.

On the MiFID II/ MiFIR side, the proposed changes around market structure, be it for example on the SI regime or changing the Double Volume Cap into a Single Volume Cap, are certainly appreciated and should advance the EU on reaching the political objective of transparency.

As regards the consolidated tapes, I believe that the concept of separate tapes for bonds, OTC derivatives, ETFs and equities is in itself a good vision. We should ensure that the project is cheap and fast to implement to guarantee a strong contribution to the current macro-economic realities. If the overarching approach is designed in an overly complex manner, we may run the risk of not being able to deliver in this cycle. Against this background, I believe we should focus on sequencing the different tapes, depending the empirical realities in terms of transparency and data quality. This will also facilitate ESMA's important work in this context.

Finally, and in-line with the overarching thinking around the EU's strategic autonomy, we should continue to work on EU FMI's global competitiveness. This would match the current turning point in our history – where geopolitical realities are shifting and our democratic systems and values are being fundamentally challenged.

Q&A

DAVID SCHWIMMER
Chief Executive Officer -
London Stock Exchange Group

Open and competitive EU financial markets to deliver the Capital Markets Union

Since becoming a key pillar of President Jean-Claude Juncker's investment plan eight years ago, the Capital Markets Union (CMU) project has seen many iterations, including the latest measures proposed in November 2021. Financial indicators show that this effort is bearing fruit. According to recent data from the ECB and other central banks, during the last two years, EU corporates have utilised capital markets for funding to a larger extent than ever before, and we have seen an increase in both equity and bond issuance.

As a leading financial markets infrastructure and data provider with a presence in over 20 member states, LSEG is heavily invested in the further development of the EU's capital markets. We operate several key EU market infrastructures that help strengthen the competitiveness of EU capital markets and provide a wide range of services that enable customers to deliver growth across the financial markets value chain. These include our Paris-based CCP, LCH S.A., which offers clearing across a variety of asset classes; Turquoise Europe, which enables investors to trade across 17 European countries; Unavista TRADEcho, a trade repository which helps EU firms fulfil their EMIR reporting obligations; and FXAll, the number one dealer-to-client platform in the global foreign exchange market.

At LSEG we believe in open markets. Markets, like companies, succeed by developing and accessing best in class services on an open basis, helping us deliver value to our customers. We think the same should apply to the European Union's CMU project.

In our view, the future success of EU capital markets is centred around the following three key concepts.

First, the success of EU capital markets must be measured by how investment and savings flow to the benefit of EU consumers, investors, and companies. This flow is not simply about financing. The wider ecosystem – including the data needed to make investment decisions, the market infrastructure, and the underpinning technology – are all key enablers for making the EU's capital markets successful. LSEG supports the EU's ambition to facilitate the development of and access to best-in-class data and infrastructure providers, services, and technology. To achieve this goal, it is crucial that the EU maintains what has been the cornerstone of its competitiveness over many decades: its open approach to regulation and supervision. Measures that would impede access to third-party providers would negatively affect all firms operating in the EU in key areas such as clearing, resilience, and data (including Cloud).

Second, building a CMU worthy of one of the biggest single markets in the world takes time. While harmonisation across the EU is an important aspect, EU Capital Markets Competitiveness (CMC) should be a top priority. The path ahead lies not just in further harmonisation, but in strengthening the EU's national capital markets to enhance their competitiveness, both regionally and globally. Once competitiveness is embedded as an EU priority, the EU can focus on harmonising different national rules on insolvency, taxation, and governance to make markets more compatible and eventually draw them into a strong, EU-wide approach.

There are several areas where more can be done in the near term to enhance the global competitiveness of EU capital markets and directly benefit the wider CMU. For example, LSEG strongly supports the streamlining of EU supervision and regulatory processes. The EU needs a supervisory framework for CCPs that is more agile and strengthens its effectiveness. We have long-standing experience with EU-level supervision, on both our EU and non-EU based activities, as several LSEG entities are directly supervised by ESMA.

We think EU-level supervision, if done right, can both support the competitiveness and resilience of EU capital markets, as it would streamline complex supervisory structures, ensure better time to market and level playing field in the EU. For instance, we have been supporting EU-level supervision of CCPs due to their systemic importance to the Union. A lot can be done to ensure EU CCPs supervisory structure supports EU CCP competitiveness and resilience inside and outside the EU.

Third, there is a strong link between more effective EU capital markets and a successful transition to net zero. As the European Commission has noted, the transition to a climate-neutral economy alone will require financing of trillions of euros over the next several decades. This transition will only be possible if the EU has developed capital markets. The right transition frameworks can also further support EU capital markets. As mentioned in LSEG's paper "mobilising capital for a sustainable global economy", efforts introducing domestic disclosure frameworks on an economy-wide basis and requiring the disclosure of corporate revenues derived from products providing green solutions are a good way to start.

Additionally, mandating the publication of transition plans across the economy and facilitating the development of voluntary carbon markets can also play an integral part in shaping the future of the EU's capital markets.

Ensuring the EU's long term global competitiveness does not require wholesale change, but well targeted fine-tuning to both mitigate risk and maximise Europe's global competitiveness.

LSEG is and will remain committed to supporting the EU's financial stability and empowering its economies and businesses, whether it is through making the financial system safer through our post-trade risk management capabilities or helping Europe's transition to a green economy as one of the world's largest suppliers of ESG data.

CMU: WHAT CAN BE DONE IN THIS POLITICAL CYCLE?

VERENA ROSS
Chair - European Securities and Markets Authority (ESMA)

Making headway on centrepieces of the CMU

Recent challenges to the geopolitical and economic landscape have reinforced the need to develop a genuine single market for capital in the EU. This is necessary not only to boost resilience to economic shocks, but also to stimulate sound and sustainable growth for the future. Improving access to a diverse range of funding and investment possibilities and improving the overall attractiveness of EU capital markets remains an urgent priority. Therefore, supporting the development of the capital markets union (CMU) remains at heart of ESMA's mission.

The CMU package proposed in 2021 represents an important step in bringing forward some key actions to better integrate EU capital markets. The four legislative initiatives aim to improve availability of and access to company and trading data for investors, as well as increasing the attractiveness of certain investment funds.

With these proposals now in the hands of co-legislators, we wait to see the outcome of the political negotiations. Strong ambition remains necessary to progress on the CMU project which has only grown in importance over the years, and also remains a fundamental part of the digital and green transitions.

One clear signal from the November 2021 CMU package is that data and transparency are a cornerstone of smooth capital market functioning. There has been a clear and pressing case for increased transparency in building the CMU, and both the European Single Access Point (ESAP) and consolidated tape proposals aim to deliver on that.

ESAP, offering financial and sustainability-related information on companies and investment products, as well as the consolidated tape, offering real-time trading data on shares, bonds and derivatives, are necessary and welcome steps to strengthen the CMU infrastructure and facilitate flows of information to investors. Both measures will open up new sources of EU-wide data to investors, particularly retail investors, thereby facilitating better investment decision making and broadening sources of financing for companies.

While the proposals provide for some challenging new responsibilities for ESMA, we welcome the central roles that have been envisaged for us in a) building and operating the ESAP and b) selecting, authorising and supervising the consolidated tape. We are committed to function as a European datahub and to further streamlining of data reporting and collection burdens.

The outstanding, critical piece of the CMU Action Plan is the Retail Investment Strategy. Investors' trust is an essential condition for their participation in capital markets and to build such trust, transparency is key. In our advice to the European Commission, we therefore recommended several measures in this respect ranging from addressing the overload and complexity of information investors face to the effective use of online engagement (while combatting misleading marketing campaigns on social media). On the sustainability front, addressing greenwashing and tackling mis-selling rank high on our agenda to keep our investor protection framework up to speed with the rising sustainability ambitions of investors.

Overall, we must bear in mind that high-quality supervision underpins effective progress in building the CMU. It will foster more market integration while creating new opportunities for market participants and investors to exploit the benefits of the EU capital markets. The EU supervisory model needs to provide for an adequate level of consistency in supervision and enforcement within a harmonised regulatory framework. This is why we at ESMA retain supervisory convergence amongst national authorities at the heart of our mandate, but also continue to strengthen our direct supervisory efforts. Wherever supervision is undertaken, whether at EU or national level, we continue to work closely with national authorities – to foster a common EU supervisory culture and build shared principles of risk-based, data-driven and outcome-focused supervision.

As the CMU continues to evolve, so will ESMA. In the near term, we are excited to play a key role in both the ESAP and consolidated tape initiatives, as we are firm believers that more transparency will help to unlock the potential of EU financial markets. It is an essential ingredient to help sustainable growth, to the benefit of companies, citizens and the society as a whole.

With more CMU legislative initiatives expected later this year, we remain enthusiastic in our support for a genuine European and effective capital market and will do all we can to contribute to its continued construction and strengthening.

KRISTINE BRADEN

Europe Cluster Head, Citi & Chief Executive Officer,
Citigroup Global Markets Europe (CGME)

Optimising policy making and minimising policy contradictions

Two and a half years after Brexit, there is uncertainty over whether or when EU and UK policy making will take different paths. Both the EU and the UK look to boost their markets and to further improve their respective regulatory regimes. To achieve this goal, they will need to balance considerations of market access and competitiveness while safeguarding financial stability. The COVID-19 pandemic, the war in Ukraine and surging inflation have required significant political focus. It is important to balance these considerations, keep them in focus and not underestimate the impact of fragmentation or inadvertent protectionism in policy and regulatory choices.

In Europe, the concept of open strategic autonomy has emerged as a driving force behind European politics and is now being translated into specific policy proposals. Adopted as the leitmotif of President von der Leyen's 'geopolitical' European Commission, it refers to the EU's capacity to pursue its interests without too heavily relying on foreign states. In today's uncertain world this is an understandable position. Furthermore, the pandemic has demonstrated the fragility of the world economic order, with its reliance on global supply chains. By near-shoring production, diversifying access to key materials, or investing in a strong digital or financial services capacity, Europe seeks to reinforce its position on the world stage while strengthening its economy.

However, for a strong Europe, global trade and access to financial services will remain a key driver of economic growth. By enabling the expansion of Italian or French corporates or helping foreign companies operate in Europe, global banks like Citi contribute to Europe's success story. Cross-border market access and market efficiency are crucial elements of global trade and prosperous economies. It is therefore important that the current negotiations on Europe's banking rules acknowledge, and do not unduly disrupt, the vital role that banks like Citi play. For instance, in providing lending and investment banking services, cross border payments as well as access to deep liquidity in a host of foreign currencies to European companies. Furthermore, as EU firms are major users of clearing houses in Europe, the UK and internationally, the upcoming EMIR review should leave clearing participants free to choose where to clear, based on commercial and risk considerations.

Naturally, market access should be based on mutual respect for rules and regulations. Regulatory standards, implemented regionally or nationally, and enforced by strong cross-border supervision are crucial elements of our international system. The strong cross-border supervisory system incorporated in EMIR 2.2 is an excellent example of this. Similarly, in sustainable finance, the EU has taken a pioneering role in setting the most ambitious disclosure and classification regulations. However, the EU should also strive for international harmonization of sustainability standards, reducing frictions for market participants and increasing overall transparency.

Within a global rules-based system, there should be ample opportunity for competition. The EU and its trading partners each strive to offer the best infrastructure and regulatory environment to attract commerce, create financial capacity and thereby grow their economies. A good example is the European Commission's review of MiFID and MiFIR, which in response to feedback from market participants aims at striking the right balance between the need for market transparency and financial sector firms' cost-efficient service provision to European clients. Europe should aim to hold to the same set of regulatory principles and only calibrate them if there is a legitimate need to do so.

An open Europe with a level playing field for market participants should be our collective ambition.

Recognizing Europe's aspirations, Citi calls for a truly 'open strategic autonomy' that provides a level playing field for market participants. Unless it is open, strategic autonomy risks creating a policy contradiction, where the drive for inward investment and the efficient supply of cross-border services bumps into protectionism. We risk creating duplicative structures making service provision by European and Third Country financial institutions unduly onerous. The ongoing crisis in Ukraine underlines the importance of like-minded partners working closely together to secure European interests and values.

A strong autonomous Europe which promotes foreign investment facilitated by a vibrant banking sector with close trading ties to the rest of the world should be our collective objective. Global standards set by international partners who share mutual interests, supported by a robust regulatory dialogue, will provide the backbone for a financial services sector that supports Europe's growth. Let's move forward – together.

BJØRN SIBBERN
President European Markets - Nasdaq

CMU – a North star for the long-term

If Europe manages to stay on the CMU path, our chances to truly deliver a stronger European capital market will remain strong.

One of the core strengths of the European capital market is the retail investor engagement. In Nasdaq's European markets, particularly Sweden, retail investors play an absolutely key role in providing financing and growth opportunities for companies, especially for SMEs. On the Nasdaq First North Growth Market, retail investors provide up to 50% of investments as well as trading volumes. Retail investors are stable shareholders that induce long-term sustainable capital. This contributes to favorable conditions for IPOs in the primary market as well as for a company's onwards life on the secondary markets.

I support the European Commission's retail agenda, but seeing how retail investor activity is very much influenced by national policies, member state initiatives are crucial, such as on financial education, pension systems and Investment Savings Accounts, especially when they mean a flat tax for investments and also automatic tax reporting, which significantly reduces administrative barriers for individuals. Over 3 million Swedes have such an account. In Finland the introduction is more recent, and numbers are increasing with currently over 225,000 accounts. In Estonia the number of retail investors on the exchange quadrupled in 5 years and is now up to 100,000.

The high retail participation on the lit and multilateral exchanges means good execution quality. In the Nordics, more than half of retail orders are traded in the spread between the best bid and ask. Against this background I see no need for dark execution for retail orders and am worried about payment for order flow. If it would be widely introduced and accepted in Europe, there is a risk that retail volume may be shifted away from the lit and multilateral markets, for no real benefit.

On the contrary, retail investors are needed where IPOs happen, where share prices are formed, and where they benefit from non-discretionary execution.

All investors, including retail, need access to data to be active on the markets. Currently Nasdaq's equity data is available for free after 15 minutes and real time data on best bid and ask at cost, which to retail investors we offer for 1€ per month. What investors lack is a picture of the non-exchange market. A consolidated tape in EU could provide this by covering equity data from all exchanges, MTFs and Systematic Internalizers. What is important to note is that Europe's geography has natural built-in latency. For a tape in EU to provide a true picture of all transactions equally and fairly for all users, it needs to have some delays.

From my experiences of market data, the highest demand for the fastest data comes from bigger and very sophisticated professional market participants and concern blue chip shares. Having exchanges bear the cost of a close to real time tape would hence tend to mostly benefit the bigger and professional market participants to the detriment of transparent markets. However, for smaller players such as retail investors, SMEs and smaller venues, a delayed tape is the product that would deliver benefits compared to costs. This is an example of when keeping the CMU as a North Star is important.

Stay on the CMU path, our chances to truly deliver a stronger European capital market.

An initiative that better keeps to the spirit of the CMU is the Listing Act initiative. Parts of this initiative that I support are clarifications in the Market Abuse framework which should leave less room for diverging interpretations and sanctions. Furthermore, simpler prospectuses can be helpful documents instead of obstacles for both issuers and investors. I also insist that each issuer should be given the power to decide when translation costs for disclosure documents add value, and English only should always be allowed, as it is the prominent language within finance today. A European Single Access Point will not add value unless investors from outside the local can actually use it.

Letting CMU be the North Star across policy areas for the long term would increase the opportunities of further improving the European capital market and help Europe to strengthen its competitiveness in the global economy.

Supporting stability and growth opportunities for individuals as well as corporates is what is needed to manage through the current times of many levels of uncertainty and crises.

BJÖRN STORIM
Chief Executive Officer -
BNY Mellon SA/NV

How to deliver a European Capital Markets Union – The European perspective

The Capital Markets Union (CMU) project has a problem.

The fundamental challenge, and until now the fundamental failure of the project, is the need to build a political connection between the high-level narrative explaining why a CMU is desirable and necessary, and the individual policy measures that are needed to deliver a CMU.

The high-level narrative explaining why a CMU is desirable and necessary has been set out many times. Capital markets are a mechanism that can transform savings into long-term investment. Capital market financing offers increased resilience, flexibility and choice to savers and investors and to the economy as a whole. At a time when there are great needs for long-term investment – to deal, for example, with the climate emergency and to finance infrastructure investments – capital markets offer the possibility to finance additional investments.

Capital markets are eco-systems. Developing a European capital market eco-system, especially given the weak and under-developed state of many European capital markets, will not be achieved by just one or two individual policy measures. There is a need for a broad and diverse range of policy measures.

But we run into the problem that in many cases each individual CMU policy measure is viewed in isolation, and the costs and benefits associated with that policy measure are viewed from the perspective of current individually segmented national capital markets.

Taken in isolation, and from a national perspective, many individual CMU policy measures involve cost and risk, and may deliver few immediate obvious concrete benefits.

But if we look at these measures from a European perspective, the story is very different.

From a European perspective, it is grotesque and counter-productive that investors, both European and non-European, buying European securities are forced to manage 27 separate and different national withholding tax procedures. Dealing with this issue, and building a common pan-European operational process, should be an absolute priority. It would be absurd that we can build a pan-European operational process for late settlement penalties, a relatively minor issue, and not manage to build such a process for a major issue such as withholding tax.

From a European perspective, the lack of a depositary bank passport is a similar absurdity. The current obligation placed on investment funds to use depositary banks from the same member state is a prime example of a measure that segments national capital markets, that handicaps depositary banks in Europe, and that reduces choice for investment funds and for investors in those funds. The lack of a depositary bank passport is a clear gap in the Single Market.

A European perspective should cover not just the questions of how to develop individual capital markets and how to break down barriers between individual markets; it should also cover the question of what core features are necessary to create common pan-European markets.

The creation and development of common pan-European markets require that all market participants, no matter where in Europe they are located, have access to the same core rights, to the same ability to issue, invest in, and hold, securities, and to the same core information.

But if we look at these measures from a European perspective, the story is very different.

One important question is to what common core reference data do market participants and all parties in the custody chain (issuer agents, CSDs, and intermediaries) need to have access, in order for markets and the custody chain to work fairly, efficiently and effectively.

This question highlights the need to build and deliver both a consolidated tape and a European Single Access Point (ESAP), but also draws attention to some of the weaknesses of the current ESAP proposal. ESAP today is very much an incremental and reactive proposal, building on existing data, rather than a proposal that is based on an analysis of the underlying needs for core data.

The European perspective is valuable not simply because it tells us which policy measures are important to deliver a CMU, but also because it holds the key to creating awareness that the rationale, and high-level political narrative, for a CMU, apply just as much, and much more concretely, to individual CMU policy measures.

FABRIZIO CAMPELLI

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

EU needs progress on the Capital Markets Union to deal with future challenges

European capital markets will face extraordinary challenges over the next years, and we must accelerate measures to address them.

The CMU was originally conceived in 2015 to ensure borderless capital flows in the EU. While some progress, such as for cross-border venture capital investments, has been made, overall success has been limited. The EU capital market is still smaller than its counterparts in the US and APAC relative to GDP and comprises 27 capital markets with different maturities and regulatory frameworks. Moreover, due to Brexit, not only has the EU lost around a third of its capital market, but it has gained a competitor with high liquidity.

Whilst the latest iteration of the CMU action plan from 2020 tries to address some shortcomings of the project, the need for a functioning CMU has increased significantly. We are entering a phase of economic and geopolitical uncertainty triggered both by the longer-term impacts of Covid and the direct and indirect consequences of the war in Ukraine.

In addition to facing the extraordinary task of funding the transition to a green and digital economy, Europe now also needs to accelerate this transition to reduce its energy dependence, increase commodity security and diversify its global supply chains. McKinsey estimated in 2020 that reaching net-zero would require an estimated €28 trillion investment in clean technologies over the next 30 years (about €5 trillion of this would be additional investment, while €23 trillion would come from redirecting investments that would otherwise have funded carbon-intensive technologies).

The source of funding for all of this remains unclear. On the public side, Covid support packages have depleted public finances and rising costs for lending will further limit funding capacity, while there is at the same time also the need for significantly increased defence spending. On the private side, banks will be unable to provide financing on their own, not least because they are constrained by regulatory headwinds such as contributions to the EU single resolution fund, (national) macro-prudential buffers and potential impacts from Basel III implementation.

All this means that there is an accelerated need to finally get things moving for a CMU. Given the challenges we face, we need to readjust and recalibrate the priorities of the CMU to focus on the most impactful measures to finance Europe's economic transformation.

To achieve these goals, we need 3 focus areas:

1) European capital markets need to be globally competitive

The regulatory framework in which European firms operate in must provide a level playing field with global competitors to access global liquidity pools. There are a number of areas to address: (i) the extraterritorial application of the regulatory framework limits EU banks in their ability to compete for international clients and investments - greater deference to international standards is needed to adjust for this, (ii) proposed measures to foster strategic autonomy, such as in clearing could result in penalising European banks and drive business outside the EU and (iii) the European regulatory framework is not flexible enough to react to changing market environments - more agility in decision-making processes is needed to prepare it for future challenges.

There is a need for recalibration of the CMU to fund a diverse set of challenges.

2) Capital market funding needs to be increased

To diversify away from the dependency on banks for funding we need to address the EU securitisation framework. The current rules with punitive capital treatment for banks and insurers are overly onerous. Progress needs to be made quickly - a lot of time has been lost with the current regime. Also, trust of investors in capital markets need to be strengthened and retail investors need the opportunity to invest into a broader range of financial instruments, with levels of investor protection commensurate with their knowledge and experience.

3) Greater harmonisation of national regulatory frameworks

The EU capital markets framework is still deeply rooted in national provisions which have developed over decades and hampers cross-border provisioning of services. A greater harmonisation of these frameworks combined with the completion of the Banking Union would facilitate cross-border bank mergers.

Only if we focus on putting these measures into practice quickly, will the CMU project be a success in providing the funding needs to the EU economy.

We thank **the partner institutions** for their support to the organisation of this Forum

BNP PARIBAS

J.P.Morgan

RETAIL INVESTMENT STRATEGY

NATASHA CAZENAVE

Executive Director - European Securities and Markets Authority (ESMA)

Building a sound Capital Markets Union for retail investors

The time has come to put retail investment at the core of the Capital Markets Union project. In this respect, initiatives to empower retail investors and foster their participation in EU capital markets are welcome. Not only to offer them affordable options tailored to their preferences and to help them save for their retirement, but also to contribute to the Union's shift towards a more sustainable economic model.

Through its legislative proposals on the creation of a European Single Access Point and the establishment of a consolidated tape, the European Commission has already demonstrated its willingness to serve the needs of investors by easing access to information and improving market transparency.

ESMA is also strongly supportive of legislation that will allow retail investors better understand the true level of sustainability of their investments and avoid greenwashing.

Going forward, the EU strategy for retail investors will be crucial to address structural challenges. Minimising conflicts of interests shall therefore be a priority and we are eager to see issues related to the role of inducements and the practice of payment for order flow properly addressed.

Furthermore, in a context of increased engagement of young people in capital markets coupled with a concerning frenzy around cryptos, the strategy will have to embed rules fit for the next generation of retail investors and provide future-proof safeguards adapted to the digital age.

At ESMA, we believe that a safe environment is essential for retail investors to make sound financial decisions, whether they choose to use their smartphone or rely on face-to-face advice.

A safe environment is essential for retail investors to make sound financial decisions.

In this regard, we have recently published a comprehensive set of recommendations to the European Commission in support of enhanced disclosure requirements. We are indeed convinced that ergonomics matters in information sharing, as an overload of information is not necessarily conducive to well-informed investment choices. In this spirit, we have proposed to define minimum 'vital information' that investors need to be able to make informed decisions and to use 'layering', frequently offered in user friendly apps, to provide relevant information step by step to investors and hence address overload and complexity.

As business models evolve, it is also ESMA's duty to ensure that retail investors embark on a trustworthy journey while taking full advantage of innovation. Our view on 'gamification', i.e., the use of game-like elements in non-game contexts, illustrates the balance we aim to strike when monitoring online marketing and distribution strategies, including on social media. In our assessment, gaming tools should be authorised as long as they are in the best interest of customers. They can convey information in a simple and understandable way, demystify trading, and thus facilitate informed investment decisions. On the contrary, these features may also blind investors to risks and harm them, e.g. where gamification nudges retail clients to take on undue risk. To protect investors, ESMA notably advises on how to improve and implement legislation, checks firms' conduct, and, if necessary, ban toxic practices.

More broadly, beyond bringing further alignment and consistency across legal instruments, we expect the Retail Investment Strategy to reflect a change of paradigm: instead of primarily relying on products' characteristics, progressing towards an investor centric model would notably ensure that consumers are provided with clear and comparable information, thereby pushing costs downwards and increasing confidence, which is key to well-functioning markets.

Finally, to be successful, the Retail Investment Strategy will have to be supported by strong and effective supervision on the ground to ensure that investors are protected wherever they invest in the EU. This especially calls for upgraded supervision of cross-border activities in the traditional MiFID retail space and beyond, where rules are gradually being built to deal with the mounting risks associated with cryptos.

Retail investor protection is obviously a challenge to be tackled collectively in the current tense geopolitical and macroeconomic context. Whatever the future holds, retail investors can be assured that ESMA is committed to playing its part by using its supervisory convergence toolkit, whether through facilitating data sharing between home and host countries, coordinating supervisory exercises, or, where appropriate, resorting to our product intervention powers to prevent significant consumer detriment.

TSVETELINA PENKOVA

MEP, Committee on the Internal Market and Consumer Protection - European Parliament

Retail Investor Strategy as a long-term social strategy

The Retain Investor Strategy is one of the most important long-term social strategy that the Commission is working on. All the priorities are underpinned by the need to secure a better financial income for the retail investors while preserving their fundamental rights of access to information and access to education.

With no doubt the main priority for the Commission should be to improve the financial literacy of the retail investors. Currently most of the savings in the EU are held in deposit bank accounts. They have increased significantly during the COVID-19 pandemic. However, currently with the rising inflation, savings are losing their monetary value.

This has a negative impact on the financial stability of citizens and on the EU economy. The regular circulation of currency on the market is one if its fundamental economy purposes – investments in new projects, technologies, innovation, etc. Higher participation in retail investment leads to better ratio between the GDP and the market capitalization.

Yet, in order to fulfil this purpose people need to be aware of why and how they can make the most of their savings and turn them into additional income. Citizens have to be informed in a clear and precise manner that their retail investments are a long-term investment that guarantees financial stability in their pension years.

Once our society understands the importance of the retail investments, people will subsequently seek for digital tools to get information and advisors about different products offered on the market. However, the fundamental first step is to improve the financial literacy of our citizens.

When talking about retail, the holistic approach is the best path one can take. Legislative amendments, harmonization of the capital market regulations should be coupled with information campaigns, increased effort to maintain and develop high level of cybersecurity and low level of fake news in the digital environment.

In addition, one key aspect that also needs to be addressed when we talk about the holistic approach is the protection of the interest not only of the retail investors but also of the financial advisors. It is beneficial.

Retail investment will secure people's financial stability during pension years.

Policy makers should strike the balance between the interest of the financial advisors and the retail investors so that the incentive of both stakeholders is mutually beneficial. Working only on the protection of retail investor will increase the so called "principal agent conflict".

The policy regarding the Retail Investor Strategy cannot avoid, neither eliminate the principal agent conflict since it is within the human psychology to act biased. Therefore, it is obligatory to create a policy in which the biased perspective of both stakeholders aims at one and a same goal.

Incremental improvements might lead to even further complication and fragmentation of the legislative basis concerning the retail investors. Right now, we have various legislative instruments to regulate the market and to impose variety of requirements. Such are for example the UCITS Directive, the ELTIF Regulation, the PEPP, and the MIFID II. All of these legislative tools, albeit concrete and construed in favor of the investors are fragmented, complicated and hard to work with.

When talking about Retail Investment Strategy we need to consider two major factors that play a role in deciding the way forward. Firstly, this Strategy is part of the goal to set up a real and effectively working Capital Markets Union. Second, Retail Investors usually do not have a financial background, nor work in the financial sector. They do not have the time, the knowledge or the research capacity to dig into all the various tools and instruments in order to grasp an understanding of the opportunities in front of them. Retail investors are crucial participants in a properly functioning Capital Markets Union. Thus, we need to make sure to be inclusive and protective of them.

The retail investment strategy for Europe can be crucial for the development of the Capital Markets Union (CMU) and to tackle the economic effects not only of the COVID-19 pandemic, but as well as the current geopolitical crisis that European Union is currently facing. Europe needs investment strategies that further encourage retail investors that will support our economy and hasten the sustainable recovery.

However, there needs to be a rapid shift in the approach taken by the EU. The legislative basis for retail investors needs to be structured in a codified, non-burdensome way. In other words – rules are simple and they are there to protect our consumers so it is better to be followed.

JEAN-PAUL SERVAIS

President - Financial Services and Markets Authority, Belgium (FSMA)

A new protective framework for retail investors

From a supervisor's perspective, it is to be welcomed that the European Commission is planning to take an investor-centred approach to shaping its Retail Investment Strategy (RIS). A renewed focus on the demand side is needed so that citizens can reap the benefits of the CMU via increased retail investor participation, including on a cross-border basis.

A number of recent game-changing developments have strengthened the need for a focus on a new protective framework for retail investors.

Firstly, since the outbreak of the COVID crisis, we have witnessed increased retail participation in the equity markets. This trend was illustrated in Belgium by research by the FSMA on the behaviour of Belgian retail investors over the past four years, based on a data analysis of the reporting of stock exchange transactions. One of the main trends identified was that the stock market continues to attract new and young retail investors.

In addition, technological developments are greatly influencing the retail investor landscape. Investors want to access financial services anytime, anywhere and using various types of devices, platforms and apps. Trading apps are easy accessible and are used mainly by new types of investors who tend to be younger and take more risks. Investment choices are often made based on the information available on apps, websites and social media platforms, and rely less on regulated financial advisors. Social media are used by non-regulated persons, such as influencers, to send marketing messages and provide investment recommendations to investors.

Thirdly, EU citizens need the necessary tools and the trust to put their savings to work by investing in sustainable capital markets and being part of the climate transition.

The RIS should focus on the following priorities: streamlining disclosure rules, digital and sustainable investing, cross-sector consistency and financial literacy.

Retail investors face an information overload that is not conducive to their protection. It is therefore a priority to streamline the different disclosure requirements stemming from the various regulatory pieces, where appropriate. However, this should not serve as an excuse to withhold essential information from retail investors. Both EIOPA and ESMA's recent technical advice to the Commission suggest possible improvements in this regard.

RIS should focus on digital and sustainable investing, cross-sector consistency & financial literacy.

The regulatory framework needs to be fit for the age of digital and sustainable finance. Disclosure requirements should be digital-friendly. Innovation and technology bring real opportunities to inform retail investors in a more meaningful way, using techniques such as layering: the most vital information (i.e. the information investors "must know") being disclosed in a first layer and in a visually attractive way, layer 2 including information that investors "should know" and layer 3 "nice to know" information.

Flexible rulemaking should be enhanced by empowering the use of Level 2 measures to make it possible to regulate how the clients' best interests can be promoted when they are offered services via trading apps.

Building on its sustainable finance strategy and using feedback from the ESAs or NCAs on possible greenwashing practices, the EC should be constantly looking for areas of improvement of the current regulatory framework regarding the Green CMU.

It is also important to ensure a level playing-field among comparable products, including crypto-assets. The single rulebook should guarantee consistency in the rules applicable to economically equivalent products, in order to avoid regulatory arbitrage between sectors.

The 2020 CMU Action Plan puts forward a number of measures that seek to enhance the financial literacy of retail investors, including regarding sustainable finance, in order to enable them to make better financial decisions as well as to finance the climate transition, and leverage the possibilities provided for by capital markets. On this front, the RIS can provide a boost, complementing consumer protection. As proposed by EIOPA in its Technical Advice to the Commission on Retail Investor Protection, EU directives could be modified horizontally in order to follow the model of the Mortgage Credit Directive and enshrine the task of consumer education in the mission statements of the NCAs and the ESAs.

Over the longer term, it may be appropriate to engage in further reflection on the future of retail investing, taking into account developments in the US (e.g. SEC work on digital engagement practices) or the UK (FCA's initiative on a new 'Consumer Duty') as well. Such reflection may examine a number of key questions (e.g. the possible development of simpler products) with a view to an optimal and holistic investor protection.

BARBARA ANTONIDES

Manager Public and International Affairs - Dutch Authority for the Financial Markets (AFM)

Retail investment strategy must help nudge financial well-being

The retail investment strategy is a key component of the Capital Markets Union, one that is aimed at promoting sustainable financial well-being of citizens. This is as close to the AFM's core mission as it gets. The AFM promotes fair and transparent financial markets, protection of consumers in vulnerable situations and ensuring long-term financial well-being.

The retail investment strategy addresses several issues. One is to unlock capital that is needed for the digital and green transformations. With increased access to capital, European companies are in a better position to take advantage of digital and sustainable opportunities. Second, the strategy aims to improve consumer outcomes by making capital markets accessible.

Recently, AFM published a paper[1] demonstrating that about half of Dutch citizens have adequate buffers to invest responsibly but currently do not. Depending on, among others, individual trading behaviour, this could offer returns of several hundred euros per year.

Value for money

In the Netherlands, approximately 85% of citizens already participate in capital markets through occupational pension schemes. The Netherlands has one of the lowest old-age poverty rates globally. This contrasts with the broader EU situation where one in seven EU citizens have inadequate pension savings. For this group, and for the self-employed, additional pension savings, sensibly invested in the long-term, may be necessary to supplement old-age income. There need to be ample products that offer value for money and cater to financial needs of citizens and society.

There is plenty of work to do in this regard. EIOPA[2] has repeatedly conducted research showing consumer detriment. This detriment can take the form of high-commissions which mis-align the incentives of advisors and clients, high fees (sometimes in excess of 4% per year, as also shown in ESMA's recent research[3]), or highly complex products that are simply not suitable for the majority of retail investors. All this substantially hurts the legitimate interest of retail investors and will ultimately lead to a decline in trust in the financial sector.

Half of Dutch citizens have adequate buffers to invest but do not.

Nevertheless, supervisors are not price police. While we can address excessive costs, firms should be able to offer competitive and fair market prices for their services. Similarly, supervisors neither can or ought to tell consumers which products to invest in, as long as firms operate within the consumer protection framework. Speculation has always been part of financial markets; while we can combat excesses, consumers should have a fundamental freedom to choose.

Financial literacy and behaviour

An increase in financial literacy may seem a win-win situation. Indeed, there is nothing against education and better understanding of finance and economics. Financial markets are inherently complex and difficult to navigate for average citizens, hence financial literacy can never be your only shot. Expectations on the real impact of increased education should be managed. Increased financial literacy does not change that consumers (even those with high levels of education) are not the rational homo economicus that economics textbooks presume. They will remain prone to exploitations of behavioural biases and unfair commercial practices by firms. Especially in a highly digitalized financial sector.

Choice environment

Nudging consumer behaviour happens all around us but is especially potent in a digital environment. Particularly in the financial sector, mis-selling can lead to long-term detriment. Traditional protection measures, such as disclosures and transparency, are not effective in the face of irrational consumer behaviour. A more powerful tool would be to require the design of the choice environment of trading apps and platforms promotes sensible decision-making by consumers or at least prohibits promotion of the products that have the highest risk of mis-selling.

A truly successful Retail Investment Strategy considers the supply-side of the market, i.e., the products. Making sure they offer value for money through strengthened product governance norms, by aligning the interest of the advisor and the client and taking away perverse incentives in the advisor-client relationship and making sure that digital distribution models work in the interest of the client by offering suitable products that meet demands as well as needs at a reasonable cost.

[1] AFM, "Meer Nederlanders zouden kunnen beleggen in plaats van sparen," 24 maart 2022, https://www.afm.nl/nl-nl/nieuws/2022/maart/meer-nederlanders-beleggen-sparen.

[2] See for example EIOPA's annual Cost and Past Performance Report for costs of IBIPs and UL products.

[3] See also ESMA's research on performance and costs https://www.esma.europa.eu/system/files_force/library/esma_50-165-1677_asr_performance_and_costs_of_eu_retail_investment_products.pdf?download=1.

FAUSTO PARENTE

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

The Retail Investment Strategy: unlocking its full potential for life insurance

The Retail Investment Strategy is a key plank of the European Commission's Capital Markets Union and aims to promote more transparency, simplicity, fairness and cost-efficiency for retail investment products across the internal market.

EIOPA strongly supports these objectives. Insurance-Based Investment Products (or IBIPs) are often the first, if not only, retail investment product which consumers buy. Life insurance, because of its societal benefits, is often connected to tax and inheritance-related incentives, leading many investors to opt for insurance over other available retail investment products.

Therefore, firms must actively engage with consumers and support them on their investment and savings journey to address growing protection gaps. The EU regulatory framework for retail financial services can assist by:

- Driving appropriate longer term investment behaviours and opportunities;
- Creating a safe environment for consumers that enables them to make the right choices, and ensure products are suited for the proposed target market;
- Promoting further the principle that investment products should be cost-efficient and simple to understand and contribute to improve consumers' overall finance health; and
- Enabling a risk-based approach to conduct of business supervision.

At the end of April 2022, EIOPA delivered technical advice to the Commission on Retail Investor Protection where we set out our views in a number of areas such as enhancing consumer disclosures, tackling damaging conflicts of interest in the sales process and addressing complexity in the retail investment market.

Improving the quality of consumer disclosures is a critical first step. We see the need for a shift towards truly consumer-focused disclosures, built upon an enhanced supervisory framework that fits the digital age. The starting point when designing consumer disclosures should be behavioural research and consumer testing.

Giving due consideration to the unique structure of insurance distribution could bring real benefits.

More needs to be done to tackle damaging conflicts of interest arising throughout the product lifecycle, including the product design phase when underlying funds are selected for unit-linked products. We think improvements to the existing rules on inducements are necessary and a combination of different policy options could also bring specific benefits. Too often the debate is a binary one between banning or not banning commissions.

To address cost-efficiency and complexity in the retail investment market, there needs to be more coherence in the current regulatory requirements to identify which products are complex. We would like to see a clearer notion of the objectives when considering product complexity and cost-efficiency of IBIPs and take due account of the level of complexity in the different stages of the product lifecycle. Furthermore, improvements to the Key Information Document can bring greater transparency on the impact of the costs of "wrapper" products.

There is also scope for making the sales process for life insurance products simpler and more affordable, but this should not be at the expense of a lower level of consumer protection. The ongoing digital transformation in the sale of financial products and further automation of the sales process such as more enhanced portability of the suitability assessment, can help in this respect, but we need to make sure that any risks (such as misuse of customer data) are also effectively supervised.

Recent ideas put forward to amend the existing suitability/appropriateness assessments with a more portfolio-style approach need, in our view, to consider the specific nature and structure of the products involved. The goals which the customer seeks to achieve may be fundamentally different when comparing, for example, a sophisticated investor buying equities and seeking to maximise return with a consumer buying life insurance seeking to secure some savings for retirement, and coverage for risk of death, critical illness or disability.

Some IBIPs are associated often with long recommended holding periods of 20-30 years with limited possibilities for customer intervention during the contract period. This can present challenges for consumers purchasing such products to properly assess the true cost of those products and their risk. Therefore, consumers may often require ongoing advice from an intermediary because their personal circumstances may change during that period.

In conclusion, if we really want to unlock the full potential of the CMU and the Retail Investment Strategy, it is important that the EU regulatory framework sufficiently takes into account the relative size and structure of the European insurance market, its existing heterogeneity and the way consumers engage in this market. Insurance distribution is one of the most important ways that allows small savers and investors to participate in capital markets. Therefore, a more consumer-focused approach which gives due consideration to the unique structure of insurance distribution could bring real benefits in this respect.

MATTHEW HOLMES

Group Head Political and Government Affairs - Zurich Insurance Company Ltd

A retail investment strategy to empower consumers and protect tomorrow

The Capital Markets Union set out an ambition of mobilising investments and savings within the EU to support green growth, the digital transition and a more inclusive and resilient society. The EU retail investment strategy offers a critical opportunity to realise that ambition through modernization of regulation and empowerment of consumers.

The bulk of EU citizens' savings is currently sitting in saving accounts, providing limited return, and not actively contributing to investments which are needed to help transform the EU economy for a green, digital future. A retail investment strategy that makes it easier and simpler for consumers to invest in EU financial markets with confidence could help transform that picture. It could also help close the significant gap in pension saving across the EU, by supporting take up of long-term savings products, such as insurance-based investment products.

To achieve these goals and foster EU retail investment, Zurich believes that there is work to be done in 3 areas:

1. **Digital first:** More and more customers are expressing the wish to receive communications in a digital format. Digital formats offer the opportunity to present information in a way that customers might find more intuitive and understandable. Whether it is through techniques such as layering, where consumers are able to access more detail or explanations with a simple 'click' or touch of screen, or dashboard summaries available at any time, digital channels offer a raft of opportunities. Moreover, digital disclosure could save a lot of paper, contributing to environmental sustainability objectives. Unfortunately, local and EU rules often require that information to customers is provided on paper. Zurich believes it's time for EU conduct regulation to make digital disclosure the default option, whilst ensuring that customers who prefer paper-based communication are not excluded.

This EU strategy offers a critical opportunity to modernize regulation and empower consumers.

2. **Information tailored to customer needs:** To empower customers to make confident, informed financial decisions, all customer information must be tailored to customer needs. Ex-ante consumer testing, to ensure that customer information is meaningful and fit for purpose, is key. No new retail disclosure requirements in EU financial markets should be enacted without it. The work done by EIOPA to outline duplicative disclosure requirements, that are not only unnecessarily costly, but may also lead to confusion, is an important first step. Regarding the Key Information Document (KID), customers could be further empowered by giving more prominence to essential information on the existence or lack of insurance cover, payment flexibility and other benefits. The industry can, and already does, contribute by actively listening to customer feedback, continuously improving its products and its customer communication.

   In addition to improved information, expert advice contributes to customers' awareness of available investment options and potential risks. The more complex, or longer-term products are, the more expert advice is important. By nature, insurance-based investment products are more complex than pure investment products as they provide additional benefits, such as in form of insurance cover. Zurich firmly believes that all customers should have easy access to expert advice, taking into account their level of financial education, life circumstances and preferences as well as major differences in the financial culture across European countries.

3. **Financial education:** The final step towards customer empowerment is to increase investment in financial education. Financial literacy levels in the EU vary, but every EU citizen should have at least a basic understanding of financial services, to enable informed financial decision making. We are proud to have worked together with Oxford university, during a research cooperation in 2015 to 2021, and have gained practical insights to support improving people's financial protection. We also note that there are a number of national initiatives in place that aim to provide guidance to citizens in making financial decisions. Zurich believes that there would be benefit in promoting public-private cooperation to scale and potentially improve such initiatives to ensure that they are accessible for all European citizens.

A future-oriented approach in these three areas, with joint effort from regulators and the industry has the potential to enhance consumer confidence and retail investment in the EU financial markets.

SIMON JANIN

Head of Group Public Affairs - Amundi

Meaningful information paired with qualified advice is key for retail investors

As all OECD countries are facing a dramatic resurgence of inflation, ensuring a better allocation of households' assets is more than ever essential. This not only to finance sustainable growth and digital transition, but also to allow investors to have access to more diversification and then achieve higher return for their savings, in order to preserve them from capital erosion.

Against this backdrop, the forthcoming Retail Investment Strategy (RIS) should be properly calibrated with a focus on creating a favorable environment to foster investor participation, without jeopardizing distribution models, which are contributing to a sound diversification of investors' savings. The future RIS should then follow three priorities.

First, it should ensure that a retail investor receives information that can easily be understood and fit for the purpose of making the right choice. Less sophisticated investors should not be overflown with large quantity of information, which have a deterrent effect and drive retail investors away instead of helping them to make an informed choice. These investment decisions are essential for households financial future and the realization of their life financial goals, such as, acquiring a house or means of transport for they family, paying for education or planning for their retirement and addressing the future pension-gap. In order for investors to make these important choices, information needs to be readable and meaningful.

New regulations, such as MiFID2, are also requiring investors not only to make investment decision that work for them, but also to take into consideration their potential impact on environment and on the broader society. While we are strongly supporting these initiatives, it is essential that retail investors benefit from an understandable information on these issues to help them navigate among all these new requirements.

Secondly, the future RIS should maximize the possibilities offered by digitalization hand in hand with an increase of financial knowledge. As highlighted by various studies, investors may miss many opportunities when they are not adequately educated on financial matters. A striking evidence is the fact that the vast majority of European retail investors keep most of their financial wealth in bank deposits, therefore missing out opportunities to receive higher returns and to protect their savings against inflation. As underlined in a comprehensive study, the financial wealth of European households would have been EUR 1.2 trillion higher had they had gradually reduced the share of deposits in their financial wealth from 41% to 30% by investing in equity and bond funds during the 2008-2019 period[1].

A portfolio approach allows to achieve a more balanced overall risk-return profile for an investor.

We are very supportive of any initiative the European Commission (EC) and Member States are working on in the field of financial education – it is a win-win for both consumers and industry. In addition to these measures, we also believe that the best way for investors to learn to invest is to drive them closer to investment experiences (i.e. learning by doing). In this respect, it would make sense to explore the possibility to boost employees' share ownership by harmonizing legislations across the EU.

Thirdly, we praise the EC's intention to have a more investor-centric approach. To this end, we are supportive of the initiative of enhancing the current suitability and appropriateness test including a portfolio approach, which allows to achieve at a macro level a more balanced overall risk-return profile for an investor. However, we would invite the EC to consider the practical implications of both the personalized asset allocation and the portability of the assessment. Indeed, while in our view the standardized asset allocation will be detrimental to the investors since it will reduce the competition between firms, the portability raises a number of questions with respect to both the financing of the exercise by firms and responsibility to keep the assessment always up to date.

Last but not least, we strongly recommend the European legislators to avoid initiatives that may endanger the current distribution models that are supporting clients in Europe, including the retrocessions model. Under the 'commission-based' model, the mass retail investors are all given access to advice at a reasonable cost and can benefit from added value services.

In sum, to be a success, the RIS will have to focus on initiatives enhancing retail investors experience and easing their access to financial education and products, whilst preserving their protection. In the meantime, measures that may have the opposite effect, such as reducing retail investors access to financial advice or overflowing investors with information, should be avoided.

[1] See EFAMA, Household Participation in Capital Markets, September 2020 https://www.efama.org/sites/default/files/files/KPI%20Report_FINAL%20version%20%281%29_1.pdf

GUILLAUME PRACHE
Managing Director - Better Finance

The EU Strategy for retail investors must not drop its own key objectives

Since the launch of the Capital Markets Union Action Plan (2015), much has been said about better outcomes for investors and increasing retail investments into capital markets . Two Action Plans and three high-Level reports later, EU households – as the main source of long-term and sustainable funding for the Green Transition and EU economy – see no real improvement of their situation.

Financial repression at a historical high, widespread and highly damaging biased advice (both for retail investors and for capital markets), inadequate disclosures, and lack of enforcement characterise the "retail" investors' journey through EU capital markets.

The EU Strategy for Retail Investments announced by the EU Commission in 2020 set out very relevant objectives to improve investor protection, and to ensure:

- "that rules are coherent across legal instruments", and that retail investors benefit from:
  - "adequate protection,
  - bias-free advice and fair treatment,
  - open markets with a variety of competitive and cost-efficient financial services and products, and transparent, comparable and understandable product information.

EU Commission pressured to give up the main objectives of the Retail Investments Strategy

However, it all seems now just a noble wish without any chance to see the light of day given the strong backlash from a large number of stakeholders including influent Member States. In particular, the crucial objective of ensuring "bias-free advice"will most likely be replaced with another soft promotion of adult financial education.

Indeed, EU policy makers too often turn back to financial education as a panacea to improve investor protection, instead of identifying and reprieving practices that are harmful to non-professional savers, EU decision-makers promote financial literacy to empower investors to make "informed investment decisions". As such, responsibility is shifted from providers to non-professional investors as the latter are asked to get educated and fend for themselves. Also, it not realistic to assume that adults will go back to school for getting investment education.

EU Commission pressured to give up the main objectives of the Retail Investments Strategy.

Being a "retail" investor is not a full-time job, nor is it expected from consumers in any other market to level the expertise or knowledge of traders in order to filter products and challenge services that are not suitable for them. Moreover, investment services and products have the particularity of being credence goods, meaning that consumers must trust that the provider is competent and acts in their best interests.

The EU Commission seems to be now exploring an alternative option: to introduce value for money in the product governance and distribution processes of retail investment products. It is an interesting approach already used by the UK FCA and being looked at by the EIOPA. But it may be too late, as the long overdue review of the major EU investor protection rules cannot be postponed much further.

To avoid consumer detriment, the retail investor strategy - likely failing to get closer to its most critical goal of ensuring bias-free advice - must at least better protect "retail" clients' interests by:

- ensuring a coherent standard of investor protection across all sectors, by harmonizing the rules from investment products within MiFID scope (a minority) to those (the majority) in the scope of other EU sectoral rules;
- achieve its goal of ensuring clear and comparable key disclosures, in particular by at last disclosing the long-term real returns (net of the impact of inflation), and the investment objectives of the provider alongside the largely fictitious nominal returns;
- enabling supervisory authorities to enforce value for money, by eliminating regulatory loopholes with clear definitions of key concepts (best interests, undue costs, greenwashing, etc.);
- improving the enforcement of existing conduct of business rules by the ESAs, in particular by using their product intervention and "breach of EU Law" powers – very seldom if at all used for investor protection so far, and actually fulfil their duty of promoting simplicity, i.e. simple products;
- and enabling investors to obtain compensation and redress against breaches of their rights.

"Putting people at the heart of the financial system is part of my vision" (EU Commissioner Mairéad McGuinness).

How many mis-selling scandals, financial crises or other harmful practices do we need until we take action to truly protect EU "retail" savers? In 2022 alone, EU savers are likely to lose more than one trillion euros in real value (purchasing power) due mainly to the "financial repression" orchestrated by policy makers, but also due to their over reliance on fixed income-linked, intermediated and fee-laden packaged products, that are selected with biases.

The time to learn has passed, the EU needs swift and impactful measures to attract and motivate households to invest and stop destroying the real value of their pension savings.

ASSET MANAGEMENT TRENDS AND REGULATION

RODRIGO BUENAVENTURA

Chairman - Spanish Securities and Exchange Commission (CNMV)

Making the single market for funds work even better

The proposed amendments of the AIFMD, UCITS and ELTIF directives developed by the European Commission, pursue several meaningful goals. Firstly, to contribute to the main objective of the Capital Markets Union (CMU) through the stimulation of the collective investment schemes and thereby the improvement and development of European stock markets, making them more attractive, efficient and safe for retail investors. Secondly, the improvement of liquidity management regarding AIFMD and UCITS, providing common tools in all jurisdictions and thus, in situations of a high market volatility, providing an efficient and effective response to concerns about the protection for investors and the systemic risks.

Risks associated with liquidity management have been at the forefront of the regulatory debate, namely at the FSB level. Some think that funds contain an inherent instability factor that puts at risk financial markets when dire times come. I disagree. There is nothing risky embedded in funds, with the exception of CNAV MMFs, which is different from any other investment portfolio (including banks' portfolios). It all depends on how they are managed and supervised. Funds do not owe money to others, so regulating them as banks, with capital requirements, is a completely flawed approach. Leaving MMFs aside, there are ways to manage and supervise funds that minimize financial stability risks.

The CNMV, has been traditionally very active in the supervision of appropriate tools to manage redemptions in times of market stress and lack of liquidity, trying to avoid conflicts of interest between outgoing investors and those who maintain their investment. We have published guidelines in 2021 on fund liquidity management for the entire management industry as well.

The UCITS framework has been a success, though some tweaks could make it even better.

The third of the common goals is to improve supervision by establishing a harmonised reporting regime to national authorities, including the details of individual portfolio positions. The supervision based on the detailed knowledge of the assets of fund portfolios - at an ISIN level of each fund- has been carried out in Spain, with a monthly frequency, since 1990. It has allowed an extremely effective and close supervision, being able to analyze abnormal returns, non-eligible assets or compliance with limits and coefficients, among other issues. For NCAs, having position-level information is an essential tool to improve fund supervision. And this is again linked with the financial stability perspective. For instance, it allows the supervisor to anticipate liquidity tensions based on significant market events before they arise. It improves the monitoring of financial stability risks and represents a next level in the supervision of funds. I consider that the new harmonised reporting regime, is a key aspect to improve both the single market of funds and the monitoring of financial stability risks.

The promotion of the ELTIF products is also laudable, insofar as it has been an instrument with a little success among the European investors. The amendments pretend to make a more flexible regime, not only with technical and operational details, but also by including a mechanism as a "secondary market" for the crossing of possible purchase and sales offers o the ELTIF "shares" among investors. The mechanism could allow an exit before maturity, though actual liquidity will be probably scarce.

The recent report by the Court of Auditors of the EU is a welcome perspective on the UCITS market. However, it is somehow critical with regards to the achievement of a single market for funds, the limited realization of the benefits linked from the promotion of cross-border activities and the profits that these could give to the investors in terms of lower rates due to greater competition. The conclusions may be valid in small countries and where, as a general rule, the collective investment industry is less developed. But this is not the case in medium-sized and large countries, like Spain. In large markets, there is a true single market for UCITS, with significant choice of domestic and imported products. Funds truly promoted by foreign providers reach close to 45% of market share in Spain, proving that the single market works. So called round-trip funds are absolutely residual in Spain.

I think that the UCITS label has been a true EU success and only minor tweaks are needed. Among them, the new reporting regime to NCAs and the new liquidity management tools stand out.

Investors may not yet be able to fully reap the benefits of cross-border activities as a result of some obstacles and drawbacks. The solution to these obstacles has been tackled through the cross-border distribution of funds package that came into force a year ago, which requires some more time for a fully-fledged evaluation.

MICHAEL MCGRATH

Assistant Secretary,
Financial Services Division - Department of Finance, Ireland

Evolution & not revolution: Council's position on the AIFMD framework update

Over the course of the first half of 2022, member States discussed the European Commission's legislative proposal that formed part of the November package of measures to boost Europe's capital markets with the aim of stimulating the real economy and facilitating post COVID-19 growth. Under the French Presidency, Council reached an agreement on a review of the AIFMD, and the consequential updates to the rules applicable to UCITS. This General Approach will now guide the Czech Presidency on behalf of the Council in the trilogue discussions with the European Parliament over the coming months.

Member States, throughout the Working Parties, sought to ensure that the developments built on the effective AIFMD framework which has provided high levels of investor protection while also facilitating EU Alternative Investment Fund market integration. It was important to preserve that which has proven to be solid and to limit the focus for change to areas where improvements were required.

The Commission concluded that AIFMD had largely achieved its original objectives and that the overall approach should be evolutionary, with targeted amendments progressed to modernise the framework to reflect market developments since 2011.

Ireland, home to a vibrant fund and asset management industry, actively participated in the Council discussions. We sought to ensure that the cross-border model and the openness to global expertise and services was preserved in line with our support for the CMU. We also recognised that greater harmonisation is desirable in certain areas to improve the resilience of investment funds and enhance the single market.

Therefore, it is heartening that the Council General Approach seeks to build upon this integral aspect of the EU's global fund offering - it will be important that the post-trilogue text safeguards this framework.

Liquidity Management Tools (LMTs)

The Council agreement emphasised the need to enhance the ability of fund managers to deal with liquidity pressure in stressed market conditions. The General Approach stresses that this can be achieved by providing for a common set of Liquidity Management Tools (LMTs) available to Fund Managers and by ensuring harmonisation in this area. Recent events, including the Russian invasion of Ukraine, are testament to the need to ensure that fund managers are well equipped to effectively deal with instances of financial turbulence.

Loan Origination Funds

Ireland was one of the first EU member States to introduce a domestic regulatory framework for this activity. The establishment of a basic EU framework, such as proposed in the Council text, will support a more efficient and effective internal market in relation to this activity. These funds play an important and positive role in a well-diversified financial system. Such funds complement bank-based funding and supporting the real economy. The need for an effective EU framework for Loan Origination by investment funds encompassing governance and risk management is clear to see. This is an example where the existing AIFMD framework needs some modernisation in light of recent developments. In addition, the legislative proposal is further strengthened by proposing a new limitation on leverage and by adding a prohibition on AIFMs from managing funds designed with an "originate-to-distribute" focus.

Delegation

The current delegation framework in AIFMD has worked well and remains one of the key pillars supporting the EU's cross-border investment market. Our framework allows Fund Managers to benefit from cost savings, utilise expertise in specific markets and access global trading capabilities through delegation while being subject to strict control, oversight and accountability by those funds' national regulator in compliance with EU rules. The Council agreed that it was crucial to ensure that any changes made do not undermine the global funds model or contradict our agreed goal of deepening the EU Capital Markets Union. At Council we have further clarified the rules, and the need for increased transparency and supervisory cooperation in this area. We wish to achieve these adaptations to the framework while avoiding the creation of letterbox entities and ensuring appropriate regulatory oversight. To this end, the Council introduced minimum substance requirements and new reporting requirements on delegation arrangements allowing for improved supervision of the application of the EU regulatory framework.

Access to Depository Services

Finally, the Council discussions also sought to build upon the Commission's proposal to allow for cross-border access to depositary services under strict parameters. The final Council position of placing additional safeguards in this area is a pragmatic compromise.

Conclusion

The AIFMD has proven to be a European success story that continues to fulfil the stated objectives of providing robust investor protection and addressing systemic risks. Furthermore, the importance of the AIFMD brand cannot be overstated. Therefore, it is heartening that the Council General Approach seeks to build upon this integral aspect of the EU's global fund offering - it will be important that the post-trilogue text safeguards this framework.

RIMANTAS ŠADŽIUS

Member - European Court of Auditors (ECA)

No true single market for investment funds yet – the EU auditors' view

As the Union's independent external auditor, the European Court of Auditors (ECA) not only assesses the implementation of the EU budget, but also the performance of EU institutions and bodies in reaching their objectives. In our recent audit report, we assessed EU efforts to develop a Single Market for investment funds, facilitating cross-border business, ensuring a high level of investor protection as well as consistent and effective funds supervision.

The Single Market should provide increased and fair competition, uniform investor protection, more choice for investors and less administrative burden on asset managers through uniform rules. As a result, it should lower costs for investors and enable more cross-border risk sharing. Most stakeholders generally consider the EU's regulatory framework a success story, especially as a quality standard abroad. However, we found that so far there is no true Single Market benefitting investors in the EU.

The EU's regulatory framework for investment funds mainly consists of Directives. While they set a minimum standard to follow, they are unable to create a level playing field. Indeed, diverging national rules usually come on top of the transposed provisions of Directives. On the other hand, Directives very often mean a higher administrative burden and significant delays in implementation. Just think - it took long eight years to fully transpose the AIFMD in all Member States. How many years are we ready to wait for the present review of the AIFMD and UCITS to complete? We conclude that Regulations would be a better and more efficient tool to achieve legislators' objectives, especially in a fragmented area like financial services.

The Single Market is based on passporting, which allows asset managers to operate cross-border funds. However, this only led to concentration of funds domiciles in a few Member States and the so-called "round-trip" funds, and did not ensure real integration. Nearly 70% of funds held in the EU continue to be focused on domestic markets and are sold by domestic asset managers. In addition, in Eastern Europe to date markets remain far less developed. Consequently, we need to create powerful incentives for true cross-border funds and their EU wide distribution.

We need to create powerful incentives for true cross-border funds and their EU wide distribution.

ESMA's main task is to ensure the equal and just application of European rules across all Member States. However, we found that in practise, ESMA has to rely a lot on the goodwill of national authorities, when it comes to sharing information or participation in convergence tools. As a result, the Agency is not sufficiently aware of the actual level of convergence. Nevertheless, ESMA found various divergences, which it was often not able to address despite significant efforts over many years. For instance, ESMA was unable to overcome differing views on the extent of delegation and enforce common standards. Thus, the Commission had to include this topic in its AIFMD review proposals.

Despite ESMA's efforts, the quality of funds supervision differs between Member States and enforcement measures remain rare. We found that while ESMA helped national authorities to better identify risks and incompliances, it struggled to persuade them to follow-up on regulatory breaches. We observed that national authorities are generally reluctant to use formal supervisory powers, even in case of clear breaches of law.

The level of investor protection is generally high in the EU. This is important, as households are key investors into funds, either directly or indirectly via insurance and pension providers. Nevertheless, some issues exist. For instance, it remains difficult for investors to compare products and to gain a reliable overview of available funds and their respective costs. We recommend developing a tool to allow investors to compare funds, very similar to the idea of the European Single Access Point. Another growing concern is greenwashing as ESG ratings and tools are currently unregulated and unsupervised. Investors, relying on these ratings, are usually not aware of this fact.

The supervisory reporting for investment funds needs improvements. While a comprehensive system for MMFs exists, there is no harmonized reporting regime for UCITS, and the one for AIFs lacks granularity. In light of numerous on-going crises, we also highlight the need for better data and for more work to understand and address possible financial stability risks in the funds sector.

As the next step, we recommend the Commission to perform a comprehensive fitness check and to propose significant changes to the current framework. We are convinced that currently proposed minor revisions, despite addressing relevant issues, will hardly achieve the key objectives of the Single Market and the Capital Markets Union. We also recommend to change ESMA's governance structure in order to ensure efficient and consistent supervision of the market in the interest of the Union.

CHRISTOPH BERGWEILER

Chairperson of the Board of Directors - J.P. Morgan

Unlocking EU's retail investor potential requires open and competitive markets

Unprecedented global events have spurred a rapid evolution in the asset management industry over the past two years – from green and digital transitions to increased engagement by citizens with their finances. Such significant changes can be a driver for strengthening the investment culture within Europe and, provided markets remain open and competitive, offer investors an optimal opportunity for investment success.

European citizens stand ready to benefit from greater economies of scale and the potential for better returns if EU policymakers work to foster greater retail participation by ensuring access to a wide range of suitable investment opportunities. Sustainable investing and digital developments offer, for example, a catalyst for potentially turning more savers into investors. At the same time, to ensure the best possible investment outcomes for these investors, Europe should seek to expand the set of suitable products on offer, while preserving the great foundations for retail investment built through the considerate development of the UCITS ecosystem.

Looking at noteworthy industry developments, it's worth taking a moment to first reflect on the growth of sustainable finance; for example, since 2019, the level of green finance raised in European capital markets has more than doubled, reaching €311 billion. The possibility of steering capital towards enabling companies to transition has attracted new participants to the markets. We are encouraged by the recent focus of policymakers on supporting the transition of parts of the economy that are not yet green but have the potential to be, which has not been the case to date. In addition, as climate risk is a global matter, we strongly recommend international alignment of standards. While the EU should be commended for elevating climate risk to the forefront of the international agenda, a globally coordinated response is the only way to facilitate the green transition.

Second, digital developments have made the process of investing more simple and less costly, and have helped to improve transparency. Innovations in automation and artificial intelligence have also given firms the opportunity to provide products and services tailored to the differing needs of investors. We encourage the EU to harness the potential of increased digitalisation, while engaging with international partners on globally consistent rules and creating proportionate regulation which ensures a sufficient level of investor protection.

Greater retail participation by ensuring access to a wide range of suitable investment opportunities.

Third, largely thanks to the easier and more seamless access to financial services, there has been an increased interest in investing. However, to engage a significant proportion of Europeans for their financial future in a meaningful way, the EU needs to ensure that the investing public has access to a broad range of products suitable to their needs. For example, the European ETF sector has continued to grow steadily, with over €1 trillion last year. When also considering the growth of active ETFs, European investors now have the opportunity to benefit from a range of cost-effective products that may better suit their investment needs.

More broadly, the growth of the UCITS fund market has been exponential, turning this fund structure into a flagship European product. Its' global success has been enabled by a robust framework, including the ability to utilise international talent and expertise from across the globe, through delegation, whilst maintaining a very high standard of investor protection. We welcome targeted efforts to achieve better convergence in this area, while cautioning against overly prescriptive rules that do not serve the best interests of investors. This may also cause avoidable uncertainty among investors in EU funds, both European and international, thereby adversely affecting EU competitiveness.

In addition, to further strengthen long-term investing, the EU should seize the opportunity to move the ELTIF from a niche product to a mainstream, trusted structure. Adding clarity and flexibility to investment rules, while also simplifying retail distribution rules, has the potential of transforming the ELTIF into a vehicle of choice for long-term investing. It is positive to see that the restrictive nature of certain provisions in the original framework is currently being reconsidered, without compromising other key elements.

If Europe is to unlock the potential from increased retail investor interest and fulfil its ambitious goals for the long-term funding for the transformation of its economy, it needs to ensure that its capital markets remain open and competitive. It is an opportune time to further strengthen the attractiveness of the UCITS brand, by preserving the current model of distribution, and develop investment vehicles such as ELTIFs into a world-leading framework for long-term investment. It would be remiss of both industry and policymakers not to seize such an opportunity.

STÉPHANE JANIN

Head of Global Regulatory Developments and Public Affairs - AXA Investment Managers

How to ensure a true Single Market for EU fund investors?

As recognized by the European Court of Auditors earlier this year, the current EU regulatory framework for investment funds has allowed for facilitating the development of the Single Market to the benefit of investors.

The multi-decennial, step-by-step process of adoption and amendments of the UCITS Directive, the AIFM Directive, the ELTIF Regulation and complementary pieces of EU legislation has been, and is still, a reasonable way to build that framework. Many practical tools were set up: cross-border marketing of UCITS and AIF funds; cutting-edge and safe design of UCITS funds (recognized now as the global golden standard by non-EU investors and firms); attempt to provide for cross-border retail funds invested in EU real economy assets (ELTIF).

From this product management and offer perspective, the current AIFMD/UCITS and ELTIF Reviews will secure further benefits to investors. First by ensuring clearer rules for fund management (e.g. regarding portfolio management delegation or loan-originating funds in the context of the AIFMD Review; wider scope of eligible assets regarding ELTIFs). But also in allowing easier access by investors (typically in the case of ELTIFs, by repealing the current minimum threshold of investments). Additional pieces such as the Cross-Border Distribution of Funds legislation were also helpful, e.g. in clarifying the notion of pre-marketing at EU level. In fact, the main remaining obstacle to allow for a complete Single Market vis-à-vis EU investors does not lie in the regulatory framework as such, but in the taxation one: for instance regarding ELTIFs, as long as principles on tax transparency are not agreed by Member States, full EU-wide diversification of invested real assets across several Member States will be deterred. We understand the wish by Member States to keep knowledge and control on taxpayers and national sources of tax revenues. But solutions should be found as soon as possible by improving tax neutrality across European jurisdictions, in order not to hinder the development of the Single Market for investment funds.

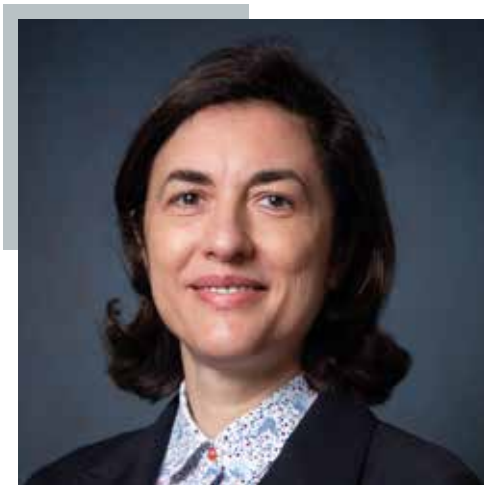
From another perspective, what is also critical is to make the EU fund industry more competitive vis-à-vis those based in other regions, to offer the best products at the best prices to both EU and non-EU clients. The cost of regulation plays its role here. Over decades, data clearly demonstrate that the market share of EU-based fund managers vis-à-vis their US-based peers is regularly decreasing.

Avoidance of new red tape should remain a central underlying parameter.

Positively, we have taken note that recently the EC has proposed three actions which will save costs for EU fund managers. First, in the context of the Digital Operational Resilience Act (DORA), as users of cybersecurity service providers we asked for and obtained a better legal protection vis-à-vis them. Second, regarding the EU DLT Pilot Regime, we were pleased to see taken on board our request to include UCITS funds. Third, the current EC's initiative for potential legislation on ESG Data Providers shows that we were heard too – although we keep asking for a wider action vis-à-vis Data Providers beyond ESG ones. Those three initiatives will be sources of cost savings for EU fund managers and their clients, and EU institutions must be thanked for that.

However, regarding fund legislation as such, in order to secure the competitiveness of EU-based fund managers and funds, avoidance of new red tape should remain a central underlying parameter. As an example, in the current AIFMD/UCITS Review, the wish by some Member States to introduce an EU-wide Reporting by fund managers to their National Securities Regulators – potentially applicable to each of the existing 33,000 UCITS funds – would be a bad signal: since ECB Regulation 2013/38, we have had to provide the detailed inventory of each of those 33,000 UCITS funds already to National Central Banks on a regular basis. The risk – and related buildup and running costs - of an additional reporting to securities regulators on the same UCITS funds cannot be taken. Instead, we suggest that national central banks share with the national securities regulators the data they have already been receiving from us for almost ten years.

That UCITS reporting simple case demonstrates the current big room for improvement regarding cooperation between securities regulators and national central banks. Even if from a mere securities regulators' perspective, the main objective remains to transfer progressively more powers from NCAs to ESMA over time, in parallel the transversal cooperation between banking bodies and securities ones is critical and should be facilitated (including through some EU measures, e.g. the compulsory sharing between central banks and securities regulators of our current UCITS fund data reportings). The price of insufficient cooperation between regulators and supervisors should not be paid by asset managers.



MIRELA AGACHE DURAND

Chief Executive Officer - Groupama Asset Management & Vice-Chair - AFG

Succeed in the sustainability transition

At a time of urgency for climate issues, the European institutions engaged those past years an impressive work, with notably:

- in June 2020, the adoption of the EU taxonomy defining the main criteria for the economic activities to be considered as 'sustainable',
- in March 2021, the entry into force of the Sustainable Finance Disclosure Regulation (SFDR), aiming at improving transparency in the market for sustainable investment products
- last February, the publication of the proposal of the European Commission for a Directive on corporate sustainability due diligence (CSDD),
- last June, a political agreement reached between the European Parliament and the Council of the EU on the Corporate sustainability reporting directive (CSRD).

Those texts represent only the first step towards an EU sustainable framework. A tremendous effort is also made to 'translate' their political objectives into concrete action.

In the context of CSRD, the European Commission mandated EFRAG as technical advisor to provide the draft European Sustainability Reporting Standards ('ESRS'). Those standards are crucial as they will, for all economical and financial players, establish operationally the ambitious EU political framework in the wake of the green deal. They will also have to reflect EU political will to standardize sustainability reporting and to spread the EU norms towards international standard setters.

We welcome the work of EFRAG which allows for the harmonization of this new reporting. Yet, the framework remains extensive and very complex to implement. In order to ensure the ability of all stakeholders to meet the upcoming requirements, we believe that exposure drafts should be simplified. In addition, the challenge will be to ensure a reporting done at a sufficient level of granularity to meet the information needs of investors, yet without overburdening companies.

International cooperation is key for enhanced comparability on sustainability disclosures.

In this context, we fully support the concept of 'double materiality' introduced by the European Commission and the EFRAG. This European concept is key and will allow a company to determine which information is material in the context of its activity. Nevertheless, to allow its effective implementation, we believe that it should be further clarified and illustrated. Practical guidance should be provided, first to be better understood and implemented by companies. Second, to gain weight at the international stage.

AFG is supporting the principle of 'rebuttable presumption' which allows a company to report only information that is material to its activity. Yet, it should be reminded that as investors, asset management companies face many obligations related to sustainable finance and therefore need tangible information from their counterparts to comply with these requirements. Consequently, we believe that the principle of 'rebuttable presumption' shouldn't apply to all SFDR Principal Adverse Impact indicators (PAIs) mandatory and optional and to certain climate-related information such as net-zero scenario, forward-looking information and decarbonization plan. This information is essential for asset management companies to be able to finance their counterpart in full knowledge.

Interoperability and consistency between the different regulatory frameworks must be a priority. At this stage, we acknowledge some differences between ISSB, SEC and EFRAG framework. The framework proposed by EFRAG, which we support, is much broader and accurate than frameworks proposed by the ISSB and the SEC. Indeed, EFRAG considers the Environmental, Social and Governance aspects in their globality, whereas the ISSB and the SEC only focuses on climate matters. In addition, EFRAG rightly introduces the notion of double materiality, absent from the other frameworks which only focuses on financial materiality. We also call the ISSB and the SEC to take into consideration the work of EFRAG and notably certain information such as SFDR PAIs.

We are convinced that success of the sustainability transition lies into international cooperation. In this regard, we support the ISSB initiative to set up a working group of jurisdictional representatives (including notably the SEC and the European Commission) to establish dialogue for enhanced comparability on sustainability disclosures.

The reality is that we are all stakeholders – investors, industry, NGOs, consumers, citizens – experiencing a sustainability revolution that will transform thoroughly our current economical and financial paradigms.

LISTING ACT AND DEBRA: PROSPECTS FOR EQUITY MARKETS

CARMINE DI NOIA

Director of Financial and Enterprise Affairs Directorate - Organisation for Economic Co-operation and Development (OECD)

Towards a more equity-based Europe – DEBRA and beyond

It is difficult not to sound repetitive when discussing European capital markets. Alas, because the core issue remains the same, it falls upon me to start off with a familiar dictum: Europe is punching below its weight when it comes to market-based financing.

This is particularly relevant when it comes to equity, and becomes most evident when comparing Europe to other regions. Consider for example the fact that while US GDP is about a third larger than the EU's, the total market capitalisation of its listed non-financial companies is nearly four times larger. Further, when looking at the top 10 jurisdictions globally by number of non-financial IPOs in the last decade, only one EU country is featured (Sweden). Several emerging Asian economies rank ahead of most advanced EU countries. In every year between 2008 and 2020, the number of delistings from regulated exchanges in the EU exceeded the number of new listings, resulting in a shrinking pool of publicly listed companies. Although 2021 saw an upswing in the number of IPOs, this seems unlikely to constitute a break with the longer-term trend.

The relative lack of capital market dynamism in Europe in general, and for equity in particular, is likely restricting its economic growth more broadly. Behind these seemingly abstract statistics are innovative companies, not least SMEs, that do not have the same access to risk-willing, long-term capital as their counterparts in other markets. That limits innovation, job creation and economic growth. Perhaps most notably, higher shares of equity financing are associated with lower per capita carbon emissions, making the general bias for debt over equity particularly costly. In the EU, the aggregate ratio of equity to financial debt for non-financial companies is about half of that in the US.

DEBRA is no silver bullet – but a bullet no less, and one that should be used.

The European Commission's DEBRA proposal to remove the institutionalised debt-equity bias by putting the two types of financing on equal footing from a tax perspective is therefore encouraging. It may be especially important in the current macroeconomic environment, with rising inflation and rapidly tightening monetary conditions. As interest rates increase, so does the intensity of the debt-equity bias. That is because, in absolute terms, the debt tax shield grows with increases in interest costs.

It bears mentioning that DEBRA is not an entirely new concept. A handful of European countries have already implemented similar Allowance for Corporate Equity measures. Italy, for example, has a long experience with this.

However, we should not settle there. There is also a broader, but less concrete, challenge of changing a deep-rooted habit and culture of using a financing mix that is not as equity-based as it could be. Removing the debt-equity bias will be a tool in changing that, but we must also recognise that creating more dynamic, equity-based capital markets is a broader undertaking. In short, DEBRA is no silver bullet – but a bullet no less, and one that should be used.

In addition to their exacerbating effect on the debt-equity bias, current macroeconomic conditions also make a more equity-based economy an increasingly important ambition from a resilience perspective. In economic crisis times, bank lending tends to contract, in turn further slowing down economic activity. Market-based financing can often offer more flexibility. This was evident during the COVID-19 crisis, when already listed companies were able to tap equity markets for record amounts of new financing. The same dynamics played out in corporate bond markets. In addition to broadening corporate access to capital, then, more market-based financing can also contribute to economic and financial resilience. Lacking such resilience can be damaging, as Europe's post-2008 and subsequent euro crisis experience shows, when the share of non-performing loans and non-viable "zombie" firms remained elevated for years.

The EU's upcoming Listing Act provides an opportunity to realise the ambition of ensuring that companies have access to finance in all weathers. It can help facilitate public listing, without compromising on minimum disclosure requirements. When developing policies to that end, the main obstacles companies currently face should be kept in mind. Previous OECD research, for example, shows that complex regulation, high corporate governance and compliance costs, as well as low market liquidity are key deterrents keeping companies from going public. SMEs should be at the centre of this endeavour, given that they make up 99% of all European companies and account for more than half of GDP. The DEBRA proposal recognises this by offering SMEs a higher risk premium on the notional interest rate that forms the basis for equity-based tax deductions.

These efforts are welcome, and, if properly implemented, should help develop European capital markets, to the benefit of its companies, households, and economy more broadly. Perhaps it will even allow me to start my next article on a less repetitive note.

BENOÎT DE JUVIGNY

Secretary General - Autorité des Marchés Financiers (AMF)

Attractiveness? Yes, but not at all costs!

SMEs represent the backbone of the European economy and 99% of the number of non-financial companies in the euro area.

Yet, European SMEs heavily rely on bank financing. Insufficient own funds remains an obstacle to investment for 28% of SMEs[1]. Though the reasons why SME favour bank financing are numerous, this can hamper their development and be a source of financial fragility, especially in a context of slowing activity.

In particular, in a less buoyant macro-financial context, the overall attractiveness of equity markets has lately diminished. IPO activity slowed from end-2021 into the first months of 2022 in the EU as well as in the US. The amounts raised over the first five months of 2022 in Europe did not exceed €3bn, ten times less than over the same period in 2021, and the number of deals felt by two-thirds[2].

Against this background, one key question we should reflect upon is how to spur SMEs to seek listing on public markets?

SMEs stand out as a centrepiece of the Capital Markets Union. The recent "New European Innovation Agenda" recalls that the Commission is still determined to keep on with its priority to enhance the financing of European entities, including through the envisaged simplification of the listing process. This is of course excellent news, considering the above-mentioned challenges as well as EU global competitiveness stakes associated.

But this does not mean that it is time for a regulatory overhaul. Firstly, the reasons for the comparatively limited attractiveness of the European market are numerous. The regulatory constraints associated with the listing process are only one part of the story, together with several more structural issues e.g. EU investors' relative risk aversion, to name only one example.

Beyond listing, EU regulation should avoid introducing new requirements only for listed entities.

Secondly, the European regulatory framework is sound and robust, and provides with tools that allow agility and reactivity. In the prospectus field, the Universal Registration Document (URD has already proven its worth in France, with around 300 issuers (including SMEs) using a shelf-registration scheme every year. The URD bundles together the annual financial report and the registration document into a single medium, to which a securities note and a summary may subsequently be added to form a prospectus. An important feature that needs also to be preserved within the Prospectus Regulation lies with the flexibility left regarding the optional formats of prospectuses: a one-size-fits-all approach (regarding lengths, formats, etc.) would be counterproductive considering the complexity of the ecosystem with a wide variety of companies, securities and circumstances involved in offerings.

Finally, although current regulations entail costs and administrative burden, re-establishing the symmetry of information between investors and an issuer, conveying robust and non-scattered information, and ensuring market integrity are necessary components of the attractiveness of the markets. Both the Prospectus Regulation and the Market Abuse Regulation have slowly developed well-understood and beneficial toolkits. Alleviation of regulatory constraints should not compromise investor protection and market integrity, nor spark off legal uncertainty.

Nevertheless, some targeted adjustments would facilitate SMEs' access to capital markets, without weakening the framework for market integrity and investor confidence. A good example would be a focused amendment to the Prospectus regulation through setting a minimum period offer of 3 working days instead of the current 6-days minimum period between the publication of the prospectus and the end of an offer. This would ease the fundraising process, reduce execution risks, for all primary offers to the public made by issuers, including SMEs, on regulated markets.

Incidentally, beyond the listing process, EU regulation should avoid introducing additional reporting requirements only for listed entities. The difference in treatment between listed and non-listed companies may indeed serve as a disincentive for companies to go listed, and therefore undermine the attractiveness of capital markets.

[1] Source : BPI France, « 75ème enquête de conjoncture semestrielle auprès des PME », July 2022 https://lelab.bpifrance.fr/get_pdf/2945/analyse_nationale_75_def.pdf

[2] Source AMF 2022 Markets and Risk Outlook | AMF (amf-france.org) https://www.amf-france.org/en/news-publications/publications/reports-research-and-analysis/2022-markets-and-risk-outlook

MÄRTEN ROSS

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Trends in Baltic capital markets

What are the current trends in the Baltic countries in terms of equity funding and IPOs?

During the last turbulent years any trend is obviously difficult to call. But in terms of growth of market-based capital raising the Baltic markets have been relatively active. While lead by some bigger IPO-s also the activity of medium sized companies has been notable. And not just for IPO-s on stock exchanges, but also in broader market context, including crowdfunding platforms.

True, starting point was not very high and there is room to reach satisfactory market financing level. But while Estonian startups raised EUR 464 mln in 2020, that number doubled last year. And the figure of the last year had already been surpassed in the first four months of 2022.

The growth has been visible also in the number of companies raising finance on trading venues. In 2021, there were 8 IPO's in Estonia and 2 more in Latvia, in contrast there had been on average 1 IPO per country in the previous years. There are similar positive developments in the bond market with 5 new bond issuers in both Latvia and Lithuania, and 3 new issuers in Estonia. However, this year with global turbulences can be assumed to e more problematic.

On the investor side fair amount of this growth has been matched by the increase in local retail investor base. That has been supported by progress in lowering investment fees and other costs. Eg in Estonia the share of households having investment portfolio outside the pension system has more than doubled in five years.

Is there a major equity funding gap and if so which companies does it concern most?

Based on macro level indicators the economy remains somewhat overfinanced by debt. However, in Estonia one should note that the company taxation system that is based on taxing profits only after distribution of dividends has helped capital accumulation on equity side. This has been probably most helpful for growing medium sized companies. As internal equity capital accumulation has this way been boosted it might have tilted companies' attention for additional financing towards debt, that is still mostly from the banking sector.

When assessed by more micro research, some public funding gap, both equity and debt, has been reported particularly inside smaller enterprise sector. At the same time, according to Fintech report 2021, Estonian fintech companies considered the access to finance only the seventh current most pressing problem for them, the bigger issues being finding customers, regulation, availability of skilled staff, expansion to foreign markets.

The priority of listing initiative should be to alleviate the regulatory and cost burden.

What are the main obstacles to SME company listing in the Baltic region and what should be the priorities for the upcoming Listing Act?

Main reported obstacles concern the regulatory burden and other costs that come with listing. And that includes both main and alternative exchanges and even after recent lowering of costs observed. This concern is not surprising when one notes in parallel more cost-effective alternatives to raise capital that some fintechs have introduced.

Thus, the priority of listing initiative should be to alleviate the regulatory and cost burden in parts where possible without significantly reducing the investor protection. For example, it should find ways to further the information already published elsewhere, take advantage of digital innovation and support availability of investment research.

Obviously, there are costs and constraints on listing beyond Euroepan regulation and listing initiative can't solve them. For example, there is regional consideration in the Baltics to further streamline the small prospectuses template. And the fact that Baltics tend to be still outside the major indexes tends to limit visibility.

How significant an obstacle to equity issuance is the debt-equity tax bias and does the DEBRA proposal put forward an appropriate solution?

DEBRA is a tricky issue. It is clear on the one hand that in general conceptual level the removal of debt-equity tax bias could be classified as a lower hanging fruit to pick if one wants to support both relative importance of equity finance in economy and also directly lower the overall cost of equity finance.

However, on the other hand, the extent to which this unequal tax treatment influences real life decisions on capital allocation and is reflected in the implicit relative cost of own capital is not very clear. This is the case particularly among smaller and medium sized enterprises. In addition, in the context of our corporate taxation system there is a feeling that this bias is somewhat smaller than under traditional corporate taxation regime and therefore the extra cost for equity finance could be rather low.

If at the same time proposed changes are themselves introducing new complexities and therefore potential costs into the corporate taxation system, then overall net beneficial effect for equity capital raising could be quite low or even negligible. At least in our system. The problem needs therefore further research.

ALAIN GODARD

Chief Executive Officer - European Investment Fund (EIF)

The InvestEU IPO Initiative

Public equity markets offer businesses access to potentially deep pools of equity capital, which are particularly useful to high growth companies when scaling up. A listing brings a business many advantages including attracting talent, raising brand profile and financing acquisitions. A well-functioning IPO market is an integral part of a healthy funding ecosystem and liquid public markets underpin the provision of core financial services such as pensions and insurance. A strong public equity market can also help attract foreign investment.

When comparing IPO volumes in Europe, the US and Asia, Europe is lagging behind. Beyond the, hopefully, temporary trend like the Ukraine war and the rising inflation which led recently to a dramatic drop in IPO volumes globally, weak public equity markets are a contributing factor to the departure of some of Europe's largest scale ups from the EU. In addition, Venture Capital ("VC") fund managers' perception is that the European exit environment is deteriorating and they identify the exit environment as one of the biggest challenges facing European VC funds i.e. a weak IPO market can create a feedback loop affecting investor confidence around earlier stage investments.

EIF has been supporting the EU's private equity and venture capital markets for nearly 25 years. A few years ago, following enquiries from managers launching funds with "cross-over" strategies and subsequently given discussions with the EC, EIF started to explore how it could potentially support the EU's IPO ecosystem. In order to properly understand the market need, and what form a solution should take, EIF has consulted various stakeholders across the EU including stock exchanges, listing advisors, investment banks, investors and listed companies. Based on EIF's analysis, there is a need for public intervention to promote investor interest in (newly listed) public companies.

EIF's analysis indicates four key issues facing businesses when attempting to list:

1. Readiness of SMEs

- The journey from a private company to public market company requires fundamental business changes to meet the additional standards required of a public company e.g. financial reporting and corporate governance. This transition has a financial cost and consumes considerable management time.
- Many companies list prematurely, causing problems post IPO particularly when returning for secondary issuances to finance further growth plans.

2. Information asymmetry

- Information asymmetry is exacerbated as c. 30% of all companies listed on SME-focused stock exchanges include a technological component and often operate in the ICT, clean tech or life sciences sectors. The low level of technology listings stems from the information asymmetries and lack of investor sophistication in analysing young technology companies.

3. Investor base

- High growth companies often require significant capital when scaling up and need an institutional investor base that can anchor and fund both primary and secondary issuance (follow-on investments).
- The investment hypothesis for certain sectors, such as in life sciences, requires a strong technological understanding. The commitment from a credible institutional investor can therefore have a very strong signalling effect in the market.

4. Liquidity

- The lack of liquidity in shares of smaller listed companies is one of the major issues with listed investments in SMEs and midcaps. SME equity markets typically have about 30% of the liquidity of main markets (measured by volume of shares traded relative to total free float).
- Most small listed companies are not are not included in any indices and therefore miss out from substantial liquidity coming from passive investment strategies such as exchange traded funds.
- 95% of the liquidity of a small equity market is concentrated in 5% of the companies.

5. Cost

- Listing costs contain an element of fixed costs but are negatively correlated to the size of the IPO. For example, the listing costs represent c. 10% for an IPO of c. EUR10m, however only represent c. 5% of an IPO of c. EUR100m.
- For similar reasons, the costs of regulatory compliance are relatively higher for smaller businesses. Additionally, the (fixed) penalties for regulatory breaches are disproportionately high for smaller companies.

The EU's overall public market ecosystem would benefit from specialist financial intermediaries with investment strategies targeting pre-IPO and/or public equity market investments. Such financial intermediaries can substantially support IPO fundraisings by acting as an "anchor investor" to take a material allocation of the shares issued, providing a strong signalling effect, and reducing information asymmetries. An anchor investor can be particularly beneficial where the investment hypothesis includes technology components or life science companies requiring a strong domain knowledge. In addition, such investors can play a positive role assisting companies with the transition from a private company to public company e.g. financial reporting standards, corporate governance and shareholder communication.

Given the evidenced market failure and in order to support EU enterprises access to public equity markets, EIF will implement a new initiative under the InvestEU Fund (the "InvestEU IPO Initiative").

The InvestEU IPO Initiative will seek to strengthen the EU's public market ecosystem by supporting investment funds targeting pre-IPO and/or public equity market investments in European SMEs and Mid-Caps, active at national level and/or cross-border, as described further below. The ultimate general policy goal of the Invest EU IPO Initiative is to support companies considering a public listing and listings of companies on EU trading venues . IPO Equity Intermediaries (as later defined) are positioned to support IPO fundraisings by acting as an "anchor investor", providing a strong signalling effect, and reducing information asymmetries thus unlocking additional private capital for IPO support investment strategies. An anchor investor can be particularly beneficial where the investment hypothesis includes technology components requiring a strong domain knowledge. In addition, such financial intermediaries can play a positive role assisting companies with the transition from a private company to public company e.g. financial reporting standards, corporate governance and shareholder communication. To pursue the IPO support policy objective, IPO Equity Intermediaries shall follow predominantly a "buy and hold" strategy and shall not engage in speculative short-term resale strategies, as further set out in the relevant Term Sheet.

The InvestEU IPO Initiative will be implemented on a demand driven basis. Equity Intermediaries will be identified and reported as IPO Equity Intermediaries where executing an investment strategy supporting IPO activity.

GERASSIMOS THOMAS

Director General, DG Taxation and Customs Union - European Commission

DEBRA - Reducing the tax debt bias in EU corporate taxation

The green and digital transition of the EU economy can only be achieved with the help of substantial private sector investment in innovation and in cutting-edge technologies. But for European companies – big and small - to compete and lead globally, and in order to help them play a key role in international supply chains, we need to see a significant U-turn in how those activities are financed. Traditional debt continues to be the main source of external finance for European enterprises, while alternative market-based resources such as equity play a relatively minor role compared to the US and other regions. The EU's tax system as it currently stands reinforces and perpetuates this trend. It's increasingly clear that businesses need better access to financing, including equity funding, if we are to achieve our common goals.

The EU´s long-term tax agenda for a fair and sustainable business environment sets out targeted measures intended to unleash productive investment and entrepreneurship. In that vein, the Debt Equity Bias Reduction Allowance (DEBRA) initiative, proposed by the European Commission in May 2022, puts forward an important and comprehensive solution to addressing financing issues across the Single Market. DEBRA also complements efforts to complete the EU's Capital Market Union.

Indeed, the difference between the cost of capital for debt and equity – i.e. the debt-equity bias – is stark, standing on average at 1.8 percentage points in 2021, and ranging between 0.1 and 3.1 across Member States. Research suggests an impact coefficient of the corporate income tax (CIT) rate on the debt-asset ratio of about 0.27. This means that for the weighted average CIT rate in the EU (26%), the debt-equity bias is responsible for a 7 percentage-point higher debt-to-equity ratio on average. All considered, companies should be able to make the trade-off between debt and equity without tax rules influencing those business decisions. This would provide a much better basis for businesses to take on the risky investments in vital break-through technologies we need in the coming decade.

Six EU Member States – Belgium, Cyprus, Italy, Malta, Poland and Hungary - have already attempted to address the debt-equity bias with positive results. While the measures differ in policy design, all provide for a tax allowance on equity.

An EU solution to the tax debt-equity bias to give businesses better access to equity financing.

Under DEBRA, a notional interest rate allowance would be granted on new equity for a period of 10 years and would be based on the year-to-year increase of equity. The time dimension of the allowance approximates the average maturity of debt, striking the balance between limiting the fiscal costs of the allowance and providing some planning horizon and stability for investors.

The equity allowance would be calculated with a notional interest rate based on the currency-specific European Insurance and Occupational Pensions Authority (EIOPA) risk-free-rate, plus a risk premium of 1% and 1.5% for SMEs. This top-up in the risk premium approximates the EU average in differences of financing costs between SMEs and larger firms, as observed in Member States. On the debt side, the deductibility of net interest payments (interest paid less interest received) would be limited to 85%. The DEBRA proposal seeks to mitigate the tax debt equity bias while at the same time limiting the budgetary impact for Member States. This is achieved by combining a tax allowance on new equity with a limitation of the deductibility of interest expenses.

The review of existing notional interest deduction regimes by the EU's Code of Conduct peer review group clearly shows the importance of a comprehensive and robust anti-abuse framework. In particular, anti-abuse rules should target, amongst others, cascading of allowances through equity, using a mix of intra-group loans and participations, and re-categorisation of old into new equity. The DEBRA proposal provides a robust and complete anti-abuse framework to avoid such unintended use of the allowance.

DEBRA would apply to all non-financial companies, the financial sector having been carved-out since it is already subject to regulatory requirements that prevent under-equitisation. In any case, many financial firms are unlikely to be affected by the countervailing interest limitation deduction applicable to exceeding borrowing costs. Therefore, should the financial sector be included in the scope, the economic burden of the measures would be unequally distributed at the expense of the non-financial sector.

While discussions have just begun, EU Member States seem supportive of the objectives of the initiative. If adopted, DEBRA could lead to higher equitisation levels, making companies and the whole economy more resilient. It would discourage debt accumulation and reduce the risk of sudden surges in corporate non-performing loans during severe economic downturns.

SOPHIE JAVARY
Vice-Chairman CIB EMEA - BNP Paribas

The challenge of building effective and deep financial markets in the EU

The EU will face in the coming decade huge financing needs in order to both develop a sovereign Tech sector and address the needs of the energy transition. Equity will be needed in a large proportion due to the risk and duration of these investment needs. In that context, efficient, sustainable and competitive capital markets are essential to help EU companies to access wider sources of financing without resorting to US capital markets or investors.

Implementing the Capital Markets Union or rather a unified capital market without boundaries, including through the Listing Act initiative, should be an imperative objective of the European Commission. It is all the more imperative after Brexit as large pools of money directed at equity in EU companies are of UK origin and since the London City is implementing reforms to ensure its long-term attractiveness.

Significant progress has already been made in terms of providing a more harmonized capital markets. However, despite the long-standing stated goal of developing a Capital Market Union, EU Capital Markets – especially in equity - remain underdeveloped when compared with the US markets. While EU savings are large and could – if effectively allocated – provide a large portion of the financing needs, they are still too much directed towards short-term instruments / bank deposits and debt products.

Main obstacles to SME company listing in the EU

The level of investments in the capital of SMEs remains low in the EU mainly due to a lack of liquidity and incentives to do so (legal and tax). The EU market has to develop a more mature and deeper investor base for IPOs. In particular, cornerstone and anchor investors are necessary to reduce execution risk. Ensuring insurance companies can invest more in equity would be a key measure. We should also make the retail distribution channels more efficient, and encourage pension and insurance holdings by individuals to remove some restrictions on pension managers and insurers investing in equity markets.

Public markets for SMEs need to be supported by a healthy ecosystem including investment research. Indeed, equity research is of particular importance as it is a component of the decision-making process for investors. However, the unbundling introduced by MiFID II has had a clear negative impact on the amount and quality of equity research published and notably on SMEs. Independent research and issuer-sponsored research are useful and the privileged way to go.

Efficient capital markets are essential develop deeper equity financings for corporates in the EU.

In addition, we do not have enough specialized investment funds towards SMEs. If there were some incentives to direct AM funds towards SMEs, asset managers would have more scale to invest in this segment.

Another deterrent for corporates of all sizes of going public is the imbalance in terms of disclosure between public and private companies. Legislation should aim at reducing this imbalance by providing a level playing field in terms of disclosure notably on management compensation.

Priorities for the upcoming Listing Act

We still encounter a substantial diversity of local interpretation of regulation and of market practices, mainly due to the differing views of local regulators and market participants. The Listing Act initiative is highly timely and necessary to facilitate and simplify listing on equity markets in the EU.

International investors expect a well-established series of market practices and are used to the high standards they witness in other markets. EU regulation must therefore be consistent with regulatory practices applied in the US and the UK in order to offer an attractive and competitive European market. We therefore cannot make compromise on the quality and rigor of public disclosure.

To remain a competitive market amongst the increasing number of prospective issuers desiring dual class of shares, such structures should be permitted or reviewed to determine the best EU approach.

We also recommend retaining a favorable environment for SPACs in the EU in a context of strong competition of US SPACs. SPAC is an innovative vehicle that allows private equity and public markets to work together. When benefitting from a high quality structure allowing for a proper alignment of interests, SPAC is a way to list a company of a certain size on the stock exchange that complements the traditional IPO process and establishes a potentially fruitful link with private equity.

Another item for discussion around the Listing Act is whether we should not build a path towards a single Regulator for a unified capital market namely ESMA to be empowered with similar powers as the US SEC or the ECB in the field of banking?

Finally, the objective of achieving an effective CMU cannot be reached without an initiative aiming at really harmonizing, national corporate law, corporate taxation and bankruptcy regimes. There have been a lot of progress in these fields but there are still substantial differences, which may cause international investors to still regard the EU as a fragmented market.

GERBEN EVERTS

Executive Director - European Investors' Association

Retail flow will be decisive for market dynamics in SME markets: attract them!

European Investors-VEB, by its nature, approaches these topics predominantly through the lens of investors, predominantly retail. Europe needs to remain attractive for existing and new investors. Developing capital markets is key, were Europe to develop a sustainable strong economy, with attractive jobs, a solid retirement provision and financial support for carbon-neutrality. Recent research shows that small, active investors have the largest influence on market dynamics, asset valuation and growth in SME markets. Larger investors tend to calibrate their portfolios pro-rata throughout market segments and are incentivized to replicate relevant global indices. Conservatism and herding behavior would lower execution costs, but also stifle innovation.

The issue of strengthening SME markets in Europe invariably stands to gain from considerations within the larger context of the EU Capital Markets Union. On paper, the urgency to boost the development of an equity culture in Europe hardly needs further illustration. In the EU, market-based financing of SMEs is underdeveloped. SMEs overly rely on bank financing. The scales of the balance require calibration, such that the share of equity financing gains appreciable weight. For innovation on the ground, an attractive SME markets for retail investors is a prerequisite. Currently, smaller investors tend to be left out at promising corporate events in those markets. They are excluded from preemptive rights and private placements of shares. These phenomena do not contribute to boost the demand of private investments and innovation which is needed.

However, the need and urgency for a retail equity culture may not be seen in isolation. It's a means and not a goal. The need for an equity culture arises since retail investors increasingly depend on their own financial resources and planning for providing their future retirement and asset growth. In sync, we recognize the important requirement for SMEs to tap additional sources to finance their businesses. Shaping an equity culture heavily depends on investor confidence, presuming a sentiment among investors that they are adequately protected throughout the EU. Investor protection should be bolstered by actual and powerful pan-EU means for obtaining collective redress when companies and boards willingly misbehave. Collective redress should be accessible throughout all Member States without suboptimal red tape being introduced at local level. Only then, pan-EU investment opportunities are as attractive and safe as pure local candidates. Retail investors are more vulnerable and dependent on agreed upon investment protection. They cannot be expected to be able to effectuate their rights fragmented, in jurisdictions they are not familiar with.

Only with adequate pan-EU investor protection, a true pan-EU equity market will follow.

The imbalance between bank financing and equity financing is not helped by the debt equity bias in tax deductions. The prevailing debt-equity bias serves to perpetuate overreliance on bank financing, and hence, upholds the leverage involved in borrowings. The debt-equity bias penalizes the financing of innovation through equity. Thus, tax stimulation measures clearly are a double-edged sword. We advocate either dampening the tax stimulation of borrowing, or, alternatively, counterbalancing such existing stimulation with equivalent stimulation of tapping equity financing. Hence, we support the fundamental thinking behind the DEBRA proposal. In this perspective, it is equally relevant to consider the competitive advantages which private equity financiers gain by having recourse to financial engineering. Here too, in the full awareness that PEs are capable of cherry-picking, advocates tax stimulating measures promoting IPO's of SMEs.

Such re-establishment of a level-playing-field is not helped by the introduction of special voting rights and loyalty shares. It is not to the legislature to take initiatives for the advancement of long-term shareholding. 'Loyalty' may sound fair, but rewards controlling shareholders to the detriment of minority shareholders. It implies a disloyalty to the market, market functioning and essential protection for minority shareholders. True loyal and engaged shareholders tend to switch between different shareholder-bases of individual companies based on developments in market valuation versus their own valuation and risk metrics. Were any party (or parties acting in concert) benefit from special voting rights nevertheless, their total voting rights should never exceed the threshold to launch a bid included in the EU mandatory bid rule. The same should be required in the context of the free-float regime and in re-assessing grandfathering provisions in existing legislation. The level-playing-field is also not helped if the scope for relaxation of the MAR regime would be considered. Only with adequate pan-EU investor protection, a true pan-EU equity market will follow.

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MIFIR REVIEW

HANZO VAN BEUSEKOM

Member of the Executive Board - Dutch Authority for the Financial Markets (AFM)

MiFIR Review: three key challenges for the Czech presidency

The coming into force of MiFID II and MiFIR in early 2018 has had a significant impact on the European capital markets. The MiFID/MiFIR framework is the Operating System (OS) for the financial markets. As with any OS, it needs a regular upgrade. So, there is currently the opportunity to further improve this OS by way of the 'MiFIR Review'. The European Commission drafted an ambitious proposal. Negotiations began under the French presidency, with several compromise proposals being discussed. It is now up to the Czech presidency to take up the mantle and finish the good work already done. We would like to summarize what are, in our view, the three key challenges.

The first challenge is Payment for Order Flow, colloquially known as PFOF. It describes the practice where a venue or market maker pays a broker a fee in exchange for the exclusive right to execute the orders of this broker's clients. The AFM believes there is a lack of transparency in the costs to investors and our research shows that PFOF venues underperform in both quoted and executed prices. ESMA has warned about the risks of PFOF as well. A ban on PFOF would appear appropriate, although not all Member States agree. Some are more supportive of these practices and revenue models deployed, for example, by neo-brokers.

We should realize the debate on PFOF is not an EU-only matter, but part of a global policy debate. The UK has a ban on PFOF. Australia has recently installed a ban on PFOF. In the US, in response to the wild-west trading in GameStop, the SEC is moving towards reforming the (PFOF) system substantially, e.g. by creating an order-by-order auction system, but with an outright ban on the table. The negotiations on the MiFIR Review must be seen within this global direction of travel. All major financial markets around the world are banning PFOF due to issues around conflict of interest and best execution. The European Capital Markets Union should not ignore this and take the wrong turn.

The European Capital Markets Union should not take the wrong turn.

The second challenge is the establishment of consolidated tape provider(s) (CTP) for different asset classes. These consolidated tapes (CT) would add significantly to transparency, resilience, and execution quality. It would reduce fragmentation in the Capital Markets Union, increasing visibility, comparability, funding opportunities and improve market resilience. As with the first challenge, the AFM has been vocal in its support for a CT.

We have been particularly supportive of establishing a real-time post-trade bond CT, facilitating the generation of ideas, business models and proofs of concept by way of our Regulatory Sandbox that includes a group of technology companies and an industry working group consisting of both buy- and sell-side, trading venues and liquidity providers. This allowed for rapid progress to be made and for market based, practical policies to be developed into an agreement on high level technical principles for a corporate bond CTP. The AFM invites the co-legislators to take note of these principles.

An equity CT is perhaps more complicated. The EU market for shares is very fragmented, with a significant amount of local or national exchanges. Whilst a real-time equity CT with limited pre-trade information (on a voluntary basis) is the desired outcome, there is opposition. It should be noted, however, that an equity CT would not compete with proprietary market data franchises: this business model for venues would remain unaffected. In return, better visibility and revenue-sharing models could provide a tangible benefit for smaller and non-interconnected venues in particular.

The third challenge is to enhance 'meaningful transparency'. It suggests transparency should be improved where it makes sense to do so and in a manner that is useful to market participants. An example is the calibration of the deferral regime for bonds. The current regime allows for notable differences between Member States: an EU-wide regime would be a significant improvement in itself, especially if it is both shorter and less complex. Furthermore, the correct calibration of this EU-wide regime is essential for the establishment of a bond CT. A way forward could be to have different categories, with a price being either real-time, 15min. delay or end-of-day, and the corresponding volume at 15min. delay, end-of-day, or two weeks.

Another example of achieving meaningful transparency is the improvement of market data quality and consistency. There are several ways of achieving this. Strengthening ESMA's role in handling and enhancing data quality and reporting consistency is one. Another is to form an industry expert group to advise on some of the key issues in reporting market data, which we strongly support.

In our view these are the three key challenges to overcome in order to have the MIFIR review become successful and providing a useful 'OS' upgrade to the MiFID/MiFIR framework that is a tangible improvement for the financial markets. We wish the Czech presidency the best of luck.

CARLO COMPORTI

Commissioner – Commissione Nazionale per le Società e la Borsa (CONSOB)

The CTP project in the perspectives of competition and investor protection

The establishment of a CTP at European level, after it failed under MiFID I and MiFID II, is one of the main objectives of the current MiFIR review. The expected benefits of the CTP are known, following the extensive discussion on this project since long time. The project also leverages the significant experience of TRACE in the USA.

Nonetheless, the negotiation at EU level proved to be difficult so far on the scope of the CTP and its link with the proposed ban on Payment for Order Flow ("PFOF").

One of the major issues is whether CTP should include all asset classes, or whether differentiation should be included particularly between equity to non-equity products. Whilst non-equity markets have been characterized by less transparency and more fragmentation, the equity space is already characterized by a more transparent price-discovery process. The potentials for introducing a consolidated tape could hence seem higher in the non-equity space; nonetheless this raises specific implementation issues, in terms of both data collection from a variety of venues and data quality, particularly for derivatives, which would need to be significantly improved for the consolidation to be valuable. On the other side, one could consider that the existing higher level of transparency in the equity space would make it more natural for a CTP to start from there; however, this may come at a higher cost, considering the value of market data for the industry, in a context where this has become one of the main drivers of competition across exchanges.

The distinction between pre-trade and post-trade also matters for the CTP project. Whilst broadening the scope of pre-trade information to be reported to the CTP could help strengthening the price-discovery process in the non-equity space, some might argue that it could undermine incentives for the research of trading strategies capable at supporting liquidity, due to the amplified trading and liquidity risks borne by brokers/dealers. Again, from a more practical stance it would certainly be easier to achieve such an important goal for the equity side and get the project started before considering any extension into other asset classes.

Whilst it is doubtful - at least at the CTP inception - that data could be used for trading purposes, considering the foreseeable latency issues that consolidation might entail, this has nevertheless the potential, particularly for more traditional investors (non-algo/HFTs), to immediately bring about more clarity and consistency for the best-execution compliance and supervision.

Benefits are also expected on competition between EU and US venues, aligning the respective regimes. In addition, small firms will benefit from easier and cheaper access to data, that will allow improvement of the quality of their trades' execution.

As stated above, the CTP project is also linked to the treatment of PFOF. As recently stated, we can argue that this practice is *"symptomatic of a broader issue of national EU regulators interpreting rules differently"* [1].

The existing rules on best-execution and inducements, represent a good framework to protect investors (together with transparency on costs and charges, management of conflict of interest). However, these rules proved to be interpreted and applied differently, particularly with regard to PFOF. A concrete example of this is offered by the divergent outcomes of studies performed by some NCAs as well as by the private sector. This seems to go beyond the different existing practices across Europe.

The lack of a common set of data and of a common methodology contribute to non-convergence across the EU. This was one of the weaknesses clearly highlighted in the impact assessment conducted by the European Commission, accompanying the proposal to set up a consolidated tape.

Data is available, but needs to be collected at different places, making it hard not just the collection but also the subsequent analysis. A single-entry point would have the benefit of facilitating better choices by investors and brokers/dealers, but also more efficient and effective supervision (particularly on best-execution) and more competitiveness between EU execution venues, as well as between the latter and non-EU venues.

[1] MEP Danuta Maria Hübner, rapporteur of the Commission legislative Proposal.

RODRIGO BUENAVENTURA

Chairman - Spanish Securities and Exchange Commission (CNMV)

Beyond the tape and transparency, best execution also needs regulatory attention

One of the most wide and deep legislative initiatives designed by the European Commission is the Capital Markets Union (CMU), which was born with the aim of improving the European stock markets to achieve greater attractiveness for new companies and, at the same time, increase the base of investors, institutional and retail.

A single market cannot exist without an integrated vision of securities trading in the EU, this being the objective of the consolidated tape (CT). An initiative that aims to provide consolidated data on price and trading volumes, improving not only market transparency but also competition between trading venues.

Transparency is a key factor as the EU trade landscape is highly fragmented and financial instruments, bonds and shares, are traded on hundreds of platforms. The existence of systematic internalizers (SI), OTC transactions, large pan-European investors operating single funds, and the development of technological platforms implemented in independent exchanges, have contributed to the development of fragmentation. However, trading fragmentation has not yet created a decrease of liquidity. It seems that market participants have adapted their business models accessing different types of trading venues to find the liquidity they need.

In this context, regarding non-equity transparency, the MifiR review proposal is moving into the right direction. There current proposal will significantly increase the level of post-trade transparency and intends to simplify the regime, although there are some aspects that need to be polished. For example, the current proposal sets a special deferral regime for sovereign bonds, with less transparency. However, it is unclear why not adopting the same deferral regime as for other types of bonds, as sovereigns are the most liquid class of bonds, and it seems counter-intuitive to require the lowest level of transparency to the class where more transactions occur. We should not regulate financial markets trying to protect the interest of public sector issuers differently from corporates.

On the side of non-equity pre-trade transparency, there has been a substantial and welcome change of direction after the proposal coming from the UK wholesale market review. The UK has proposed to remove pre-trade transparency requirements for RFQ and voice trading systems for well explained reasons. Publishing those pre-trade prices might give misleading signals of liquidity, that is not accessible for all types of investors.

We need to better define how execution quality is measured, before PFOF models expand further.

Regarding the introduction of a CT, the evidence shows that introducing a CT in less transparent markets, such as bonds, can be a significant improvement. On the other hand, it is not clear at this stage if the equity CT will have sufficient demand.

In my opinion, the equity CT will not solve in itself liquidity fragmentation. But, more importantly, the tape will not be a silver bullet to improve the execution quality. The EU best execution regime needs much more than a tape to fix retail execution quality. Models relying on payments for order flow, among other techniques, are actually bringing worse execution quality to EU retail investors. While the tape would definitely help professional investors to assess the execution quality they are getting, I doubt very much that retail investors would make any use of the tape to check, ex-post, if they obtained the best possible results.

For that, we need detailed rules on how best execution should be measured and assessed for retail clients. The current rules only require a periodic review. But how to do that is left open to firm and national discretion, bringing supervisory divergence and putting investors at risk. We need to define better, more detailed criteria of how execution quality is measured in the EU, and we need it now, before PFOF models further expand cross-border.

The potential of a pre-trade CT is to my mind still unclear. A pre-trade CT is an appealing idea, but it could create a false sense of liquidity and show a picture of the market which would be delayed in comparison to private data feeds, creating differences in latency. Retail investors may not be able to access many of the quotes shown in a pre-trade CT as brokers do not offer connectivity to all venues in Europe and SIs can discriminate between which investors they do and do not offer access.

In any case, when developing the tape, we need to ensure that ESMA has enough leeway to adjust and configure the project, without being put in a straightjacket. This is a complex project that will require flexibility to be implemented and very probably will only be doable in a staggered manner: starting with bonds and building the next steps from there.

EVA WIMMER
Director General -
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Germany

The MiFIR review should strengthen trading on transparent securities markets

The MiFIR review offers the opportunity for the EU to take a major step forward towards achieving the goals of the Capital Market Union (CMU). The CMU aims to improve the transparency, reduce the fragmentation and foster the competitiveness of EU capital markets and to increase retail participation in these markets. Key proposals made by the European Commission in the MiFIR review include the creation of a consolidated tape for bonds and shares, measures to limit share trading on non-transparent venues and by systematic internalisers, the harmonisation and simplification of the waiver regime on EU corporate bond markets and a ban on payment for order flow (PFOF).

To achieve the goals of the CMU, the MiFIR review should seek to strengthen trading on transparent securities markets, and the proposed measures should be conducive to that objective. It is crucial to strike the right balance.

In this regard, it should be reconsidered whether the proposed general ban on PFOF serves the objective of strengthening trading on transparent markets or the wider CMU goal of increasing retail client participation on these markets. PFOF reduces the costs of execution and allows retail investors to execute orders free of charge or at very low order prices. In Germany, it plays a key role in boosting the participation of retail investors on securities markets. Furthermore, several studies for the German market show that prices achieved at venues that use PFOF are similar to or better than prices on the reference market. Against this background, a general ban would appear to be disproportionate. It would be better to enhance the transparency of PFOF and to observe whether specific risks emerge that have not yet been addressed.

Another measure that needs further scrutiny is the consolidated tape for shares. While the level of transparency in EU corporate bond markets is low and the creation of a consolidated tape for bonds is therefore warranted there, share trading on EU stock exchanges already has a high level of transparency. In EU equity markets, the creation of a consolidated tape must therefore be carefully assessed, and the interests of all stakeholders, including stock exchanges, need to be properly balanced. The most feasible way forward at the present stage would be a consolidation of post-trade data. The possible consolidation of pre-trade bid and offer prices should be decided upon at a later stage. Proposals to limit the equity tape to the largest markets in the EU would run counter to the objective of achieving an EU-wide internal market for share trading and the wider goals of the CMU.

MiFIR review should seek to strengthen trading on transparent securities markets.

With a view towards strengthening trading on transparent markets, this discussion on the consolidated tape for shares should be seen as part of a broader discussion on the appropriate level of transparency, and the appropriate structure, for the EU equity market as a whole. The benefit of a consolidated tape requiring venues that are already highly transparent to further enhance accessibility to trading data would appear to be limited in a market where trading has shifted to a large extent to non-transparent venues and to systematic internalisers that offer lower levels of transparency. Instead, it is crucial to increase the overall level of transparency in EU equity markets and to establish a level playing field for trade execution.

Thus, the Commission's proposal to raise the thresholds below which systematic internalisers should be subject to full pre-trade transparency goes in the right direction. An option should be added that the threshold can be raised further based on analysis conducted by ESMA. In addition, the threshold for using the reference price waiver, which allows venues to rely on prices provided by reference markets, should be increased accordingly.

The objective of strengthening transparent trading should also be kept in mind when reviewing existing limitations on share trading at non-transparent venues, such as the double volume cap (DVC) mechanism. An abolition or suspension of the DVC mechanism seems therefore not warranted.

If our aim is to strengthen European capital markets, it is essential to avoid steps that might have a negative impact on the liquidity of transparent venues.

PIERRE CHABROL

Chef du bureau épargne et marché financier - Ministry of the Economy, Finance and Industrial and Digital Sovereignty of France

The MiFIR Review: progress made but still divergent visions to bring together

After six months of French presidency, it is a good time to take stock of the state of the MiFIR negotiation. As you may remember, the Commission proposed at the end of November 2021 a text revising the regulation governing the European markets in financial instruments. We like to distinguish three pillars of this text: i) the amendments intended to ensure the creation of a European consolidated tape (and more precisely of a single private consolidator for each of the main asset classes, namely shares, exchange traded funds, bonds and derivatives), ii) an update of our existing transparency regimes for both equities and non-equities, and iii) a proposal to introduce an EU-level ban of payment for order flow arrangements between retail brokers and execution venues.

This proposal was an excellent working basis for initiating discussions in the Council under our presidency at the beginning of 2022. It quickly became apparent that we would need time to set up the discussion on a good conceptual basis, ask ourselves the right questions - particularly in a context of regulatory divergence from the United Kingdom and the pressing need to advance the Capital Markets Union to meet our common challenges in terms of financing innovation and the energy transition – and eventually bring together views which were sometimes divergent between Member States on some key topics.

Each of the three pillars mentioned above indeed raised specific and difficult questions. Regarding the consolidated tape, especially for shares, what should be the appropriate latency to make it a useful tool for market participants? Should data on quotes (known as "pre-trade data") or only transaction data (so-called "post-trade data") be included? How should we build a revenue sharing mechanism to make it palatable to data providers, especially stock exchanges, while limiting the administrative constraints that could discourage potential service providers from applying to the tender run by ESMA?

Going forward, we want our market structure policies to become increasingly evidence-based. Above all, this requires good quality data and that is one of the reasons why the consolidated tape is such an important project.

With regard to transparency regimes, how to find the right balance between the need to preserve a diverse and competitive trading ecosystem in the EU and the desire to encourage more trading on transparent protocols which play a more central role in the price formation process? And finally, on payments for order flow, what are the dangers of this business practice for retail investors and for our market structure as a whole and what can be the possible advantages – if any - in terms of competitive pressure and innovation in the retail brokerage space when properly regulated and supervised? Therefore, should we go as far as an outright ban or rather consider regulatory safeguards likely to suit everyone and ensure equal treatment of market participants and retail investors in the EU?

The discussions were rich and sometimes revealed opposing visions. Now, what is the state of the negotiation and what can we expect? On the transparency regimes, we believe that we are close to an agreement subject to a few technical adjustments. We have proposed to simplify midpoint trading rules and the tick size regime to make European markets more competitive worldwide. Besides, we plan to entrust ESMA with determining the size below which dark trading will be severely limited. To this end, ESMA should run a controlled experiment over a few months window to ensure that the beneficial effects outweigh any negative ones from an investor and market quality perspective. We thought that we did not have sufficient inputs to adequately define a binding size limit in the level 1 text as initially proposed by the Commission. Going forward, we want our market structure policies to become increasingly evidence-based.

Above all, this requires good quality data and that is one of the reasons why the consolidated tape is such an important project. Unfortunately, there were still too many dissensions on this topic to conclude the negotiation at the end of our presidency. Two groups face each other with incompatible views for now: one in favor of a real-time pre- and/or post-trade consolidated tape and the other only ready to accept a deferred post-trade only tape. We will collectively have to find a solution that allows us to converge on common ground. We strongly believe in the relevance of a European consolidated tape, so this negotiation should not be another missed opportunity for lack of common ambition.

To conclude, we have read the European Parliament's report with interest and were glad to see that, on many important aspects, it follows a rather similar approach to the one that we have instilled in the Council during our presidency. We will now continue these discussions under the Czech Presidency with the aim of reaching a general approach at the Council by the end of 2022.

NIELS BRAB

Head of Group Regulatory Strategy & Chief Regulatory Officer - Deutsche Börse Group

Wake-up call? A fit-for-purpose MiFID has never been more pressing

When we came together during the last Eurofi in Paris, especially Covid and the post-Brexit realities were high on the agenda. At least until the outbreak of the war in Ukraine overshadowed discussions, marking a serious turning point in European history and the world order. Meanwhile, prices have skyrocketed with new realities around high inflation and the overall outlook has darkened dramatically, leading to a reshuffling of priorities.

With new constraints around monetary policy and public finances, paired with a picture of high debt levels and an increasingly constrained banking system, the new realities also mean that the capital markets agenda of the EU is turning into an urgent "must-have", rather than a "nice to have". Even more so, as key financing challenges, such as around ESG or digitalisation, are not going away.

Therefore, the need to progress on strategic autonomy, the broader CMU, as well as global competitiveness has never been more pressing! And: We should remain ambitious, building on a new reality around financial stability as the sustainable basis for economic growth, notably injected via the regulatory reforms since the global financial crisis.

Safeguarding stability and competitiveness are two sides of the same coin, catering for the vision of an open, multilateral, and rules-based global economy. However, time has come to step up the game when it comes to boosting the growth contributing capacities of EU capital markets.

This becomes even more urgent when benchmarking EU capital markets at global level, where key proxies continue to highlight the unleashed potential. Out of more than 2600 IPOs globally last year, 60% went live in the US and Asia, only 12% in the EU. The market capitalisation of any one US GAFA company is bigger than all of the German DAX combined. And: The EU's markets are significantly more fragmented with roughly 500 registered execution venues, a trend particularly pronounced in equities.

While the UK is already adapting to the post-Brexit realities with a series of changes aimed at boosting the City's attractiveness, the EU' review of MiFID II/ MiFIR runs the risk of missing the chance to make the framework truly fit for purpose, especially in light of new geopolitical realities. If we are serious about our strategic autonomy and competitiveness, we cannot miss the opportunity to deliver on the MiFID II/ MiFIR review as the centre piece of EU capital markets legislation.

The EU's strategic autonomy will be boosted by uniting rather than dividing our markets.

With Commissioner McGuinness clearly articulating the need to "strengthen EU FMIs", we should not lose sight of the need to redesign our market structure to match political objectives and ultimately societal ambitions. Transparency is a major issue in this regard, where the picture around the EU's bonds markets is only the tip of the iceberg in underlining that the rules simply do not deliver on the promised objectives.

The counterproductive implications of the MiFID II/ MiFIR market structure realities are also observable in other spheres, let's look at ETFs. Originally an innovation driven by exchanges, marked by higher performance and lower fees if compared to many of the active alternatives, only about 30-40% of the EU's ETF trading is actually happening on exchanges. The reason for this is simple: Higher spreads and arbitrage in the off-exchange world – to the detriment of end-investors.

On equities, the proposed tweaks around order sizes, transparency waivers, and the single volume cap will unlikely result in significant changes to the current picture on transparency. In conjunction, they would only allow dark venues not subject to those restrictions to grow. Increased transparency requirements for SIs are a step in the right direction – but for a well-functioning market structure, SIs should be used for what they were intended – executing large institutional orders.

Proper monitoring of SI activities and enhanced enforcement of rules remains critical. This is particularly true when it comes to data quality where the lack of enforcement and accuracy from the non-lit execution venues continues to constitute a serious problem.

In light of the need to establish a consolidated tape, we should ensure that the starting point to this project, reliable and high-quality data, is being guaranteed. Otherwise, the tape will either lead to a misleading picture for investors or, in the absence of being able to integrate the data, lead the whole project ad *absurdum* by not providing a 100% overview of the EU's markets.

The latest ideas around a division of the EU's internal market, based on the degree of artificial fragmentation injected via MiFID since 2006, occurs not only highly discriminatory towards exchanges but also questions the EU's vision for the future of the internal market in financial services and notably capital markets. At this critical juncture of European history, it occurs that the EU's strategic autonomy will be boosted by uniting rather than dividing our markets.

NICHOLAS BEAN

Chief Executive Officer - Bloomberg Trading Facility BV

MiFIR, transparency and the subjectivity of what success looks like

When debating transparency requirements within EU securities markets there are divergent views on both the objective of future amendments and the success of the current framework.

If meeting the international commitments in relation to transparency made at Pittsburgh in 2009 is taken as a benchmark for policy success, then the EU has exceeded expectations. The relevant non-equity derivatives are now largely executed on Trading Venues (TVs) and MiFIR went further by also encouraging greater corporate bond execution on TVs. These non-equity TVs provide popular 'at time of trade' competitive price transparency (via negotiation-based trading systems) and perform very well regarding post-trade transparency obligations versus non-TVs (see AMF paper, April 2022, 'Summary of bond post-trade transparency').

Yet despite this positive outcome, frustration persists about a perceived failure of MiFIR transparency. Amongst other things this likely stems from expectations that transparency would also, i) lower market data costs, and ii) encourage a 'harmonised' price stream/market - but such expectations may be misplaced.

Market data costs

To lower market data costs policymakers will have to lower the revenue of the beneficiary of its sale. This being the TV producing the data who, in effect, is a market data vendor.

The value of market data is correlated to its youthfulness for it is 'perishable information'. Pricing information 'perishes' at different rates across asset classes – no more significantly than across shares and corporate bonds. This reflects the differential of execution frequency between these asset classes. The frequency of execution for a given share may occur in milli or microseconds. For a corporate bond it may occur in hours or days – or even beyond. As such pricing information for shares is highly relevant to the next pending order, yet this is not the case for corporate bonds as the last executed price may bear only limited relevance to the next. In essence corporate bond pricing information 'perishes' easily.

Pricing information 'perishes' in value at different rates for different asset classes.

Consequently, TV revenue for corporate bond pricing data is significantly less lucrative than for shares. Typically, a non-equity TV makes the bulk of its revenue from execution fees, whereas a notable amount of an equity TV's revenue comes from being a market data vendor. Therefore, if policymakers anticipate that a corporate bond Consolidated Tape (CT) will meaningfully lower market data costs then they will be disappointed. On the other hand, a shares CT holds out the prospect of the inverse - if there is legislative appetite to address the impact on a key revenue stream of equity TVs.

Harmonised traded price stream

A CT provided by a Consolidated Tape Provider (CTP) will have benefits beyond the provision of the CT itself, however it should not be strictly necessary to form a harmonised price stream. Market participants should be using the 'free' data published by TVs and APAs after 15 minutes to form their own harmonised price stream, i.e. an 'in house' CT. At MiFID II go live there were three blockers to this, i) technical collection, ii) data standards, and iii) licensing. At the time of writing technical collection (machine readability) is largely resolved (thanks to ESMA guidance), data standards look likely to be addressed as per the proposals contained in the MiFIR review, yet the licensing blocker is never really mentioned.

From a practical perspective 'free' data is not 'free' but 'licensed'. It is 'loaned' by the vendor subject to the license conditions. If data was truly 'free' and unburdened by licensing then a FinTech provider would be selling software to collect and aggregate this data which would enable their customer to consume and utilise that data in any manner they may choose.

Such a solution for corporate bonds would not notably impact the revenue of APAs and TVs. As observed corporate bond TVs make the bulk of their revenue on execution fees and not as a market data vendor. In a similar vein the relevant APAs make the bulk of their revenue on the 'inbound' services (data ingestion and associated services – such as waiver and deferral calculators) and not selling 'outbound' pricing information.

Therefore, if policymakers wish to make a corporate bond harmonised price stream available to market participants, then there are options beyond a CTP - presuming a common data standard and some lateral thinking in respect of the licensing challenge.

Conclusion

A narrative has been fostered that non-equities transparency is lacking, largely in relation to corporate bonds. This narrative persists because of comparisons to equity practices. Trading systems already offer 'at time of trade' transparency for corporate bonds. As such, given the lower frequency of execution for bonds, the value of post-trade transparency is in relation to price prediction models – and if 'free' data was truly 'free' then it could readily be used for such.

STEPHEN BERGER

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Strengthening financial markets and empowering investors with consolidated tapes

The MiFIR Review provides a critical opportunity to strengthen EU financial markets and meaningfully enhance transparency for all investors. While MiFID II laudably aimed to shine light on the historically opaque bond and derivatives markets, regrettably, the post-trade transparency framework has yet to deliver concrete benefits for investors. As the MiFIR Review proceeds, addressing implementation shortcomings and establishing post-trade consolidated tapes for non-equities are necessary course corrections that will materially benefit EU investors, capital markets, and the broader economy. Other leading global financial centers have embraced comprehensive consolidated tapes as a core element of building fair, efficient and resilient capital markets, and the EU must keep pace.

Establishing Consolidated Tapes

Consolidated tapes should be comprehensive, require mandatory contribution of both on- and off-venue transaction data, disseminate information immediately upon receipt, and allow only targeted and limited deferrals for larger sized trades. Prospective consolidated tape providers are already actively developing offerings and consolidating currently available data across asset classes in the EU – illustrating the viability of consolidated tapes once a framework is finalized.

First-hand market experience and a wide body of in-depth empirical research illustrate that increased post-trade transparency, in the form of real-time public reporting of transaction prices and sizes, narrows bid-ask spreads and enhances liquidity. First, this transparency empowers investors to accurately assess execution quality, demand accountability from liquidity providers, and obtain best execution.

Second, it removes information asymmetries and allows all liquidity providers to better manage risk, and in turn, more confidently quote prices, commit capital, and warehouse risk across all market conditions.

Finally, real-time public reporting makes markets more resilient, especially in times of stress, by ensuring that new information is efficiently assimilated and reflected in current price levels.

Empirical research illustrates the value and viability of well-tailored consolidated tapes.

While deliberations continue in the EU, other leading global financial centers are more ambitiously moving forward. In the UK, following its Wholesale Markets Review, HM Treasury stated in March 2022 that it was "priority to develop a consolidated tape for fixed income data." In the U.S. – where CTs are already in place for equities, ETFs, options, corporate bonds, municipal bonds, mortgage-backed securities, and OTC derivatives – measures to expand and further enhance these offerings have recently been put forward. Notably, in June 2022, the U.S. Department of the Treasury launched a consultation regarding the appropriate design of a potential post-trade consolidated tape for the U.S. Treasury securities market. Meanwhile, in August 2022, FINRA proposed shortening the timeframe for the reporting and attendant public dissemination of transaction-level data on corporate bond transactions from fifteen minutes to one minute.

Streamlining Transparency Deferrals

In addition to establishing consolidated tapes, the EU should also streamline post-trade transparency deferrals in the bond and derivatives markets. This is essential to leveling the playing field for investors and to creating the conditions necessary for a consolidated tape to emerge. Aged and stale data yields no tangible benefits for investors and, left unaddressed, would leave little meaningful data for a consolidated tape to publish.

Today, real-time pricing data is not available in vital markets for the vast majority of transactions. Specifically, real-time price data is not available for over 85% of trading activity in EU bonds and over 90% of trading activity in OTC derivatives, due to the large number of post-trade deferrals. Furthermore, this price data is often deferred for four weeks, meaning that there would be little non-equities information for a consolidated tape to publish under the current framework. The Commission's proposal would importantly harmonise and shorten the available deferrals, and allow price data to be published in advance of volume data for deferred transactions in order to provide investors with critical price transparency.

Conclusion

The myriad benefits of asset class-specific consolidated tapes far outweigh their implementation costs. Further, the diverse beneficiaries far outnumber the limited cadre of trading venues and intermediaries who, despite casting doubt on consolidated tapes, remain well equipped to thrive even in a more competitive and transparent marketplace.

The EU should embrace the opportunity presented by the MiFIR Review to further strengthen and integrate EU capital markets and empower investors through comprehensive and real-time post-trade consolidated tapes tailored to each asset class.

JAMES HILTON
Head of Advanced Execution Sales EMEA - Credit Suisse

Successful European financial markets need continued focus on investor outcomes

The introduction of competition into European equity markets through the introduction of MiFID I was a resounding success for end investors, with the cost of trading during the continuous market significantly reduced both from an implicit and explicit perspective. MiFID I handed end investors a huge 20% decrease in implicit transaction costs according to our research. Competition has also brought innovation, delivering different trading modalities to suit different investor needs, without impairing price formation. An ongoing focus on delivering favourable outcomes for investors must be maintained even where this challenges commercial interests and long-standing constructs. The protection of legacy arrangements to the detriment of end investors is a short-sighted strategy that will not help but in fact will likely hinder Europe's place in the global financial eco-system.

The European Commission's efforts to facilitate the emergence of a fast consolidated tape in Europe would do much to democratise access to real-time trade data and to reinforce the understanding of European securities markets as a single market. All types of investors, institutional and retail alike, would instantly have a true overview of investment opportunities across Europe rather than the existing system, which favours those with the wallet and resources to piece the picture together. Both European companies and markets would instantly become more attractive to global investors, increasing funding and growth opportunities – growing the pie for all participants, including encouraging more primary market listings. With an appropriate revenue allocation model, the fear that the tape may be detrimental to smaller exchanges should be allayed, and in fact a strong model could accelerate their success.

It is imperative that a consolidated tape does not come at the cost of decreased competition in the execution space: on the contrary, the European economy would benefit from increased focus on areas of the existing framework where requirements or incentives are not optimally aligned with investors' and issuers' interests. Measures that seek to limit investor choice, such as restricting their ability to interact with different types of liquidity, should be re-considered. Such an approach appears designed to appease legacy constructs rather than delivering benefit to investors, who prefer to make their own judgement on the liquidity they wish to interact with in different scenarios.

A political aspiration to compete with other global financial centres is required.

It is crucial that policymakers focus on improving market-wide resilience during outages, which is one of the subjects raised in the recent UK FCA Consultation Paper, "Improving Equity Secondary Markets". As it stands today, trading venue outages (of which there were seven across Europe in 2020 and 2021) cause significant disruption to all market participants and put them at risk of financial loss. In order for European markets to thrive, technical issues on a single venue should not mean every other venue in Europe being prevented from trading: the richness and diversity of the European multi-venue marketplace should be allowed to provide increased resilience. The additional benefit of a consolidated tape is that it would help in outage scenarios by making it easier for investors to see clearly where trading is still available.

MiFID I delivered great benefit to the European economy by allowing competing trading venues. As these cheaper and more innovative venues have emerged, the commission rate paid by end investors has gone down significantly, but we believe there is more progress that can be made. Our cost of trading on primary exchanges (developed Europe, excluding Austria) is six times more expensive than trading on MTFs, and has gone up since MiFIDII, despite it being very difficult to distinguish the service offering; we believe there are other more structural issues that are preventing competition from working effectively.

First, the cost of trading services should be easy to understand through simple trading cost schedules, rather than the documents that run to 20-30 pages, requiring a team of people at every bank and broker to decipher.

And second, the same trading costs should apply across both the continuous trading period and the closing auction: the closing auction is a near monopoly because investors need a single closing price to use to benchmark their funds.. Pricing schedules that appear to take advantage of this situation should be abolished.

Much has already been done to improve the functioning of EU equity markets, but there are some big opportunities that would deliver significantly more. Albeit complicated, these challenges are not technically insurmountable, but will require a political aspiration to compete with other global financial centres, rather than regress towards.

FOLLOWING EUROFI EVENT

THE EUROFI FINANCIAL FORUM 2023

SANTIAGO DE COMPOSTELA - SPAIN
13, 14 & 15 SEPTEMBER 2023

STRENGTHENING EU CLEARING

KLAUS LÖBER

Chair, CCP Supervisory Committee - European Securities and Markets Authority (ESMA)

Upgrading EMIR

Since its entry into force in 2020, EMIR 2.2 has endeavoured to respond to the high level of dependency of the EU on UK CCPs through an enhanced EU regulatory and supervisory approach, thanks to the creation of a new category of systemically important CCPs (so-called Tier 2) subject to direct supervision by ESMA and compliance with EMIR. However, EMIR also contemplated cases where a CCP or a clearing service may be of such systemic importance that the enhanced Tier 2 supervisory framework may still not be sufficient and required ESMA to conduct a comprehensive assessment on whether there are such risks inherent to certain of their services.

As part of this comprehensive assessment, ESMA identified three clearing services as being of substantial systemic importance, namely LCH Ltd SwapClear for euro and Polish zloty, ICE Clear Europe for credit default swaps and STIR services for euro products. While ESMA's assessment concluded that, at this point in time, the cost of no longer recognising these services in the EU would outweigh the benefits, ESMA also identified significant risks and vulnerabilities in connection with the continued recognition of these clearing services, in particular in times of distress. As a result, we proposed a number of measures to address the risks stemming from current exposure levels of EU participants to these clearing services.

The European Commission has added a new milestone to these reflections with the publication of its targeted consultation on the review of the central clearing framework, considering a broad array of measures to further build clearing capacity and liquidity in the EU, as well as to strengthen supervision.

In its high-level response, ESMA has put forward, amongst others, considerations regarding the scope and implementation of the clearing obligation, leveraging on recent workstreams and analysis such as the recommendation for pension scheme arrangements (PSAs) to clear as from June 2023, and also exploring new avenues, such as supporting voluntary central clearing by public entities at EU CCPs.

A significant shift in risk to the EU would require a robust and resilient supervisory system.

ESMA also finds that possible incentives for EU clearing participants to reduce their exposures to certain clearing services deemed of substantial systemic importance – such as prudential treatments of Clearing Member exposures, exposure reduction targets and active clearing accounts requirements – would warrant further work, noting that no single measure seems sufficient on its own. This would first require a thorough assessment of the risks and benefits of each measure or combination thereof to ensure that their costs are not disproportionate to the expected benefits for the financial stability of the Union and to avoid creating a shift of activities to other third-country CCPs, where the EU has limited oversight.

Reflections on potential incentives would of course not be limited to Clearing Members and should consider different routes to incentivise clients to clear at EU CCPs (such as reviewing counterparty exposure limits for funds), and to make EU CCPs more attractive.

Should these cumulative measures prove to be successful, a significant shift in risk to the EU would require a robust and resilient supervisory system. ESMA has identified possible routes to streamline supervisory procedures, and avoid duplicative and sometimes burdensome processes to ensure common supervisory outcomes. These proposals should also help shorten the time to market for EU CCPs, which need to be able to compete globally. However, this cannot and should not be perceived as a substitute for a necessary deeper and longer-term reflection as to how EU wide cross-border risk and fiscal responsibility should be addressed in the EU.

Last but not least, this process will not be completed instantaneously. In the meantime, ESMA and the CCP Supervisory Committee (CCP SC) need to be able to address the ongoing remaining risks within UK Tier 2+ CCP clearing services. This is why ESMA has made a number of proposals to ensure that the risks linked to the elevated exposure levels of EU participants to these clearing services are better addressed during this transition phase.

We at ESMA believe that it is essential to fully recognise the substantial systemic risks related the three services identified and to acknowledge that certain EMIR provisions (such as the current comparable compliance framework) may be ill-suited to address them.

More importantly, the EMIR framework caters primarily for business-as-usual situations and currently does not address crisis or distress scenarios, as the equivalence decision and the related Memorandum of Understanding between ESMA and Bank of England do not extend to the CCP Recovery and Resolution Regulation.

It is therefore vital to provide ESMA with related additional powers in order for the CCP SC to have access to timely information and to be able to intervene effectively in stress situations, in order to manage financial stability risks for the EU or individual Member States.

PAULINA DEJMEK-HACK

Director for General Affairs, DG for Financial Stability, Financial Services and Capital Markets Union - European Commission

The EU clearing strategy

The United Kingdom hosts some of the most significant central counterparties (CCPs) in the world, which play a crucial role for clearing the trades of EU market players. Significant volumes of financial transactions denominated in Union currencies are cleared through UK-based CCPs. In this context, the withdrawal of the United Kingdom from the EU and, as a consequence, from the internal market and from the Union framework of regulation, supervision and enforcement in the financial sector, created some challenges.

In light of the importance of such infrastructures for EU market players, from the very beginning of the Brexit discussions, central clearing was identified as an area where financial stability risks could be significant in case of an abrupt disruption of access of EU market participants to UK-based CCPs. The Commission adopted temporary equivalence decisions, covering the UK framework for CCPs, to avoid such an abrupt interruption of access.

In parallel, the Commission has repeatedly called on EU market participants to reduce their exposures and reliance on UK CCPs that are systemically important for the Union, particularly OTC derivatives denominated in euro and other Union currencies. However, given the moderate changes witnessed so far, the possible risks to EU financial stability caused by this over-reliance remain. This was also confirmed in the analysis made by the European Securities and Markets Authority (ESMA) under the European Market Infrastructures Regulation (EMIR), published in December last year. ESMA examined the degree of systemic importance of the Tier 2 CCPs, LCH Ltd and ICE Clear Europe, and found that certain clearing services provided by those CCPs are of substantial systemic importance to the EU or its Member States.

With a view to reducing this over-reliance, in November 2021 Commissioner McGuinness highlighted the need for the EU to develop its own clearing capacity and the intention to come forward with measures to make EU-based CCPs more attractive to market participants. At the beginning of 2022, the Commission held a public consultation to collect the views of stakeholders on a broad array of options to increase the attractiveness of clearing in the EU, enhance infrastructure development and strengthen supervisory arrangements with regard to EU CCPs. While the main aim is to address financial stability risks related to the over-reliance on certain CCPs, further development of financial market infrastructures in the EU will also support the Capital Markets Union. The consultation allowed the Commission to gather the views of a broad range of market participants and authorities.

Building a path to enhance clearing in the EU and support financial stability.

Clearing can be further developed in the EU in various ways. The public consultation included options on both the supply and the demand side of clearing services. In assessing the options and the most appropriate way forward, the Commission will consider the best ways of enhancing liquidity at EU CCPs and creating the conditions for expanding the range of clearing solutions on offer from EU infrastructures. For example, on the supply side, several stakeholders suggested that it might be easier for CCPs in other jurisdictions to expand their business than is the case for EU CCPs, given that some EU procedures may be longer and more complex. A short approval time for new products or services is key for international competitiveness.

As regards the demand side, the public consultation explored various options, ranging from measures to disincentivise clearing in systemic third-country CCPs to measures imposing more specific obligations on market participants to increase the share of clearing in EU CCPs. For example, the possible role of bank capital requirements in favouring a reduction of exposures to systemic CCPs was explored, as was the possibility for clearing participants to have an active account at an EU CCP. A combination of demand and supply-side options may be necessary.

In addition, the consultation explored ways to ensure that the supervisory framework for EU CCPs is robust and fit for the future. The Commission will look at how to improve the efficiency of supervision in view of a deeper EU clearing market. An increased capacity for central clearing needs to be accompanied by appropriate EU supervision of the risks.

The Commission is currently finalising its reflections on the most appropriate solutions to enhance clearing in the EU and support financial stability, with a view to proposing measures by the end of the year.

JULIAN REISCHLE

Director General Payments and Settlement Systems - Deutsche Bundesbank

Building EU clearing capacity – the way forward

Last year, the European discussion about central clearing focused heavily on the question of whether it could be necessary, based on financial stability concerns, that UK CCPs relocate parts of their clearing business within the EU to continue servicing EU-based clearing members. A comprehensive assessment carried out by ESMA to answer that question concluded that three clearing services at LCH Ltd and ICE Clear Europe Ltd are of substantial systemic importance to the EU's financial stability. However, ESMA also determined that the costs and risks of derecognising these UK clearing services would actually outweigh the benefits to the EU.

The European Commission also concluded that the EU would need more time to build strong and attractive central clearing capacity in order to reduce its overreliance on UK CCPs and consequently extended its time-limited equivalence decision for UK CCPs until June 2025. Despite the extension of the status quo, the current situation where the EU has large exposures to UK CCPs is not sustainable and continues to carry inherent financial stability risks that need to be addressed in the medium term. Consequently, targeted measures enabling EU CCPs to further expand their EU-wide clearing capacity are urgently needed.

To this end, the Commission publicly consulted stakeholders on possible measures that would help to improve the EU's central clearing framework. Summing up, it is true to say that there is no one measure that can single-handedly pave the way for a huge transfer of clearing volume to EU CCPs. However, some measures appear fairly promising when it comes to fostering the usage of EU-based clearing houses. In particular, a regulatory requirement in EMIR for clearing members to establish a clearing account at an EU CCP and to use it actively ("active account") could, depending on the final design, help steer clearing volume towards EU CCPs. Such a solution would also allow for the possibility of setting quantitative minimum levels of activity, which could be activated if the systemic overreliance on UK CCPs remains too high.

Moreover, further analysis is needed to ascertain whether explicit overall exposure reduction targets or guidelines could be set to help market participants and supervisors to monitor the progress made towards reducing the overreliance on UK CCPs. In addition, it is worth considering ending the current exemption with respect to the clearing obligation for pension scheme arrangements. This could further facilitate the use of central clearing in the EU and thus contribute to deeper market liquidity and lower costs for all market participants.

Policymakers should currently instead focus on how to streamline EMIR procedures and processes.

The second pillar of the Commission's strategy to strengthen central clearing in the EU is to improve its supervisory framework. While everybody will probably agree that current and future risks related to central clearing should be managed appropriately, there are different views on how best to achieve this. Since the introduction of EMIR there is a fairly broad consensus that various stakeholders need to be consulted on the supervision of EU CCPs. EMIR established supervisory colleges for each EU CCP, where stakeholders with different mandates of relevance to a CCP are represented (e.g. banking supervisors, national overseers, central banks of issue). This structure ensures that all relevant functional as well as European perspectives are reflected in the supervisory process for EU CCPs. This process has shown a positive track record and truly represents a joint European supervisory culture.

I do have doubts whether stronger EU-level supervision at the expense of the established college processes will positively contribute to the Commission's goal of building clearing capacity in the EU. Any shift in supervisory competencies away from the national competent authorities and the supervisory colleges towards ESMA runs the risk to render the already long and complex EMIR procedures even more costly for EU CCPs. In my view, policymakers should currently instead focus on how to streamline EMIR procedures and processes without endangering the high quality of supervision with respect to EU CCPs. For example, the process for determining which model changes and product introductions are classified as significant could be scaled back. At the moment, a lot of changes are classified as significant where this is not always warranted on pure risk management grounds.

Alternatively, more changes could be adopted by EU CCPs without a lengthy and costly procedure and then validated ex post by the national competent authority if necessary. This could help EU CCPs to be faster and more flexible when adjusting their products or currency offerings and thus to attract more clearing volume. These are vital components for building the EU clearing ecosystem, thereby offering viable alternatives to UK CCPs, and enhancing financial stability in the EU.

DANIEL MAGUIRE

Group Head, Post Trade & Chief Executive Officer - LCH Group

Resilience and competitiveness through open markets

Europe benefits from an effective clearing framework, based on high regulatory standards, openness, and cross-border cooperation. This model also supports the Euro as a global reserve currency. Leveraging it is critical for the EU's competitiveness. We believe there is scope to improve the current EU regulatory framework whilst avoiding exclusion and operational constraints for EU firms. Those improvements must, above all, come from within.

LSEG has a strong presence in the EU with over 2,200 people across 20 member states, including France, Germany, Italy, the Netherlands, and Ireland, making us one of the biggest Financial Markets Infrastructure (FMI) groups in the EU. LSEG operates LCH SA in Paris and LCH Ltd in London, two prominent EU and non-EU CCPs, which puts us in a unique position to support the EU's competitive agenda on both EU and third-country aspects.

LCH CCPs lead in several markets, including Interest Rates Derivatives (IRD), Credit Default Swaps (CDS), equities and government debt repos, where we clear most of the Euro denominated debt from 13 Member States, but also SURE and NextGenEU programs, which are of strategic importance to the EU. LCH SA's CDSClear is the only EU-based service clearing CDS and has increased its market share in recent years, clearing 49% of EU single names and 34% of the iTraxx© Index market from 5% over a period of five years. Meanwhile, LCH Ltd is a leading clearer for the global Interest Rate Swaps (IRS) market, where EU firms represent 14% of its business in IRD notional registered.

When it comes to EU CCPs, LSEG supports streamlining the supervision and approval processes, including by centralising the supervision at EU-level. This would make the current construct more efficient, reduce time-to-market and create a more efficient ecosystem in which EU CCPs can compete globally more effectively. The EU clearing ecosystem needs dynamic CCPs able to deliver new products, adapt risk models seamlessly, and capitalise on global opportunities in a timely manner.

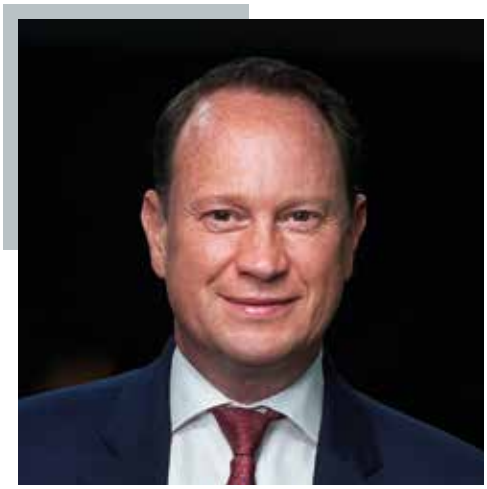
A competitive clearing ecosystem also needs to enable a level playing field for all EU participants and CCPs compared to their non-EU peers. The Derivatives Trading Obligation (DTO) is a direct impediment to the competitiveness of EU CCPs and the further development of an OTC derivative clearing service in the EU. Existing restrictions under the EU DTO pushed the CDS interdealer trading and clearing subject to the DTO to the US. We believe it is important for the EU to holistically consider the DTO and similar regulatory initiatives that may impede the development of the EU clearing.

The best approach is evolving the current system rather than fragmenting it.

With regards to cross-border access, EU firms need access to global pools of liquidity (86% provided by non-EU firms). The European Commission's efforts to further enhance the EU's resilience and competitiveness should focus on greater cross-border supervision of Tier 2 CCPs. ESMA's proposal to increase its powers over the recovery and resolution process for Tier 2 CCPs could address the perceived risk stemming from EU firms' activities at those CCPs while ensuring undisrupted access to global pools of liquidity. Accessing global pools of liquidity in Euro and other currencies would maintain a level playing field for EU firms, supporting the Union's real economy ability to hedge its risks effectively and remain competitive, especially as EU firms tend to clear more IRD in non-Euro than in Euro.

Prudential tools would implement a gradual denial of access, have detrimental effects on both EU firms' competitiveness and the EU's financial stability. Attempting to place strict thresholds on EU firms' clearing activities would limit their ability to compete and negatively impact the execution and management of trades, with significant impacts on market transparency, price discovery and liquidity. In addition, capital requirements constraints would eventually lead to a fragmentation of the market, increasing costs for EU firms due to the loss of multi-currency efficiencies, the weakening of financial stability and increasing counterparty risk across the EU. This would also raise risk issues from a CCP perspective as EU firms would be limited in their ability to manage a default alongside non-EU members.

The EU has a non-restrictive system that works, and one which has guided its financial markets through recent storms unscathed. The latest thinking around improvements to the existing supervisory framework of CCPs would strengthen that EU ecosystem further and we support them. To deliver these improvements for Europe's businesses and consumers, we believe the best approach is evolving the current system rather than fragmenting it.



ERIK TIM MÜLLER

Chief Executive Officer - Eurex Clearing

A market-driven approach in symbiosis with the EU clearing roadmap

In light of the current geopolitical and macro-economic instability, the envisaged EU strategic autonomy agenda has been prioritized. Member States are increasingly aware of the EU's vulnerabilities in critical sectors and taking steps towards improving resilience. European Commissioner Mairead McGuinness emphasized that the EU's strategic autonomy considerations particularly apply to financial market infrastructures. EU finance ministers in turn expressed their backing of the Commission's efforts to reduce reliance on third-country infrastructures and build a competitive clearing ecosystem within the EU. Against this background, the Commission aims to utilize the time until the prolonged equivalence for Tier 2 UK CCPs expires in June 2025 to structurally strengthen and promote clearing within the Union. This is where the review of the EU clearing framework comes in.

Eurex Clearing welcomes the Commission's efforts to foster the Union's clearing ecosystem and the competitiveness of EU CCPs. From the launch of our partnership program five years ago, we have consistently advocated for a market-driven approach. Looking ahead, we believe the focus should be on broadening the clearing participant base, providing clearing incentives, and generating additional activity within the EU, whilst avoiding broad regulatory intervention which could undermine EU market participants' global competitiveness.

That is why we support in particular the idea that EU market participants maintain an active account with an EU CCP. From a risk management perspective, an active account would mitigate the risk of a reoccurring cliff-edge situation when equivalence elapses and ensure progress in building exposure in the EU. Clear communication by the EU regulators on active accounts could help to overcome the "first mover disadvantage" situation in which many firms already have the necessary arrangements in place to clear with an EU CCP but remain hesitant to use them without regulatory guidance. However, only if the market-driven approach does not deliver the envisaged results by mid-2025, regulators could consider setting target levels of business to be held in the EU. Any usage targets should be calibrated carefully with due regard to EU dealer's market making business and client clearing services for non-EU clients.

It is high time to "rethink and repower" the EU central clearing framework.

In addition, a broader scope of clearing participants could prove valuable to further boost the EU clearing ecosystem. Some pension scheme arrangements and public entities already clear at EU CCPs. If more of them cleared their business in the EU, it would contribute to a healthier and more balanced ecosystem of fixed payers and fixed receivers, and increase liquidity within the Union. As a result, there could be pull effects for other market participants, too, further increasing efficiency gains and progressing on the financial stability end.

Last but not least, temporary incentives to make the EU clearing environment more attractive should be considered as part of demand-side policies. These could include, for instance, a lowering of the capital charges for EU market participants facing an EU CCP or conceded rates by the ECB for funding initial margin or depositing cash collateral.

We note that EU policymakers are also contemplating a review of the supervisory framework to enhance the EU clearing ecosystem. From a process perspective, we would welcome targeted amendments to streamline the supervisory approval procedures for new services or model updates. Such streamlining would not just be about supporting the business development of EU CCPs. If EU CCPs are slowed down in bringing their offering to the market due to lengthy or complex approval procedures, markets of strategic relevance may be established off-shore, posing oversight challenges to EU supervisors. Limiting the scope of fully-fledged approval procedures to significant cases and letting less significant changes go through a simplified non-objection process would decrease CCPs' time-to-market significantly without lowering the quality of supervision.

Time is of the essence. The prolonged equivalence for Tier 2 UK CCPs provides a reasonable timeframe to implement the measures above and make progress on the EU's regulatory objectives. If market participants and CCPs contribute to the upcoming EU clearing roadmap constructively, a significant increase of clearing activities and sufficient rebalancing of exposures to the continent can be achieved. In the spirit of the Czech Council Presidency's motto, "rethink, rebuild, repower", it is high time to "rethink and repower" the EU central clearing framework to ensure a robust EU financial system contributing to the resilience of the whole economy.

CHRISTOPHE DELAFONTAINE
Head of Global Markets Regulatory - BNP Paribas

Clearing: an EU strategic autonomy relying both on actors and infrastructures

The Capital Markets Union's (CMU) ambition is to create a single, unified EU capital market and improve the EU financial ecosystem – but how exactly will this be achieved? More specifically, regarding clearing infrastructures – an important piece of this ecosystem – what developments and measures could positively contribute to these efforts?

To meet these objectives we must:

- Ensure EU actors (clients and clearing members) subject to the clearing obligation have - for EUR and PLN derivative instruments identified as substantial systemic importance for the EU ("derivatives in scope") - a reliable and live clearing solution in the EU.
- Increase the intrinsic liquidity of the EU clearing market to make it more attractive to both EU and non-EU actors and generate a new competitive equilibrium between EU and non-EU CCPs.

However, forcing the relocation and liquidity shift from non-EU to EU CCPs would fail to reach this objective in the absence of extra territorial measures binding on non-EU actors. In fact, it could have the opposite effect and harm the international role of EU banks in the efficient functioning of EUR markets, resulting in missing both EU strategic autonomy objectives.

As such, following measures proposed by the Commission could help develop EU clearing services for derivatives in scope:

- Develop 'active accounts' at EU CCPs for EU actors, i.e. with daily margin calls, but without any minimum quantitative threshold in absolute or relative terms: we favor a market led approach, i.e. a guidance set by the regulator rather than a legislative measure. Not only a guidance could be announced without delay, but both approaches could be combined, the legislative process being launched concurrently and the implementation of the mandatory measure being contingent to the lack of a meaningful impact of the market led approach, to be assessed before the end of the temporary equivalence extension.
- Not renew the Pension Funds ("PSAs") temporary clearing exemption, subject to the appropriate accompanying measures to ensure PSAs would have, at all (including stressed) times, a smooth conversion tool of their securities holding into cash in order to face their clearing margin calls (Leverage Ratio exemption for banks of EGBs repos, dedicated fall back ECB repo facility available to banks under stressed markets).

Building a vibrant financial center : developing and attracting key actors, and strengthening post trade services.

- Encourage, mandatorily or not, EU public entities to clear at EU CCPs. Public support would contribute to the liquidity of, and confidence in, the EU clearing system.
- Address some technical blocking points, such as facilitating transfer of contracts from one CCP to another; payment in EUR currency in T2S system over an extended time range (possibly 24h); regulatory approval process when CCPs are extending their offer/amending their rulebook; or streamlining the accounting rules in case of transfer of cleared portfolios.

On the other hand, punitive capital charges targeting EU banks only should be absolutely avoided, as they will miss the objective of strengthening the EU clearing system. This would also impair the competitiveness of EU banks both on international markets and in the Union regarding activities with EU and non-EU clients. Losing competitiveness would question the ability of EU banks to stay in EUR derivatives market making and clearing activities, where they already face fierce competition from non-EU banks. If EU banks exit those activities, the EU market for end-users and the EU CCPs would end up relying fully on non-EU banks.

We must remember that market making and client clearing activities are 'client driven' activities: the client has the choice where to clear and EU banks cannot impose a clearing location.

If/whenever it is introduced, any prescriptive measure limiting the access to UK CCPs, or making it more expensive, should exclude these client driven activities with actors which are not in scope of these measures.

Finally, we believe that a stronger, simplified role granted to ESMA in the supervision of EU CCPs can significantly help grow the EU clearing system.

There are two last points to consider - not strictly speaking amongst the measures under review by the Commission - but which are critical developments:

- EU CCPs must expand and enrich their clearing offer. Successful relocation depends greatly on their capacity to be more attractive than non-EU CCPs. For EU CCPs to be successful they need to be credible competitors at the global scale, especially for US investors. It requires full capabilities to service US clients: extended hours (operations, risk management), proper regulatory licences, compatible legal framework, etc.
- Building a vibrant financial center is about attracting key actors at the heart of financial services - Clients (especially buy side, end investors), Sales and Traders – as much as strengthening the post trade services. The latter should be seen in conjunction with the other major components of the financial ecosystem. The post-Brexit rebalancing of the Sales and Trading forces to the EU – well advanced but still under completion – will be a key contributor to the new equilibrium in the clearing space.

JOSÉ MANUEL ORTIZ

Head Clearing & Repo Operations - SIX

Strengthening EU clearing. Key issues and priorities

Last February, the European Commission (EC) confirmed a three-year extension of the UK CCP equivalence. This confirmation came alongside a targeted consultation on measures to improve the competitiveness of EU CCPs and promote their usage among European participants. This consultation is the preamble of an ambitious package potentially affecting a very broad range of players in the private and public space.

Before discussing the details of the proposal, it is important to consider the potential unintended consequences of public intervention in the capital markets industry. Recent examples are restrictions in short-selling or dividend pay-outs adopted in Europe during the pandemic that resulted in a reduction of volumes and liquidity in the EU derivatives markets at the advantage of the US clearing industry. It must not be forgotten that we are part of a globalized environment where similar products are substitutes for each other independently of the origin of the investors.

Diving into the details of the EC's proposal, some measures could have a more positive impact on the competitiveness of EU clearing. The planned requirement for banks to have an active account in a EU CCP could become a sensible compromise solution, providing a real choice to diversify their CCP exposures, or to clear in the EU. The EC is also exploring how to extend the choice to client clearing by imposing obligations on clearing intermediaries. This is a relevant discussion, as client clearing is as crucial to the OTC derivatives business as the inter-broker activity.

Moreover, the EC is considering additional measures to attract new players into the clearing space, especially on the buy-side (funds, insurance companies, and MMF). The EC has exposed some inconsistencies in pre-EMIR legal pieces that limited or penalized the exposure of buy-side to CCPs. Therefore, it is likely that the legislative package will address these shortcomings too. Regarding public institutions' role in EU CCPs, a clarification on how to deal with public bodies' restriction to taxpayer money being exposed to private sector's default loses must be provided, rather than imposing non-expedient obligations.

Diversification is core to the EU CCPs strategy. Agile consistent supervision is key for innovation.

Although the initial proposals to explore product-widening plans have not been significantly supported by respondents to the EC's consultation, diversification is at the core of CCP's growth strategy. Investor appetite toward new assets is increasing and market providers are catching up. Let's consider for instance ETFs, which started as basic index-replication products and have evolved toward sophisticated structured and leveraged investments, or ETPs that have been designed to deliver exposure to digital assets. Some investors are particularly reluctant to get involved with unregulated products or service providers. Regulated market infrastructures add value and safety by managing the risks associated with these new volatile assets, providing solutions through sound, reliable systems, connectivity, and risk management processes that are highly valued by market participants and their clients.

At the same time, we are witnessing an increasing demand for voluntary clearing solutions beyond the OTC derivatives space. Some providers aim at freeing balance sheets from client exposures in traditional cash equity markets by channelling their internalized order book into CCPs. Others are looking into traditional digitalization (not DLT) to enable the representation into shares of any type of valuable property. Others are seeking to reduce funding costs by optimizing collateral and treasury management through central clearing, areas in which CCPs have been contributing with proven efficiency. To enable this, fostering innovation is required. New participation types, access profiles, or account structures may be needed. EU CCPs also need to be able to provide services at late hours and weekends, which requires support from central banks and regulators to facilitate collateral management beyond RTGS working hours. If the solution cannot come from central banks themselves, then regulators may need to alleviate the costs of commercial bank collateral deposits for banks and market infrastructures. Support to alternative innovative digital transfer of collateral may be an alternative too.

EU CCPs are currently competing with third-country CCPs under different supervisory frameworks, and with unregulated newcomers providing services that often mimic those of regulated infrastructures in the eyes of the unqualified investor. At the same time, market participants expect regulated infrastructures to cover new innovative access types, assets coverage, or trading flows.

EU regulators must support the innovation and diversification by providing agile supervisory and approval processes and avoiding those measures impacting the competitiveness of clearing participants and CCPs such as the anti-procyclicality measures or margining practices are taken without a critical global outlook.

EUROFI MEMBERS

Allianz
American Express
Amundi Asset Management
aws
AXA
Bank of America
Bank of China
Barclays
BBVA
BlackRock
Bloomberg
BNP Paribas
BNY Mellon
Groupe BPCE
caceis Investor Services
Groupe Caisse des Dépôts
CaixaBank
Capital Group
Citadel
citi
CLS trusted market solutions
CNP Assurances
coinbase
covea
Crédit Agricole S.A.
Crédit Mutuel
Credit Suisse
Deka
Deutsche Börse Group
Deloitte.
DNB
DTCC
Erste Group
euroclear
Euronext
European Bank for Reconstruction and Development
European Investment Bank The EU bank
Federated Hermes
Fidelity International
Finanzgruppe
Generali
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Google Cloud
Groupama
HSBC
ICE
ING
Invesco
J.P.Morgan
KPMG
La Banque Postale
LSEG
mazars
MetLife
Mizuho
Moody's
Morgan Stanley
MUFG
Nasdaq
Nordea
Norinchukin
OliverWyman
Optiver
Posteitaliane
pwc
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State Street
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Tradition
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Zurich

COMPETITIVENESS AND RESILIENCE OF EU INFRASTRUCTURES

DENIS BEAU
First Deputy Governor,
Banque de France

The path toward a more integrated and resilient EU financial sector

More integrated, efficient and resilient European financial market infrastructures (EU FMIs) are the cornerstone of a strong EU financial sector. Hence the efforts deployed to keep FMIs and their regulations tuned to market demand and evolving practices and risks.

This holds true in particular for the FMIs operated by the Eurosystem, with the consolidation of TARGET2 and TARGET2-Securities under a single environment, planned for November 2022. This milestone will be followed one year later by the launch of the European Collateral Management System, a unified platform for managing assets used as collateral in Eurosystem credit operations. By providing synergies, more efficient processes and allowing for optimised liquidity management across TARGET Services, these key projects aim at enhancing EU FMIs in the broad sense.

In the years to come, further steps will have to be taken to help improve the integration, resilience and competitiveness of our market infrastructure sector.

First, market integration and settlement efficiency should benefit from the proposal in March 2022, of the European Commission refit for the Regulation on improving securities settlement in the EU and on central securities depositories (CSDR). CSDR refit will notably provide awaited simplifications on passporting and clarifications on the settlement discipline regime.

Second, the financial sector resilience should be enhanced through a comprehensive approach to cyber threats via the adoption this autumn of the Digital Operational Resilience Act (DORA). By promoting high cybersecurity and operational resilience standards across the EU financial sector, DORA will strengthen the resilience of each actor and reinforce the stability of the financial sector as a whole against the background of a continuous increase in cybersecurity risks. Of major importance in this regard is the introduction of a direct oversight of third-party entities, such as cloud service providers, that will be identified as "critical" for the EU financial sector.

Integrated, efficient and resilient European financial market infrastructures should be the backbone of a strong EU financial sector.

Strengthening the resilience of EU FMIs will also build on information-sharing initiatives, bringing together public authorities, market players and intelligence providers to build joint experience and expertise on cyber threats. At the EU level, TIBER-EU has been developed to this aim; the Euro Cyber Resilience Board (ECRB), a forum for strategic discussions, has been set up in order to improve collective public-private knowledge of the cyber landscape and foster trust and collaboration, in normal as well as in crisis times.

Finally, market players have shown a growing interest for the tokenisation of financial assets to enhance the functioning of market infrastructures. This creates improvement opportunities but also new challenges that need to be addressed. In this respect, in line with their financial stability mandate, central banks have an important role to play as oversees and service providers. There is in particular the need to avoid the creation of monopoly situations linked to technological silos that could emerge with new ecosystems based on distributed ledger technology (DLT) and to prevent regression in the use of central bank money for wholesale transactions.

The Regulation on a Pilot regime for market infrastructures based on DLT, entering into force in March 2023, will appropriately help address these issues: by temporarily granting specific exemptions from existing rules, it will allow multilateral trading facilities and central securities depositories, for a period of up to 6 years, to test the DLT for financial markets and post-trade activities, while ensuring a safe asset tokenisation. However, the Pilot regime would be safer and more efficient, from an exploratory point of view, if access to wholesale CeBM – the safest and most liquid settlement asset – were also provided under a tokenised form.

The Banque de France's wholesale CBDC experimentation programme could serve as a basis for the experimental issuance, at Eurosystem level, of a wholesale CBDC designed for the Pilot regime.

ULRICH BINDSEIL

Director General, DG Market Infrastructure & Payments - European Central Bank (ECB)

Progress and challenges in the securities post-trading ecosystem

The Eurosystem has always emphasized the need for harmonisation and standardisation in the EU-post-trading space to achieve further integration, efficiency and resilience. One practical example for this is the TARGET2-Securities (T2S) harmonisation agenda in the context of the work of the Eurosystem's Advisory Group on Market Infrastructures for Securities and Collateral (AMI-SeCo), which has driven harmonisation activities regarding e.g. corporate actions, ISO20022 adoption, as well as legal issues.

In the field of collateral management, major progress has been made since 2019 across European markets in the definition and implementation of the Single Collateral Management Rulebook for Europe (SCoRE) standards. The introduction of Eurosystem Collateral Management System (ECMS) will be another milestone and demonstrates that the Eurosystem has the capacity to drive harmonisation also from within its own central bank operations.

Enabling greater and more fluid movement of payments, securities and collateral across Europe is a key factor in optimizing market participants' liquidity management and allowing them to centralise their liquidity in central bank money. Thus, the ECB supports the call from the market for minimising liquidity fragmentation in the euro area and for creating a single pool of EUR central bank liquidity efficiently available for settling securities transactions, but also for collateral mobilisation and retail and wholesale payments. The T2-T2S consolidation project, which is scheduled to be finalised in November 2022, includes a Central Liquidity Management (CLM) tool, which will allow participants to steer, manage and monitor central bank liquidity across all TARGET Services.

At the same time, there is still significant room for improving efficiency and integration between CSDs and other stakeholders of the securities trading, clearing and settlement ecosystem.

First, there needs to be more competition between CSDs for issuers and for investors/CSD participants.

Second, full ISO20022 adoption in the securities and collateral management space, leveraging global standards for transaction and entity identification and further improving access to central bank money settlement are vital to make the CSD landscape more competitive.

The use of new technologies should not diminish the focus on further harmonisation in post trading.

Third, remaining fragmentation, in particular in the processing of corporate actions and tax, should be eliminated by further harmonisation and possibly also legislative efforts. In this context we are also looking at the European Commission's Capital Market Union agenda to provide further impetus to the existing market harmonisation efforts from the regulatory side.

Besides the harmonisation efforts, digitalisation and transformative financial technology are key drivers in the development of the EU post-trading space. The Eurosystem maintains an ongoing dialogue and analysis with market stakeholders on the benefits and risks of using new technologies in payments and securities infrastructures.

One aspect of such analysis is assessing the scenario of making central bank money settlement available via new technologies such as distributed ledger technologies (DLT). These could one day be introduced in the securities ecosystem if it leads to a material increase in efficiency without compromising safety and security, i.e. any undue introduction or increase of operational or other types of risks.

The Eurosystem has taken note of various projects and/or experimentations involving market participants and welcomes these pioneering efforts. Nevertheless, discussions on the use of new technologies should not diminish the focus on further harmonisation of rules and practices to facilitate financial market integration. On the contrary, it may even be the case that more innovation requires more harmonisation efforts to ensure that new competing proposals and models are interoperable and do not re-introduce fragmentation and overall cost increases.

In summary, there are a lot of challenges ahead but there is also encouraging progress. For the Eurosystem operational part, it has been noted that T2S and the TARGET Services in general are becoming a magnet for more EU and EEA markets as exemplified by the formal interest expressed by Euroclear Bank, which signed the T2S framework Agreement at the end of 2021, the Nordic countries Sweden, Norway and Denmark, the planned EUR joiners Croatia and Bulgaria and others who are interested in using the TARGET Services.

We are committed to continue the evolution of T2S as part of the wider TARGET Services, and we aim at making it future proof.

PIERO CIPOLLONE
Deputy Governor - Banca d'Italia

Integrating DLTs with FMIs: challenges, regulation and steps forward

Distributed ledger technologies (DLTs) have great potential for use in securities trading and financial markets infrastructures (FMIs). As in other domains, they are expected to bring significant efficiency gains, thanks to process simplifications, extension of operating times, reduction of costs and times for cross-border transactions and faster security transfers. Greater transparency and traceability will improve control activities. A reduction is expected in both counterparty risks, because of time compression and greater traceability, and operational risks, due to fewer manual activities and the storage of information in decentralized databases. The broader accessibility to investment platforms is expected to facilitate investments too.

However, these benefits could take time to materialize. It will be necessary for: i) DLTs to grow in maturity, containing operational risks and increasing cyber resilience, scalability and sustainability; ii) common standards for DLT platforms to be defined, overcoming interoperability issues; iii) integration with legacy systems of investors to be pursued, until DLTs are able to support the entire transaction cycle; and iv) a complete regulatory framework to become operational, at least at European Union (EU) level. The adoption of DLTs inevitably raises concerns relating to cyber risks, the disintermediation of financial intermediaries (or even central banks), increasing reliance on external providers, and greater liquidity risks until the volume of transactions in DLT platforms consolidates. Governance aspects are also important as, for regulatory and supervisory actions to be effective and enforceable, the identification of accountable entities is needed. All this could undermine the smooth functioning and efficiency of financial markets.

As regards DLT-based Financial Market Infrastructures (FMIs), up until now, business cases have been unable to gain much momentum. This is also due to the lack of a harmonized legislative framework, capable of guaranteeing and promoting initiatives in that direction. An important stimulus in the EU is provided by the recently introduced Regulation on a Pilot regime for FMIs based on DLTs. This regulation allows FMIs to experiment with the supply of trading and settlement services for financial instruments using the DLTs, through the temporary exemption from some regulatory requirements. It aims at promoting innovation while ensuring investor protection, market integrity and financial stability. However, it is not yet sufficient. At national level too, it is necessary to create essential legal prerequisites allowing operators to issue and circulate native digital securities. In Italy, legislative regimes are considering relaxing legal requirements, requiring minimum criteria for DLT technologies, and defining a monitoring regime for DLT-based products and services.

DLTs in financial markets could bring significant efficiency gains and facilitate investments.

Another element that could contribute to the adoption of DLTs in financial markets would be the availability of a Central Bank Digital Currency (CBDC), which could facilitate the use of a comprehensive Delivery vs Payment (DVP) approach in a DLT framework. In the absence of a Eurosystem service to settle the cash leg of DLT transactions in central bank money, market players could turn to other means of payment, such as commercial bank money or stablecoins.

An alternative approach would be a 'trigger solution', which is a component for integrating DLT platforms with existing Eurosystem market infrastructures. Because it relies on existing infrastructures, a trigger solution would be characterized by shorter time and lower costs of adaptation for the Target services, compared with a completely new DLT-based CBDC. Indeed, as noted above, DLT technology does not yet appear to be sufficiently developed for an extensive application in euro-area financial markets. Furthermore, the use of the trigger solution would reduce the risks of fragmentation of the liquidity needed for the cash-side of the settlement systems and would considerably reduce the risk of an impact on Eurosystem market infrastructures, in particular on T2S, a fundamental milestone in the integration of the European securities market.

In this regard, Banca d'Italia has just published a paper[1] on a trigger solution centred on the Eurosystem's TIPS instant payments platform. This solution builds a bridge between DLT platforms, where digital securities are issued and circulated, and the Target services, where central bank money settlement takes place. This Banca d'Italia model provides a DLT-agnostic API to synchronize the asset-leg and the cash-leg, making an instantaneous DVP transaction possible on a 24/7 basis. The paper also reports the results of experimental activities conducted with Algorand, one of the most advanced blockchain for the financial sector available on the market.

[1] https://www.bancaditalia.it/pubblicazioni/mercati-infrastrutture-e-sistemi-di-pagamento/approfondimenti/2022-026/index.html?com.dotmarketing.htmlpage.language=1.

JULIAN REISCHLE

Director General Payments and Settlement Systems - Deutsche Bundesbank

Capital Markets Union: the next steps of a collaborative initiative

The Deutsche Bundesbank, as an integral part of the Eurosystem, has always been a driving force in advancing both the post-trading landscape and payment systems. We are part of a consortium of central banks that successfully built T2S, operates it smoothly, and is developing it further with the upcoming TARGET2/T2S consolidation project. However, Eurosystem projects can only reach their full potential if they are supported by harmonisation and legislative initiatives. The Capital Markets Union (CMU) is ultimately not an infrastructure project, but a multilevel integration of capital markets within the European Union. While the Eurosystem is always willing to play its part in the integration of capital markets in Europe, it must certainly be accompanied by legislators and market actors.

A prime example from the recent past is the Shareholder Rights Directive II. While T2S made cross-border settlement easier, it alone did not guarantee that investors could also exercise their rights as shareholders. The financial industry itself did not have any incentive to facilitate this, especially for retail clients because it is costly and rarely are clients actively asking for it. For this reason, European legislators had to step in and propose the Shareholder Rights Directive II, which compelled intermediaries to reconsider. Ultimately, it was these intermediaries that developed the standards and processes that enabled the interaction between investors and listed companies.

European legislators seem to be swifter than the Member States when it comes to forcing private actors to contribute to the CMU. However, the next step should be EU-wide harmonisation of withholding tax procedures. Taxation is considered an obstacle to the integration of capital markets due to the lack of harmonisation between national legal systems. Different withholding tax procedures may discourage cross-border investment if taxes are paid in both Member States (of the investor and the investment) and can only be reclaimed via bureaucratic procedures. This mechanism is burdensome and expensive in terms of time and resources and clearly has a negative impact.

CMU is not an infrastructure project, but a multilevel integration of capital markets within the EU.

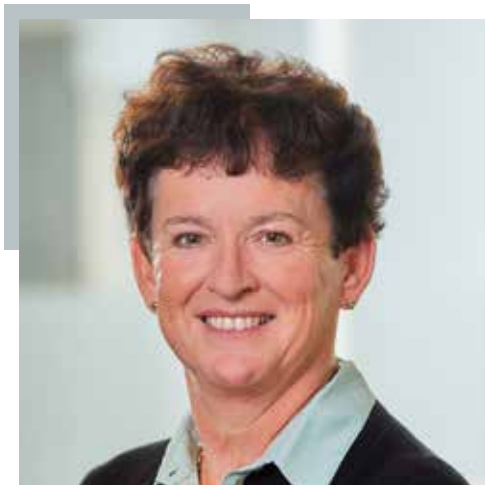
While doing more may be warranted in some circumstances, doing less is the right choice in others. We therefore welcome the European Commission's proposal to review the CSDR, which would pare down the mandatory buy-in regime. In its original form, this was too complex to implement and placed unnecessary burdens on the non-failing trading partners. In the published proposal, the regime would be eased significantly and activated only in specific circumstances. This guarantees that this policy instrument remains part of the toolkit and can still act as a deterrent to reduced settlement efficiency by market participants. Similarly, we welcome the simplified CSDR passporting process and the revision of the rules concerning CSDs' access to banking-type ancillary services.

The launch of the European Collateral Management System (ECMS) and the accompanying harmonisation initiative to establish a Single Collateral Management Rulebook for Europe (SCoRE) next year is a yet another example of the Eurosystem going hand-in-hand with the financial industry to take the opportunity to advance the integration of EU financial markets. The existing national collateral management systems of the NCBs currently used in the context of collateralising Eurosystem monetary credit operations will be replaced by the ECMS, but the accompanying push towards harmonisation goes far beyond this and will simplify the cross-border handling of collateral in Europe.

A real game changer for the European capital market would be a central bank digital currency (CBDC), either a retail or wholesale version, as a digital form of a truly European means of payment. It would serve as a monetary anchor and support European sovereignty in the landscape of digital payments. In particular, it could enhance the settlement of future digital securities. Past experiences also hold true here: collaboration and the appropriate amount of action by the central bank are crucial. The Eurosystem does not strive to abolish the two-tier banking system, but intends for it to continue to form an integral part of the future payments landscape. Striking the right balance is difficult, especially when large-scale experiments are not really feasible.

The Eurosystem's High-Level Task Force on CBDC is investigating several options for how a digital euro could be designed and it has an intensive outreach programme to both professionals and everyday consumers in order to better understand their needs when it comes to digital payments.

It is too early to say what the solution may be, but it is clear that, as is so often the case in post-trading and payments, its success will depend on the joint effort of the Eurosystem, financial institutions, regulators, and legislators.



ILSE PEETERS

Head of Government Relations and Public Affairs - Euroclear S.A.

Securing the achievements of the EU CSDs' ecosystems while innovating – a call for pragmatic progress

A lot has been written and said regarding the EU CSD landscape over the last 20 years. The Giovannini reports marked the start of a well-known journey that took CSDs from a Code of Conduct on Clearing and Settlement to Target2Securities, the CSDR and its implementation (until even very recently with the settlement penalties), and numerous harmonisation efforts, including in the area of collateral management in the frame of the Eurosystem Collateral Management System (ECMS). Today, the European Commission proposal on CSDR REFIT is being discussed. We welcome the REFIT proposal which is designed to cut red tape and make the cross-border provision of CSD services easier.

It is now time for reflection on (i) the achievements of CSDs, (ii) realistic avenues for further progress in this area and (iii) expectations on how technologies such as DLT can help CSD's and their ecosystems to progress.

First, the achievements in the CSD area are numerous and successful. CSDs have weathered several recent challenges such as Brexit (with the successful migration of Irish corporate securities to Euroclear Bank), numerous COVID19 impacts including dealing with very high levels of volatility, the issuance and distribution of new debt securities such as SURE and NGEU, implementation of Russian sanctions. In all these circumstances, CSDs have served issuers, investors and their agents well. CSDs have proven to be true safe and resilient havens.

Second, we still hear and appreciate there are expectations that further integration or even consolidation amongst CSDs should be the end goal. Conceptually, this expectation makes sense, as some activities of CSDs represent sizeable economies of scale and further integration would allow to reap more synergies and hence increase efficiencies both for domestic and cross-border activities. Yet, a pragmatic approach must be taken in the current EU political environment. Experience tells us that Member States in particular do not see further harmonisation of crucial elements (such as securities law harmonisation and withholding tax procedures) as a priority. Also, very often, Member States understandably consider their CSD of domestic critical importance. Other elements that render further integration challenging are the existence of different holding models within EU CSDs as well as the fact that there are multiple currencies in the EU. Those realities make that progress in the CSDs' ecosystems will continue to take place at an incremental pace.

New technologies, in particular DLT, hold a promise for capital markets and CSDs' ecosystems.

Third, at the same time, we see new technologies, in particular DLT, inherently hold a promise for capital markets, and for the CSDs' ecosystems in particular. Some of the benefits DLT could bring are a reduction of the reconciliation workload between intermediaries, facilitation of the identification of end-investors and the management of registers, a reduction in the trading settlement cycle, etc.

DLT, because of these potential promises, has been attracting a lot of attention from the market over the last few years and has led to many experimentations, including the central bank digital currency pilot with the Banque de France and we have also seen some real life implementations. From those experiences, we can conclude it is probable that DLT could be effectively introduced in the capital market processes in the coming years. Uncertainties however remain on the pace, scope and extent of these upcoming changes.

DLT is not the panacea that will resolve all market problems. Indeed, DLT will initially add complexity to the capital markets that was built around non-DLT systems over the past decades. In addition, some elements that are not harmonised at EU level will need to find their way into the DLT implementations, making them a possible source of fragmentation or additional costs. For example, entities that want to enter the Pilot Regime for DLT Market Infrastructures will have to adapt to different national laws on digital assets which may even not be available yet in all Member States.

A move to a DLT environment without having gained sufficient maturity on its potential impacts may bring the EU capital markets backward rather than forward. Thoughtful and measured pace must be ensured. We therefore support the recently published regulation that designs a DLT Pilot Regime. This should allow for an environment where we can analyse the possibilities and complexities of the implementation of this new technology for trading, settlement and custody of digital assets, answering questions like, what are the more suitable solutions with regard to the cash leg of DLT settlement, and what could be possible market re-shaping that would be warranted.

The above arguments demonstrate how critical it is to have a regular and open dialogue between the public and private sector to understand and support the evolving CSD environment with the aim to bring most benefits to EU's capital markets.

DANIELA PETERHOFF

President of Clearing and Head of European Markets Strategy - Nasdaq

Resilience, efficiency, competitiveness: finding the right balance!

Post-trade infrastructures are often referred to as the plumbing of financial services, suggesting they are highly complex and a bit secondary while in fact they are tremendously important, not least for financial stability. Without them markets cannot function successfully! Looking at CCPs, one can only be impressed by the resilience and containment effects that CCPs brought to financial markets during the global financial crisis. The same holds true for the way market infrastructures navigated through the exceptional market conditions that emerged during the COVID pandemic and more recently because of the invasion of Ukraine by Russia.

CCPs control of markets dynamics are in big part due to the stringent common regulatory requirements that EMIR created as well as its successive refinements imposed to CCPs throughout the EU, including to manage Brexit. Effective supervision, now coordinated by ESMA CCP Supervisory Committee, is also playing an important role there. Nonetheless, I would like to underline that CCPs have worked tirelessly to implement these standards, leading to robust risk management frameworks across the board as suggested by the very encouraging results of ESMA´s fourth stress test.

And, as we cannot rest on our laurels, just a few months back the European Commission carried out a targeted consultation on the review of the central clearing framework in the EU, asking the industry to reflect on several important topics, including the attractiveness of CCPs.

Nasdaq naturally contributed to this exercise and welcomes all the reforms and requirements that make post-trade infrastructure more resilient and prone to support stability. At the same time, a part of me also thinks that all these requirements and changes to implement come at significant costs for the infrastructure themselves and the broader industry with consequences on competitiveness. First, I have in mind the competitiveness in the EU markets, vis-à-vis Over-The-Counter markets for instance, and internationally, vis-à-vis third country markets.

Policy makers therefore need to keep both aspects of resilience and competitiveness in balance.

For me, the reality we must face is that being reliable, resilient, sustainable is not sufficient for post-trade infrastructures. It is not worth very much if such infrastructures end-up not being used because of a lack of competitiveness. The right balance needs to be struck between requirements imposed for resilience and stability purposes and allowing infrastructure to remain competitive in the EU markets as well as globally. For instance, in commodities markets, such as European power markets, a trend has emerged whereby market activity is moving to over-the-counter, away from organized markets and central clearing because their requirements are becoming too burdensome. This development deters the resilience, stability, and sustainability of the markets.

There are also new challenges ahead of us where we will need to stay in balance between too heavy requirements and keeping post-trade market infrastructure competitive. This is especially true in the areas of new technologies, such as DLT and AI but also climate change. Given we see these sectors as essential for society in the future, adopting the adequate frames to facilitate their uptake and monitoring their development is hugely relevant for us and an integral part of Nasdaq strategy.

Whether it is the creation of new types of financial and non-financial digital assets, inventive ways of structuring clearing services using technology to disintermediate or to rethink the status-quo of the traditional trading-clearing-settlement-custody divide in the chain of transacting and holding a financial instrument, policy decisions will have to be made to ensure safe while competitive market solutions. Nasdaq is embracing these new technologies as they have the potential to create more competitive and agile markets and services, while at the same time recognizing the need for ensuring a level playing field between various service providers based on the principles of a technology neutral regulatory framework. The other side of the coin is also that these new technologies can facilitate developments in market infrastructure by putting in place even more effective controls and managing complexities more effectively than today´s markets, allowing even more resilient and orderly markets in the future.

We also need to understand how climate change could pose risks affecting the financial markets including post-trade infrastructures, especially CCPs, and determine an adequate regulatory framework. While ensuring the resilience of markets by posing regulatory requirements on the market infrastructure, it is important to maintain their attractiveness by keeping the demands reasonable.

Importantly, post-trade infrastructures need to be both truly competitive and resilient for remaining efficient and attractive. Policy makers therefore need to keep both aspects of resilience and competitiveness in balance to ensure an efficient and sustainable European capital market!

HAROUN BOUCHETA
Head of Public Affairs -
BNP Paribas Securities Services

CMU: next regulatory challenges to boost the EU post-trading area

Since the first Giovannini Report from 2001, we know that in order to promote an efficient functioning of EU post-trade markets and to develop cross-border transactions some barriers should be removed.

Significant progress is about to be made with regard to the capital markets union (CMU). The second action plan dated 2020 includes renewed policy objectives which take into account not only the sources of inefficiency notably in the post-trading area but also political developments such as Brexit. Public policy objectives have therefore been redesigned with a balanced approach mixing items like the need to decrease costs and to promote an open EU market with the need to encourage a strategic autonomy.

Having in mind these policy objectives and focusing on the post-trading area, four paths may be followed in order to integrate national capital markets into a genuine single market.

1. "Quick removal" of some technical issues to create a more integrated EU capital market

- Review of the shareholder rights directive (SRD II) through a dedicated regulation aiming at harmonising the definition of shareholder so that cross-border investors are able to exercise their voting rights and their intermediaries can be subject to clear and harmonised rules across the EU,
- Introduce a common EU-wide system for withholding tax to simplify the process for cross-border investors and their intermediaries. It is now time to move forward through political will despite the fact that tax issues should usually be tackled at Member State level,
- Stabilise the settlement discipline regime through the targeted review of the central securities depositories regulation (CSDR) avoiding imposing unnecessary burdens on market participants. Mandatory buy-ins could hurt liquidity and negatively impact the competitiveness of European capital and post-trade markets.

Achieving a genuine post-trade market implies to move quickly on a number of regulatory priorities.

2. Meeting the "strategic autonomy" objective while ensuring a fair competitive landscape

For legitimate reasons, the Commission would like that EU clearing members and market participants reduce excessive exposures to systemically important UK central counterparties (CCPs) in particular for their euro-denominated OTC derivatives exposures. Maintaining a fair competitive landscape is key and any policy that would only involve EU-based clearers will damage those firms and their clients. Punitive capital charges targeting EU banks only would not meet the CMU objectives. Regarding exposures to UK CCPs, the only valid way is to promote policy measures preserving the competitive landscape and including reasonable conditions and timeframe.

It is clear that it is a common interest to maintain liquidity and efficiency benefits of CCPs – regardless where they are located - through a critical mass of non-EU but also EU clearing members.

3. To decrease costs, market structure should evolve

The review of the markets in financial instruments regulation (MiFIR) is a key component of the CMU action plan. Both the consolidated tape and the open access are building stones that could contribute to the CMU goal.

Firstly, regarding the consolidated tape, it is a fact that there is a lack of access to data at a reasonable commercial cost. Market data should be made available as widely and cheaply as possible. One way to achieve this goal could be to have a consolidated tape which is run as a utility by providing data according to a fee reflecting the cost of aggregation and distribution.

Secondly, regarding open access for ETDs, we think that it is too early to stop discussing especially in a CMU perspective. Open access for cash equity markets spurred competition among financial market infrastructures and lead to an overall decrease of costs. Concerning ETDs there are potential risks and costs associated with open access but there are also potential advantages especially in terms of competition and fees.

4. Ensuring client protection for custody and depositary services including for digital assets

The conditions under which custodians and depositaries provide their services to clients is a key component of the investor protection regime.

On the one hand, under the draft review of the directive on alternative investment fund managers (AIFMD), national competent authorities may be allowed to authorize AIFs to appoint a depositary in another Member State. Given the lack of harmonisation of national rules and supervisory approaches applicable to both AIFs and depositaries, it is important for investor protection to limit this possibility and to clarify rules applicable regarding both the supervisory requirements and the duties of depositaries.

On the other hand, the regulation on markets in crypto-assets (MICA) has made clear that custodians will play an important role in this market appropriately accompanying issuers and promoting a secured crypto-assets market. That is why their liability regime should be well calibrated to protect investors but also to encourage players to engage in this new market.

NEXT EUROFI EVENTS

THE EUROFI HIGH LEVEL SEMINAR 2023

26, 27 & 28 APRIL 2023

STOCKHOLM

SWEDEN

THE EUROFI FINANCIAL FORUM 2023

13, 14 & 15 SEPTEMBER 2023

SANTIAGO DE COMPOSTELA

SPAIN

SECURITISATION IN EUROPE

DOMINIQUE LABOUREIX

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

Do not miss the opportunity of the review

Securitisation creates a bridge between credit institutions and capital markets and accordingly is an effective product in the toolbox to foster the Capital Markets Union. Soundly structured securitisations enable banks to optimise their allocation of capital, increase their capacity to finance the economy and have access to new liquidity providers. Buying the different tranches of a securitisation with various risk-return profiles offer different opportunities for investors.

In view of its complexity, securitisation requires a robust and prudent framework that limits harmful practices. On the other hand, this framework should not contain undue obstacles to its use by originators and investors.

The implementation of the new European cross-sectoral securitisation regime in early 2019 was an important step forward from the previous situation. However, it has not yet produced all expected results and the development of the market has been limited since its inception. To some extent, this may be due to certain elements in the regulation that need an upgrade.
The current review of the European framework offers an opportunity to improve its efficiency. While maintaining the key principles that governed the reform, all relevant areas of the framework should be assessed without any bias, so that issues are correctly identified and addressed.

Ahead of the upcoming response of the Joint Committee to the Call for Advice issued by the European Commission in October 2021, I would like to underline that in our view some technical amendments to the prudential requirements would be highly welcome without prejudice to the risk-based sensitivity of the framework.

1. The so-called non-neutrality "p" factor in the RW securitisation function for banks has in fact three roles (allocation of capital between tranches, overall capital surcharge post-securitisation and steepness of the cliff-effect). Reaching these three goals in an optimal fashion with only one parameter may appear a difficult objective; the European Union could propose that the Basel Committee reviews this part of the international standard in the future. However, I believe that in the meantime a targeted reduction of the risk weight floors and of the "p" factor, at least for certain qualifying tranches retained by the originators, could be introduced in the CRR.
2. The assessment process of the significant risk transfer (SRT) should be framed through a strong and structured dialogue between the originators and their supervisors. In that regard, I welcome the delegated act that the European Commission intends to release soon in order to implement the recommendations of the EBA Report on SRT published in November 2020, subject to an appropriate calibration of the proposed tests.

3. A potential upgrading of certain STS securitisations to level 2A of the LCR (with adequate haircuts and subject to observed liquidity) would likely stop discouraging institutions subject to the LCR to invest in such securitisations. Then, the increasing demand on the "buy side" may produce positive effects on the offer from the "sell side", potentially creating a virtuous circle.

4. A clarification of the definition of private transactions would help to design proportionate disclosure templates, tailored for the investors' needs. On the other hand, it is sometimes difficult for supervisory authorities to become aware of the issuance of private securitisations without any notification. Making the information for private securitisations available by means of a securitisation repository would allow supervisory authorities to access and query the information in an easier and more structured way.

5. The role of insurance companies as investors is also critical. In this regard, the prudential framework for insurers could be made more risk-sensitive. Indeed, Solvency II capital charges encourage insurers to invest in senior STS categories only, putting aside other categories of securitisations. It may explain the limited appetite of insurers to invest in such financial instruments. Here again, we are in front of an egg and chicken dilemma. A first step towards improvement may be to include in Solvency II a segmentation of the non-STS securitisation tranches into two sub-categories at least (senior and non-senior) - as in the banking prudential framework. Such a segmentation would allow these products to benefit from a better risk-adjusted treatment without adding too much complexity to the framework.

As a preliminary conclusion, I would support that the outcome of the European Commission review triggers, along the lines mentioned above, some fine-tuning of the European securitisation regime that is overall fit for purpose.

I really hope that the appropriate amendments to the framework can be implemented as soon as possible in order to make securitisation more competitive with comparable products and to ease its liquidity while maintaining the necessary transparency.

FAUSTO PARENTE

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

Trends in securitisation investments by insurers

The Solvency II Directive came into effect in Europe on 1 January 2016 and was a true milestone, resulting in real progress in terms of risk management and the harmonisation of prudential standards in the European Economic Area (EEA). The insurance industry now uses a risk based approach to assess and mitigate risks. It also has better aligned capital to the risks it runs for all asset classes held by insurers including those of securitisation.

As far as the treatment towards securitisation is concerned the current calibration on securitisation is based on Art 178 of the delegated act which was updated in 2019 by the European Commission. This is an amendment of the previous article 178 of the delegated act from 2015 used initially in Solvency II. The amendment of 2019 introduced the treatment for the new Simple, Transparent and Standardised (STS) securitisations which increased the number of the categories treated within the framework of Solvency II for this asset class.

Stress factors were adjusted by replacing the previous categorisation according to type 1, type 2 and re-securitisations with a new classification of senior STS, non-senior STS, Non-STS and re-securitisations. Exposures to STS securitisations receive a more favourable capital treatment under certain conditions are met (STS eligibility criteria).

The aim of this revision was to boost investments in securitisation by insurers in a prudent way. Three years after the new delegated regulation has come into effect, investments in securitisation have been overall stable to approximately 12.5 billion euro for the solo standard formula users which operate in the EEA. According to data from EIOPA's quantitative reporting templates, in 2021, when looking within the STS and the Non-STS segments, in relative terms, one can observe small increases to both categories since 2019 by approximately 3%. Within the STS segment this increase is observed mainly in respect to the senior STS category.

Demand for securitisation investments across the majority of insurers in the EEA seems to be stable.

In addition to the above it has to be mentioned that the distribution of securitisation investments within the EEA is concentrated in a small number of undertakings (255 out of 2086 solo undertakings according to data from EIOPA's quantitative reporting templates in 2021) located only in a few countries (in eight countries in 2021 – Belgium, Denmark, France, Germany, Ireland, Italy and Spain). The vast majority of European insurers have not been investing in securitisations since the introduction of Solvency II. Of those who invest, 85% do so for an amount of less than 5% of their total investment assets. Only a small number of insurers seem to be active players in the securitisation market.

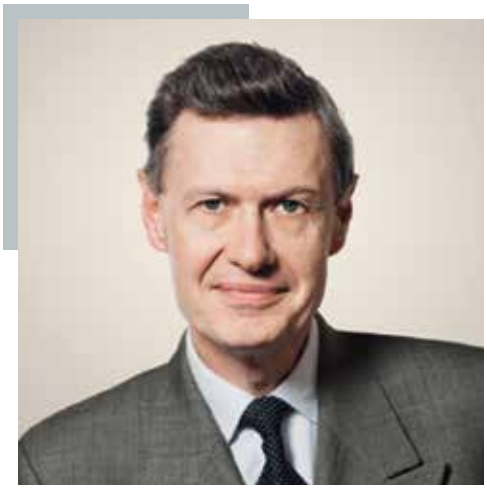
In order to better understand the investment behaviour against this asset class, EIOPA launched a survey to the insurance industry which indicated that the appetite of insurance undertakings with regards to investments in securitisation is very diverse. This can be partly explained by the individual insurers Asset and Liability Management (ALM). In this regard, each undertaking has a different liability structure and adjusts its investments accordingly. While a few undertakings seem to use securitisation for this purpose, the vast majority seem not to do so.

A few insurers mentioned that the high capital charges are one of the reasons that is holding them back from investing in this asset class. In addition, some other insurers highlighted that if an undertaking's solvency position is very robust, the significant driver for investment activity is primarily risk and expected return rather than capital requirements. Some of the additional reasons were reported to be:

(i) Other asset classes show better risk-return profiles;
(ii) Portfolio consists of "hold-to-maturity" bonds. Securitisation investments do not fit into this portfolio;
(iii) Given the profile and nature of the liabilities, insurers tend to invest in longer duration fixed rate investments.

In conclusion, the demand for securitisation investments across the majority of insurers in the European Economic Area seems to be stable since the introduction of Solvency II. The Simple, Transparent and Standardised label is in place only since 2019 and at the moment there are small indications that investments may increase.

As part of its ongoing work, EIOPA will continue to follow closely trends in securitisation.



PHILIPPE BORDENAVE

Senior Executive Advisor to General Management and the Chair of the Board - BNP Paribas

Securitization : quick fixes or complete overhaul ?

I have been advocating for a holistic review of the securitization framework for many Eurofi conferences now.

While some quick fixes have been implemented, such as the extension of the STS eligibility to on-balance sheet securitization, most of the obstacles that had been identified by the High Level Forum on the CMU back in 2020 are still unsolved:

- Inefficiency of the Significant Risk Transfer assessment by the ECB/SSM
- Excessively penalizing capital charges for banks and insurance companies
- Unfairly penalizing liquidity treatment, notably compared to covered bonds
- Excessively burdensome reporting requirements, that do not meet investors' need.

2022 was supposed to be the year of this "holistic review", however:

- The European Commission seems to have decided not to reopen the Securitization Regulation to address the simplification of reporting
- The Joint ESAs are still to issue a response to a September 2021 Call for Advice from the European Commission, and preliminary industry outreach has been disappointing, as to the level of ambition of this report.

As co-legislators are currently negotiating the CRR3-CRD6 package, as well as the revision of Solvency 2, Europe cannot afford to leave this subject unaddressed.

Indeed, Europe is facing multiple challenges, which will require massive investments in the coming years. Estimated in 2020 by the Commission to 650 bn€ additional investments per year to finance the green and digital transition, this amount is likely to grow toward 1 trn€ per year, considering the responses to the consequences of the Ukrainian war as regards reindustrialization, defense, and strategic autonomy at large.

Public funds can only finance a limited part of these investments, given high levels of public debt and rising interest rates. So the main share will have to be financed by the private sector, where banks currently represent about 75% of this financing.

Although banks have currently high level of capital, the amounts at stake are well beyond their capacity to increase risk-taking, given ever increasing regulatory and supervisory pressure: "finalization" of Basel III, reinstalment of buffers, supervisory pressure on lending to corporates with "high" leverage, continued goldplating of MREL...

Missing the opportunity to unlock this market would mean that Europe will have to slow down its investment programs, and will not achieve its Green, Digital and Strategic autonomy ambitions.

While Capital Markets can develop, from the low base that they currently represent, they cannot become a substitute to banks' long-term relationship with clients, notably in the SME sector. The only solution to square this circle is to allow banks to originate those investments, and to package them for investors in the form of securitization. This combines the safety and soundness of banks' regulated lending practices, and the capacity to share risks with the very deep European saving markets, offering them profitable, robust, and purposeful exposure to the real economy.

The Joint ESAs report should not miss the opportunity to provide well-known and effective solutions to well-recognized issues today preventing the European securitization market to take off. The Commission and co-legislators should ensure that such answers find their way in the current revisions of CRR and Solvency 2.

The potential is huge: securitized assets represent only 8% of GDP in the Eurozone, compared with 47% in the US. Missing the opportunity to unlock this market would mean that Europe will have to slow down its investment programs, and will not achieve its Green, Digital and Strategic autonomy ambitions.

ALEXANDER BATCHVAROV

Structured Finance Expert - Bank of America

EU securitisation has large potential, but needs a re-launch

The Global Financial Crisis was a watershed for the EU and US securitisation markets. It tripped both markets, but while the US market got up, brushed the dust off and moved on, the EU market is still struggling, we think, to regain its footing. The best summary of the contrast between the two markets' evolution is the ESM Blog statement: in 2008 the size of the European securitisation market, including the UK, was 75% that of the US, and in 2020, it was just 6%. The EU share is even smaller given that the UK market is about a quarter of the European market.

The difference in the US and EU securitisation market's sizes is often attributed to the Agency MBS market in the US. In fact, US Agency MBS does not meet the EU securitisation definition; its MBS credentials are as close to EU securitisation-law-abiding MBS as are EU covered bonds. The differences between US Agency MBS and EU mortgage covered bond include: sovereign guarantee explicitness and format, degree of collateral pool disclosure and sheer issuance volume (about $3trn and about €0.5trn p.a. in recent years); they represent 38% of US and 17% of EU GDP. Yet, $8trn outstanding US Agency RMBS means that the US banks do not hold that amount on their books. In contrast, the entire amount of mortgage loans backing the nearly €3trn outstanding covered bonds is on EU banks' balance sheets, locking in capital and credit lines.

Away from US Agency MBS, the US saw about $850bn of securitisations in 2021, while the EU volume (placed with investors) was c. €96bn, with additional volume of c. €94bn retained by banks to access ECB liquidity facilities. This is a far cry from the €270bn+ volumes p.a. placed with investors before the GFC. In recent years, (non-agency) securitisation issuance was c. 4% of GDP in the US and c. 2.5% in Australia.

By comparison, EU placed issuance was barely 0.5% of EU GDP. In 2Q21 EU securitisations (both placed with investors and retained by issuing banks) represented only 2% of the total assets in the EU banking system; in the USA (excluding US agency RMBS) it was about 9%. To reach the Australian securitisation share of GDP, EU securitisation can easily provide an extra €350bn of funding p.a. to the EU economy. What more evidence is needed about the contribution of securitisation to both the GDP and the banking system of a given country? Note that SSM identified one of the reasons for the lower, than their US rivals, EU banks competitiveness as the much weaker EU securitisation market relative to the US.

EU securitisation can easily provide an extra €350bn of funding to the EU economy p.a.

In the GFC's aftermath, EU corporate finance was largely disintermediated and the credit markets doubled their size as a share of Eurozone GDP (c. 23% in 2022), with the help of the ECB. Since the Eurozone crisis, the ECB has regularly propped up the Euro covered bond markets, too. The resulting sovereign-bank-corporate nexus is unprecedented; the need for funding diversification and limiting the systemic implications of the above nexus requires a much bigger role for securitisation in the EU. Last but not least, EU green securitisation market lags those of the US and China by a wide margin. A green securitisation market, able to support fully the sustainability transition of the EU economy, is predicated, in our view, on an already well-functioning securitisation market, not vice versa.

The question of why the EU securitisation is not contributing to its full potential to the growth and sustainability transition of the EU economy has many answers, of course. We believe that the key one is EU regulations: both in their wording and implementation they create high barriers to entry for both issuers and investors, and distort incentives across capital market instruments and players.

There is little, if any, historical proof of agency and model risk in EU securitisation; US data justifies capital neutrality of c. 0.15%-0.25%. Capital non-neutrality is a regulatory barrier to bank investors: a p-factor of 0.5-to-1 cannot be justified in the EU. Solvency II charges incorporate 'capital non-neutrality' in a different way: the absence of EU insurers among securitisation investors, in contrast to the US, is a case in point. There is no historical evidence that the agency risk in securitisation is higher than that in whole loan portfolios or covered bonds; EU consumer lending laws largely equalise those risks.

We see no justification for disclosure gap for securitisation vs. covered bonds and whole-loan pools: all are asset-based instruments, the dual recourse fall-back has not been proven in real life and covered bonds are not homogeneous across EU, despite being subject to a uniform light-touch regulation. The EU-only launch of STS securitisation is yet to bring new issuers and investors to the EU securitisation market.

The EU securitisation market is delivering below potential. The High Level Forum on CMU detailed how to unleash its power for the benefit of the EU economy and transition. We think these proposals should be acted upon.

MASCHA CANIO
Head of Credit & Insurance Linked Investments - PGGM

The Pension Fund Standard for Credit Risk Sharing Transactions

The European economy is facing two main challenges today: recovery following the COVID-19 pandemic, which is being threatened by high inflation and potential lack of sufficient gas supply, and simultaneous transition towards a sustainable economy. Securitisation is perfectly designed to address these challenges as through its ability to transfer part of the risk from the banking system to capital market investors, it facilitates continued bank lending to the real economy. This is crucial in times of economic stress, like today.

Since 2006, PGGM invests in balance sheet synthetic securitisations, which we call 'Credit Risk Sharing' (CRS) transactions, on behalf of PFZW, the € 229 billion Dutch pension fund. We have been a vocal supporter of establishing the Simple Transparent and Standardised (STS) Securitisation Framework, which now also applies to the CRS market and we applaud Europe's leading role in this field. The benefits of the STS label are already showing. Yet, to realise the full potential of securitisation, more can be done.

Echoes of the Global Financial Crisis (GFC)

Alas, securitisation still has a stigma dating back to the GFC, where misalignment, overconfidence and insufficient risk awareness in the US securitisation market contributed to a financial breakdown. The misuse of securitisation before 2008 has tainted the full spectrum of securitisations and has driven regulatory caution for well over a decade. This is reflected, amongst others, in the non-neutrality of securitisation capital risk-weights and overly detailed ESMA disclosure templates which stack layers of conservatism on the securitisation products. This conservatism persists, despite the fact that several analyses of the EU CRS market since 2008, such as the comprehensive EBA Report (May 2020), show very low loss rates in CRS securitisations. Introduction of the aggregate output floor under Basel III, while not specific to securitisation, will exacerbate this due to the conservative treatment of securitisation under the Standardised Approach and is a key issue to address.

Standards always matter

That said, we recognise ourselves in the cautious approach and we have experienced low losses in over 60 CRS transaction we have invested in so far. As a prudent long-term pension fund investor, we always aim to thoroughly understand the risks involved and mitigate where appropriate to gain comfort prior to investing. As such we have always applied our own 'pension fund standards'. The STS criteria for CRS, which have been an excellent first step, partially encompass these standards, yet, further finetuning is needed to truly capture the risks involved. Our pension fund standards both work for an investor and simultaneously address regulatory concerns regarding these transactions.

> **Securitisation rules, if set properly, can truly support the financial system in economic stress.**

The Pension Fund Standard

Our CRS transactions, which all concern blind portfolios (i.e. bank clients' names secret),are based on the principle of understanding the underlying and genuine sharing of credit risk between the bank and the investor. This leads to three key principles that are not yet fully captured by the current STS rules:

- Adequate risk alignment of 20% to avoid the originate-to-distribute model. CRS transactions, unlike the typical true sale securitisation, are focused on covering the first losses on a loan portfolio. As such, for CRS the regulatory minimum of 5% risk alignment is insufficient as that is quickly compensated through origination fees and a few coupon payments.
- Mitigation of counterparty credit risk to the bank by collateralising the funded notional. Not including this for CRS transactions has led to a lower STS standard for CRS compared to true sale, which by its nature is collateralised. In addition, it runs counter to a key lesson from the GFC and the regulatory trend.
- Having the right data to evaluate the credit risks of the loan portfolio and estimate expected losses throughout the economic cycle. This includes reporting data that is fit-for-purpose, reflecting the bank's modelled PD and LGD data, as well as significantly more than 5 years of historical data to understand the performance of the portfolio through economic cycles.

Setting these high standards will contribute to ensuring a robust CRS market through coming downturns. Capturing these adequately, for example in the STS framework, provides a rationale to reduce some conservatism in the regulatory framework.

Conclusion

So far, 2022 has been very active for the CRS market and we see this trend continuing this year. The CRS market is growing, yet how it develops into a mature market over the coming years largely depends on regulatory standards. If these are set properly, they will stimulate more direct participation by long-term institutional investors like ourselves, adding further stability in capital deployed. The result will be a healthy and sustainable CRS market that can continue to support European banks in lending to their clients and as such contributing to the real economy throughout time.

THE **EUROFI** FINANCIAL FORUM **2022**

PRAGUE | 7, 8 & 9 SEPTEMBER

6

DIGITALISATION AND PAYMENTS

ISSUES AT STAKE

Digitalisation and new technologies such as DLT, AI and cloud services are key drivers of innovation, agility and efficiency in the EU financial sector. These innovations also bring many changes in the financial ecosystem that raise new questions in terms of competition, financial stability and consumer protection and also create new challenges for supervisors.

The EU Digital Finance Strategy (DFS) together with the DLT pilot regime and the DORA framework for digital operational resilience aim to support this transformation by adapting the financial framework to increasing digitalisation, removing potential obstacles to digitalisation and also addressing possible new risks and level playing field issues related to these changes. Cryptoassets are a further area of development and innovation that is addressed by MiCA, which proposes a new EU legal framework for cryptoassets that do not fall under existing EU legislations such as unbacked cryptoassets and stablecoins. Achieving an appropriate balance between risk mitigation and supporting innovation remains a challenge in this area, as well as tackling new developments, such as decentralised finance (DeFi).

EU retail payment markets remain fragmented along national borders and dominated by non-EU card schemes. The arrival of BigTechs adds to these challenges. In response, the EU Commission and the ECB have been taking steps to build an efficient, autonomous, and integrated market for payment services (PSDs, IFR, TIPS, ...). The forthcoming adoption of CBDCs, including a Digital Euro, is a key part of the EU response.

At the global level, many challenges, including the need for sufficient autonomy in order to preserve the continuity of transactions, impact financial infrastructures for high and low value payments, central securities depositories, securities settlement systems, central counterparties, and trade repositories.... which have consequently been launching ambitious modernisation projects and strengthening regulations and standards.

DIGITALISATION TRENDS IN FINANCIAL SERVICES

VERENA ROSS
Chair - European Securities and Markets Authority (ESMA)

Embracing the digital age of finance

From Gutenberg's invention of the printing press to the arrival of IBM's first personal computer, technological innovation has always been a symbol of progress in society. We are now in an era where digital technologies are profoundly changing the way we learn, work, and interact with one another. This is in turn providing an opportunity to create a competitive digital EU economy and an open society. Clearly, the world of finance is very much at the centre of this.

Digital technologies are reshaping the financial services industry and paving the way for innovative financial products and services for consumers, as well as transforming traditional value chains and giving rise to new business models and entrants. Digitalisation is making finance more competitive, accessible and inclusive. New FinTechs and mobile applications are constantly emerging, offering cheaper, simplified and faster access to finance for consumers. Advancements in artificial intelligence (AI) are improving the speed and capabilities with which the plethora of modern data can be analysed in order to improve human decision-making and reduce risk. Distributed Ledger Technology (DLT) holds much promise in decentralising the recording of transactions and reducing the need for costly intermediated chains. Cloud computing technology has improved the storage capacity and recording of data, enabling better access and management of customer information.

While all these possibilities give good cause for excitement, it is equally important to be mindful of the risks and challenges that digitalisation brings. Across the broad spectrum of emerging innovations, we must remain vigilant to the risks of greater exposure to potential cybercrime, operational resiliency failures, and data protection and privacy issues, especially in a world where such threats are increasing across society. We also face challenges in addressing accountability and transparency issues, as well as market concentration issues with potential overdependence on third-party providers.

It is for these reasons that pioneering public policy is crucial. The EU has been at the forefront of embracing the need for ground-breaking policy considerations. The European Commission's Digital Finance Strategy in 2020 set the groundwork, with the objective to adapt the financial regulatory and supervisory framework to the increasing digitalisation of the EU financial sector. Much progress has been made since then, in particular in recent months with political agreement being reached on key legislative initiatives on new safeguards for crypto-assets (MiCA) and strengthening digital operational resilience standards (DORA).

The DLT pilot regime has also been set in place to facilitate market infrastructures in exploring tokenisation solutions for trading and settlement. More broadly, rules have been introduced to tackle large, systemic online platforms (Digital Markets Act), while discussions are advancing on harmonising rules for AI (AI Act).

Such novel frameworks require a careful balance of focused standard setting for aligned activities (same activity, same rule) on the one hand, and proportionality and flexibility on the other. Only if we get this balance right can we protect investors, ensure market integrity and protect financial stability, while also allowing innovation to flourish. Both MiCA and DORA include important new mandates for the European Supervisory Authorities (ESAs) to refine the applicable rules for crypto assets and digital resilience and reflect further on that important balance. Earlier this year, the ESAs also put forward ideas to ensure that the EU's regulatory and supervisory framework remains fit-for-purpose in the digital age, which focused on adequate supervisory oversight, strong consumer protection, and ensuring a level-playing field.

The potential for innovation to outpace regulation makes it essential for supervisors to be agile.

The potential for innovation to outpace regulation makes it essential for supervisors to be agile and responsive. To remain abreast of rapidly changing technology, supervisory authorities like ESMA must continue to build expertise and talent. As supervisors we should also embrace new technologies in how we conduct our supervisory tasks.

All in all, the exceptional pace of digital innovation in finance to date shows us that we are still only at the beginning of this new era. In anticipation of what is to come, we remain excited but vigilant.

ONDŘEJ KOVAŘÍK

MEP, Committee on Economic and Monetary Affairs - European Parliament

Digital finance legislation must balance innovation and consumer protection

In September 2020, the European Commission adopted a digital finance strategy, setting out the general lines of how the EU can support the digital transformation of finance while also sufficiently addressing its risks. In the European Parliament, we adopted the Digital Finance Legislative Initiative Report, which outlined the main areas we considered important to legislate on the European level in order to achieve similar objectives.

The institutions therefore recognised that new legislation was necessary in order to both support and regulate the increasing digitalisation in the financial sector. This proactive approach has led to the EU agreeing various measures which aim to facilitate the digital transition in the finance sector. These include three initiatives proposed by the Commission in 2020 - the Markets in Crypto Assets Regulation, the Digital Operational Resilience Act and the Distributed Ledger Technology (DLT) Pilot Regime.

These pieces of legislation aim to provide an appropriate framework for supporting the growing digitalisation in the financial sector. They address different areas - trading in digital assets, cyber resilience in the financial sector, and the further development of new technologies which could bring efficiencies to the sector.

In negotiating the first pieces of legislation, the institutions aimed to ensure that they took a risk-based approach, that all measures allowed sufficient flexibility to encourage innovation and global competitiveness, while addressing the risks in the sector. Furthermore, given that the EU is a pioneer in regulating the digital finance sector, we were also determined to have a sufficiently flexible regime in terms of the future development of both technologies and the financial sector as a whole. Therefore, the approach as much as possible was to regulate in a technologically neutral manner.

Going forward, and with the first pieces of legislation taking effect both in Europe and around the world, we will have a benchmark from which to develop our regulatory regime. Frequent reviews and consultations will be necessary to fine-tune the legislation in order to calibrate the right balance between encouraging innovation while also ensuring sufficient protection for consumers.

There are some concerns, both in the digital finance sector itself and also among some policymakers, that the first set of rules for the crypto-sector, for example, are overly prescriptive and could harm the development possibilities in Europe. Indeed, given the fast-paced development even between the period of the Commission's proposal and the final agreement, it is clear that updated impact assessments and public consultations will be necessary in order to keep on top of the innovations in the crypto sector. These would enable policy makers to take decisions to better reflect the dynamic nature of the sector.

In terms of supervision, it's clear that the digitalisation of the financial sector reflects the increasingly borderless nature of many of our day to day transactions. Therefore, it makes sense to have further involvement of supervisory authorities on the European level, as well as greater global cooperation to address, for example, money laundering risks and to share information about the global trends. However, it would not always make sense for the smallest actors to be supervised on a European level. Thus there needs to be a combination of both national and European supervision.

The ability to act quickly and proportionately will be paramount in the years to come.

One aspect of financial supervision which must evolve to reflect the digitalisation of financial services is the use of new supervisory tools and technologies to better address the development of the sector. Already in the initial pieces of legislation, we have made reference to new regulatory and supervisory technology to be used in order to have a broader range of tools to optimise supervision.

Going forward, we will have new initiatives and updated legislation which should reflect this increasing trend of digitalisation, for example the approach to open finance and also an updated Payment Services Directive. The Commission must keep its pulse on developments in order to react to potential innovation and also to emerging risks in the financial services sector brought about by increasing digitalisation. The ability to act quickly and proportionately will be paramount in the years to come.

BÁRBARA NAVARRO
Head of Research and Public Policy - Banco Santander

Simplify. Adapt. Overcome.

Financial firms, seen for some time as digital laggards, undertook a big part of their digitalization process ahead of COVID-19. It was accelerated by the emergence of fintechs, the growth of digital platforms and Big Techs, and the pandemic itself. Banks work together with such companies, and have even learnt from them. Digitalization is no longer seen as an alien component, but as a core embedded part of the business.

Promising applications and expected benefits continue to materialize. Thanks to Artificial Intelligence (AI), we are offering new products and ways of using existing ones (e.g. robo-advisors, paying using biometric authentication and chat-bots). Cloud has created a new paradigm for banks IT infrastructure. It provides simplicity while continuing to provide solid trust and security, which banks have always delivered to customers.

As digitalization moves forward, new challenges and risks continue to emerge. Cyber threats are at the top of the list. The growing dependence on technology providers, by the financial sector, has raised authorities' attention on how to strengthen financial institutions' ability to manage third-party risks. Also, new technologies might enable the development of new services and industries. This is the case of crypto-assets, which pose opportunities, but also risks, if not properly regulated and supervised.

Both risks and challenges have been well noted by regulators and authorities; and they are moving ahead.

At EU level, regulators are in the process of implementing the so-called Digital Finance package: DORA (cyber resilience), MiCA (crypto-assets) and the pilot regime. Other positive outcomes are the harmonization of the EU's anti-money laundering efforts; the creation of a digital identity; and the formal adoption of the Digital Markets Act (DMA), which will help bringing a level-playing field in digital markets.

Going forward, everything will be digital. Thus, in order to make sure we are able to adapt and innovate, there are three reflections I would like to share with you:

Firstly, regulation and supervision should be simple and future-proof – based on principles and guidelines. New cross-sectorial regulations, focused on the use of technology, such as the AI regulation, risk adding a new regulatory layer on questions that are already regulated for banks; e.g. credit provision and creditworthiness assessments.

Secondly, as new regulations will come with new cross-sectorial enforcement authorities, there could be an overlap. Harmonization and cooperation among different authorities, in Europe and across borders, will be key to ensure legal certainty. For Europe to have global players, we need global consistent regulatory approaches.

Thirdly, all these new regulations will help providing security and assurances to the financial sector. This reinforces the idea that, as part of one of the most regulated sectors, banks are well-positioned to offer new products and services, which are not yet fully regulated. Banks should be given room for manoeuvre, while regulation catches up with those new products, services, and even with non-regulated actors.

One more thought. Data has demonstrated the crucial role it plays, however, there are unexploited opportunities. With access to cross-sectorial data, banks could be able to provide more and better (tailored) credit, reducing the number of cases in which credit is denied. Mandatory access rights, under PSD2, forced banks to open core transactional data without reciprocity and fair compensation. I am concerned about the upcoming Open Finance proposal, which could continue this path by opening further financial data (banking, insurance, investments and pensions).

A principles-based regulation that can bring banks' strength to the customers' benefit.

The right approach: an EU voluntary data sharing framework, customer centric (to their benefit) and cross-sectorial (data from all sectors participating in the economy). It is the combination of data from different sectors which holds the greatest potential for delivering new services and experiences for customers.

Citizens and companies continue to adapt to the digital world, marking the path to be followed. Regulation and supervision must do the same. Today, more than ever, collaboration between the public and the private sector is key to understand opportunities and to avoid risks.

SCOTT MULLINS
Managing Director & General Manager -
AWS Worldwide Financial Services

Accelerating the digitalization of the EU financial services sector

Financial organisations have accelerated their adoption of the cloud to help them navigate the global pandemic and other challenges presented over the last 2.5 years. The cloud has played a pivotal role in helping to expand digital services in the financial services sector, such as online banking and instant and contactless payments when consumers needed them most. Providing relevant and responsible personalization and seamless interactions is now expected by consumers and provides an opportunity for institutions to remain competitive and optimize consumer engagement. Consumers want more personalized, seamless interactions, and on-demand customer service via their preferred channels, and consistent experiences across all channels.

The European Commission (EC) has proposed a bold vision for Europe's digital transformation by 2030. According to a new study by Public First—Unlocking Europe's Digital Potential—the EC's Digital Decade could unlock an extra 2.8 trillion euros in economic value for Europe's citizens. Over half of this projected figure relies on the increased adoption of cloud computing and accelerating the digitalization of organizations of all sizes and across all sectors, including financial services.

Reports by industry analysts indicate that the financial services industry is at a tipping point, with Deloitte noting that they need to disrupt or be disrupted. While still in the early stages of adoption, an increasing number of financial institutions are modernizing legacy systems to meet growing consumer expectations for digital channels and personalized products, reducing time-to-market for new products and services, responding to increasing cyber threats and enhancing their security and operational resilience.

The cloud is helping more financial services organizations achieve this by enabling access technologies – from compute, storage, and databases, through to artificial intelligence (AI), data lakes, Internet of Things (IoT), and fully-managed data management and analytics services – on demand. In particular, the use of artificial intelligence and machine learning (AI/ML) is accelerating across the industry and most companies are either investing in these technologies or planning to do so. We are seeing customers, from insurers to banks and asset managers, accelerate their adoption plans due to the availability of cost-effective and virtually unlimited capacity in data storage and compute power from cloud services.

Cloud is also enabling the digitalization of the financial sector by providing increased agility and the ability to create resilient, real-time, highly available applications which are able to scale rapidly on demand. At the same time, firms are achieving higher levels of security by leveraging secure infrastructure and newer technologies, such as continuous monitoring. This move is helping institutions to manage the operational risks within their cloud environment and ensure they have sufficient processes and security measures in place to support encryption, authentication, and reporting.

We expect to see more automation in security with infrastructure and application checks that can help enforce security and compliance controls continuously while reducing human configuration errors. These processes allow financial institutions to maintain the confidentiality and integrity that their customers demand, while maintaining timely and accurate reporting required by industry regulators

Regulatory certainty and the ability for financial firms to choose from the world's best technologies, so they can continue to innovate and compete at home and globally, are fundamental to this transformation process. The Digital Operational Resilience Act (DORA) provides an opportunity to accelerate the modernization and digitalization of EU financial services firms, bringing innovation, security and resiliency benefits for the sector.

While still in the early stages of adoption, an increasing number of financial institutions are modernizing legacy systems to meet growing consumer expectations.

While DORA does not introduce requirements that could limit a financial entity's ability to freely choose its service providers, this freedom to choose needs to be replicated in all legislation that impacts the sector. The ability to make technology choices based on customer needs, not limited by where the technology provider is headquartered, is critical for growth, economic development, and global competitiveness. This is crucial at a time when we see increasing cyber-threats, including from hostile states, with potential implications for financial stability.

As the European regulatory landscape evolves, AWS will continue to provide the financial services industry with the most advanced data control, security, and privacy capabilities, empowering the EU's financial sector with additional choices to address its needs as it continues to modernize.

CRYPTOASSETS: ARE REGULATORS ON THE CURVE?

JOSÉ MANUEL CAMPA

Chairperson - European Banking Authority (EBA)

Preparing for MiCA: The early mover advantage

In June 2022, the Council of the European Union and European Parliament reached a provisional political agreement on the European Commission's landmark proposal for a regulation on markets in crypto-assets (MiCA).[1] The agreement sets out a holistic approach to the regulation of crypto-asset activities in the European Union and marks the beginning of a new phase as both the financial sector and supervisory authorities turn their attention to readiness for application.[2]

For the financial sector, firms active in the sector need to gain an early understanding of the new obligations deriving from the regulatory framework, and to adopt a 'compliance by design' philosophy as crypto-asset products and services come to market in the transition phase. Moreover, those firms also need to ensure the proper marketing of products and customer profiling to make sure that consumers possess the skills they need to actually understand crypto-asset features and the value provided to them.

From a supervisory perspective, relevant supervisory authorities need to strengthen their abilities to understand better crypto-asset products and services. Such understanding should namely cover crypto-assets regulatory classification, distribution channels, and the interconnectedness both within and beyond the traditional financial sector. Furthermore, supervisory authorities need to continuously monitor the crypto-asset sector, including the marketing of crypto-assets via non-traditional channels, such as social media.

To support capacity-building by supervisory authorities, the European Banking Authority will continue its actions to facilitate monitoring and assessment of emerging crypto-assets and use cases across the European Union. With strengthened monitoring, we can equip ourselves with the information needed to ensure an effective enforcement of the requirements under MiCA and surveillance of new or emerging activities that may fall outside its scope but could warrant inclusion in the future.

Firms need to gain an understanding of the new requirements and a compliance-by-design philosophy.

The European Banking Authority will also continue to act where needed to mitigate any immediate risks, as demonstrated by our warning to consumers in March 2022[3] issued jointly with the other European Supervisory Authorities, and ongoing thematic analysis. The assessment of risks arising from new developments or uses in this front will continue to be a priority going forward. A case is crypto-asset staking and lending as highlighted in the European Banking Authority's May 2022 report on non-bank lending.[4] Another is decentralised finance, also known as "DeFi".

The European Banking Authority will also commence actions to prepare to deliver the extensive number of Level 2 mandates assigned to it under MiCA, for which the European Banking Authority will initiate early industry outreach. This outreach will namely include round tables and the publication of at least one discussion paper in addition to the normal consultation process. Crucially, the European Banking Authority will also begin the build-up of its new supervision function for issuers of significant asset-referenced and e-money tokens.

Strengthening the work of international standard-setters, including bodies such as the Basel Committee on Banking Supervision and the Financial Stability Board, and ensuring global coordination, in view of the importance of ensuring a globally consistent approach to the regulation of crypto-asset activities to secure the effective mitigation of risks and the unlocking of opportunities should continue to be a highest priority.

[1] Link to the EU regulation on markets in crypto-assets: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020PC0593.

[2] The EU regulation on markets in crypto-assets is expected to enter into force in 2023, with asset-referenced and e-money token provisions applying from 12 months from entry into force, and the rest 18 months after said entry into force.

[3] Link to the European Supervisor Authorities' warning from 17 March 2022: https://www.eba.europa.eu/eu-financial-regulators-warn-consumers-risks-crypto-assets. For all European Banking Authority publications on crypto-assets and FinTech, see the European Banking Authority's FinTech Knowledge Hub: https://www.eba.europa.eu/financial-innovation-and-fintech/fintech-knowledge-hub.

[4] Link to the European Banking Authority's report on non-bank lending from 4 May 2022: https://www.eba.europa.eu/eba-provides-its-advice-eu-commission-non-bank-lending#:~:text=In%20this%20Report%2C%20the%20EBA,new%20players%20entering%20the%20market.

MINDAUGAS LIUTVINSKAS
Vice Minister of Finance
of the Republic of Lithuania

Encompassing the crypto sector into the regulatory perimeter

New financial technologies have an increasingly crucial part in delivering cutting-edge services and products to consumers. They can make financial products more accessible and effective, enhance those already available, and meet market demands. Particularly, decentralized finance and crypto assets are becoming prominent industry keywords that are gaining more attention from both market participants and public institutions.

In order to guarantee investor safety while supporting innovation and maintaining Europe's competitiveness on a global scale, we, as policymakers, must keep up with these changes and apply appropriate regulatory adjustments. Furthermore, market participants are also becoming more outspoken about their concerns regarding cryptocurrencies as a means of wealth storage, which adds to concerns about their long-term durability as an asset class, especially in the changing interest rate environment.

Increased risks of illegal money laundering and terrorist financing activities involving such assets at an international scale, have demonstrated the need for efficient regulation and oversight of business operations in the crypto industry. In contrast to regulated traditional financial instruments, many services linked to crypto-assets are still mostly unregulated. This issue has become even more acute in the context of Western economic and financial sanctions against Russia in due to its war of aggression against Ukraine, with crypto assets providing a potential bypass of the sanctions regime. All this calls for action at the regulatory front.

In this regard the upcoming EU Regulation on Markets in Crypto-assets (MiCA) is very welcome and timely. It will introduce a wide range of regulatory requirements including prudential and conduct of business rules, a bespoke licencing regime and additional supervisory instruments. These new standards – in essence expanding the regulatory perimeter to cover crypto assets – will offer increased legal certainty and enable sustainable development of this market segment. Efficient and unified EU-level safeguards will be put in place, ensuring enhanced market stability and protecting investors' interests.

Awaiting pan-EU regulation to kick-in, Lithuania moves with enhancing domestic crypto regulation.

Lithuania has been an active supporter of the MiCA Regulation alongside with the Transfer of Funds Regulation, as both will bring better consumer protection, legal clarity and help ensure a level playing field for the crypto-sector market as well as create new legal instruments for the supervisors in terms of risk management. In this regard, we welcome the recent agreement along the co-legislators on the Regulations and look forward to their timely implementation. This crypto-tailored regulation puts the EU ahead of the curve globally.

While the EU level agreement is indeed a positive step forward, the new Regulations will come into force after a transitional period, with implementation of most elements expected to start in 2025. Taking this into account and reflecting on the domestic market developments, Lithuania has taken proactive steps – by "doing our homework" and upgrading the national regulatory framework – along the lines of the upcoming EU-level regulation – to tackle the potential risks heads-on and increase transparency and sustainability of this rapidly expanding market segment.

In June, 2022, Lithuania amended its national AML/CFT regulations applicable to the crypto assets sector. The amendments – which are seen as an interim step awaiting for unified EU regulations to kick-in – introduce a number of regulatory changes. For instance, it significantly increases capital requirements for crypto asset service providers, establishes a more immediate connection to the domestic market, strengthens reputational requirements and ensures more thorough customer identification procedures – including via prohibition to open anonymous accounts and obligation to identify transactions parties from a given threshold. The regulatory changes also enhance transparency of this market segment by establishing a public list of all crypto-asset service providers operating in Lithuania.

These amendments will increase regulatory clarity, enabling sound and balanced development of the sector and substantially enhancing risk management capacities – be it AML/CFT or risk of avoidance of the international sanctions regime. These changes allow Lithuania to remain one step ahead in the broader Fintech regulation context and lay the groundwork for broader pan-EU regulatory changes that will be brought about by MiCA.

As a jurisdiction, Lithuania will continue with a proactive and balanced approach, providing well-defined regulatory climate and promoting innovation in the financial sector, bringing benefits to consumers, investors and the broader economy.

TOMOKO AMAYA

Vice Minister for International Affairs - Financial Services Agency, Japan (JFSA)

Three major policy perspectives for financial regulators regarding crypto-assets

There are three major policy perspectives for financial regulators to consider concerning crypto-assets: financial stability, user protection, and AML/CFT. Crypto-asset related AML/CFT measures have been developed by FATF (Financial Action Task Force) since 2015. On the other hand, international regulatory discussion is still at an early stage in the areas of financial stability and user protection. In Japan, partly in response to the cases of massive hacking and spread of speculative transactions, a regulatory framework has been developed from all three policy perspectives. Most recently, amendments of relevant laws have been enacted and will enter into force by June 2023 to provide a regulatory framework for digital-money type stablecoins (e.g. fiat-currency backed stablecoins and equivalent ones).

Financial Stability

From the perspective of financial stability, particular attention should be paid to stablecoins, which are, or are claimed to be, linked to a fiat currency, since they are susceptible to runs. To address the risk of a run, policy measures need to be taken to ensure redemption at par and price stabilization.

To this end, in Japan, only banks, fund transfer service providers, and trust companies are entitled to issue stablecoins, and each is subject to the requirement to ensure redemption, as follows.

- Banks issue stablecoins as deposits. They are already subject to prudential regulations and stablecoin holders are protected by deposit insurance in the same manner as conventional bank deposits.
- Fund transfer service providers issue stablecoins as claims on outstanding obligations. They are required to secure the obligation through either money deposits with official depositaries, bank guarantees, or segregated safe assets, such as bank deposits and government bonds.
- Trust companies issue stablecoins as trust beneficiary rights. They are required to hold all the trusted assets in the form of bank deposits.

International discussion is at an early stage regarding financial stability and user protection.

In the Japanese regulatory framework, tokens that do not meet the above requirements are categorized as "crypto-assets," the same category as bitcoins. As explained later, crypto-asset exchange service providers are subject to advertising and solicitation regulations and are required to explain the risk of price fluctuations to customers. They may handle so-called stablecoins, but they have to explain that the prices are not necessarily stable. As of now, DAI is the only token, or so-called stablecoin, circulated in Japan.

Other policy measures to ensure financial stability include capital requirements for stablecoin intermediaries. In addition, traditional financial institutions' involvement in crypto-asset business is limited because of the scope of business regulations and supervisory guidance. The various user protection measures below also serve financial stability by enhancing confidence.

User Protection

User protection consists of various aspects, including the protection of user assets and the provision of sufficient information to users. From this perspective, crypto-asset exchange service providers, including custody service providers, should be subject to proper regulation and supervision and maintain proper internal control systems.

From the viewpoint of the protection of user assets, in Japan, service providers are obligated to preserve user assets, to have proper segregation of assets and financial statements audited, and to maintain system security. In particular, in response to the experience of major hacking incidents, service providers are required to manage crypto-assets deposited by customers in an off-line environment (so-called cold wallet), in principle.

From the viewpoint of the provision of sufficient information, crypto-asset exchange service providers are subject to advertising and solicitation regulations and prohibited from deceptive advertisement as well as solicitation enticing speculation. Furthermore, in order to avoid highly leveraged speculative transactions, a minimum margin of 50% is required for CFD transactions by retail users.

Stablecoin intermediaries are subject to similar requirements to protect user assets. In addition, they are required to enter into contractual agreements with issuers that stipulate the sharing of liability for losses in order to ensure proper coordination between the issuers and intermediaries in case of accidents.

Globally, the recent turmoil in crypto-asset markets has crystallized the vulnerabilities of crypto-asset markets and risks to financial stability as well as user protection. The FSB and international standard-setting bodies are intensively working on regulatory and supervisory approaches to address the risks posed by crypto-assets, including stablecoins.

This is a matter of urgency and JFSA will actively contribute to the discussion.

MORTEN BECH

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

DeFi - crypto's microwave moment?

In 1945, engineer Percy Spencer was experimenting with radar. While testing a machine called a magnetron, he noticed that the heat it produced melted a chocolate bar in his pocket. Additional tests with popcorn and eggs cooked food quickly. Spencer then developed a metal box to keep the energy trapped and voilà: the microwave oven was born.

The history of science is full of ground-breaking discoveries made almost by accident, as by-product of research on something else. It might be the case again with cryptocurrencies. Cryptocurrencies do not perform money's fundamental functions and their shortcomings have been well known-for some time.[1] Today, in an era where the focus is on energy conservation, crypto now gobbles up as much power as Argentina and its 40 million inhabitants, according to research by The Cambridge Centre for Alternative Finance.

Crypto's microwave oven might well be decentralised finance – "DeFi". DeFi seeks to replace traditional financial intermediaries (like banks, custodians and settlement companies) and centralised systems with smart contracts, self-executing pieces of code governed by the blockchain. These new decentralised systems could offer a glimpse of features to enhance the current monetary system. The ability of DeFi to safely hold assets directly might help to broaden access to financial markets. New governance arrangements might spread control of infrastructure more equitably. Blockchains could make infrastructure more operationally resilient by removing single points of failure. Smart contracts could automate processes that require intermediaries today. Put together, these improvements might also streamline the processes for cross-border payments.

But DeFi still requires trust – trust in both its code and its governance. And even more importantly, it requires of its users both technical and financial nouse. Today crypto insiders are exploiting users' lack of experience. Activities that are illegal in traditional wholesale markets (eg front-running), are carried out with impunity in the crypto sector. Money launderers too love crypto.

So can DeFi be saved and its merits put to use for the public good? Earlier this year the BIS Innovation Hub held a conference on DeFi with the Swiss National Bank.[2] Much of the discussion centred on this question. For many, the answer was the same as traditional finance – "regulation" is required. But what exactly do people mean by this?

Safer DeFi is possible with the right regulation.

Regulation is broad. Starting from the foundations, the acronym soup of KYC, AML and CFT is the equivalent of regulatory hygiene, boring but necessary for the integrity of the system. But, as in day-to-day life, basic hygiene is necessary but not sufficient for success. Regulation should mean a lot more than just compliance and can be a business enabler as it can foster trust. Good compliance does not prevent algorithmic stablecoins from incorporating feedback loops that exacerbate stress rather than dampen it (eg so-called "death spirals"). Nor does it require other stablecoins to be backed with sufficient, diverse and high-quality assets. It prevents neither hacking nor front-running. Neither does it outlaw opaque governance structures that subvert control of seemingly decentralised arrangements.

Put simply, DeFi needs to instill more trust. It needs accredited auditors and reliable due diligence for code. It needs clear requirements for stablecoins where possible. And decentralised systems need to meet clear standards. Oversight could then look like traditional infrastructure oversight: those responsible are held to standards and censured if they fall short. The focus is on the participants and the overall system. Enforceability may be more difficult than today (ie there may be no operator to censure) but as data are all public, risks could be assessed. Changes to system design and governance could be accomplished indirectly, for example by requiring supervised intermediaries to participate in safe infrastructure.

Safer DeFi is possible with the right regulation. But no financial system is really safe unless it is built on stable money. Central banks are currently wrestling with the question whether to issue their own digital currencies, which might run on new distributed ledger-based technology. The BIS Innovation Hub is collaborating with central banks on how these new currencies might also interconnect across borders.[3]

Issuing a central bank digital currency for use in DeFi might be the next policy frontier. It might help make DeFi successful and sustainable. Yet the basics need to be in place first. "Radarange", the first commercially available microwave oven, was 1.80 meter tall, weighed over 300 kilos and cost over 60,000 US dollars in today's money. Today they are in most kitchens because regulation made them safe enough to trust while innovation made them small, cheap and efficient. Both are needed, as well as responsible use. Cooking something unattended on full power usually results in a hot mess.

The views expressed in the article are those of the author and not necessarily the views of the BIS.

[1] https://www.bis.org/publ/arpdf/ar2022e3.htm
[2] https://www.bis.org/events/220404_defi.htm
[3] https://www.bis.org/publ/othp51.pdf

FARYAR SHIRZAD
Chief Policy Officer - Coinbase

Seizing the potential of Crypto for Europe

Well-designed and appropriately implemented crypto regulation will put economies at the forefront of the digital finance revolution and the advent of Web3. The recent EU agreements on the Markets in Crypto Assets (MiCA) and Transfer of Funds (TFR) regulations are groundbreaking: Europe now has the most comprehensive regulatory regime globally and a single rule book for crypto assets across the world's largest economy. This provides important legal and regulatory certainty to the market so that firms have the confidence to invest and grow within Europe.

The innovative potential of crypto technology presents enormous opportunities for Europe. These opportunities fall into three buckets: crypto as an investment, as a new financial system, and as an application platform. They are closely connected, but each explains a different use case as to why crypto could be transformative for the global economy.

Crypto as an investment is the use case most people are familiar with. Making such an investment shows a belief not only in crypto and blockchain technology generally, but also that the token being invested in has some characteristic, be it technological or otherwise, that makes it worthy of investment consideration. This investment in a still somewhat nascent market is driving the innovation and use cases of tomorrow.

Crypto as a financial system means creating new digital tools and services beyond buying and selling, as the needs of crypto customers broaden. Decentralized finance, smart contracts, and other new technologies will drive financial inclusion, and exponentially expand opportunities to improve our financial system around the world. Europe must decide what role it sees for stablecoins in this new financial system, versus CBDC and fractional reserve banking; for now, it appears the EU will be a challenging market for stablecoin issuers.

While the first two areas are critical, the one with the most opportunity for creativity, innovation and expansion into different industries is crypto as the next app platform and the basis of Web3. The decentralized ownership afforded by crypto gives users the opportunity to develop new financial and non-financial applications. In content creation for example, crypto increases the ability for creators and owners to monetize their content by allowing owners to track their content indefinitely, and be paid when content is transferred. This is the premise of Web 3 - giving users ownership over their content, data and assets via crypto and blockchain technology.

The innovative potential of crypto technology presents enormous opportunities for Europe.

It's crucial that Europe makes the right policy choices now, so that it is well positioned to capitalize on the next wave of technological innovation for the future. There is an important debate around personal wallets (self hosted wallets) and the right level of privacy, balanced against the potential illicit finance risks. The reality is that personal wallets reduce cyber risks, break open monopolies, and are essential for advancing user ownership in Web3. Like all crypto, they are an exceptionally weak tool for money laundering because of their transparency, traceability, and permanence; this is why the threat of crypto enabled financial crime is insignificant relative to Tradfi. Principles of privacy should be upheld, and the potential innovation personal wallets can foster should be recognized.

Europe has been grappling with the appropriate regulatory treatment for crypto assets to foster this important innovation, whilst also addressing the risks. MiCA has the potential to drive a legitimate and trusted industry of Crypto Asset Service Providers (CASPs). Key to this is ensuring consistently high standards applied by national authorities in the assessment and awarding of MiCA licenses - ESMA will have a critical role to play to ensure consistency in supervisory outcomes and full compliance by CASPs. The EU must also take a stance against entities that have strong links with jurisdictions that have weak or no regulatory or AML standards. Standards must be raised across the sector: this means that firms offering services to EU customers must adhere to important regulatory, AML, illicit finance and sanctions rules.

Countries around the world are watching carefully to see if the EU has the balance right: between fulfilling the important regulatory objectives of financial stability, market integrity and consumer protection, and creating the right conditions to spur innovation and growth.

The next wave of technological innovation is upon us, and the rewards are there for the taking.

ANTONIO ALVAREZ
Chief Compliance Officer - Crypto.com

Mainstreaming of crypto-assets: the next frontier

The current financial system needs an upgrade. Our historical system is built on slow and expensive capabilities, leaving many underserved or even poorly banked completely. With its promise of borderless access, transparency, auditability, and programmability, blockchain and the tokenization of assets can help create a financial system that is more affordable, efficient, inclusive and secure.

Blockchain technology has the potential to reshape many industries beyond finance, and be the most significant disrupter since the Internet. Many governments globally are investigating and encouraging the adoption of blockchain technology across several sectors, such as energy, telecoms, healthcare, and supply chain management. Responsible innovation through blockchain is possible, and most effective, when governments, multilaterals and the private sector work together.

We are also seeing greater institutional interest in the crypto asset market and accompanying regulation which is positive: it signals a maturing crypto asset industry. Regulation tailored to crypto asset service providers and issuers of crypto assets is key to our long-term success.

A globally connected economy must have global standards. They ensure safe, secure, and responsible behavior across the ecosystem on which more impactful end products can be built. The building blocks for a comprehensive regulatory environment no matter which country are, amongst others: Consumer Protection, Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT), Sustainability, Data Privacy and Security across the entire customer journey, including the on/off ramp into the crypto industry.

I believe that there are three key areas on which industry and policy-makers must collaborate to lay the foundation for an even broader segment of society to participate in the crypto economy in a safe and secure way.

Firstly, effective AML and CFT rules and KYC policies are core to the continued growth and success of the crypto industry. Policy-makers must encourage the adoption and use of next generation compliance solutions, including best-in-class digital onboarding, identity and verification solutions as well as use of blockchain analytical tools for ex-post monitoring of transactions. And as importantly, policy-makers must rely and accept the standards, controls and supervision imposed by other policy-makers deemed to comply with FATF's global standard. Blockchain technology is inherently global, so there is no concept of domestic versus cross-border transactions.

Regulation tailored to crypto asset service providers and issuers is key to our long-term success.

Secondly, high standards for transparency, market integrity, resilience, security and investor and consumer protection are non-negotiables in any safe crypto market. This means proportionate regulation of stablecoins, in particular with respect to the composition and transparency of their reserves and customer redemption rights. We believe that the EU Markets in Crypto Asset (MiCA) Regulation will be an important reference point for other jurisdictions in this regard.

Thirdly, we believe that sustainability disclosure requirements and increased regulatory scrutiny of the consensus mechanisms used to validate crypto transactions may both accelerate the transition to Proof of Stake - a trend that incentivises greater use of renewables in Proof of Work mining, which is already in train. And ultimately, as crypto assets become increasingly mainstream with institutional participation, an additional driver to reduce the carbon footprint of Proof of Work will come into play.

Our principled approach to regulation is to support an approach that balances open access to global crypto markets with a local presence to exercise supervision. MiCA affords the possibility to passport services across borders, which supports this balance.

At the macro level, international alignment and consistency on areas such as AML/CFT rules is important: consistent global regulation and implementation reduces regulatory and jurisdictional arbitrage and makes the business environment easier. Efforts by the Financial Action Task Force (FATF), International Organization of Securities Commission (IOSCO) and the Financial Stability Board (FSB) to set minimum global standards for the crypto industry are welcome and partnership with industry on setting these standards will be critical.

The importance and utility of the underlying technologies and principles of crypto assets are constant and irrefutable. Whilst the industry is cyclical - like many others - industry and regulators must stay focused on advancing the expansive opportunities for crypto.

We believe that forward-looking, globally aligned, tailored regulations will enable an environment for even more responsible innovation by the crypto industry, and critically protect consumers and uphold market integrity in all its facets.

DANIEL KAPFFER

Chief Financial Officer & Chief Operating Officer - DekaBank Deutsche Girozentrale

Big, bigger Blockchain!

The EU efforts in harmonizing the market for crypto-asset issuers and service providers are impressive. MiCA, DORA, CSDR and the DLT Pilot Regime are important regulations to push Europe towards a digital technical leader in the financial sector. In these regards, we highly appreciate the regulation proposals of the Digital Finance Package.

In this context, blockchain technology plays a pivotal role. Essentially digital assets can only unleash their full potential when they are DLT based. It has inherent advantages (anti-counterfeiting, etc.) that no other technology can offer. On the long run, blockchain and DLT will lead to a convergence of pre- and post-trade processes into a trusted single point of truth for transactional data. Increasingly, digital assets are on the investors agenda. They hold digital assets and want to continue to increase allocation, while at the same time various institutions and infrastructure participants are expanding their digital asset capacities.

Undoubtedly digital assets need to take a significant portion of the securities market and the capital markets overall. Competition on digital assets is global!

However, the EU needs to be faster and more decisive in its regulatory plans. Obviously, blockchain is already becoming an arena for competition between countries. For example, as a result of the U.S. President's executive order on crypto the U.S. Treasury Department published a fact sheet stating the objective to reinforce "U.S. leadership in the global financial system". More from a technological stand point China has well understood the relevance of blockchain for its international ambitions.

In addition to emerging geopolitical and geo-economic challenges, political challenges also arise with the development of blockchain, as a truly decentralized blockchain challenges the ability of authoritarian governments to exercise tight control over their populations.

Currently, activities in the EU seem to be unfolding primarily in response to external pressure (LIBRA/DIEM, Chinese digital central bank money, etc.). In addition, they are highly focused on risks not opportunities – however missing out on the opportunities is quite frankly the biggest risk of all. This could lead to a further loss of competitiveness as a financial center in Europe.

The biggest risk is missing the boat and thus not being present in the market.

A current example for a pragmatic and quickly implemented regulation is the EU DLT Pilot Regime. The DLT Pilot Regime introduces an EU-wide regulatory sandbox within which companies willing to operate securities trading and settlement systems based on DLT, can be exempted from certain requirements that apply under the existing EU regulatory framework and that could hinder the use of DLT in securities trading. Thus, the regulation offers the possibility to examine how DLT-based projects can be developed for mass business.

Although these efforts are very welcome, further efforts need to be made at this stage to enable technical developments. First of all, the scope of action of the Pilot regime is very narrow. The DLT Pilot Regime will only apply to certain types of financial instruments. In addition, the aggregate market value of all the DLT financial instruments that are admitted to trading on a DLT market infrastructure shall not exceed EUR 6 billion. If this threshold is surpassed, the operators of the DLT market infrastructure must initiate a special transition strategy to reduce trading activity on their platform.

Given these limitations the EU DLT Pilot Regime might not be as attractive as the EU Commission would like and as it needs to be. The limited use should not be interpreted to mean that the industry does not need such a regime – the opposite is the case.

In principle, the European institutions have already recognized the blockchain as an emerging technology to invest in. Thus, the EU is already taking an active role in shaping of blockchain standards, but the standards landscape is complex, fragmented and competitive. Like the internet, blockchain raises a variety of political challenges and is already becoming a battlefield for competition between different types of political systems.

To sum up, the digital market is maturing and taking shape in the financial industry. So the more digital assets gain in importance, the greater the need for an ecosystem specialized in the needs and specifics of digital worlds. The classic financial architecture will not become obsolete. The new structures must be integrated, because the traditional structures offer far too many advantages that traditional banks in particular should not give up.

Therefore, we need to encourage the development of crypto assets and the wider use of DLT and support innovation in Europe. The biggest risk is missing the boat and thus not being present in a foreseeable significant part of the market. Let us ensure that the EU does not fall behind other jurisdictions.

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DEFI PROSPECTS AND REGULATORY IMPLICATIONS

IOTA NASSR

Economist, Financial Markets Division - Organisation for Economic Co-operation and Development (OECD)

DeFi - TradFi interconnectedness and the role of stablecoins

DeFi has been attracting an increasing number of retail and institutional investors in an environment that lacks any of the traditional safeguards for investor protection and market integrity, giving rise to risks that call for policy consideration and action.

Such risks are associated with excess volatility, unregulated leverage and other forms of regulatory arbitrage, governance weaknesses, risk of market manipulation and new forms of concentration risks, and risk of illicit finance or outright fraud.

Growing interconnectedness between DeFi and traditional finance (TradFi) can give rise to investor risks at the micro-level, while it may also create channels of potential contagion to traditional markets.

Stablecoins: a double edged sword for DeFi and the key bridge to TradFi

Stablecoins are an indispensable ingredient and a foundational basis of DeFi. As stablecoins are perceived to be more stable than highly volatile crypto-assets, they are used as a way to hedge against crypto volatility without needing to convert crypto into fiat and without the use of traditional financial institutions. Stablecoins are also used as collateral in leveraged lending, and as trading facilitators within DeFi in decentralised exchanges.

But stablecoins also constitute one of the greatest points of vulnerability of DeFi, and the connecting tissue that links DeFi and TradFi. Recent OECD analysis around DeFi and the institutionalisation of crypto-assets anticipates a scenario where a major stablecoin loses its peg and describes the risks of disruption to digital asset markets that could result from mass redemptions of stablecoins.

The recent Terra failure points to the need for action

The recent failure of Terra's UST stablecoin was a good case study of such risks: UST broke its peg and suffered a "death spiral" that resulted in significant losses for holders without any recourse for compensation, becoming a valueless stablecoin in less than a week.

Although there are indeed differences between the different types and design models of stablecoins, the run-risk that UST experienced applies across the board for such arrangements. A fall in the price of reserve assets, failure to safeguard them appropriately, lack of clarity regarding the redemption rights of holders or operational risks and disruption related to cybersecurity are all factors that can undermine investor confidence, leading to self-reinforcing cycles of redemptions and fire sales of underlying assets.

A negative sentiment toward crypto-assets or a severe disruption in DeFi platform could spike large demand for stablecoin redemptions that would as well turn into a classic run due to an insufficient amount of liquid backing assets. Such fire sales could disrupt critical funding markets with potential impact on financial stability overall, especially given that traditional financial institutions may hold assets of stablecoin reserves.

The importance of confidence in DeFi markets

The subsequent de-pegging of Tether's USDT stablecoin points to these risks: although the price of Tether's stablecoin recovered quickly, the incident highlighted stablecoin vulnerabilities and the important role of trust and confidence in DeFi markets.

This is particularly critical amid a broader market sell-off of mainstream crypto-assets and given the possible spillovers of risks from DeFi to TradFi. As OECD analysis highlights, given the significant holdings of commercial paper as part of reserves backing major stablecoins such as Tether, sudden mass redemptions of stablecoin arrangements can affect the stability of broader short-term credit markets.

DeFi risks and growing interconnectedness DeFi - TradFi calling for policy consideration and action

If the adoption of crypto-assets continues to increase, the linkages between DeFi and TradFi may become stronger, possibly increasing the risk of spillovers into traditional financial markets. Policy makers have a role to evaluate emerging risks and consider policy actions to address them, in a coordinated manner given the inherent global nature of DeFi markets.

All that said, the potential benefits of DeFi should not be underestimated or overlooked. It is important that policy makers consider ways to enable safe and responsible DeFi innovation in a compliant manner, while anticipating and addressing emerging risks for both participants and the markets.

The OECD and its Committee on Financial Markets remain committed to exploring how to foster the benefits of digitalisation for financial markets and their participants, while proactively addressing the prudential and potentially systemic risks emerging from applications such as DeFi at a global level.

For more on DeFi https://www.oecd.org/finance/why-decentralised-finance-defi-matters-and-the-policy-implications.htm ;

https://www.oecd.org/publications/institutionalisation-of-crypto-assets-and-defi-tradfi-interconnectedness-5d9dddbe-en.htm

FERNANDO RESTOY

Chair - Financial Stability Institute (FSI)

DeFi: some points for a regulatory reflection

In principle, the concept of DeFi extends way beyond the cryptoasset world. While both share a reliance on new technological capabilities enabled by DLT, such as programmability, composability and tokenisation, DeFi could, at least theoretically, expand over a large set of financial activities that do not need to be associated with specific tokenised assets. Yet, in practice, most relevant DeFi applications are linked to cryptoassets. In particular, DeFi applications have been instrumental to the development of lending and trading facilities for some (normally unbacked) cryptoassets. Moreover, such applications rely on stablecoins (SC) for the transfer of funds and settlement of transactions.

In other words, DeFi is currently far from becoming an alternative mechanism for the allocation of financial resources within the real economy. Instead, it has focused mainly on speculative investment in a set of specific instruments that contribute little to market completeness or social welfare.

Yet one should not underestimate the potential of DeFi to become much more relevant in the future. The possibility of using new technology to facilitate financial transactions without the participation of intermediaries may contribute to cost-efficiency. At the same time, it remains to be seen whether totally decentralised systems can achieve sufficient scalability and security to become a truly effective substitute for traditional financial intermediation.

In any case, the currently limited importance of DeFi applications and the potential for further future expansion make a good environment for policy reflection. This should aim at establishing a regulatory framework that could ensure that DeFi developments take place in an orderly and socially acceptable fashion.

There is already an emerging consensus on the main risks posed by DeFi. These risks arise from the possible use of such instruments to finance illegal activities, their potential to promote overleveraging and lending procyclicality, operational discontinuities stemming from the underlying technology and cyber attacks and a number of issues affecting consumer protection, among others.

DeFi requires specific regulation and enforcement but let's start with stablecoins.

These risks are no different to the ones currently addressed by existing financial regulation. Yet, it would be a mistake to conclude that DeFi requires authorities only to adjust the regulatory perimeter of different financial activities to include DeFi alongside traditional finance. This is so for at least two reasons:

- First, specific rules may be required, as most of the risks posed by DeFi manifest themselves in a singular fashion. This is certainly the case with AML/CFT regulation. Standard obligations relating to customers' due diligence and KYC, as currently imposed on legal entitites, could be ineffective in a decentralised setting. As for excess leveraging, this may come from specific developments such as the multiple use of the same (cryptoasset) collateral for different lenders, a problem that is less likely to apply to bank lending. In addition, operational risks stem from unique features such as unstable or insecure software or automatic protocols (smart contracts).
- Second, for both regular and DeFi-specific rules, enforcement procedures need to be specifically designed to cope with decentralised operations that extends beyond borders. A major task should be to identify the parties benefiting from the DeFi business and assess whether and how they could be made responsible for regulatory compliance.

Under such conditions, it is not sensible to simply rely on the slogan "same activity, same regulation". Since the activities are performed differently and the risks materialise in different forms, regulation would need to address DeFi's special characteristics. Furthermore, the application of the (conceptually sounder) slogan "same risk, same regulatory outcome" may face substantial challenges. A thorough and internationally coordinated consideration of these issues is therefore needed.

An area where regulatory action is particularly urgent is that of SC. Recent experience shows the potential for SC to generate considerable stress. Failure to maintain confidence in the convertibility of SC with fiat currency at par value could generate runs and turbulence that could eventually spill over into other payment instruments.

The use of SC in DeFi applications – including collateralised leveraged transactions – could certainly amplify the disruption that stablecoins could generate, creating the potential for contagion to the traditional financial system. DeFi therefore strengthens the case for regulatory actions aiming at addressing risks posed by SC-related activities.

At the very least, it would seem warranted to introduce prudential requirements – akin to those imposed on credit institutions – for SC issuers to ensure that they can manage the risk and liquidity transformation they undertake.

MARTIN MOLONEY

Secretary General - International Organization of Securities Commissions (IOSCO)

What is decentralised finance telling us?

As the prices of crypto assets have plummeted, it might seem to some that crypto require less attention. Decentralised Finance ('DEFI') tells us a very different story, simply because it has been replicating so much of what happens in traditional finance, but in slightly different ways.

The similarities to conventional finance are significant, particularly when considered with the differences. The best illustration of the point is the publicly reported application by FTX to the USA CFTC for approval to offer Bitcoin futures contracts with an automated margining mechanism. The proposal relates to Bitcoin and is based on ways of doing things developed in DEFI. However, the implications for margining practices more widely in the futures markets are obvious. In an intermediated market, margin calls involve a lag while the intermediary gives some time for the investor to provide the additional margin. In the DEFI world, there is no margin call and no time delay. Additional margin is automatically withdrawn and if unavailable immediately the futures contract is closed out.

Irrespective of the CFTC's decision on the FTX application, the point in the example is clear: there are other ways to design financial products with lower intermediation costs and some of those are the focus of experimentation in the world of DEFI.

A futures contract with an automated margining mechanism is probably a different product than a conventional futures contract with a margin call mechanism. The two could in principle exist side by side: different products with different pricing and different risks. But they don't. They could compete for survival and the market could decide which it likes: but they don't.

Conventional markets don't offer automated margining mechanisms and DEFI markets do. That is the point: 'crypto' has proven to be an alternative space over the last decade and particularly since DEFI emerged for financial products to develop.

To build an analogy with evolution in nature, we might imagine a peninsula turned into an island by rising seas, new species evolve in this separate space and somehow get back to the mainland to compete with their erstwhile brethren. DEFI shows that crypto might be such a space.

In some ways, this development answers the long-term, often valid scepticism over the last decade that crypto has no substantial uses. Its claimed use-cases are often just empty hype. In the case of DEFI, we see some apparently viable new species of products. Will any survive contact with the mainland?

DEFI signifies that crypto has become an alternative space for financial products to develop.

Regulators now face the challenge of deciding whether to facilitate the potential competition between financial products designed in DEFI and more conventional financial products. How will regulators proceed? The principle of 'same risk/same regulation' guides most regulators in figuring out what to do. An additional key principle can be imported from IOSCO's work with the CPMI to assess how Stablecoins should be managed, namely that there must be clear and direct lines of human responsibility and accountability for the operations and actions of any supposedly decentralised system. As legislators begin to develop better legislative frameworks – notably MICA – that also helps, particularly when it comes to the key issue of how far to go in facilitating innovation.

IOSCO has recently published its roadmap for crypto regulation. This comes after publishing a detailed report on DEFI. We think DEFI is very significant for indicating what crypto has become. Close attention again to DEFI is, unsurprisingly, at the heart of what we are going to focus on in this next phase of our work. Our ambition is to lay out a basic, internationally applicable framework based on our principles and recommendations to govern crypto and digital asset activities that mimic financial products.

Regulators will need to keep in mind that crypto has repeatedly shown us that the challenges to market integrity and the risks of investor harm that we work to address in all financial markets recur as soon as anyone tries to replicate any aspect of financial markets. As part of recent events, we also saw the failure of the Anchor Protocol and a number of crypto lenders in a chain reaction of significant distress.

One of the lessons of those events is that if DEFI can replicate financial products, it can also replicate other features of financial markets: in particular, their capacity to develop inter-connections that can threaten system-wide instability. The brave new species that developed on the crypto island will need to prove its competitiveness if released back into the mainland and will be at least as in need of regulation. What has been will be again.

JENNIFER PEVE

Managing Director, Head of Strategy and Business Development - The Depository Trust & Clearing Corporation (DTCC)

FMIs have a crucial role to play in advancing accessibility of DeFi

Decentralised Finance, more commonly known as DeFi, has been one of the finance industry's hottest buzzwords this year.

At a high level, DeFi is defined as technology-enabled access to financial services such as the trading, lending and safekeeping of assets without the reliance on financial intermediaries. However, recent events have shown that this term is often overused and that, in many instances, DeFi activities are not as decentralized as some may think. The most recent crypto crash, and the resulting scrutiny, has shone a spotlight on intermediaries, raising questions about just how decentralised these DeFi models really are and what risks they may introduce to the ecosystem.

At the same time, the industry has begun to differentiate between specific areas of financial services, such as traditional finance (TradFi) and centralised finance (CeFi), as well as pure DeFi where there is truly no central control/operator. While aspirations to establish true DeFi models remain, the practical reality is that many institutional market participants are not yet ready to realise this vision and some functions will continue to be performed by central intermediaries.

When considering the move to DeFi, regulated financial market infrastructures (FMIs) have an important role to play. FMIs are the optimal providers to serve in an intermediary role, bringing the robust risk management and proven capabilities that come with such a responsibility. Additionally, FMIs are well placed to ensure the worlds of TradFi and DeFi do not develop in silos. The concept of on-ramps and off-ramps, where there is an exchange of DeFi assets with TradFi assets, clearly highlight where regulatory checkpoints are needed if TradFi assets are to interact with DeFi.

FMIs can also provide solutions around on-chain identities to address regulatory compliance concerns, as well as to satisfy KYC requirements. For example, consider the use case where an FMI plays a role in credentialing market participants with a verifiable ID. This could go a long way in building trust in DeFi by ensuring that even if a transaction occurs without any intermediary, the parties to that transaction can be confident in who they are transacting with.

Regulated financial market infrastructures have an important role to play in DeFi accessibility.

What is more, FMIs could potentially provide solutions that put TradFi assets to work in a DeFi ecosystem, leading to greater adoption by the institutional marketplace, and ultimately benefitting end investors. TradFi assets have significant potential to be leveraged in DeFi strategies, but only if the worlds of TradFi and DeFi can work together. Many opportunities could be unlocked, such as tokenising traditional assets to be leveraged as collateral in the DeFi lending ecosystem.

DTCC firmly believes in the potential of an increasingly digitised financial services ecosystem. However, any new technology initiatives in this space must provide equal or greater risk management and operational resilience capabilities than existing infrastructure and solutions, protecting and safeguarding the industry and individual investors.

Consider smart contracts that manage tokenised securities. While smart contracts could technically operate without any 'owner' and be truly decentralised, security and governance risks inherent to this model remain. There is also the possibility for FMIs to manage the smart contract, much like the approach DTCC is developing with its Digital Securities Management (DSM) service. Pending regulatory approval, DSM will employ technologies that allow for tokens to be held in a decentralised manner, with DTCC still providing governance and oversight, enabling more efficient processing and regulatory compliance.

As a final point, more concise regulation of DeFi in global jurisdictions can be expected to drive meaningful change in the marketplace by bringing clarity to existing participants and confidence to those adopting a wait and see approach. Asset definitions and regulatory agency oversight within the DeFi ecosystem could lead to more responsible growth and enable more institutions to participate in DeFi.

It is important to recognise that as the development and use of DeFi technologies evolve, it will continue to present risks as well as opportunities to the industry. Regulators worldwide are showing great interest in understanding the potential of DeFi and, as requisite legal parameters become more defined, it is crucial the industry can operate within an appropriate regulatory framework to capitalise on these opportunities, while mitigating risks to the financial system.

GEOFFREY KOT

Managing Director and Global Head of FM Electronic Trading - Standard Chartered Bank

Bridging the gap between Decentralised Finance and Traditional Finance

Standard Chartered Bank believes that Decentralised Finance (DeFi) offers important lessons and presents new opportunities for traditional finance. Whilst growth has predominantly been in North America and Western Europe, new platforms, exchanges and service providers have emerged globally, participating in a new decentralised, digital and open-source ecosystem built on blockchains. DeFi has grown rapidly in recent years, but its volumes are still small compared to traditional finance. According to the DeFi Pulse Index, the total value locked (TVL) of the DeFi market peaked at USD106.1 billion in December 2021. After significant volatility in April 2022, the TVL fell to USD 38.7 billion in June 2022.

The recent volatility in crypto-assets has been notable for triggering the collapse of a well-known protocol as well as several DeFi platforms and crypto investment firms. This is a timely moment for regulators, traditional finance and DeFi players to come together to review the journey so far and discuss the opportunities and risks that adopting new financial infrastructure may bring.

DeFi as an emerging financial technology is worth adopting

The technological innovation behind the DeFi evolution is an increasingly interesting proposition for traditional financial institutions. One of the interesting applications of the blockchain technology behind DeFi is peer-to-peer networks. The decentralised peer-to-peer model is scalable and can be applied to various forms of financial transactions that require an intermediary today (collateralized lending, interest-bearing deposits or investment portfolio management), the potential impact to the existing global financial system and its intermediaries become significant. By following the evolution closely, traditional finance could enable more efficient and scalable financial services to its clients.

Current challenges requiring consideration

To fully realise the potential of DeFi, key issues need to be addressed. An example is the lack of clarity on where the accountability lies in the event of a smart contract protocol not working as intended as the activity is performed by a software rather than a legal entity.

While TradFi and DeFi are now portrayed as competitors, the two models will co-exist.

While DeFi has been increasingly attracting both retail and institutional investors, it remains fundamentally unregulated on the global scene. It lacks the safeguards for investor protection and market integrity that are embedded within the regulatory framework for traditional financial services. This is particularly concerning given the excess volatility, leverage and new forms of concentration risks which are currently associated with the technology.

Inherent issues of the technology coupled with the recent market downturn are proving that regulatory consideration and action are needed. Based on the principle that activities displaying the same risks should be subject to the same rules, appropriately calibrated regulation is required to protect consumers and provide security and confidence in DeFi's underlying protocols. Effective regulation could in turn foster responsible innovation and improve institutional adoption.

In this context, we support the early work of international standards setters to explore and address existing regulatory gaps. Further consideration is needed on whether effective DeFi regulation could be achieved by applying existing rules to DeFi platforms or would necessitate a new set of rules tailored to the borderless and transnational nature of the technology.

Bridging the gap between DeFi and traditional finance

DeFi is a technological evolution that is still in progress. While traditional financial institutions and DeFi are currently portrayed as competitors, in the future the two models will co-exist.

To get to this end state, policymakers and market participants should work together and have an ongoing dialogue on the opportunities and address the challenges to support a proportionate regulatory framework that promotes responsible innovation.

At Standard Chartered, leveraging on our experience and capabilities operating as a traditional bank, we could help bridge the gap between traditional finance and the emerging DeFi ecosystem by contributing to policy and regulatory conversations and enabling digital asset service providers with access, services and tools to connect to our network through a wide range of solutions.

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DATA-LED INNOVATION IN FINANCE

DR. ALEX IVANČO

Director, Financial Markets III Department - Ministry of Finance, Czech Republic

Getting ready for Open Finance

The financial services sector is being transformed by greater digitalisation and through the exploration of possibilities offered by new technologies. Financial innovations are significant tools to promote the development of our economies, generate productivity gains and pave the way for greater financial inclusion. The single biggest enabling factor of FinTech innovation is data.

Several jurisdictions are engaging in Open Banking initiatives with great success, attaining a wide range of goals such as promoting competition in the banking sector to facilitating innovation, boosting financial inclusion, and creating new business models and services. The core of Open Banking resides in sharing financial data across the sector, however, there is no consensus across jurisdictions on the exact scope or form of data sharing, and usually the scope of shared data is fairly limited.

Yet, the potential of data is far from fully-exploited. Rather than strictly limiting the type of shared data, we should be actively paving the way to Open Data, to unlock data's full potential and to allow for a vast environment of discovery and exploration. The next step in this pursuit is the implementation of Open Finance. In general, Open Finance concerns the financial data of consumers at all regulated financial services providers: banks and non-banks such as payment institutions, investment firms, insurance companies and pension funds. Open Finance enhances the competition within the financial sector as it allows SMEs to access data in order to provide better or new services, while also forcing traditional financial service providers to understand consumers' needs and adapt their services accordingly. Simultaneously, it leads to greater financial inclusivity of consumers and their increased financial literacy as they are able to access the complete view of their financial lives in one place and are thus able to make more informed choices.

Within the EU scope there are currently a few important regulatory bases for data sharing in the financial sector as foreseen in Open Finance: PSD2, GDPR, and the digital policies within the European Strategy for Data such as the Data Act, the Data Governance Act or the AI Act. However, the European Commission has envisioned to have an Open Finance Framework in place by 2024. Consultations towards the Framework are currently ongoing, and its legal text should be published in the late 2022. Parallel to the consultation, the European Commission also calls for innovative firms considering to leverage Open Finance to provide their input within the Open Finance Virtual Fintech Lab as a part of its Digital Finance Outreach.

To establish the ideal environment for data sharing and to exploit the full potential of Open Finance, EU policy-makers should proceed with caution on legislation, making sure that technology-neutrality stays at the core of any activity. As open finance is about legitimizing innovation across multiple sectors in a consistent way, there is a growing need for non-duplicated regulation where regulations fit together meaningfully.

In addition to innovation-friendly regulation, the creation of a technical infrastructure for Open Finance is key and standards are a must-have in regards to Open Finance. Without unified/standardised forms of data, their sharing will be hindered, more difficult to use and therefore less useful for entitiesm hindering adoption of such schemes. Standards are also essential within the financial sector as there are already elaborate and difficult to navigate regulations for the field as well. Upon the creation of standards the potential conflict of regulations or uncertainties can be addressed and the clear certainty and orientation within the relations of regulations can be reached.

The European Union has had its long lasting focus on creating standards within numerous sectors to facilitate the free movement of goods, services and capital, including the financial services sector. EU has adopted common international financial regulatory standards as well as reporting requirements. While the extensive reporting requirements have greatly increased the responsibility of entities to build, maintain and invest into the necessary IT systems for the data to comply with the requirements that has been to all intents and purposes an essential positive development.

In regards to Open Finance, the creation of technical standards for sharing data through APIs is crucial. Furthermore, in the evermore globalised world, the EU should turn to the creation of International Standards for Open Finance. International Standards in general are an ideal tool in ensuring smooth trade and providing confidence in the products or services in question. Creating only local standards can artificially create technical barriers and later lead to waste of resources.

The European Union already recognises the need for technical standards in prescribing essential requirements regarding interoperability within the Data Act, which, if adopted, will be also implemented in the legislative acts of the European Strategy for Data. The need for interoperability and interconnection is also addressed within the Commission Staff Working Document on Common European Data Spaces, where the Commission calls for its development on international standards.

Open Finance and its adoption through Europe is an opportunity and a need, and it is upon us to ensure that its adoption is as smooth as can be. A strong focus on establishing fact-based secure interoperable global standards early on in the process will allow us to reap the benefits of Open Finance without any hindrance.

TSVETELINA PENKOVA

MEP, Committee on the Internal Market and Consumer Protection - European Parliament

Open finance is the next phase in the evolution of open banking

Open finance is the next stage in the evolution of open banking, expanding its capabilities and increasing value for customers, third-party vendors, and financial institutions. Open finance can be considered as an expansion of access to banking and financial data beyond the scope of just data on payment, that has already been in place for several years.

For the purposes of inclusiveness, it is logical to begin with making a distinction between the two concepts in order to convey the revolutionary possibilities of open finance. With open banking, data on bank customers can be accessed by outside financial service providers. In order for the latter to provide more individualised and use-case-tailored offers, banks employ this method to share data on their clients' transactions with outside parties. However, this method could be considered quite limited, as it does not go beyond data sharing in the bank operations itself.

Open finance, on the other hand, is a concept of collecting all of a user's financial information in one location, including but not limited to bank transactions, purchases made with digital wallets, payments made with insurance and retirement accounts, investments, money transfers, and cryptocurrency transactions. Open finance has the potential of opening new horizons for both consumers and businesses. Yet, challenges persist.

Opening more data for product providers, start-ups, scale-ups and SME's, would certainly lead to innovative services and products being deployed in the internal market. Further expansion of data will bring extra diversity of products that are innovative and better reflecting customers' needs.

Open finance can bring more transparency for both investors and customers. The latter will have the chance to improve their financial and credit score based on all of their financial data rather than just the financial information that their bank owns. Likewise, is advantageous for the investors, because it will provide further opportunities and low-risk strategies.

Proper standardisation can only be achieved via working together with the public and private sector.

The EU institutions are currently working towards implementing legislations and strategies to support the opening of the market to wider opportunities for all actors on the market.

In the finance industry, banks and insurance companies operate in a complicated, competitive business that is facing significant transformation pressure to stay in the market. AI certainly has the potential to boost the financial sector and transform entirely the way services are being delivered. Hence, the implementation of the new AI Act will facilitate and encourage the use of AI in the financial sector while ensuring minimisation of the risks associated with it.

Further, the new proposal for the Data Act will unlock even more data that will encourage a bigger competition on the data market and will open more opportunities not only for the already established financial institutions, but also for smaller players and newcomers on the market.

Likewise, the Digital Finance Package provides for even further guidelines for how Europe might promote the financial industry's digital transformation in the years to come while managing its risks. Thus, it will stimulate more companies to engage in the market, which will lead to new and innovative financial services to emerge. Of course, opening more and more data to freely flow in the market comes with certain risks, especially when it comes to cybersecurity and protecting personal and sensitive data. That is why at the European Parliament we are working continuously to improve the upcoming laws. Our aim is to make them coherent and future proof in order to allow business opportunities to flourish while ensuring the uppermost level of consumer protection.

PSD2 is a great example illustrating how to ensure security standards for the protection of customers' financial information while processing customer's data in electronic payments.

The Commission believes that there is a merit in extending the approach taken in PSD2 to other sectors, thus extending open banking to open finance. However, a standardized approach for sharing data and a high level of trust among actors is necessary. Proper standardisation can only be achieved via means of working together with the public and private sectors.

Challenges such as data safety, clear and precise legal framework, customer distrust and cyber related risks require special attention. We need to address those challenges before we proceed with the open finance implementation. Legislative elements must be cleared out first, before introducing a new ecosystem on the market.

In conclusion, the concept of open finance has the potential to foster a new financial revolution. Open finance can contribute to the twin transition – digital and green, which is the main political priority of the EU. However, important challenges remain and in order to ensure a high level of customer protections a proper regulatory, technical and digital implementation is required.

SÉBASTIEN RASPILLER

Head of Service for the Financial Sector - Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

Making the European financial market a world leader in data exploitation

Financial firms have always been among the major producers, owners and users of data. The explosion of banking and financial information exchanged by customers, the multiplication of data used in the financial markets, the increase in storage and computing capacities as well as the multiplication of analysis and prediction methods explain the financial industry's enthusiasm for big data and its algorithms.

Mastering data in the financial sector is a key competitive advantage that creates opportunities: optimising existing operating models, disrupting established value chains or implementing new business models. As a result, data are a central element of strategic transformation for traditional financial companies, offering a key to digital conversion of their business models. The challenge is also to build an efficient, responsible and ethical use of personal data. A leading financial company will probably gain more and more dominance by combining the power of its distribution networks with its ability to exploit the data available.

In the European Union, regulators are working to adapt the regulatory framework in order to allow financial sector players to innovate and use data properly. European supervisors have not only been thinking about the challenges of digitisation and how to deal with them, but have also adopted ways of using innovation to increase efficiency.

One important initiative to illustrate the above is the adoption of the European Payment Services Directive (PSD2), which was one of the first regulatory initiatives to open up bank account data. PSD2 has been in force for over four years now and has already reshaped the European payments industry.

The European Commission actually wants financial companies and others to share more data in order to create a "wider open financial space" with new services for citizens. This will involve creating a European financial data space where data can be accessed in a standardised electronic format.

It is possible to envisage even more accessible, efficient and innovative financial services.

Furthermore, in its 2020 Digital Finance Strategy, the European Commission has stressed as a third priority the objective of stimulating data-driven innovation in the financial sector by promoting data sharing between companies. In addition, in June 2021, the Commission established an expert group to provide it with advice on technical aspects in the preparation of legislative proposals and policy initiatives in the area of data sharing in the financial sector, in order to foster the creation of a common data space. The advice will also address the need for interaction with other sectoral data spaces as well as data sharing beyond the financial sector. Indeed, innovation in finance also relies on non-financial data, notably from online platforms, public entities, utilities, the Internet of Things (IoT).

The pressure to open up data now extends to insurance and savings: after open banking, we now speak about open finance. This pressure is pushing for further adaptation of the regulatory framework. In the payments sector, the main objective of PSD2 was to reconcile openness and security. While this issue remains relevant for moving from open banking to open finance, with digitalisation and the development of the platform economy, two other issues have emerged: reconciling innovation and integration on the one hand and competition and sovereignty on the other.

The European Commission has also recently published a proposal for a regulation on harmonised rules on fair access to and use of data (the Data Act). This legislation is intended to ensure fairness in the digital environment, stimulate a competitive data market, open up opportunities for data-driven innovation and make data more accessible to all.

We can therefore observe that public authorities have not only thought about the challenges of digitalisation and possible ways of dealing with them, but have embraced ways of using technology and innovation to support increase efficiency. This approach calls for a new supervisory culture and is part of a logic of exchange and mutualisation between supervisory authorities.

It is clear that the current transformations in the financial sector make it possible to envisage even more accessible, efficient and innovative financial services, while at the same time raising new challenges both for market players and for public authorities. Only a multi-faceted response, always complementary between public and private players, can face these challenges. In particular, this response should take into account strategic autonomy concerns, which have become key for the European Union and its citizens.

NATASHA CAZENAVE

Executive Director - European Securities and Markets Authority (ESMA)

Gearing up data-driven regulation and supervision in the EU

Data has become the fuel of today's economy. It feeds into business processes and the work of the public sector in a wide range of ways. It allows us to collect information and provides us with evidence upon which decisions can be taken. We can have data without information, but we cannot derive meaningful information without data.

The relevance of data is corroborated by the increasing number of innovative data-centric business models. Traditional financial firms rely more on third-party services, while FinTechs enter the market offering specialist services. At the same time, BigTechs have vast datasets from their consumer networks which can be used to strengthen their network effects.

Regulators and supervisors also collect and analyse more and more datasets that enable them to further their understanding of market functioning and refine their risk monitoring efforts. Data also provides the right conditions for the design of evidence-based policies that tackle market failures more effectively, as well as the remediation of entity-specific risks through data-driven supervision.

One key area of focus of regulators is data quality and standardisation to ensure the data collected is actually usable. Regulators should aim at ensuring standardisation and consistency across various data requirements. Standardisation supports effective supervision and reduces compliance costs because the same data can feed into multiple reporting and transparency obligations, while also facilitating the improvement of data quality.

In the EU, various initiatives have been put forward that underscore the Union's ambition to lead in a data-driven world. Data is an important element of legislative proposals for an EU regulatory framework on crypto-assets and on digital operational resilience. It is also a pivotal aspect of existing sectoral legislation, such as major reporting regimes. Overall, the existing framework provides a robust base for the use of data in the financial sector, including by ESMA and National Competent Authorities (NCA) to deliver on their mandates.

Agility and adaptability are key factors to determine the success of a data-driven environment.

In pursuing new policies, the European Commission and co-legislators will want to weigh the underlying benefits and risks of data-driven technologies, while ensuring that legislative proposals account for centralisation and the standardisation of data. Importantly, ESMA believes that consideration should be given to the agility and adaptability of the EU framework, as these are key factors to determine the success of a data-driven environment for both the public and private sectors.

ESMA has been building up its role as the EU capital markets data hub and, in partnership with the NCAs, executed several action plans to improve information accessibility and usability, harmonisation and standardisation, which ultimately have been enabling evidence-based policy development, supervision and risk assessment. For instance, in the area of reporting, ESMA has developed a new IT system to support the processing, storage and supervisory analysis of large volumes of MiFIR transaction data.

ESMA aims to establish an ambitious strategy for the years to come that rely on data to further reduce the reporting burden and, more generally, strengthen its capabilities to identify, assess and mitigate risks across the board, and improve supervision.

By enhancing its role as a data hub, ESMA will endeavour to improve data accessibility, harmonisation and standardisation. ESMA will also have a prominent role in providing service to its stakeholders by contributing to relevant, understandable information in machine readable format. This is will facilitate the use of data and alleviate information asymmetries that could, otherwise, hinder the ability of market participants to take informed decisions.

ESMA will also gear up its supervisory function to fully capture and remediate risks posed by supervised entities and new business models built upon data-driven technologies, consistent with SupTech trends and ESMA's ambition to establish high standards of risk-based, data-driven, effective supervision in the EU. This is particularly topical owing to the enlargement of ESMA's supervisory mandates in January 2022, as these now include entities that are heavily reliant on data, such as data reporting service providers.

Where supervision is carried out by the NCAs, ESMA will facilitate their efforts to strengthen convergence of supervisory practices throughout the Union. Certain supervisory tools and technologies might also be centralised to achieve efficiencies thus avoiding duplication of investments.

Data has been shaping financial markets. Now, it is up to regulators and policymakers to shape the way that data can be used in meaningful ways. It is essential that action by authorities adequately capture financial risks while not stifling innovation. I trust that ESMA's role in a data-driven world – supported by a robust, yet flexible European framework – will continue to contribute to those objectives.

DIANA PAREDES
Chief Executive Officer &
Co-founder - Suade Labs

Leveraging data for financial stability: a key supervisory tool

Data is at the heart of financial regulation as well as the supervision of regulated entities. Since the global financial crisis (GFC) of 2007, financial institutions have experienced a surge in regulatory requirements. Many of these were designed to address the shortcomings of the pre-crisis regulatory system that contributed to, and in some cases even exacerbated, the effects of the GFC. Regulations include the Basel III prudential standards, governance and conduct rules, and transparency requirements among many others. Across all these regulatory developments runs a common theme: data is a key supervisory tool. Nevertheless, leveraging the information collected remains a challenge for financial institutions and regulators alike. Basel III data offers an interesting use case that highlights the need for timely and accurate submissions and disclosures from financial institutions. Recent enforcement action from the UK's Prudential Regulation Authority on regulatory reporting highlights the importance that regulators are placing on regulatory reporting.

Monitoring financial stability

Since the GFC, the introduction of Basel III has resulted in a set of new prudential requirements for banks to hold minimum levels of capital and liquid assets, among others, designed to ensure adequate protection in cases of market stress. To this end, banks perform a set of calculations to determine their capital and liquidity levels, while regulators have a set of supervisory tools at their disposal to monitor these levels. These include regulatory reports submitted to regulators and Pillar 3 disclosures for the wider public. BCBS 239 further creates a set of principles whereby financial institutions are encouraged to optimise their data and technology solutions to facilitate risk data aggregation for better risk management. The combination of efficient risk management, reports submitted to regulators, and Pillar 3 disclosures to the wider public offer effective tools for regulating and supervising banks. Leveraging data is essential to achieving the desired outcome of micro- and macroprudential stability.

Data standardization

Despite the significant benefits, leveraging the data effectively has been a challenge for many years. Key obstacles include the lack of a common data format or standard, legacy technology systems, and challenges around lineage and auditability. Banks' technology systems were set up in pre-crisis years with bespoke solutions for each financial institution. The resulting disparity in technology stacks and data formats has resulted in significant complexity for financial institutions undergoing data gathering exercises. For regulators, this translates into submissions that may not be as comparable across institutions and the sector as intended. Equally, the reliability of the data itself may be called into question.

Standardisation is the key starting point for regulators and institutions looking to leverage data.

Standardisation is the key starting point for regulators and institutions looking to leverage data, providing harmonisation across a financial institution and the sector as a whole. Through data standardisation, it is possible to harmonise data at financial institutions. This allows financial institutions to gather their data more efficiently, track movements through all systems and databases through efficient data lineage and produce highly accurate regulatory reports in a timely manner. Regulators, on the other hand, benefit from comparable submissions across financial institutions, as the data is derived from similar sources and of an equally high standard. If regulators decide to enquire further about a specific set of reports on, e.g., a bank's derivatives portfolio, the bank can easily extract the information because data standardisation facilitates data lineage and interoperability.

Data standardisation has been on the agenda for regulators around the world. The European Central Bank and European Banking Authority have, for several years, been working on the Bank Integrated Reporting Data Dictionary (BIRD) which aims to standardise data at financial institutions for regulatory reporting. The Bank of England and Financial Conduct Authority have also been exploring data standardisation and other options for optimising regulatory reporting processes. The open-source financial regulatory data standard (FIRE) is a data standard that successfully harmonises data at financial institutions in terms of definitions set out in financial regulation. Because it is open-source, FIRE benefits from contributions from a wide range of experts in the financial services industry.

Leveraging data through technology

With natural language processing and machine learning, both institutions and regulators can make the most of their standardised data, while easily staying on top of regulatory change. Standardisation through an open-source standard like FIRE is a key building block for deploying these automation technologies. Leveraging data in this manner helps foster regulatory and supervisory objectives of financial stability.

GEORGINA BULKELEY

Director for EMEA Financial Services Solutions - Google Cloud

Data and Cloud are the key business enablers for financial services

When considering digitisation and data management, cloud computing is globally recognised as the single most effective, agile, and scalable path to digitally transform and create value. It has been a critical catalyst for growth, allowing private organisations and governments to support consumers and citizens alike, delivering services quickly without prohibitive capital investment.

In the financial services industry, firms of every different stripe are leveraging cloud to drive innovation – from traditional players, to fintechs, to fintechs that support traditional players. And, they are applying the cloud's scale and flexibility not just to speed up IT processes or cut costs, but to drive specific, tangible business outcomes.

The financial services sector is perhaps the most data-heavy industry sector in the world. Cloud and cloud-based technologies like artificial intelligence (AI) and machine learning (ML) provide financial institutions with processes to gain insights from the large volumes of information in their hands, which previously had been held in segregated data silos.

Cloud customers are using data and the insights they drive from it to develop a better understanding of their risk profiles, segment their customers to drive seamless customer experiences, track market movements, and develop new financial products and services.

An example of this is risk management. We work with financial institutions to move their legacy systems onto Google Cloud, which allows them to make huge leaps in data analytics capabilities, improving liquidity reporting accuracy and speeding up risk analysis calculations.

A very exciting, developing use case is cloud-based tools helping to combat fraud and money laundering. By using more dynamic AI and ML models, rather than static rules-based systems (combined with transactional and behavioural data), banks can now more accurately detect evolving fraud patterns while avoiding costly false positives.

The first step to bringing data together is moving from traditional infrastructure onto the cloud.

In payments, cloud platforms are helping the ecosystem centralise and organise data, facilitating near real-time data consumption to identify monetisation opportunities, such as personalised offers or new product development. Embedded finance is fast becoming one of the most disruptive trends in financial services as customers seek more hyper-personalised, digitised experiences with financial services embedded seamlessly into other experiences, making transactions and interactions convenient, simple, and continual.

Sustainability is also a key topic as financial services organisations are called upon to help create a cleaner, more sustainable world, and they need new technologies and data that help them make consistent progress. At Google Cloud we help customers assess the positive impact that migrating to our cloud will have on their carbon footprint. We also help customers calculate and disclose the carbon emissions associated with using Google Cloud services and provide recommendations to decarbonise their digital apps and infrastructure.

To benefit from some of these cloud and data management innovations, financial services companies must first address their legacy infrastructure. We occasionally see instances of poor IT integration due to mergers and acquisition activity and overall a reliance on legacy systems. This can create data silos that limit banks' efficiencies and ability to draw insights across their businesses.

When considering the data landscape, Refinitiv research has shown that capital markets firms spend "$8 on data cleaning for every $1 spent on data acquisition" [Source - Refinitiv Transforming market data strategy with the cloud, April 2021], and Forbes has noted a 50% year-over-year growth rate of spending on alternative datasets, to $1.7bn [Source - Forbes Alternative data report December 2019]. The data landscape is only growing, so it's very important to be able to harness the value within it.

Google Cloud provides solutions which help financial services institutions modernise their applications and bring their data silos together. One core offering is BigQuery which gives financial institutions the ability to pull new and valuable insights from data, so they can quickly understand the needs of customers and deliver services in real-time. BigQuery stores and computes petabytes of data to support financial services customers, with state of the art security protection.

The first step to bringing data together is moving from traditional infrastructure and onto the cloud. The sooner financial services companies do this, the faster they'll see results.

DIGITAL OPERATIONAL AND CYBER-RESILIENCE

STEVEN MAIJOOR
Executive Director of Supervision - De Nederlandsche Bank (DNB)

DORA: catching up to new realities and risks in the financial sector

In the years following the 2008-09 financial crisis, financial regulators were - understandably – focused on mitigating financial risks. However, as financial services have become increasingly digitalized, and as the digital transformation of the financial sector is set to continue to gather pace, it has become clear that the regulatory framework for ICT risks and digital operational resilience is in need of an update; and indeed of an upgrade. The DORA political agreement provides this by laying down a comprehensive framework for digital operational resilience.

The challenge for policymakers and supervisors now is to shape the implementation of DORA in a way that enables effective and efficient supervision and oversight, ensures proportionality, maintains alignment with other relevant legislation (e.g. NIS2 and CERD), and is focused on delivering on the ultimate objective of DORA: safeguarding business resilience; the resilience of financial (business) services – especially important and critical ones – provided by financial entities to the wider economy.

Realizing this ultimate DORA objective first of all requires that – as part of the DORA implementing legislation – a holistic implementation framework for managing ICT- and third-party risk is set up. Such a framework should start from the identification of individual services provided to external users by financial entities; and of the resources used in delivering them, including ICT infrastructure and third parties. Next, resilience requirements can be set for each service, based on its importance. Stress-testing the resources chain can then inform specific requirements for both the ICT infrastructure and third parties involved in the delivery of the service. Such requirements include strategies for disaster recovery, redundancy requirements, and contract terms with third-party providers.

The DORA implementation framework should be geared towards ensuring business resilience.

Creating a framework focused on the resilience of the delivery of important financial services would prevent ICT- and third-party risk management requirements from becoming tick-the-box exercises, and allow for the integration of ICT risk management into the overall Enterprise Risk Management framework. Moreover, such a framework would inherently enable a proportionate and risk-based implementation of DORA, as differentiation would be based on the importance of the ultimate service provided. Finally, it would enable effective, efficient and convergent implementation of DORA across the EU.

In addition to the overall structure and focus of the DORA implementing legislation, policymakers should also pay particular attention to what will arguably be the most impactful new elements of DORA: the drafting of a Threat-Led Penetration Testing (TLPT) standard, and the implementation of oversight of critical third-party providers (CTPPs).

The TIBER-EU (Threat Intelligence Based Ethical Red teaming) framework is a TLPT framework for financial entities that are critical for financial stability in the EU. It has already been adopted by a large number (17) of central banks, including the ECB. Given both the quality of the TIBER-EU framework and its high take up, it would be most effective and efficient for the new TLPT standard - to be drafted as part of DORA implementation - to follow the TIBER-EU framework. At the same time, the new standard can incorporate differentiation: it can include proportionate requirements for less critical entities, while going beyond the current TIBER-EU framework for the most advanced and critical financial entities and their CTPPs.

CTPPs will not only play a role in TLPT testing; DORA also enables direct oversight of CTPPs by financial supervisors. While key to ensuring the fragmenting financial-services chain can be adequately supervised, this direct oversight will also impose substantial responsibilities on financial supervisors; in particular the European Supervisory Authorities (ESAs), who will serve as Lead Overseers. Cooperation amongst the ESAs - and between ESAs and national supervisors - will be vital to ensuring effective oversight.

Some CTPPs, however, are critical not just to the financial sector, but for the broader economy. This is in particular the case for cloud providers, which will also be regulated nationally under the revised NIS Directive. Therefore, over the medium term, consideration should be given to creating an EU-level, cross-sectoral cloud supervisor. Such a supervisor should be responsible for supervising the stability of major cloud providers, and its board could consist of a number of relevant EU-level supervisors - including European financial supervisory authorities – jointly supervising cloud providers.

In summary, DORA represents a key step in enabling regulators to catch up with the new realities and risks in the financial sector. It is now for policymakers and supervisors to work on implementing legislation and an oversight framework that are effective, proportionate and holistically focused on the resilience of financial services.

EMMANUEL ROCHER

Director for International Affairs - Autorité de Contrôle Prudentiel et de Résolution (ACPR)

DORA: implementing an innovative horizontal supervisory framework for ICT risks

Since the 1970s and 1980s, finance has been a major user of Information and Communications Technology (ICT), digitalising large areas of its businesses and support functions. Not surprisingly, digital risk has long become the first operational risk for banks. As part of their efforts to enhance the resilience of the financial sector facing intensified ICT risks, the European co-legislators reached a political agreement on the Digital Operational Resilience Act (DORA) in May 2022, paving the way for its swift adoption. DORA is not only a major legislative development towards more resilience but it also innovates by reflecting that ICT risks affect all financial entities alike and shall be subject to a common ICT risk management framework. DORA introduces a new set of standards to manage ICT risks for the whole financial sector, in a way that is harmonised at the EU level, enabling to reduce regulatory costs.

The financial sector's resilience to ICT risks had so far been addressed through a fragmented approach consisting of a mix of binding and non-binding standards with significant variations across sectors and jurisdictions. Among them, the Directive on network and Information System security (NIS) covered several key economic sectors but was limited, as regards the financial sector, to banks and market infrastructures. DORA will address ICT risks faced by financial entities horizontally, outside of NIS but in coordination with the revised NIS. As most of the risk management rules set in DORA are already implemented as law, guidelines or best practices, we expect that major financial entities will only have to adjust – not recast – their practices by 2025, when it comes into force.

Beyond ICT risk management, DORA introduces new requirements, whose effective implementation is essential for a proper supervision of ICT risks. DORA will strengthen incident reporting, ICT systems testing and registering third-party providers. Some financial entities are already accustomed to these practices, especially those operating under the payment services directive. For others, these requirements come as an innovation: the implementing acts should duly reflect these diverse situations in setting out requirements whose magnitude and frequency should be proportionate to the risks. Nevertheless, there is a broad consensus that the basic elements of DORA for managing ICT risks and coordinating the response to ICT events should be valid for all financial entities since risks are similar.

A collaborative and agile functioning of the framework will be key to monitor evolving risks.

Introducing an oversight framework for critical third-party ICT service providers (CTPPs) is obviously the most innovative aspect of DORA. This was necessary given the potentially extensive impact of a technical failure on numerous financial entities. CTPPs designated as critical by the Joint Committee of the European Supervisory Authorities (ESAs) will have to hold a legal entity in the EU. All the relevant European and national agencies will join their forces to ensure a proper monitoring of the framework: the oversight tasks conducted by Joint Examination Teams under the lead of one of the ESAs will ensure that CTPPs do not build up exaggerated third-party risks for the financial system. Supervisors will have a better view of the third-party risks and will be able to monitor the effects of concentration or further outsourcing.

The systemic dimension of ICT risks is certainly a focal point for further work. DORA follows a microprudential perspective, but ICT risks can have systemic consequences or be related to system-wide issues. In this regard, DORA allows for an agile coordination between authorities. We welcome the work carried out by the ESRB on the preparedness of European supervisors to tackle financial contagion following an ICT event.

Implementing DORA will be the key challenge going forward. First, it will require significant human and financial resources from the ESAs and the national authorities, especially since ICT skills are constrained and costly to build-up. Secondly, as DORA will imply the intervention of numerous supervisory authorities, we need to build a system that is able to work as a single smart and agile team across Europe. ESAs should also capitalise on the experience of national authorities and the SSM in this matter. It is necessary to prepare for delivering an efficient supervision of ICT risks, in a full and timely manner and with a lean governance.

The first steps, in 2023-2025, will consist for the ESAs in drafting the numerous DORA delegated acts and guidelines. They will define the concrete requirements for financial entities. The implementation of DORA will follow, with the CTPPs oversight becoming effective by 2026.

With DORA, the EU will become a leading jurisdiction in the field of ICT risk management in the financial sector. Its horizontal approach will materialise the essential principle of "same risk – same rule" that ACPR promotes in international fora.

PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Digital Operational Resilience: a challenge for the supervisory community

Digital operational resilience refers to the ability of a financial entity to build, assure and review its operational integrity and reliability.

The financial sector has always relied heavily on information and communication technology (ICT) and this reliance grew during the COVID-19 pandemic as customers increasingly used digital services. The dependency on ICT makes financial entities particularly vulnerable to cyber-attacks or incidents, a risk that has become more apparent in the light of Russia's invasion of Ukraine.

The consequences of an attack or disruption of an important cross-border financial service can have far-reaching effects on other companies, sub-sectors, or even the rest of the economy, underlining the importance of digital operational resilience of the financial sector. This makes the policy of European Union's Digital Operational Resilience Act, or DORA, even more relevant.

The current regulatory frameworks cover the ICT risk management and ICT security within the system of governance rules, which have been further detailed by the European Supervisory Authorities (ESAs) and national supervisory authorities into guidelines. For example, the European Insurance and Occupational Pensions Authority (EIOPA) published in 2020 its guidelines on ICT security and governance and outsourcing to cloud service providers.

As such the existing EU legal framework for ICT risks and operational resilience in the financial sector is fragmented, with differences by type of financial entities and by Member State.

For example, although the European Central Bank's work in developing TIBER EU – the European framework for threat intelligence-based ethical red-teaming – has provided some convergence, almost every Member State has its own rules (for example, for carrying out resilience tests) and supervisory approaches (for example, for ICT third-party dependencies) leading to a lack of level playing field, challenges for cross border operating institution and also insufficient consideration of certain ICT risks.

DORA provides a comprehensive set of rules for the supervision of digital operational resilience.

Cross-border financial entities are under increased administrative and financial burden as a result of duplicative requirements and inconsistent provisions, such as the Directive on Security of Networks and Information Systems (NIS Directive) – which does not cover the insurance sector at European level, but has been included in the scope by some Member States – EU legislation on financial services, and national regulations (for example, for reporting incidents).

So the first thing that DORA will bring is harmonisation of the rules relating to operational resilience for the financial sector. As DORA will be lex specialis to the NIS Directive, DORA will cover the following important pillars: ICT risk management; ICT incident reporting; the tests of the operational resilience of ICT systems; and the management of ICT third party risks including an oversight framework of the Pan-European critical ICT service providers (CTPPs).

DORA also will enhance the cooperation among competent authorities including from different sectors (NIS authorities) and jurisdictions in relation to ICT and cyber risk management. It has already enabled the issuance of a European Systemic Risk Board recommendation to the ESAs to set up a pan-European systemic cyber incident coordination framework for relevant authorities.

Finally, DORA will provide for a framework on the basis of which oversight can be implemented on CTPPs, thereby no longer addressing the operational risks via the outsourcing arrangements of the financial institution, but also directly at the CTPP.

There will of course be challenges for supervisors. First there will be the need for the overall integration of DORA supervision into broader supervisory processes. In addition, the speed of technological change means that supervisors will need to keep pace not only with innovation in the market, but also with the skills required to supervise innovation. This in itself could be challenging given the high competition in the market.

Nonetheless, EIOPA is up to the challenge and will work closely with the other ESAs to contribute to the safety and security of Europe's financial systems.

In conclusion, EIOPA considers the arrival of DORA to be both timely and needed. EIOPA looks forward to contributing to fostering an operationally resilient industry, as part of its work to support the supervisory community and the industry to mitigate the risks and seize the opportunities of the digital transformation – including through the implementation of the DORA.

KSENIA DUXFIELD-KARYAKINA

Government Affairs and Public Policy - Google Cloud

Digital Operational Resilience Act: providers preparing for the new framework

DORA is an important framework to harmonize how financial entities must report cybersecurity incidents, test their digital operational resilience, and manage ICT third-party risk across the financial services sector and European Union (EU) member states. In addition to establishing clear expectations for the role of ICT providers, DORA will also allow financial regulators to directly oversee critical ICT providers. Google Cloud welcomes DORA.

As part of our Cloud On Europe's Terms initiative, we are committed to building trust with European governments and enterprises with a cloud that meets their regulatory, digital sovereignty, sustainability, and economic objectives.

We recognize the continuous effort by the European Commission, European Council, and European Parliament to design a proportionate, effective, and future-proof regulation. We have been engaging with the policymakers on the DORA proposal since it was tabled in September 2020, and appreciate the constructive dialogue that the legislators have held with ICT organizations. We firmly believe that DORA will be crucial to the acceleration of digital innovation in the European financial services sector.

Here are a few key benefits of DORA:

- **Coordinated ICT incident reporting:** DORA consolidates financial sector incident reporting requirements under a single streamlined framework. This means financial entities operating in multiple sectors or EU member states should no longer need to navigate parallel, overlapping reporting regimes.
- **New framework for digital operational resilience testing:** Drawing on existing EU initiatives like TIBER-EU, DORA establishes a new EU-wide approach to testing digital operational resilience, including threat-led penetration testing. By clarifying testing methodology and introducing mutual recognition of testing results, DORA will help financial entities continue to build and scale their testing capabilities in a way that works throughout the EU. Importantly, DORA addresses the role of the ICT provider in testing and permits pooled testing to manage the impact of testing on multi-tenant services like public clouds.

At Google Cloud, we share the objectives of DORA and preparing our compliance readiness programs.

- **CoordinatedICT third party risk management:** DORA builds on the strong foundation established by the European Supervisory Authorities' respective outsourcing guidelines by further coordinating ICT third-party risk management requirements across sectors, including the requirements for contracts with ICT providers.
- **Direct oversight of critical ICT providers:** DORA will allow financial regulators to directly oversee critical ICT providers. This mechanism will create a direct communication channel between regulators and designated ICT providers via annual engagements, including oversight plans, inspections, and recommendations. We're confident that this structured dialogue will help to improve risk management and resilience across the sector.

How Google Cloud is preparing for DORA

While DORA isn't expected to take effect until 2024 at the earliest, here's four important topics that DORA will impact and what Google Cloud does to support our customers in these areas today.

- **Incident reporting:** Google Cloud runs an industry-leading information security operation that combines stringent processes, a world-class team, and multi-layered information security and privacy infrastructure. Our data incident response whitepaper outlines Google Cloud's approach to managing and responding to data incidents. We also provide sophisticated tools and solutions that customers can use to independently monitor the security of their data, such as the Security Command Center.
- **Digital operational resilience testing:** We recognize that operational resilience is a key focus for the financial sector. Our research paper on strengthening operational resilience in financial services by migrating to Google Cloud discusses the role that a well-executed migration to Google Cloud can play in strengthening resilience. We also recognize that resilience must be tested. Google Cloud conducts our own rigorous testing, including penetration testing and disaster recovery testing. We also empower our customers to perform their ownpenetration testing and disaster recovery testing.
- **Third-party risk:** Google Cloud's contracts for financial entities in the EU address the contractual requirements in the EBA outsourcing guidelines, the EIOPA cloud outsourcing guidelines, the ESMA cloud outsourcing guidelines, and other member state requirements. We are paying close attention to how these requirements will evolve under DORA.
- **Oversight**: Google Cloud is committed to enabling regulators to effectively supervise a financial entity's use of our services. We grant information, audit and access rights to financial entities, their regulators and their appointees, and support our customers when they or their regulators choose to exercise those rights. We would approach a relationship with a lead overseer with the same commitment to ongoing transparency, collaboration, and assurance.

STEPHEN HESTER

Vice Chair of the Board and Board Member - Nordea Group

Digital operational resilience requires European solutions

Digital operational and cyber resilience has undoubtedly never been subject to such focus as it is currently. Following the pandemic, working models throughout banks' value chains are being digitised at a faster pace than ever before. At the same time the war in Ukraine has raised geopolitical tensions to a new level in Europe, with strong concerns about the impact on cyber security in society and the economy. Although these events could not have been foreseen they underscore the importance of EU's Digital Operational Resilience Act (DORA), as part of the EU's Digital Strategy launched in 2020.

Nordea has welcomed the DORA initiative, in particular as a means to ensure a harmonised framework for delivering operational resilience within the financial services sector in the European single market. A harmonised framework, alongside a speedy delivery of Level 2 requirements, providing clear standards for implementation, will be crucial in ensuring a successful implementation and in turn to avoid fragmentation of the single market.

Opportunities

DORA clearly presents opportunities for the financial sector. It supports a journey towards increased resilience, a journey many banks are already on. Digital resilience is one key aspect, but banks in Europe, Nordea included, are already assessing resilience across several areas: resilience in portfolios, climate issues, and people management for example.

A challenge, or call to action rather, to us as an industry is to see the business case in DORA and other related regulations. This is not just about closing a compliance gap, but to consider our overall strategies and our journey towards a resilient banking sector in Europe. A sector which is fit to support Europe and its companies, entrepreneurs and citizens in the digital age. Nordea is certainly committed to play our part in Europe's digital and sustainable future.

A pan-European framework is needed

As the leading cross-border bank in the Nordic region Nordea considers it crucial that we succeed in creating a common European framework for digital operational and cyber resilience, to ensure that banks and companies can operate smoothly across borders in the single market on equal terms. For Nordea our home market is made up of the four Nordic countries (Denmark, Finland, Norway and Sweden). The opportunity to apply one joint, strong, pan-Nordic approach to digital operational resilience is key to delivering the best service to our customers and the most efficient operational resilience.

> **It is crucial that we succeed in creating a European framework for digital operational resilience.**

National initiatives are to an extent understandable, particularly given the current European security situation. However, we must ensure that such initiatives do not result in overlaps, inconsistencies or duplicative requirements. Any such overlaps would make it more difficult for banks to finance the European economy and provide the critical financial infrastructure needed. As foreseen in the EU's Digital Strategy, fragmenting the single market with national initiatives could even undermine the stability and integrity of the European financial sector, and jeopardise the protection of consumers and investors.

The developments this spring in Europe have certainly shown that joint European action can be strong and effective. However, we need to be even stronger and more united, also in the field of digital and cyber resilience. The aim should be joint action and measures to strengthen the resilience of the whole European financial sector instead of a fragmented approach.

Speedy finalisation of Level 2 requirements is critical

As with any regulation, it is important that the risk mitigation benefits outweigh the cost of measures taken. Nordea welcomes the proposal that EU supervisory authorities should oversee critical service providers and in general any proposal to standardise and streamline processes around third-party providers. Harmonising cross-border reporting is something we are looking forward to, to ease unnecessary burden for cross-border banks. For example, we do today have issues with the "giants" accepting standard contracts, auditing rights etc. EU rules on contract clauses would help evening out the power balance. Also, one audit/inspection from an EU authority rather than all customers asking for access would be easier for the providers to accept.

However, in order for DORA to be successfully implemented by European banks, and for the framework to succeed in tackling the main risks it aims to address, it is important that Level 2 standards are developed and issued as early as possible. Delayed standards risk creating different solutions in banks aiming to become DORA compliant, and then having to redo the implementation work once standards are issued. Another alternative, equally unsatisfactory, is banks putting off large implementation projects while waiting for standards to be issued, and thus delaying the journey towards a more resilient financial sector in Europe.

FOLLOWING EUROFI EVENT

THE EUROFI FINANCIAL FORUM 2023

SANTIAGO DE COMPOSTELA - SPAIN
13, 14 & 15 SEPTEMBER 2023

DIGITAL EURO: OBJECTIVES AND CHALLENGES

BURKHARD BALZ

Member of the Executive Board - Deutsche Bundesbank

A digital euro: shaping the future of our money to benefit European society

1. Need for a digital euro

Euro banknotes and coins are a tangible symbol of European integration. European citizens benefit from a convenient and fast means of payment that is accepted throughout the euro area. Our idea behind a digital euro is to translate the benefits of cash into the digital world. While our cash is a truly European payment medium, we do not have an equivalent digital payment solution. When it comes to cashless payments in Europe, both in stores and in e-commerce, people rely on card and internet payment schemes, very often from non-European players. Thus, a digital euro would represent an opportunity to strengthen autonomy in digital European payments. Given the decreasing usage of cash for payments across Europe, we would thus be creating a digital complement – not a replacement – for our treasured euro banknotes and coins.

On top of that, a digital euro could combine the efficiency provided by modern, digital processes in payments with the safety provided by a central bank in a single means of payment. Thus, it could facilitate the emergence of a new digital ecosystem with not only full pan-European reach but also allowing service providers to offer new innovative services, resulting in possible productivity gains, for instance by providing digital money that could be used in programmable environments.

2. Risks to be addressed

However, if we decide to make a digital euro available to the public as a complement to cash, we have to address the associated risks, for example with regard to financial stability and monetary policy. We also want to preserve the valuable role that banks and other payment service providers play as intermediaries in the financial system. An outflow of deposits from the banking sector must be avoided, as well as sudden, uncontrolled shifts of bank deposits to central banks' balance sheets. Countermeasures can include maximum amounts and graduated interest rates in order to limit individual holdings and to ensure a digital euro would mainly be used as a means of payment instead of a store of value. Other risks to bear in mind are the effective prevention of money laundering and terrorist financing as well as cybersecurity risks.

> **A digital euro would represent an opportunity to strengthen autonomy in digital European payments.**

To ensure broad acceptance, a digital euro should be made accessible to all groups of society, without barriers, but in a secure way. Therefore, its technological design must ensure sufficient and secure scalability. We face a balancing act between two opposing key risks: being too ambitious could lead to a crowding-out of private payment solutions and a potential disintermediation of the banking sector, but creating an unattractive product would result in non-acceptance by consumers and enterprises.

3. The digital euro project

The Eurosystem is addressing these challenges in the digital euro project. Since October 2021, experts from the ECB and the Eurosystem national central banks have been working together in an investigation phase that will last 24 months. While many questions are yet to be answered, it is already quite clear which use cases the Eurosystem is focusing on in a first stage. We are aiming to make a digital euro available for payments in stores and in e-commerce, payments between people (P2P) and payments with public authorities. Further use cases could be added in subsequent stages. Our responses to these and other questions are informed by user needs. The Eurosystem is interacting with all stakeholders, including banks and other payment service providers as well as consumers, merchants, other enterprises and authorities.

When discussing the technology of a digital euro, we are open to innovation as long as it benefits safety and efficiency. Regarding back-end infrastructures, from a technological perspective both account-based and token-based systems could be an option. Regarding the customer-facing front end, smartphone wallets are an option, but so too are other means of access, since the euro should also be usable for less digitally savvy population groups. Concerning the customer interface, we will rely on the strong position and broad experience of the private sector. Therefore, banks will remain the "face to the customer". Thus, for banks, a digital euro would provide opportunities to not only include it in their payment solutions but also to create added value.

With the digital euro project, we as central banks are seeking to bring a symbol of our united Europe – the euro, as our single currency – into a digital future, one in which over 340 million people can pay – P2P, in stores and online – throughout the euro area using a truly European means of payment.

ULRICH BINDSEIL

Director General, DG Market Infrastructure & Payments - European Central Bank (ECB)

The digital Euro – in the middle of the investigation phase

The primary aim of a digital euro is to maintain the accessibility and usability of central bank money in an increasingly digitalised economy. Firstly, public money and commercial bank money should continue to co-exist, be fully interchangeable and yet distinguishable. Secondly, a digital euro needs to be part of citizens' payment reality and be useful to them. The investigation phase of the digital euro project has been progressing towards ensuring that these objectives can be achieved.

From the interviews conducted by the Eurosystem with so-called focus groups it has emerged that, across all countries and age groups, people perceive the ability to "pay anywhere" as the most desirable feature of a new digital payment instrument so that, ideally, all euro area merchants (in physical stores or online) should be able to accept it. Moreover, whereas cash persists as the dominant person-to-person (P2P) payment means – and access to it will keep on being ensured – the second most valued feature is the possibility to make instant, easy, contactless payments, especially for P2P payments. P2P payments in digital euro may actually grow rapidly once convenient solutions become available. Ideally, a single device could provide access to a range of payment options.

The planned use cases of a digital euro have been identified bearing in mind the Eurosystem policy objectives and market segments relevance. As physical stores are the most important market segment for digital payments and the relevance of e-commerce is growing, both are the natural initial use cases for a digital euro. Moreover, it is difficult to imagine a digital euro which would not allow for person-to-person (P2P) payments from the outset.

Other use cases and functional features can be covered in the future. Machine-to-machine payments are often mentioned as an important new field. In principle, they are possible in an open banking / API based approach without DLT and they could be potentially implemented for a digital euro. That the potential for automated payments has not been exploited at all so far is neither due to them requiring DLT nor to an unavailability yet of a digital euro. But the digital euro will be open to such use cases which without doubt will grow over time.

Beyond the use cases, the digital euro project has investigated and progressed on specifying various dimensions of a possible digital euro. In particular, work has focused on the transfer mechanism used to validate and record transactions (peer-to-peer and/or via a third party), on the possibility to settle transactions with or without internet connectivity, on the privacy enhancing features, and on the tools to avoid an excessive use of the digital euro as a form of investment.

The investigation phase of the digital euro project is on track.

Different combinations of transfer mechanisms and connectivity options are being studied, such as a third-party validated solution for online payments and a peer-to-peer validated solution for offline payments. As the digital euro will be a Eurosystem liability, the Eurosystem would have the legal responsibility to fulfil claims from end-users, independently of who validates and records transactions. For an offline peer-to-peer validated digital euro solution, the settlement validation and recording may have to rely on secure local storage devices. For a digital euro solution that would work online with third-party validation, settlement validation and recording by the Eurosystem central banks as one operational entity would appear to be a solution.

Progress has also been achieved on the functionalities for funding and defunding the end users' digital euro position. The digital euro should presumably foresee elements of manual and automatic (contingent) funding and defunding. It should probably be up to the end-user to choose whether to activate or not (some of the) automatic funding and defunding functionality.

Concerning the distribution of the digital euro, a payment scheme-based distribution model appear as suitable option. Work to progress in this direction would include scheme development (including rulebook drafting), governance and operation; payment form factor and core payments service that the scheme will need to deliver; scheme access and requirements for supervised intermediaries to distribute the digital euro; compensation model for the scheme and for the digital euro.

The development of a back-end prototype has started in July, involving a multidisciplinary Eurosystem team. Concerning the development of the front-end prototype, out of the 54 companies that had expressed their interest, a handful have been selected with the aim to best cover the different use cases of peer-to-peer, offline, point-of-sale, payee/payer initiated and e-commerce.

DENIS BEAU
First Deputy Governor,
Banque de France

Digital euro: renewing public-private cooperation for the digital age

The payments landscape is moving quickly in the wake of digitalisation. Cash payments have been receding steadily in the Euro area in the past few years and the recent health crisis has accelerated this trend. Digital payment solutions have the wind in their sails, inspired by new consumption patterns and the demand of consumers for convenient and innovative payment services. In addition, the emergence of new technologies such as distributed ledgers, and the increasing footprint of new players such as Fintechs and BigTechs stand ready to reshuffle the cards in the payment value chain.

These trends raise significant strategic challenges for the efficiency, safety and sovereignty of our monetary system and for our strategic autonomy in payments.

The response from central banks to these challenges will necessarily be multifaceted. One part, ongoing, is the necessary regulation of actors and services under the "same business, same risks, same rules" principle. Another is potentially the issuance of a retail Central Bank Digital Currency (CBDC), which the Eurosystem is actively considering through its work on a digital euro: in 2021, the Eurosystem launched a 2-year investigation phase to outline its design and explore its implications.

Having a digital euro would respond to consumers' preference for digital payment solutions – including by allowing them to use central bank money in e-commerce, while also preserving confidence that bank deposits can be fully and freely converted at par in central bank money. It would contribute to safeguarding the anchor role of central bank money and the integrity of our monetary system.

Besides, a digital euro could also help fix deficiencies in the online payments market, covering needs and functionalities that the market only partially addresses. These include for example (i) offering a peer-to-peer solution for online and offline payments; (ii) enabling governments to pay grants or benefits to unbanked individuals; (iii) providing an infrastructure promoting innovation from intermediaries.

Our exploration of a digital euro aims to pursue and refresh the public-partnership that is at the core of our monetary system.

Finally, a digital euro also has the potential to support our strategic autonomy by fostering the development of a European payment solution. In particular, the digital euro could contribute to the success of the European Payments Initiative (EPI), which brings together major European banks as well as large non-bank acquirers. This initiative could be used to distribute the digital euro, thus contributing to its attractiveness, and therefore increasing the sovereignty of the Euro area.

While a digital euro could be part of the answer to the challenges we are facing, it also raises challenges that need to be met before we can decide on its issuance. One of the most prominent ones relates to the way in which a digital euro would involve intermediaries. The coexistence of central bank money and commercial bank money is at the core of our two-tier monetary system. To strike a proper balance between a CBDC and commercial money and preserve the smooth functioning of our payment ecosystem, the Eurosystem can leverage several tools.

First, the Eurosystem will ensure that the digital euro is used primarily as a means of payment rather than as a store of value. To do so, we are considering setting a limit that would cap the amount of digital euros that an individual could hold. In addition, a disincentive remuneration could be envisaged.

Second, the digital euro aims to integrate into the current retail payment market, leveraging banking intermediaries' strong expertise in client relationship and retail payment systems. In this sense, the private sector would be responsible for the distribution of the digital euro to end-users, providing payment services and managing customer CBDC holdings. Like for cash today, the role of central banks should be limited to issuing the digital euro and making it available to intermediaries.

Overall, our exploration of a digital euro aims to pursue and refresh the public-partnership that is at the core of our monetary system, in which central banks and commercial banks fulfil different yet complementary roles to guarantee the efficiency of the payment system. It should not lead us to depart from the longstanding convention already stated in the seminal report published by the Committee on Payment and Settlement Systems (CPSS) in 2003 that central banks avoid competing with commercial banks in payment services provided to the non-bank public.

ONDŘEJ KOVAŘÍK

MEP, Committee on Economic and Monetary Affairs - European Parliament

The Digital Euro can benefit consumers and businesses

Preferences in the way Europeans spend, save and invest are becoming more digital, especially after the Pandemic. The use of cash is mostly declining while the use of easy, instant, electronic payments methods is increasing. In this scenario, it is paramount to enable the Euro to adapt to the evolution of the financial system. Central Bank Digital Currencies will uphold the role of public money in the digital world, ensuring its accessibility and usability, as it will offer additional means of payment in a fast and secure way and will contribute to inclusion at a time when a large reduction of bank branches is disfavouring vulnerable customers. On top of that, projects such as the Digital Euro would ensure open and integrated standards for payments to emerge, meaning new forms of interoperability between banks, digital wallets and small businesses. With the upcoming arrival of foreign CBDCs and the presence of large private actors offering attractive non-Euro-denominated payment solutions, we need to contemplate options to preserve the value of our currency, maintain financial stability and safeguard monetary sovereignty.

The digital payment system is strategically relevant for Europe's economy. Thus, we need a European payments market self-reliant in EU payment solutions, infrastructures, technologies and services operating on a level-playing field, that are able to respond efficiently and with high security and trust standards to Europeans' necessities. It is also of paramount importance that privacy and security are integral to the make-up of the Digital Euro. These aspects are key both to consumers and to businesses in order to gain their trust in the project.

The capacity to drive European cutting-edge innovation able to compete with global actors, will determine Europe's autonomy. The infrastructure for the Digital Euro must be designed bearing in mind the need for innovation based on its uptake.

A Digital Euro should allow synergies among market participants and contribute to create new services and products. Simultaneously, it should serve as an instrument to project global finance, contributing significantly to improve cross-border payments with non-EU jurisdictions, thereby making the EU financial market more attractive internationally.

The Digital Euro can help advance economic efficiency by offering a European digital means of payment that would be built on a European infrastructure and would meet Europe's societal challenges.

The digital payment system is strategically relevant for Europe's economy.

The vast majority of innovative digital retail payment solutions are not available across Europe. Customers are lacking a one-stop solution that allows instant payments irrespective of the platform used by the payers and payees. This would reduce the use of multiple cards, devices and ID solutions and give them access to a variety of payment options on a single device.

The Digital Euro will be helpful in overcoming structural fragmentation as if it operates in a centralised space based on common standards and infrastructure methods.

The future European payments landscape will be characterized by the interaction between private and public initiatives. As the significance of crypto-tokens grow, it is therefore important that the EU builds a safe ecosystem to mitigate risks and maintain trust and integrity in the financial system. While crypto-tokens and CBDCs are different in nature, both participate in the financial ecosystem. However, full and easy interoperability between Crypto-assets and the Digital Euro is important to ensure its right convertibility, acceptability, and portability.

The Digital Euro is a flagstone policy to reflect digitalisation trends. It does come with risks as it will be a new project and it must be calibrated in the right way. It is therefore important that the ECB and the EU institutions work closely together to develop the project.

As already said, for the European Union it is crucial to enhance its own digital payments space. From a Regulatory perspective, ensuring a level playing field is essential.

As the Digital Euro moves closer to a reality, it is important that we bear in mind the many aspects mentioned here which could ultimately affect its ability to succeed and be welcomed by consumers as a positive step forward for the Eurozone.

MONICA LOPEZ-MONIS GALLEGO

Global Head of Supervisory and Regulatory Affairs - Banco Santander

Do we really need a digital euro?

We are going through an exciting time in the retail payments space. The development of instant payments; new forms of private money such as stablecoins; consumer needs are changing very fast and payments are becoming more digital and contact-less. Central Banks need to explore opportunities arising in this new space, including the possibility of issuing CBDCs.

Europe has today a well-functioning and innovative payments market. I am not convinced that a digital euro would add significant value for retail users in their daily payments. Studies show that users and merchants feel well served by the range of payment options available. In some countries, like Spain, a widespread P2P payment solution is already in place (Bizum[1]).

We could think however about scenarios in which a digital euro might become necessary although, so far, these scenarios have not materialized. For example, if cash becomes unavailable for citizens' payments. Or if a widely adopted non-euro based stablecoin or foreign CBDC were to challenge European monetary sovereignty.

We are not in any of those scenarios as of today. Cash remains the main payment method in the Eurozone, even after the pandemic, and commercial bank money is perceived as safe and secure. According to Kantar's report, being able to hold risk-free central bank money may not, on its own, be a strong incentive for the adoption of the digital euro. Besides, regulatory initiatives on the way, such as MiCA, would also ensure that significant stablecoins would not create such risks in the EU.

However, Europe must be ready to introduce it should the need arise. European authorities need to understand in advance potential benefits and risks, as well as whether those benefits could be better achieved with alternative solutions. Besides, the discussion about CBDCs is global and the ECB cannot be indifferent to what other central banks are doing. International coordination is key to avoid creating risks for the global economy and to take advantage of the benefits that interoperability could bring to the efficiency of cross-border payments if CBDCs were issued.

At the same time, I consider that the ECB should not commit itself to a timetable in order to take a decision, which seems to be its approach so far. A digital euro must have a clear purpose and offer tangible benefits in response to specific needs. If those conditions are not met, the digital euro would become a solution in search of a problem.

Europe has a well-functioning and innovative payments market.

Which could then be the right design? On this question I would highlight 4 priorities:

- The digital euro should be designed to serve as a means of payment, and not as a store of value. Authorities agree on the potential impact of CBDCs on financial stability and monetary policy. CBDCs could be easily understood as a safer store of value than the money held in commercial banks, particularly in times of uncertainty or crisis. The ECB should set caps to individual's digital euro holdings, to avoid significant outflows of commercial bank deposits into the digital euro, which could affect the financing capacity of the banking sector. It is key to ensure that banks can continue performing their role of financing the economy.
- The ECB should be ambitious on its design. The digital euro should incorporate advanced features ensuring that the digital euro is competitive, future proof, and drives payment innovation. Compared to existing means of payment, the main opportunities to add value are in the development of programmable payments, as well as in offline payments, where it could become a reliable alternative to cash payments.
- There is broad consensus that access to the digital euro should be provided through authorized intermediaries (i.e., banks, payment institutions, e-money issuers...). The two-tier model has proven to be successful, and the private sector is probably the best placed to manage customer relationships and provide value-added services. It should be the private sector the one to provide value-added services to customers and innovate, based on the development of profitable business models.
- Finally, privacy has been highlighted as one of the most important features of a digital euro. It should not be confused with anonymity which would raise concerns against money laundering and financial crime. But more than this, payments data play an essential role in the provision of financial services, e.g., to provide more credit. GDPR sets the right framework to ensure a responsible access to transactional data. With the consent of the user, intermediaries should be able use the data to create value-added services.

Policymakers and banks must continue to work together to find the best way forward, ensuring it is designed in a competitive manner, preserving the essential role of banks, and protecting the interest of consumers.

[1] Bizum is a mobile payment solution, as a result of the collaboration of the vast majority of banks in the Spain to create a system for instant payments between individuals and purchases in PoS. It currently has more than 20 million users.

TEUNIS BROSENS

Head Economist for Digital Finance and Regulation - ING Group

The digital euro – right questions, wrong answer?

Central banks the world over have piled into central bank digital currency (CBDC) research and piloting. Problems identified by central banks are real and justify a response. Yet it is actually far from clear that CBDC is always the best solution to address the problems raised. Particularly in Europe, other policy responses may yield the same or better outcomes. This article looks at four prominent justifications for CBDC in the Eurozone: the need for access to public money in a digital world, the threat of large online platforms, excess dependency on non-EU payment solutions, and geopolitical considerations.

The European Central Bank Central (ECB) argues that "it is imperative to ensure that [people] continue to have access to central bank money" in an increasingly digital world. Public money is needed as a 'monetary anchor'" (ECB 2022). But is it indeed the case that "private" money (such as bank accounts we all know and use today) can only function if people have access to central bank-issued money, such as banknotes and coins? The ECB-commissioned Kantar study (2022) into people's payment habits struggled with the fact that many people don't realise, understand or care about the difference between central bank and commercial bank-issued money. So perhaps people are perfectly happy to pay with digital "private" money, knowing that the central bank continues to be at the centre of the system, with a wide array of tools to guarantee the stability of money.

The initial motivation for central banks to consider CBDC was to counter the threat of bigtech platforms issuing their own currency. Yet bigtechs issuing stablecoin not denominated in domestic currency, can effectively be addressed by regulation. The EU's Markets in Crypto Assets Regulation (MiCAR) does exactly that, preventing such coins from becoming too large in payments. Meanwhile, domestically denominated stablecoins will require an e-money or banking license. Hence financial stability can be preserved by the full force of existing supervisory tools, and these coins are subject to domestic monetary policy as well. So why should CBDC be preferable over a well-regulated domestically denominated stablecoin?

Large platforms are ideally positioned to integrate CBDC services into their payment systems.

But how then to prevent large online platforms from deploying digital currencies to increase user lock-in and further strengthen their dominant position? Well, legislative initiatives such as the Digital Markets Act seek to address this. And it is important to realise that platforms do not derive their lock-in power from issuing their own currency. Instead, they thrive by providing seamlessly integrated payments as part of an impeccable customer experience. As the BIS notes in a recent paper, a "core aspect of big tech business models is to run easy-to-use payment systems" (BIS 2022). In other words, it's not about the underlying currency, it's about the payment infrastructure on top of it. This means that a CBDC could in fact play into large platforms' hands! Most of them are already licensed to act as Payment Service Provider. They are ideally positioned to integrate CBDC services into their payment systems, roll out solutions across Europe and thus further optimise their customer experience.

The digital euro is also positioned as a tool to avoid or reduce dependency on a small number of non-EU-based solutions. Yet here too the question arises whether the goal justifies the means. How is adding another form of digital currency going to help reducing existing dependencies? A CBDC will still need an infrastructure to actually use it for payments. A better targeted response to the concern of excess dependency would be to develop an alternative EU-based payment scheme for digital and online payments. Such a scheme could then process commercial bank money, stablecoin and even crypto payments – no CBDC needed.

Finally, an opportunity identified by policymakers is the possible use of CBDC as a tool to strengthen the euro's position on global trading and financial markets. Yet a CBDC focused on a domestic retail audience, such as the digital euro, is unlikely to make an impact on such global markets. To strengthen the international role of the euro, a focus on large-value, cross-border and cross-currency payments would be needed.

Indeed the ECB and other central banks are looking into what is called "wholesale CBDC", while private parties are also investigating digital currency platforms backed by central bank reserves. Yet wholesale digital currencies have very different characteristics and requirements than the retail variety. They are therefore generally treated as separate projects.

In short, while central banks and policymakers have put a number of very valid concerns on the agenda, it is highly doubtful whether a retail-focused CBDC is a sufficient or even necessary answer.

GLOBAL INFRASTRUCTURES AND CROSS-BORDER PAYMENTS

ULRICH BINDSEIL

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Improving cross-border payments: from analysis to implementation

Along with globalisation, cross-border payment volumes have been increasing for many years and will keep on increasing in the future despite the current set back in international relations. Challenges remain. Although digitalisation has made instant cross-border communication quasi cost-free, the costs of executing cross-border payments have not yet declined as one would have expected. There are two main reasons for this. First, intermediaries struggle to ensure compliance with AML/CFT regulations and fear the legal and reputational risks of non-compliance, which both boost costs and reduce competition ("de-risking"). Second, whereas "front-end" payment service providers executing the first step of cross-border payment transactions have enhanced user convenience, the "back-end" facilitating payments through payment and market infrastructures continues to face challenges.

The international standards for AML/CFT are set by the Financial Action Task Force, an inter-governmental watchdog that together with the Basel Committee on Banking Supervision is in charge of "Applying AML/CFT rules consistently and comprehensively" within the FSB led G20 roadmap for enhancing cross-border payments. The part of the FSB road map concerning payment systems and infrastructures is mainly led by the BIS-hosted Committee on Payments and Market Infrastructures (CPMI).

The G20 work is now moving forward from the phase of analysis to the phase of implementation and actual progress. This requires commitment by the official and private sector to implement changes and to engage more closely with each other under an adjusted governance. To meet the targets set by the Financial Stability Board (FSB) for end 2027, progress should also be monitored and adjusting measures taken in a timely manner when needed. A guiding report on the implementation approach for progress monitoring, including Key Performance Indicators (KPIs) and data sources for calculating KPIs, will be published by the FSB Board by October 2022.

The G20 work is moving forward from analysis to implementation and actual progress.

The objective of achieving globally efficient and integrated solutions for payments has been affected by the well-justified EU and G7 sanctions imposed on Russia further to its attack on Ukraine. The sanctions excluded the major Russian banks from being served by global financial messaging service providers on which cross border payments also rely. This will however not disrupt the ongoing trend towards the common reliance on global standards and infrastructures. Global and autonomous regional solutions are somewhat more likely to co-exist in the future.

The war also seems to have brought a rise in cyber-attacks on some EU countries– forcefully reminding how crucial cyber-resilience, also against sophisticated state actors has become today. Payment infrastructures have so far proven resilient, but the ECB remains committed to applying the Eurosystem cyber resilience oversight expectations (CROE) for financial market infrastructures and the TIBER EU framework for ethical hacking.

A much-debated topic is the role of new technologies such as DLT for improving cross-border payments – both in the wholesale and in the retail domain. Certainly, new technologies have a role but often their proponents have difficulties in explaining which unique ability they possess to solve real world payment problems. Unbacked crypto-assets, for example, are unsuitable as a means of payments (e.g. due to high price volatility and lack of a fair value anchor) while global stablecoins can be based on DLT as well as on standard centralised ledgers and are centrally run by a provider. From a functional perspective, stablecoins seem close to an e-money institution and will be regulated accordingly in the EU. Regulation should be based on functional considerations and policy objectives independently of the underlying technology adopted unless that matters for the regulatory objectives. Evidently payments based on DLT/blockchain must not give rise to any loopholes in AML-CFT compliance and the public sector must remain fully committed to achieve a level playing field.

To sum up: progress is achievable towards immediate, cheap, universal in terms of reach and securely settled cross-border payments. The rapid decline in the costs of global electronic data transmission and computer processing, new payment system technology (e.g. for instant payments), innovative concepts (including CBDC), as well as the unprecedented political will and global collaboration as in the G20 work on enhancing cross-border payments are key factors supporting this expectation. Innovative concepts, such as the interlinking of domestic instant payment systems with a competitive FX conversion layer, have high potential. This solution, as well as a number of other approaches, retain a competitive and open architecture, avoid the dominance of a handful of market participants that would be tempted to exploit their market power, preserve monetary sovereignty and refrain from crowding out local currencies.

TARA RICE

Head of Secretariat - Committee on Payments and Market Infrastructures (CPMI)

Many roads lead to improved cross-border payments; central banks are providing direction

Since the launch of the G20 cross-border payments roadmap almost two years ago, the transformation of the payments landscape has continued to evolve at pace. The ongoing financial innovation offers the prospect of new payment services and greater competition in payments but also opens the door to different risks.

The global financial system faces a potentially game-changing moment as private initiatives in the field of payments proliferate, with a staggering number of stablecoins entering markets and interacting with other cryptos and decentralised finance (DeFi). Disruptions in crypto markets over the recent months have illustrated, however, that not all innovations in payment methods and technologies are safe and efficient. These recent developments have heightened the urgency for authorities to address the potential risks posed by cryptos, including stablecoins.

To address this risk, the Bank for International Settlements' Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO) in July published their guidance on stablecoin arrangements. The guidance confirms that the CPMI-IOSCO Principles for Financial Market Infrastructures apply to systemically important stablecoin arrangements that transfer stablecoins. The risk management, governance and transparency standards for existing payment systems are stringent; that same level of robustness and integrity is expected in any systemically important stablecoin arrangements. To that end, the guidance is a major step forward in applying "same risk, same regulation" to systemically important stablecoin arrangements.

This work is a key contribution to the Financial Stability Board's work on stablecoins as well as a commitment in the G20 cross-border payments programme, and the CPMI will continue to analyse how a well-designed and risk managed stablecoin could help address the frictions in cross-border payments.

Central banks play a core role in improving cross-border payments by safeguarding the payment system, supporting private sector innovation and acting as a catalyst for change.

Stablecoins first gained attention as one possible solution to enhancing cross-border payments. But there are a number of other viable options. Turmoil in crypto markets puts a spotlight on the deeper structural flaws that make crypto unsuitable as the basis of a monetary system or as the silver bullet for cross-border payments: that is, the lack of a nominal anchor, the fragmentation of the crypto universe and their reliance on speculation. Moreover, given the wide variety of payment options worldwide, as well as the diverse needs of end users, we will not end up with one single solution or platform. the future global payment landscape will be able to support a diverse ecosystem of private payment service providers at domestic and cross-border levels, rooted in settlement on the central banks' balance sheets.

Access to central bank payment systems; interlinking of fast payment systems (FPS), and fostering the development of cross-border central bank digital currencies (CBDCs) are among the G20 programme's 19 "building blocks".

In July, the CPMI published a report which lays out a framework for the interlinking of payment systems and provides practical analysis on the use of APIs. Interlinking arrangements, especially among FPS, hold promise for improving the speed, cost, efficiency, and transparency of cross-border payments. The BIS Innovation Hub Project Nexus has received considerable attention in this regard.

Another report published by the CPMI in July, together with the BIS Innovation Hub, the International Monetary Fund and the World Bank, highlights the need for CBDC design to consider cross-border access and interoperability. This report provides a tool for central banks to assess different access and interoperability options. It builds on last year's report to the G20, on domestic CBDC designs and experimentations and potential to enhance cross-border payments.

A CPMI survey showed that at the end of 2021 more than a quarter of central banks were developing or running concrete CBDC pilots. However, there is no "one size fits all" model for access and interoperability. Central banks have different motivations for exploring or developing FPS or CBDC systems, and the demand for improved cross-border payment rails differs across jurisdictions. Therefore, different central banks might opt for different access and interoperability options.

To help central banks in the planning and development of their FPS or CBDCs and to make sure that cross-border functionalities are considered in time, open and regular dialogues between central banks would be instrumental. Even jurisdictions not planning to issue a CBDC or operate an FPS ought to be closely involved in this work as they will still be part of this flourishing cross-border payments landscape.

The CPMI, alongside the FSB, has been working to identify some priority project areas to take forward the building blocks of the G20 cross-border payments. This year's (second annual) G20 cross-border payments progress report will outline the high-level priorities as well as set out measures to help stakeholders achieve the G20 targets agreed last year, thereby taking another major step on the road to enhancing cross-border payments - safely and efficiently.

This article has been co-written by Thomas Lammer and Takeshi Shirakami, CPMI

PIERO CIPOLLONE
Deputy Governor - Banca d'Italia

FSB CBP Roadmap: contemplating the idea of interlinking existing payment systems

The G20 Roadmap for enhancing cross-border payments is steadily progressing in line with the milestones established in October 2020. Several reports have been published over the last few months and foundational steps have been taken, in particular, by setting specific quantitative targets in terms of speed, cost, transparency and access. Despite the progress achieved so far, our ability to follow the Roadmap is now threatened by the new geo-political context, which is likely to be characterized by reduced mutual trust and multilateral cooperation, both fundamental ingredients for advancing the G20 program. Another factor is the less favorable economic outlook. The new scenario makes it more complicated to develop global multilateral infrastructures, driving us to focus our efforts, on maximizing what we can achieve on our targets.

One of the areas where it is of utmost importance to invest more resources is the interlinking of existing payment systems, provided that it is complemented by other actions, such as aligning regulatory frameworks to make it easier to perform AML/CTF checks and improving interoperability through greater harmonization of standards. Interlinking, in fact, means reusing existing infrastructures, thus reducing implementation times and the related costs for the financial communities of the jurisdictions involved, which to some extent may continue processing payments using legacy procedures and formats.

Fast payment systems (FPSs), in particular, have operational features that offer the greatest potential for achieving the goals of the Roadmap. First, FPSs are operational on a 24/7/365 basis, resulting in a full overlapping of operating hours across jurisdictions. Then, they are generally based on standardized messaging formats and present a high degree of semantic interoperability (i.e. they speak the same language). Finally, FPSs process payments in a few seconds or minutes, ensuring that the journey of a payment from the payer to the payee lasts a short time, whereas interconnected traditional retail payment systems may take hours, or even days, to complete payments.

Operational features of existing FPSs offer the greatest potential for achieving the Roadmap goals.

On the other hand, interlinking entails complexity when there are bilateral interconnections among a wide number of systems. This drawback can be addressed by relying on existing fast payments regional platforms, such TIPS in the European Union, which could seek to expand their geographical scope as much as possible in order to reduce the number of links between jurisdictions. Standardized interfaces and multilateral connections may further contribute to mitigating connection costs.

TIPS (TARGET Instant Payment Settlement) is a service that provides PSPs and ACHs with a Europe-wide solution for the settlement of instant payments in central bank money.

TIPS ensures pan-European reachability for instant payments. All PSPs can settle instant payments across the entire euro area via TIPS without depending on bilateral agreements between ACHs. In this regard all ACHs participate and compete in TIPS for the provision of instant payment services, with no exposure to credit risk for cross-ACH transactions. Each PSP may decide independently (i) where to instruct (in an ACH or in TIPS) and (ii) where to hold its liquidity and settle (in an ACH or in TIPS). The choice of each PSP in this respect does not condition the choices of other PSPs.

TIPS is by design a multi-currency platform, capable of processing other currencies as well as the euro. As of May 2022, instant payments denominated in Swedish kronor can be settled in TIPS. Also the Danmarks Nationalbank is currently undergoing the same onboarding process, with the objective of going live with the settlement of instant payments in Danish kroner by 2025, while the Norges Bank is assessing whether TIPS may be used to provide an instant payment service in central bank money for the Norwegian kroner and is expected to make a decision in the course of 2022.

From this perspective, when contemplating the idea of interlinking existing payment systems, TIPS may well be considered the best positioned candidate for playing the role of 'regional hub' for Europe.

Against this background and in its role as service provider of the TIPS platform for the Eurosystem, Banca d'Italia is exploring different options to support the settlement of instant payment transactions in a cross-currency and cross-platform scenario. In 2021, for example, Banca d'Italia and the Arab Regional Payments Clearing and Settlement Organization (ARPSCO) performed a joint experiment focusing on the bilateral interconnection between TIPS and Buna, the two instant payment settlement platforms operated by the two organizations.

More recently, Banca d'Italia joined the Nexus project, a proof-of-concept coordinated by the BIS Innovation Hub of Singapore and involving the instant payment systems of Singapore and Malaysia as well, with the goal of assessing the pros and cons of a multilateral connection amongst FPSs.

CHARLOTTE HOGG

Executive Vice President and Chief Executive Officer - Visa Europe

Improving cross-border payments needs public-private collaboration

Cross-border payments are often perceived as expensive, unpredictable, and slow. They involve routing across different banks, networks, and regulatory regimes and there's no consistent method of processing models, costs and speed.

Yet they are indispensable. More than €117 trillion in payments volume flows each year between businesses, and €9.7 trillion of that volume is cross-border trade.

Recent global challenges such as the Covid-19 pandemic, a high inflationary environment, and the war in Ukraine have put the spotlight again on the need for easy, streamlined, and frictionless cross-border payments.

While certain types of cross-border transactions such as e-commerce payments have become straightforward thanks to innovations by the ecosystem, there are still pain points around others such as remittances, payments among businesses, and account transfers. To answer these challenges and resolve frictions, policymakers and the private sector have come together via the G20 Cross-border roadmap.

Visa is supportive of the roadmap's workstreams in general, and we are eager to see progress made in the areas of streamlined licensing and approvals, which can facilitate market innovation, competition, global interoperability, and international standards, which can ensure that payment products and services can be easily accepted worldwide. At the same time, consistent and streamlined compliance requirements would improve transparency, effectiveness, and efficiency of cross-border solutions offered by the private sector. Particularly as they relate to anti money laundering and customer identity regulation.

To set up the cross-border roadmap for success, it has been important for policymakers to involve the private sector from the outset. The public sector doesn't necessarily need to build new cross-border infrastructure to address challenges, but it can help remove roadblocks for continued private sector innovation. At Visa, our priority is to enable smooth, swift, and safe global money movement. We believe payments infrastructure (regardless of who runs it) needs to deliver against three main policy objectives: resilience and security, innovation and competition, and value for all users. These are key to building trust and should be part of a holistic approach to thinking about things like cost and speed.

The public sector can help remove roadblocks for continued private sector innovation.

We have invested nearly €8.7 billion over the last five years in enhancing and securing our core technology platforms. Visa prevents an estimated €24.5 billion in global fraud every year and incidents of fraud occur in less than 0.1% of transactions—among the lowest of all payment forms.

We have simplified cross-border payments by investing in our payment infrastructure, connecting it to other networks for even broader reach, and exploring new offerings. In addition to our card network, we also operate Visa Direct—our global money movement platform—which enables almost 30 new types of payment flows, including remittances, merchant settlement, and gig economy wages with real time capabilities across 180 countries. For the particular challenges of business-to-business payments, our Visa B2B Connect network offers same-day payment services, enabling seamless cross-border business transactions by removing the friction associated with multiple banks in the process chain.

At Visa, we are also extending our thinking to new and innovative cross border flows. For instance, in a recent paper we propose how digital currencies, including Central Bank Digital Currencies, can be used cross-border.

The reality of cross-border payments is that the activity is simple to describe—the movement of money cross-border—but the networks, end-user needs, and value propositions governing them are often complex and interlinked. We are pleased to see that the Financial Stability Board is adopting a "use case" method to look at retail payments. People and businesses want different things from cross-border payments depending on the situation. What is important for parties in a large-value business-to-business transaction may be different than what a consumer cares about when buying goods across borders from a merchant with which there is no prior relationship. In the latter case, consumer protection and dispute resolution capabilities loom large, and these convey value to parties which are additive to pure money movement.

It is therefore reasonable that different retail use cases might have different cost structures and differing tradeoffs on a number of other characteristics, including speed. Involving the private sector in the debate is therefore crucial to ensure that cross-border payments continue to improve, and improve for all end-users, today and in the future.

MARC BAYLE DE JESSÉ

Chief Executive Officer - CLS Bank International

Shifting sands: challenges to increasing PvP settlement in the FX market

CLS is a financial market infrastructure (FMI) that protects settlement members and their clients from settlement risk in the FX market by settling the payment instructions for FX transactions between counterparties across the globe through CLSSettlement. CLS currently settles on average over USD6.0 trillion daily across 18 currencies, accounting for a large proportion of FX trades in the market.[1]

In recent years, both regulators and industry participants have become increasingly concerned that FX settlement risk is rising once again. This is because the proportion of FX transactions not settled on a payment-versus-payment (PvP) basis has increased – particularly due to increased trading in some key emerging market currencies – exposing FX market participants to substantial FX settlement risk.

This has heightened the focus on overall risk management in cross-border payments, with both the public sector and market participants calling for greater adoption of PvP mechanisms to mitigate rising settlement risk. In October 2020, the Financial Stability Board (FSB) published the G20 Roadmap for Enhancing Cross-Border Payments, an initiative targeted at addressing certain challenges in cross-border payments.[2] The FSB Roadmap's building block 9 focuses on the recommended mitigation of settlement risk for a cross-border payment. In a recent update, the FSB stated that the Committee on Payments and Market Infrastructures (CPMI) "will develop proposals for increased adoption of PvP by encouraging enhancements to existing PvP arrangements and/or the design of new public sector and/or private-sector solutions for PvP arrangement[s] that currently do not exist".

In addition to the CPMI's work to tackle settlement risk, the Global Foreign Exchange Committee called on the industry to adopt PvP more widely in its three-year review of the FX Global Code (the Code), a set of global principles of good practice for the FX market.[3] The updated Code includes amendments to the key settlement risk principles – Principles 35 and 50 – encouraging FX market participants to explore ways to further mitigate risk and reduce operational costs by adopting a best practice approach to FX settlement risk management and netting.

Settling via PvP and leveraging netting solutions are the most effective ways to reduce FX settlement risk.

Challenges with increasing PvP coverage

Access to CLSSettlement for currencies and members is governed by strict rules. As a systemically important FMI, CLS is subject to the Principles for Financial Market Infrastructures (PFMI) published by the CPMI and the Technical Committee of the International Organization of Securities Commissions (IOSCO) in 2012.

The PFMI standards are designed to ensure that the infrastructure supporting global financial markets is robust and able to withstand financial shocks. Therefore, adding new currencies to CLS is an extended effort subject to several complex factors, particularly the necessity of verifying that crucial legal, risk and liquidity standards are met in the jurisdiction whose currency is onboarded. Local authorities – and not CLS – determine the timing and pace to implement the agreed onboarding process. Also, adding a new currency involves encouraging broader, active participation in CLS from both local banks and CLS members across the global FX market, which takes time.

In response to policymakers and market participants calling for greater PvP adoption in the FX market to further enhance financial stability, CLS has actively engaged the industry to explore alternative PvP mechanisms for non-CLS eligible currencies, and these efforts have received strong support.

However, recent geopolitical events have led CLS to reassess the pace at which this project moves forward. And this highlights one of the most significant challenges when it comes to expanding PvP coverage: progress in this area does not necessarily result from strong industry cooperation and technology advancements. As a trusted FMI, CLS already has the requisite technology, oversight, governance, credibility and support of its members. Instead, progress will result from overcoming the regulatory and geopolitical challenges that currently present the biggest obstacles to expanding PvP coverage.

For these reasons, CLS has made a strategic decision to allocate further resources to make functional enhancements to CLSNet, its bilateral payment netting calculation solution that standardizes and automates post-trade matching and netting processes for over 120 currencies. The functional enhancements will provide risk mitigation for currency flows outside CLSSettlement and support Principle 50 of the Code. Given the current geopolitical environment and the regulatory challenges with expanding PvP settlement, market participants should adopt the best practices recommended in the Code by settling eligible currencies via PvP and leveraging netting solutions for non-eligible currencies. For now, these are the most effective ways to reduce FX settlement risk and increase efficiency in cross-border transactions.

[1] Australian dollar, Canadian dollar, Danish krone, euro, Hong Kong dollar, Hungarian forint, Israeli shekel, Japanese yen, Korean won, Mexican peso, New Zealand dollar, Norwegian krone, Singapore dollar, South African rand, Swedish krona, Swiss franc, UK pound sterling and US dollar.

[2] FSB's Enhancing Cross-border Payments: Stage 3 roadmap (October 2021). https://www.fsb.org/2020/10/enhancing-cross-border-payments-stage-3-roadmap/

[3] The FX Global Code (July 2021). https://www.globalfxc.org/fx_global_code.htm

THIERRY CHILOSI

Chief Executive Europe - Swift

The future of finance is a connected one

Over the last two years, the world has undergone an unprecedented transformation. Despite this, the financial services industry has proven itself to be highly adaptable, demonstrating great resilience under extraordinary pressure, and an ability to innovate during difficult times.

The global payments industry has served as a touchstone of this change. Against a backdrop of rapid globalisation and shifting geopolitical realities, the need for a frictionless and inclusive international payments system has come to the fore. To achieve this, we must collaborate on the fundamentals.

Interoperability as a key enabler

The key enabler in realising a frictionless international payment ecosystem will be a focus on interoperability – both at market infrastructure and individual firm level. By working in collaboration, industry participants can develop the standards necessary to avoid market fragmentation and encourage growth across emerging asset classes, without compromising on security and trust.

A focus on interoperability will be key to realising a frictionless international payment ecosystem.

This need for interoperability will also be crucial in ensuring the successful implementation of many innovation projects that are taking shape across payments. Indeed, accelerating innovation and enabling back-end interoperability go hand in hand in an increasingly complex and fragmented world.

This points to the promising work being done in Central Bank Digital Currencies (CBDCs) and new digital assets. The metamorphosis of money as we know it has never been at a more exciting juncture, and its digital form could create a more inclusive, connected financial ecosystem.

Again, interoperability, underpinned by a universal set of standards, will be the linchpin to guarantee this. If CBDCs are adopted at scale, ensuring that different jurisdictions and the respective industry players within each are working in collaboration will be key to their success and longevity.

Looking ahead

The financial services industry is at a point where investment in emerging technologies is no longer seen as a choice, but a necessary step in preparing for the future.

When it comes to payments, this has never been more tangible. Alongside the emergence of CBDCs and digital assets, we are seeing crucial digitisation at all stages of the payments lifecycle to power this new generation of money. From ubiquitous digital apps to machine learning, innovation across payments extends to every corner of the industry.

But an ambitious innovation agenda cannot work in isolation. As we embrace the future, we must prioritise strengthening the linkages between the various infrastructures and relationships that connect us globally. With this approach, finance has an exciting time ahead.

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EU RETAIL PAYMENT LANSCAPE

BURKHARD BALZ

Member of the Executive Board - Deutsche Bundesbank

A pan-European retail payment solution – Challenges and a potential way forward

1. Call for a pan-European retail payment solution

The Eurosystem has been constantly calling – at least since November 2019 – for a pan-European payment solution. The arguments as to why such a solution is needed are even more convincing now given the

- progress made by large non-EU technology platforms in digitalising and embedding payments,
- persisting fragmentation with a plethora of various digital payment solutions, as well as
- growing global risks that reiterate the need for independent European solutions.

The Eurosystem believes that consumers, merchants, companies and public authorities will benefit from a genuine European solution that delivers a unified payment experience throughout the EU across a large range of payment situations, such as online, offline or mobile as well as among private persons. It should enable easy, user-friendly, safe and frictionless payments. For merchants, such a solution should be cost-efficient, and convenient to take up and integrate into existing check-out systems. Moreover, this solution should be offered by European private players under a transparent European governance structure. A common brand would ensure that it is easy to recognise, also internationally once acceptance has been established in the EU.

2. Progress made so far and challenges faced

The most ambitious private project that aims at meeting these objectives is the European Payments Initiative, EPI. Initially, it was supported by 31 banks and two acquirers operating in seven markets. A number of shareholders withdrew during the first quarter of 2022. However, eleven banks and two acquirers in three markets (Belgium, France and Germany) are still participating. The scope of the proposed solution was scaled back to an instant payment-based wallet solution, abandoning EPI cards. However, the shareholders envisage a comprehensive package of features for all kinds of use cases and payment situations, including those usually associated with cards. They also see the possibility of integrating a European digital identity and, if realised, the digital euro as well as launching enhanced value-added services.

But even with the potential creation of an EPI Target Holding Company and the development of a concrete payment solution, a number of challenges remain. Why does it seem so difficult to agree on a common solution? Several issues are crucial:

First, most European banking communities invested in a mobile or e-commerce payment solution years ago. Some of these are quite successful in their home markets. Consequently, the owners are often interested in retaining the client relationships and some of the (im)material assets. The same often holds true for banking communities that own national card schemes.

Second, in countries that rely on international card schemes instead of national ones, banks might be bound by long-term contracts with the former, which they cannot terminate easily. This influences their future strategy in payments more generally.

Third, while most banks are convinced of the long-term strategic imperative of a pan-European payment solution, in the short-term each would need to invest a substantial amount of money. Depending on the internal assessment of this investment and their own financial situation, some do not want to take the risk.

Fourth, despite strong political support from the Eurosystem and the European Commission (coupled with a strong call for a pan-European payment solution), the new solution still needs to be sold to merchants, which requires considerable financial efforts. Without a sufficiently large acceptance network, consumers cannot pay with the solution.

Last but not least, the shareholders might also have felt a sense of uncertainty about the role the digital euro could play and about the need for a large coverage of instant payments.

3. Potential way forward

In short, the EPI project faces typical coordination problems combined with uncertainty. Although it has come a long way, shareholders still have much work to do. However, it is obvious that a pan-European solution would be in the interest of all European players. If they do not move forwards, the European payments market might soon be dominated by an international oligopoly. To put it bluntly, shareholders may risk losing direct client relationships and room for commercial manoeuvre as they are forced to act in accordance with the oligopoly's rules. Moreover, the sovereignty of the European payments market could be at stake. Should the Eurosystem intervene and propose its own solution?

In my opinion, private shareholders are best placed to offer a pan-European payment solution. They have the necessary expertise as well as the relationships and skills to do so. The Eurosystem, the European legislator and national authorities should support these activities even more.

If all forces – private and public – are pulled together, the European payments market can develop according to the goals announced by the Eurosystem and the European Commission.

STÉPHANIE YON-COURTIN

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

Addressing the challenge of digital (instant) payments: a matter of sovereignty

The EU retail payment landscape has significantly changed over the recent years as the result of the rise of new entrants and solutions on the market. European regulators have worked on innovative European legislations on open finance, to empower consumers in the digital age and make them access to a variety of online services at a reasonable cost.

Instant payments are at the forefront of these changes, providing consumers with the ability to transfer money within a few seconds no matter what time or day of the year it is. Instant payments can also be used together with other innovations within the payment ecosystem such as the SEPA Request to Pay Scheme, a messaging functionality to request a payment initiation. Instant payments have also proven to be a valuable solution in the context of the Covid 19 pandemic, in Europe but also in other countries, as we see a global development of instant payments in the United States or in a number of Asian countries.

The benefits of instant payments are numerous; from allowing easier cross border transfers to reducing the use of cash and the associated risks of fraud or anti-money laundering.

Instant payments can be used in different cases. While peer-to-peer payments allowing an easier split of expenses between friends, family or colleagues tend to increase, other use cases remain underdeveloped because of limitations preventing their wider spread, in particular in-store payments to a retailer.

First, a lack of integration of the instant payment market, with only 61% of payment service providers part of the EU wide "SEPA Instant Credit Transfer Scheme", and only 12% of the SEPA Credit Transfer Transactions being instant payments. Second, a lack of standardisation of QR codes on which a growing number of instant payments rely on. Third, a lack of transparency and proper information on costs, disincentivising the use of instant payments, which remain on average more expensive for consumers compared to traditional payments (close to €1 on average).

The payment regulatory framework needs to be fit for purpose to empower and protect consumers while supporting the rise of European payment solutions and providers.

There is room for improvement to unlock the full potential of instant payments for the benefit of consumers, merchants and businesses. The upcoming European initiative on Instant Payments will be instrumental to further empower, protect consumers against fraud, and ensure their proper information on the associated costs. It represents the last missing piece of the Digital Finance Strategy, following the adoption of landmark pieces of legislation on the use of distributed ledger technology for markets infrastructures, digital operational resilience or activities and services related to crypto-assets. Together with a potential review of the Payment Services Directive (PSD2), a fit for the future Instant Payments initiative should make instants payments the new norm for fast, safe and transparent payments in Europe for a variety of use cases.

Similarly to what we have done for crypto-assets with the Markets and Crypto Assets Regulation (MiCA), and beyond financial services with the recently adopted Digital Services Act (DSA), the payment regulatory framework needs to be fit for purpose to empower and protect consumers while supporting the rise of European payment solutions and providers.

In practice, this means:

- Strengthening the integration into the single market of existing pan European initiatives to reduce the current market fragmentation and allow cross border real-time payments;
- Developing innovative and user-friendly solutions for online and mobile applications as well as QR codes to provide consumers but also retailers with a real choice on the payment method they want to use for each purchase or sale, alongside credit cards, regular banking transfers or cash payments;
- Improving transparency and information on the different features, value, functionalities and costs of each payment method; and
- Increasing the guarantees associated with instant payments, to foster trust and reliability for the consumer and the retailer, when it comes to safety features or reimbursement options, while preserving innovation and sound competition on the payment market.

2022 and 2023 will be important years for creating a unified EU payment system, with beyond legislative initiatives already on the table, concrete outcomes of the European Payments Initiative (EPI), a coalition of major European financial services players supported by the European Commission and the European Central Bank, which will also conclude its preliminary work for the creation of a digital euro.

What is at stake is the European sovereignty in the field of payments, and the ability of European players to provide adequate solutions, including through instant payments, to European citizens.

The future of payments will be European and instant or will not be.

MASSIMILIANO ALVISINI

Chief Executive Officer Europe - Western Union

How the PSD2 Review can unleash innovation and growth for the European payments sector

For decades now, the payments sector across the world, and in Europe, has been serving economies and communities by delivering financial, and more widely, social growth and development – quite frequently, to those that need it the most. The pandemic showed, yet again, how the payments sector has the ability to innovate in order to deliver for millions of people, providing them with a true lifeline.

We now, slowly, emerge from the pandemic to a totally new economic environment. Our societies are facing challenges, such as the double threat of inflation and lack of economic growth that haven't been seen since the 1970s. The cost-of-living crisis threatens to throw millions into poverty – a development that previously would be unheard of in Europe. Our new challenges demand new responses. As European-wide economy and society, we cannot collectively afford to lose opportunities to further unleash innovation, and growth.

The payments sector did rise to the pandemic challenge and is ready to rise to the challenge of delivering innovation and growth once more, as it has always done. To do that, as in every industry, our sector needs legal certainty and predictability to have the ability to innovate and grow. The Payment Services Directive (PSD) does precisely that: it has been at the forefront of providing much needed certainty within the European Union. However, a lot more needs to be done: to begin with, it is essential that we harmonize the rules across the EU, ensure that Anti-Money Laundering and data privacy rules work in sync with the PSD, and of course recognize the specific nature of the non-bank payment sector. All of that, while we continue to respond to the needs and reflect the needs of our customers, always fostering financial inclusion – a cause that lies at the center of Western Union's history through the years, and one I am personally committed to.

I believe that the upcoming PSD2 review initiated by the European Commission does serve these goals and is indeed a truly welcome step in the right direction, that has the potential to deliver for our economies and societies. As the stakeholder dialogue commences, I would like to offer my thoughts on how the current framework could be enhanced:

- In the interest of building a genuine Single Market for payment services in the EU, the rulebook for payment services in the EU should be further harmonized, establishing a real level playing field for all payment service providers. Presently, national fragmentation prevents the payments industry from leveraging the real benefits of the Single Market. Western Union believes that at least parts of the PSD should be converted into a Regulation and thereby apply directly across the Union. Examples include the complaints handling procedures, rules related to central contact points, and the supervision and division of responsibilities when payment services providers use agents.
- It is important that there is better alignment between the rules of the PSD2, the EU's Anti-Money Laundering regime (AML) and data privacy regulations. We welcome the truly game-changing plans for a common e-identification mechanism.
- Member States and financial supervisors should do more to address the de-risking practices of the banking sector. The PSD provides the framework on which authorized and regulated payment service providers have to follow strict requirements in line with their business model and the level of associated risks. Despite this, non-bank payment service providers have often experienced the unilateral closure of their bank accounts across various jurisdictions. Bank refusal to offer banking services to payment service providers is, in our view against the spirit of the PSD. It is also inconsistent with the risk-based approach in the EU's AML regime. These de-risking practices by banks could potentially drive non-bank payment service providers out of the market, resulting in millions of customers resorting to unlicensed alternative channels to cover their financial needs.
- In this context, we welcome the EBA Opinion of January 2022; we believe it would be greatly beneficial for our sector should the PSD2 review were to give the EBA a formal mandate to clarify the interrelationship between legitimate AML concerns and unwarranted de-risking practices.

I mentioned above how financial inclusion is a cause that Western Union serves in Europe and across the world. Let me point out here that, the issue of de-risking is intrinsically associated with the question of financial inclusion. While technology is important, payment services providers need to cater to the needs of all their customers - including to those who prefer to transact with cash and are not a negligible part of the economy. With migrant populations in Europe a significant percentage of the total, this is particularly important.

Furthermore, should the PSD2 review deliver a more effective and innovative compliance framework across the Union, while of course not compromising on financial stability, consumer protection and crime prevention, this would allow the sector to further invest in innovation, and lower costs for consumers, making cross border payments even more affordable. This will also foster financial inclusion.

We at Western Union, with our experience of serving millions across the world, for more than 170 years now, stand ready to contribute substantially and creatively to the review, aiming at building a European payments sector that is fit for purpose and to respond to the challenges faced by our economies and societies. This is the time to truly unleash innovation and growth and put customers across the Union at the center of everything we, governments, regulators, providers, do.

BRETT LOPER
Executive Vice President, Global Government Affairs - American Express

Driving competition in payments through policy change

The second half of 2022 will usher in an acceleration of the work by the European Commission to review one of the key pillars of the European payments market: the Second Payment Services Directive (PSD2). More than four years after its entry into force, it is an opportune time for policymakers and industry to take stock of both its achievements thus far and the policy changes necessary to achieve the principal goal from 2015: a true pan-European single market for payments.

PSD2 aimed to enhance consumer protection, promote competition, and improve the security of payment services. While the Directive has been revolutionary in bringing about an open banking framework – which is being replicated globally – the goal of achieving more competition in the European market has proven elusive. There are valuable lessons in each of these areas.

Chief among these is the need to widen access to data, for all market players. While banks had historically guarded access to customer data, the open banking mandate in PSD2 finally enabled consumers and businesses to take more ownership of it. Importantly, this enabled new entrants to join the European payments market and – for some – to grow into highly successful pan-European fintechs. Take for instance the rapid rise of Swedish fintech Klarna, which effectively developed its own in-house Account Information Service Provider to power Buy Now Pay Later products. N26, the Berlin based neobank, is another example which leveraged open banking APIs to facilitate account switching, enabling it to grow to over 7 million customers. Based on these, PSD2 has undoubtedly led to more competition and greater choice for consumers and businesses.

However, given that only financial data is shared, open banking has become a one-way street with data flowing from financial providers to Big Tech players, with little or no data sharing reciprocity. The financial services industry, therefore, faces the threat of unfair competition by non-financial companies. To combat this, the industry is urgently calling on policymakers to expand the industries covered by data sharing obligations. As such, data portability should become the norm all sectors.

A competition focused "PSD3" will be key to driving competition against dominant players in the EU.

To boost the adoption of open banking, more guidance on the rules from the competent authorities is also needed and, critically, it needs to be consistent. Notably, API standardization could be the solution to avoid inconsistent customer experiences that differ wildly across products and providers. We consequently call on the European Commission to mandate the development of API standards by supervisory authorities. The Open Banking Implementation Entity, which developed such standards for the UK, is a successful example of a standardization effort that we believe can be replicated on the European market. Ideally, the European API standards would also align with international standardization efforts to ensure global interoperability.

Evolving open banking towards open data is not the only way that the review of PSD2 can promote more competition. Combining the review with the mandatory roll-out of instant payments in the EU would enable healthier competition to the two dominant card schemes, Visa and Mastercard. Already, American Express has launched an instant payments-based service in the UK, leveraging the Faster Payments Service. Bringing the European equivalent – SEPA Instant Credit Transfer – to all European banks would allow similar services to be across the EU.

A fully integrated instant payment system would not only allow companies such as American Express to provide further payment options to consumers and merchants but also help the EU achieve its goal of open strategic autonomy, while at the same time making sure EU and non-EU companies can build innovative payment services on top of it. This would improve competition and highlight the EU's openness.

A competition focused "PSD3", as well as a strong instant payments framework, will be key to driving competition against dominant players in the EU retail payment space over the next five years. The review of PSD2 should, therefore, also focus on rules that discourage fair competition. This includes rules on open access, co-brand cards, and licensee arrangements of three-party schemes, which have harmed competition by introducing unwarranted regulatory burdens on smaller card schemes seeking to compete with the dominant duopoly of Visa and Mastercard in Europe.

Overall, we are encouraged by the European Commission's initial statements on the PSD2 review and look forward to further engaging in order to foster real competition on the European market. Ultimately, this will mean better outcomes for citizens, businesses, and society as a whole.

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ABOUT EUROFI

The European think tank dedicated to financial services

- **A platform for exchanges between the financial services industry and the public authorities**
- **Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector**
- **A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors**

OUR OBJECTIVES

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

OUR APPROACH

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two-yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proved over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

OUR EVENTS AND MEETINGS

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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